Volume 25, No. 1, April 29, 2011

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

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CWS

CALENDAR OF EVENTS

May 2011
Semi-Annual Conference Call

May 30, 2011
CWS Office Closed for Memorial Day

July 4, 2011
CWS Office Closed for Independence Day

July 15, 2011
2nd Quarter 2011 Estimated Tax Payment Due

July 29, 2011
2nd Quarter 2011 Quarterly Packages Mailed

September 5, 2011
CWS Office Closed for Labor Day

September 15, 2011
3rd Quarter 2011 Estimated Tax Payment Due

October 28, 2011
3rd Quarter 2011 Quarterly Packages Mailed

November 2011
Semi-Annual Conference Call

November 24th and 25th
CWS Office Closed for Thanksgiving Holiday

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TECTONIC SHIFT

By Gary Carmell

(Note: If you attended our Annual Investor Meeting then this article may be repetitive since it was the basis of my presentation.)

Large tectonic shifts are fairly rare occurrences but when they take place the effects can be quite powerful and long lasting. Japan is the obvious and most ominous recent example. While the event is instantaneous, the stresses and strains often build up for very long periods of time. The same is true for financial bubbles and the eventual bursting of them. A chain of events was set off in 2007 that was the culmination of decades of stress buildup that resulted in a powerful financial and social earthquake taking place in this country. This earthquake has fractured the land mass in a way that the homeownership plate has been cut off from much of the government fuel distribution system that has powered our homeownership economy for over 80 years and has paved the way to make our country much more of a renter nation.

The bursting of a financial bubble is a relatively rare event, although in no way unique. When they do occur, they often last for a very long time. There are a few very pertinent examples of financial bubbles bursting that can show how long lasting they can be. Some notable ones are the Japanese bubble economy of the 1980s which culminated in the Nikkei reaching 39,000 in 1989 and today it is at approximately 9,700, a nearly 75% drop over 20 years later. There was the dot com, telecom, internet bubble that started in 1995 and ended with the NASDAQ reaching 5,000 in

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Event	Cycle Start & Value	Cycle End or Current & Value	Length & % Change
Japanese Stock Market	Dec. 1989; Nearly 39,000	April 2011; Approx. 9,700	21+ Years; -75% Drop
NASDAQ	March 2000; Approx. 5,000	April 2011; Approx. 2,800	11+ Years; -44% Drop
3-Month Treasury Bills	Jan. 1940; 0.01%	May 1981; 17.01%	41+ Years
3-Month Treasury Bills	May 1981; 17.01%	Dec. 2008; 0.00%	27+ Years
Gold	Jan. 1980; $850	July 1999; $253	19+ Years -70% Drop
Manufactured Housing Shipments	1998; 373,100	2010; 50,000	12 Years; -87% Drop

March 2000. Today, the index is still down over 40% 11 years later. Short-term interest rates increased in erratic fashion from 1940 through 1981 when 3-month Treasury yields reached 17%. They have been dropping ever since with current rates at 0.10%, although they did reach as low as 0.00% in 2008. Commodity prices were in a bull market between 1962 and 1980 and went into a bear market between 1981 and 2000 and have been in a bull market pretty much since then although we are recovering from a sharp correction in 2009.

Another example more near and dear to our hearts is in the manufactured housing industry. 1998 was the year CWS entered into an agreement to exit almost entirely from that industry. In that year shipments of new manufactured homes were 373,100. That turned out to be the highest level of shipments since 1973 only to come crashing down as investors who purchased securities backed by manufactured housing loans came to realize that the underwriting standards used to qualify borrowers had been loosened dramatically and a tremendous amount of fraud was uncovered by loan originators and borrowers. The result was tremendous losses related to these mortgages with lenders and investors getting badly burned. Sound familiar? Capital left and has not returned resulting in the industry being decimated. Shipments have gone from 373,000 in 1998 to 50,000 in 2010, representing an approximately 87% drop from the peak twelve years ago. I actually believe that what happened with manufactured housing is the best example in terms of predicting what will happen to single-family housing since it had so many similarities to what happened with sub-prime. The most important difference is that the government is much more involved in single-family housing and it is helping to lead the way in reducing the high octane fuel to homeownership as will be discussed later.

I cite these examples to show how long lasting and powerful these trends can be. I would assert that the same tectonic shift has taken place in homeownership with the earthquake having occurred in 2007 beginning with Freddie Mac's press release in February announcing it would no longer buy the riskiest sub-prime mortgages and mortgage-related securities. Two months later New Century Financial, one of the most aggressive originators of sub-prime loans, filed for bankruptcy and in June the rating agencies (S&P and Moody's) finally began to downgrade securities backed by mortgages. The cascading sequence of events continued for another two years or so as it finally became clear that the emperor had no clothes; sub-prime loans were a cesspool of sludge pouring out of broken sewer pipes and flowing into all areas of our financial

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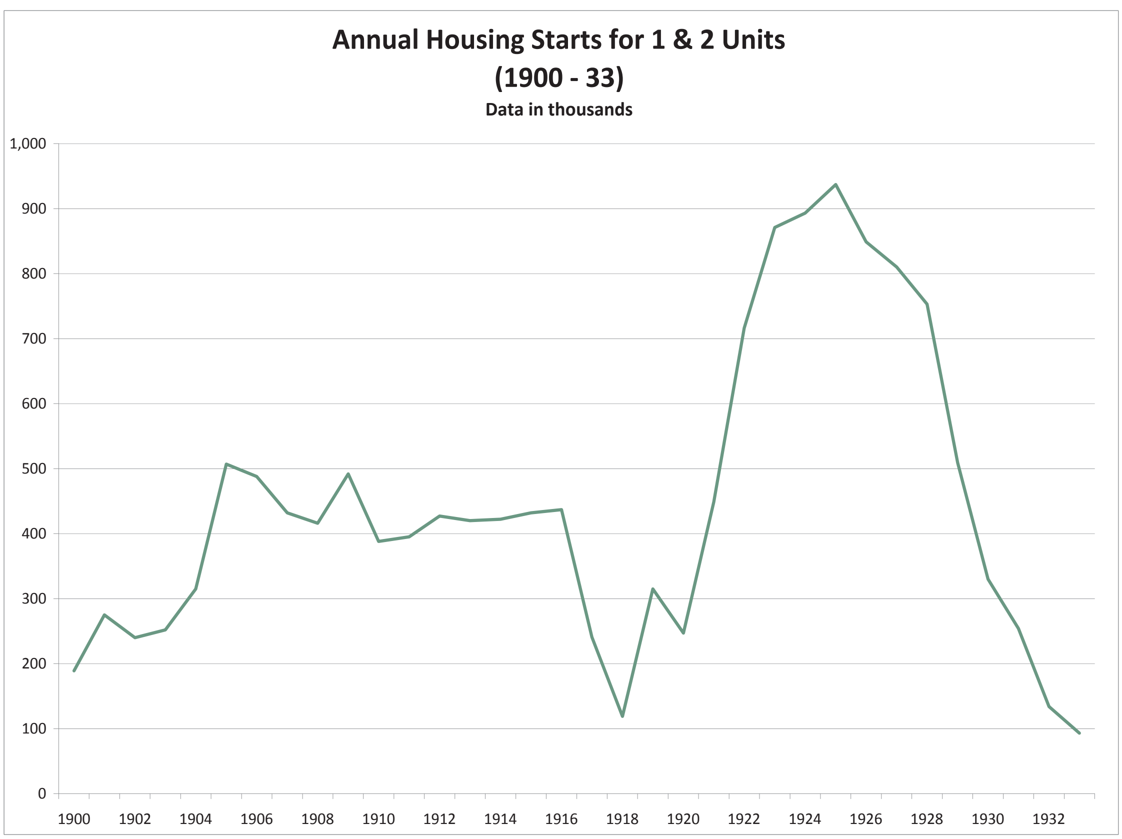
system. With most catastrophes there are some early warning signs and this was no different. For example, home building stocks peaked in the summer of 2005, more than two years before the stock market topped out in October 2007. Bank stocks peaked in November 2006, and Freddie Mac's announcement occurred eight months before the stock market peak. People wanted to believe that the sub-prime loan problem was contained. How wrong they were as it ended up leading to the near collapse of our financial system and the worst economic downturn since the Great Depression.

The formation of our homeownership land mass was propelled by three catalytic events: The New Deal programs, particularly the creation of the Federal Housing Administration under the National Housing Act of 1934, the G.I. Bill of 1944, and the advent of the unregulated, shadow banking system that flooded the world with tainted mortgages. The first two were government acts of commission while the third was one of omission. For many years the first two events created enormous benefits for our society and economy. Eventually a good idea can go too far and it was fatally exploited by an unregulated part of our financial system that took a very mature market (homeownership) and pushed it past the tipping point of equilibrium and sustainability by encouraging the creation of ever more aggressive loans to less and less qualified borrowers under the neglectfully benign eye of the Federal Reserve.

In the decade prior to America's entry into World War I, housing starts for one and two units averaged approximately 339,000 per year. By 1918, however, they had fallen to 104,000 as the United States focused its people and resources on the war effort. With the return of the GIs and America no longer focused on producing for war, there was great pent up demand for housing. At the same time, with the advent of the 1920s many forces came together to usher in an era of extraordinary innovation in real estate



Source: National Bureau of Economic Research

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finance, including securitization, which would come to reassert itself as a destructive force over 80 years later. The combination of easy money and pent up demand led housing starts for one and two units to explode from 104,000 in 1918 to 729,000 seven years later in 1925. To put this in perspective, the previous cycle peak was 401,000 in 1909. Most people think the Great Depression started with the stock market crash of 1929 but real estate peaked two to four years earlier and was a very important factor as well. What God giveth, He taketh away. By 1933 at the bottom of the Great Depression, housing starts had collapsed from 729,000 units in 1925 to 81,000, an approximately 90% drop.

Let's see if this sounds familiar. Henry Hoagland, a member of the Federal Home Loan Bank Board which was the lead agency overseeing nearly all of the federal programs designed to lessen the pain of the crisis, wrote in 1935:

> A tremendous surge of residential building in the last decade was matched by an ever-increasing supply of homes sold on easy terms. The easy terms plan has a catch…only a small decline in prices was necessary to wipe out this equity. Unfortunately, deflationary processes are never satisfied with small declines in values. They feed upon themselves and produce results out of all proportion to their causes. Our economic system has become so complex and so finely balanced that every business transaction affects vitally many other transactions. In the field of real estate finance, particularly, we have depended so much upon credit that our whole value structure can be thrown out of balance by relatively slight shocks. When such a delicate structure is once disorganized, it is a tremendous task to get it into a position where it can again function normally.

Something clearly had to be done as unemployment reached 25%, the banking system had collapsed, confidence was eviscerated, and there was great fear that the population could become radicalized. It was determined that housing should be one of the cornerstones of the New Deal. Rather than eliminating many of the aggressive lending programs that were created in the 1920s, the government decided that it rather liked them and instead focused its regulatory efforts on those who could originate loans versus the characteristics of the loans being originated. The cornerstone of these programs was the Federal Housing Administration (FHA) formed in 1934 as part of the National Housing Act.

According to a 1956 book entitled Capital Formation in Residential Real Estate:

> *Beginning with the then-revolutionary terms on which the Home Owners' Loan Corporation from 1933 to 1936 refinanced $3 billion of the outstanding home mortgage debt, 23 federal programs in the residential mortgage field have persistently sought to reduce contract interest rates, lengthen contract terms to maturity, and increase loan-to-value ratios.*

Game on. The government was all in for the first time in terms of becoming the hub of the housing finance system with the explicit goal of promoting homeownership. While these programs helped stabilize the housing market, it was initially not very effective as homeownership dropped from 47.8% in 1930 to 43.6% by 1940. Everything changed, however, with the return of 16 million servicemen from World War II and the passage of the GI bill. This was the catalyst that rocketed housing forward for the next 60 years with the suburbanization of America. Rather than get into the specifics of the GI Bill, the net effect was to make it quite easy for servicemen to purchase homes due to no down payments, capped interest rates, and longer repayment terms. Homeownership went from 43.6% in 1940 to 55% in 1950, which is a

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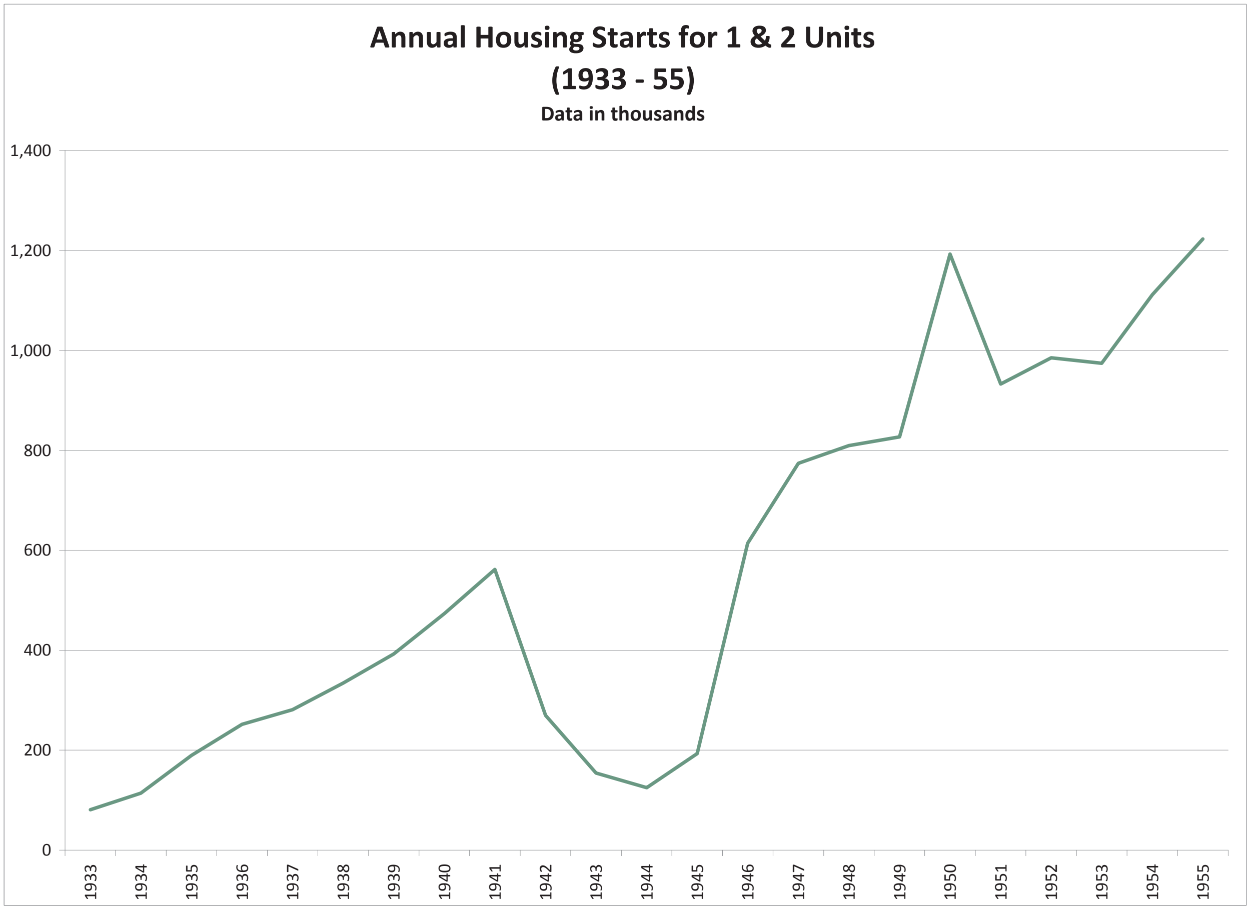

Source: National Bureau of Economic Research

huge move over a 10-year period. Ten years later the rate went to approximately 62% in 1960. In 1944 housing starts were 125,200 for one and two units and by 1950 they reached 1,193,000.

For the next 55 years or so housing prices continued on an uninterrupted uptrend nationally and housing output never contracted in a way that created systemic problems for our economy. Housing was usually impacted as the Fed sought to fight inflation by raising interest rates. This would slow down home sales and housing starts but they would eventually be reignited by lower interest rates and sometimes tax credits. Everything changed, however, as the powerful combination of lower interest rates (long-term rates dropping since 1981), innovative loan products that relied on selling bonds to global investors backed by increasingly risky U.S. mortgages, and virtually no regulation or oversight of this shadow banking system served as the high octane fuel to propel the home-ownership rocket into deep orbit. Single-family housing starts went from 1,076,000 in 1995 to 1,716,000 in 2005.

We now know how the rocket ended up disintegrating at its peak and is coming back to earth in pieces. Fannie Mae and Freddie Mac are in conservatorship after having received over $140 billion by the federal government, the $700 billion TARP program came into existence to bailout the banking system, defaults have never been higher, home prices have dropped for the first time since the Great Depression, and we have had the worst economic decline since the 1930s. Housing starts have gone from 1,716,000 in 2005 to 471,200 in 2010, a nearly 80% drop.

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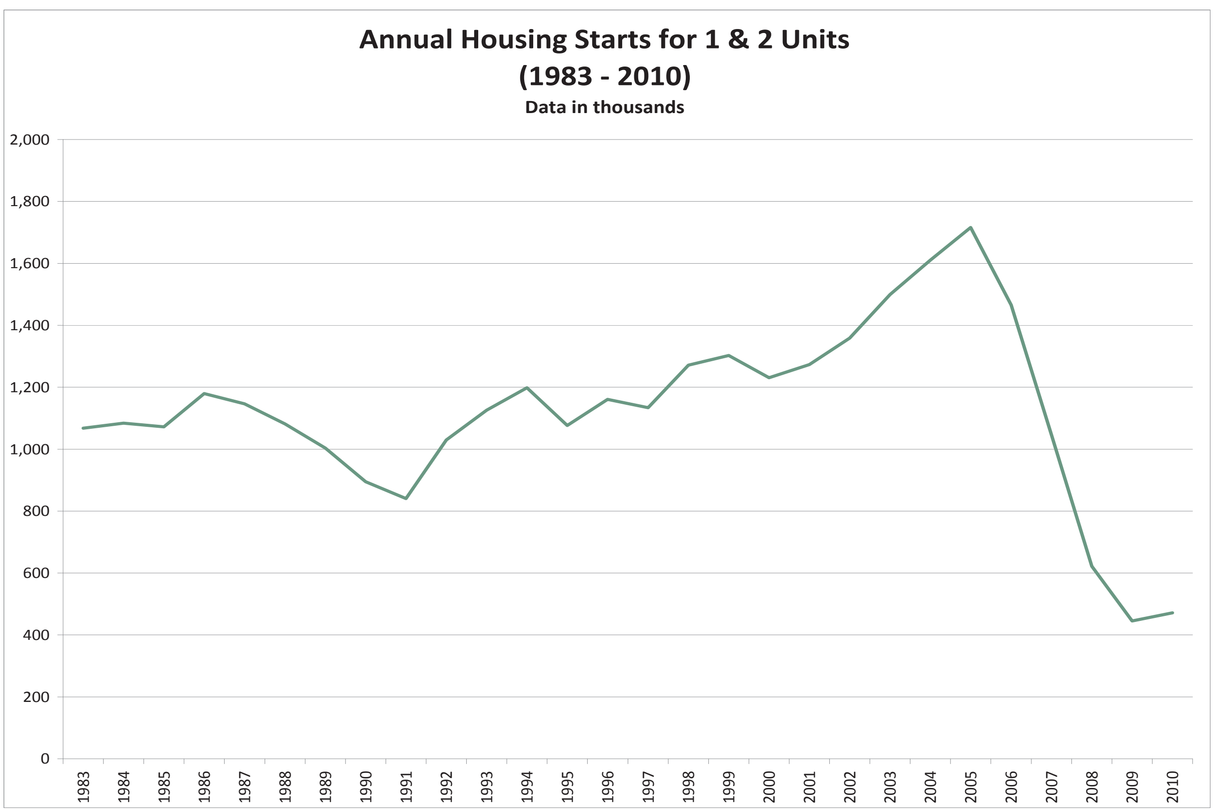
The earthquake that took place separated the federal government from its support of homeownership. The 2009 tax credit was a complete failure, Fannie and Freddie are persona non grata in Washington, the housing industry has very little lobbying clout, especially now since it represents such a small percentage of our economic activity now that home sales and housing starts have collapsed. The one area in which there is unequivocal bipartisan consensus is that we need a much more balanced housing policy between renting and ownership and that ownership should be confined to those with down payments and sound credit. Renting is vital to our economy because it provides labor force mobility, peace of mind, the opportunity to build or rebuild credit, much greater energy efficiency than larger, single-family homes, and typically shorter commute times to work or greater access to public transportation.

Today, FHA, GNMA, Fannie Mae, and Freddie Mac account for over 90% of new lending as the private, non-regulated lenders have collapsed. For example, in 2005 there were a little more than 7 million loans originated for the purchase of homes and FHA's share was less than 5%. By 2009, however, the number of purchase loans collapsed to less than 3 million and FHA's share grew to approximately 37%. Unfortunately for home purchasers, FHA is tightening its standards. Secretary Geithner said recently about FHA:

> "As we decrease Fannie Mae and Freddie Mac's presence in the market, we will also scale back FHA to its more traditionally targeted role. We support decreasing the maximum loan size that qualifies for FHA insurance – first by allowing the present increase in those limits to expire as scheduled on October 1, 2011, and then by reviewing whether those limits should be further decreased



Source: US Census Bureau

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going forward."

"We will also increase the pricing of FHA mortgage insurance. FHA has already raised premiums twice since the beginning of this Administration, and an additional 25 basis point increase in the annual mortgage insurance premium is included in the President's 2012 Budget and will be levied on all new loans insured by FHA as of mid-April 2011. This will continue ongoing efforts to strengthen the capital reserve account of FHA and align its pricing structure in a more appropriate relationship with the private sector, putting the program in a better position to gradually return to its traditional and more targeted role in the market."

In addition to FHA pulling back, Fannie Mae and Freddie Mac have also tightened their underwriting standards quite significantly. While a FICO score of 620 used to be considered an acceptable credit score for Fannie Mae and Freddie Mac, 680 is now considered the minimum score to have acceptable credit for their programs. Those between 620 and 680 in the current market will have to look to the FHA program for a mortgage unless they are making a down payment of at least 20%. Even these people will have difficulty with FHA since the average FICO score for FHA in December 2010 for purchasers was 701. Interestingly, if you look at average FICO scores by age, it's not until someone is between 45 and 54 that the average FICO score exceeds 680. The reality is even more restrictive as the average FICO score of a loan purchased by Fannie Mae in 2010 was 762 and had a loan-to-value of approximately 68%. 80% of the loans it purchased were for refinances. Similar to Fannie Mae, its average 2010 FICO score was 758 and had an average loan-to-value of 67%.

As apartment owners this is important because we historically lose a lot of people to homeownership. This should make it quite difficult for people to qualify for home purchases, especially our younger age cohort despite record affordability. Interestingly, according to Experian's National Score Index, Texas residents have the lowest average credit scores in the country which will make it more difficult for them to purchase homes given the tightening credit standards.

In summary, I believe we are in the early stages of a megatrend that will make our country much more of a renter nation. Government support for homeownership has been removed and is transitioning to a balanced housing policy emphasizing the importance of renting and homeownership for those who have the financial resources and demonstrated capacity to be owners. Much tighter credit standards will make it much more difficult for people to qualify for homes. As Marty Cohen, co-CEO of Cohen & Steers, one of the largest investment managers focused on real estate said in the March 25, 2011 edition of Grant's:

"If you've declared personal bankruptcy it is difficult, if not impossible, to get a mortgage. We are running at about a 1.5 million personal bankruptcy clip for the last two or three years, and expectations are the same for this year and next [there are 112.5 million households in the country]. So if you just look at that, you have many millions of Americans who can't buy a house, are renters by necessity...I think the world has underestimated the pool of renters, and it is not a discretionary decision anymore."

I think that last line says it all: Renting is not a discretionary decision anymore.