

Preferred Securities: High Income with Attractive Relative Value

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Preferred securities began 2015 on a positive note, benefiting from a continuation of what they experienced in 2014. Over the past year, conditions have been hospitable for most fixed income asset classes amid low and declining interest rates. Preferreds offered investors solid returns in 2014, offering high income rates but avoiding the pressure experienced in high yield. In our view, preferreds appear to continue to offer a good income choice for the months ahead.

Confounding expectations of many market observers, U.S. Treasury yields trended lower in 2014 even as quantitative easing tapering ran its course through October. This reflected modest U.S. economic growth as well as weaker global growth readings. Falling further so far in 2015, rates have also been pinned down by a generally benign global inflation outlook, supported in part by declining oil prices and aggressive monetary policy measures abroad.

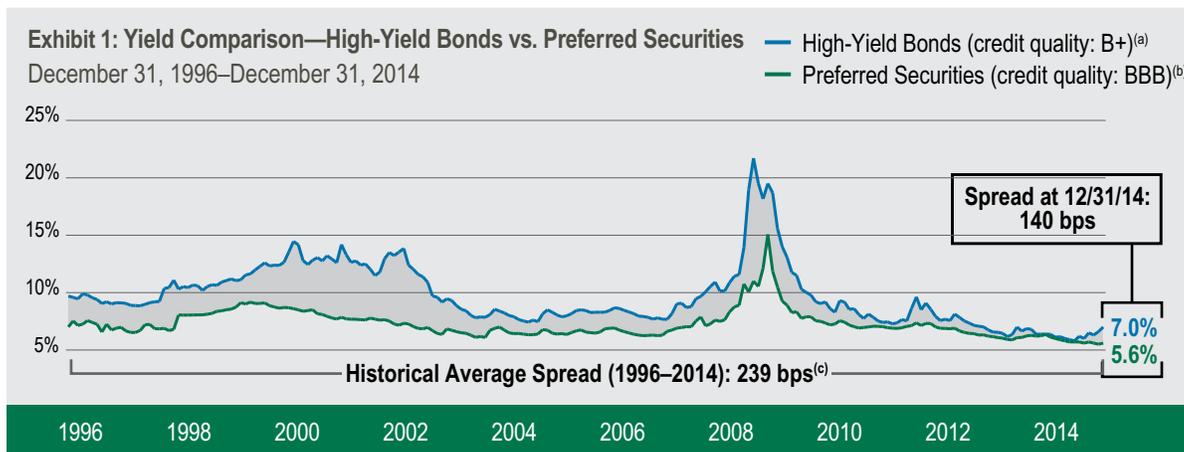
In an environment offering scant sources of income, investors nonetheless had to be judicious in 2014. Credit concerns rose, spurred by the recent downdraft in energy markets, pressuring the high-yield market in particular. Where do preferreds now stand in relation to other fixed income classes in terms of value and opportunities? This update looks at how preferreds compare with high-yield bonds, based on relative income, credit risk, and even industry risk. We also take note of the attractive income offered by preferreds on a pre- and post-tax basis, versus a range of fixed income alternatives.

In addition, we highlight the ability to manage interest-rate risk in the broad preferreds market via its many structures, a characteristic that can give active investment managers an advantage in differing interest-rate scenarios.

Yield Spread of High-Yield Bonds over Preferreds Is Low

With almost negligible yield currently found on Treasuries, investors with an appetite for more income can consider classes such as corporate bonds, high-yield debt and preferred securities, especially if the economy is improving.

Preferreds have historically offered more yield compared with corporate bonds but less income compared with high yield. However, high-yield's income advantage has been relatively narrow over the past year, with yields even briefly converging with preferred yields. As shown in Exhibit 1 below, the yield spread between high-yield bonds and investment-grade preferreds remains narrow relative to the historical average.



At December 31, 2014. Source: Morningstar.

Performance data quoted represents past performance. Past performance is no guarantee of future results. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend might begin. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Note: Yields shown on a yield-to-maturity basis.

(a) BofA Merrill Lynch High-Yield Master Bond Index. (b) BofA Merrill Lynch Fixed-Rate Preferred Securities Index. (c) Historical Average starts 12/31/96 and ends 12/31/14. See page 3 for Risks of Investing in Preferred Securities.

Exhibit 2: Top Sectors

	Sector	Index Weights		
		Preferred Securities ^(a)	High-Yield Bonds ^(b)	Corporate Bonds ^(c)
Modest overlap	Banking	49%	3%	22%
	Insurance	26%	1%	5%
	Utilities	8%	3%	8%
Negligible energy in Preferreds	Real Estate	4%	1%	2%
	Energy	1%	13%	14%
	Telecommunications	2%	10%	5%
	Media	0%	9%	4%
	Basic Industry & Capital Goods	1%	18%	10%

At December 31, 2014. Source: Cohen & Steers, BofA Merrill Lynch.

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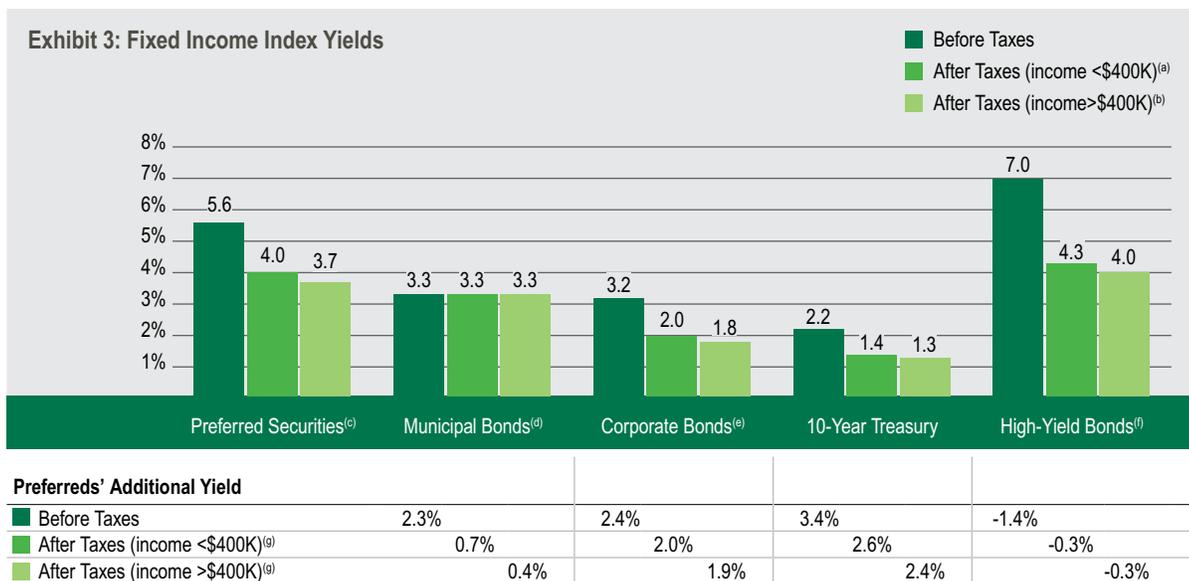
(a) Preferred Securities represented by 50% BofA Merrill Lynch Fixed-Rate Preferred Index and 50% BofA Merrill Lynch Capital Securities Index. (b) BofA Merrill Lynch High-Yield Master Index. (c) BofA Merrill Lynch Corporate Master Index. See back page for index definitions.

Preferred Securities Provide Diversification by Industry

From a sector perspective, the preferreds market offers a strong complement to corporate and high-yield bonds. As shown in Exhibit 2, preferreds are much more represented by banks and insurance companies, which have long viewed these securities as an attractive way to satisfy regulatory capital requirements. We like financial issuers today due to the very onerous and creditor-friendly new regulatory requirements placed on them in the wake of the financial crisis, which is a strong tailwind for improving credit fundamentals. Also noteworthy is the virtual absence of energy companies in the preferreds universe. The underperformance of high yield bonds seen in the past few months is in large part attributable to volatility in the energy sector.

Attractive Income Before and After Taxes

Preferred securities currently offer some of the highest yields available in fixed income markets. But as indicated in Exhibit 3, they may also provide an *after-tax* income advantage—regardless of an investor's tax bracket—that exceeds other fixed income choices. The reason is that distributions from many preferred securities are taxed as qualified dividend income (QDI), rather than as regular interest income, which helps investors keep more of what they earn.



At December 31, 2014. Source: Cohen & Steers, BofA Merrill Lynch.

Performance data quoted represents past performance. Past performance is no guarantee of future results.

Notes: Yields shown on a yield-to-maturity basis. State and local taxes are not included in these calculations.

(a) For individuals with income less than \$400K, qualified dividend income is taxed at 18.8% and the marginal tax rate used was 38.8%. Both rates include the Medicare surcharge of 3.8%. (b) For individuals with income exceeding \$400K, qualified dividend income is taxed at 23.8% and the marginal tax rate used was 43.4%. Both rates include the Medicare surcharge of 3.8%. (c) BofA Merrill Lynch Fixed-Rate Preferred Securities Index (Credit quality: BBB). (d) BofA Merrill Lynch Municipal Master Index (Credit Quality: AA-). (e) BofA Merrill Lynch Corporate Master Index (Credit Quality: A-). (f) BofA Merrill Lynch High-Yield Master Bond Index (Credit Quality: B+). (g) Preferred Income Advantage after tax calculations assumes preferred securities income is taxed at the respective qualified dividend income rate and marginal tax rate on a 50/50 blended basis. All other securities reflect full taxation at the respective marginal rates based on income. See back page for index definitions.

Preferred Securities Provide Diversification by Rate Structure

Many investors perceive the preferred market as being highly interest-rate sensitive due to the perpetual structures, but it is actually composed of securities with a variety of structures that can be used to tailor a portfolio's interest-rate risk.

Preferreds are issued and traded in two distinct markets: 1) \$25 par preferreds that trade on an exchange; and 2) large-denomination preferreds that trade over the counter (OTC). The security at the top of Exhibit 4 is reflective of securities typical to the exchange-traded market, a callable fixed-coupon issue with a long duration. This type of security is absent from the OTC market, which is dominated by the second version shown in Exhibit 4. While the second security is also fixed-rate for the first part of its life, it can be called or reset to a floating rate after the initial fixed-rate period, a feature that reduces its duration, or sensitivity to interest-rate risk. The bottom security effectively has a near-zero duration as it resets frequently based on movements of a benchmark interest rate—with virtually no interest-rate risk.

Given the overall longer duration of exchange-traded preferreds, the two groups can see wide divergence in performance. For example, while OTC preferreds had good absolute returns in 2014, the exchange-traded market did significantly better as bond yields declined; however, in 2013, a rising-rate environment, OTC preferreds fared much better. Over the course of a rate cycle, it may make sense for preferred investors to allocate to both markets, with the understanding that one can perform much better than the other depending on market circumstances.

Exhibit 4: Hypothetical Examples

Fixed-Rate Security: Retail (exchange-traded) fixed rate; 6.5% coupon, callable in 2020 at par



Fixed-to-Floating Rate Security: Institutional (OTC) fixed-to-floating rate; 6.5% coupon, callable in 2024 at par (or resets to a floating rate in 2025)



Floating-Rate Security: Retail (exchange-traded) and institutional (OTC) Floating rate security (quarterly coupon reset based on changes in LIBOR^(a))



Duration measures the price sensitivity of a fixed income or preferred security to changes in interest rates (or yields). The higher the duration, the greater the price change in response to a rise or fall in yield. The duration of a preferred security depends, in part, on how it is structured

(a) LIBOR, London Interbank Offered Rate. See index definitions on back page.

An Active Approach to Managing Credit and Interest-Rate Risk

We believe that active management of credit and interest-rate risks will continue to be critical in coming quarters. Although the Federal Reserve may increase the overnight rate late in the year to diminish its extraordinarily accommodative stance, we view longer-term bond yields as relatively pinned down for the near term by low and falling inflation as well as the strong dollar. In the current market environment, we favor preferreds with good amounts of call protection and are judicious on credit risks, particularly outside of the U.S. We believe that the powerful movements in the dollar and energy prices, together with unsettled political conditions, could result in more skittish credit markets. That said, we still like high income securities, including some below-investment-grade issues. High income is clearly in short supply, and it has historically smoothed total return volatility.

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Risks of Investing in Preferred Securities

Investing in any market exposes investors to risks. In general, the risks of investing in preferred securities are similar to those of investing in bonds, including credit risk and interest-rate risk. As nearly all preferred securities have issuer call options, call risk and reinvestment risk are also important considerations. In addition, investors face equity-like risks, such as deferral or omission of distributions, subordination to bonds and other more senior debt, and higher corporate governance risks with limited voting rights. Risks associated with preferred securities differ from risks inherent with other investments. In the event of bankruptcy, a company's preferred securities are senior to common stock but subordinated to all other types of corporate debt. Corporate bonds sit higher in the capital structure and therefore in the event of bankruptcy will be senior to preferred securities. High-yield bonds, although typically issued by different types of issuers than those that issue preferred securities and rated below investment grade, also would sit higher in a firm's capital structure than preferred securities if the issuer did employ both forms of issuance. 10-Year Treasury notes are issued by the U.S. government and are considered the safest of all bonds since they are backed by the full faith and credit of the U.S. government as to the timely payment of principal and interest.

Below-investment-grade securities or equivalent unrated securities generally involve greater volatility of price and risk of loss of income and principal, and may be more susceptible to real or perceived adverse economic and competitive industry conditions than higher-grade securities.

High coupons and wide credit spreads. In both the OTC and exchange-listed markets, we are focused on securities offering relatively high income rates and above-average spreads, but also good amounts of call protection given our expectation that long rates will remain low for the near term. While we are more cautious in some areas, we also see specific credit catalysts driven by regulatory changes at banks and general economic improvements.

A mixture of structures. The interest-rate sensitivity of a preferred security is largely the result of its structure. Fixed-to-float and pure floating-rate issues are generally the least sensitive to interest rates, as their coupons reset, often frequently. But interestingly, these structures can also offer more call protection—often 10 years, versus the typical five years for fixed-rate exchange-listed preferreds—potentially providing more upside if rates stay low, and less price risk should they turn higher.

Foreign issues. Preferreds issued in foreign currencies can help diversify interest-rate risk, as they tend to react to the yield curve of their domestic market, which is mostly a function of local economic and monetary cycles. Monetary policy in Europe, for instance, is now far more accommodative than in the U.S., which might tighten its monetary policy late in 2015.

We note that a number of new European issues in the OTC market—issued in U.S. dollars as well as in foreign currencies—feature many of the qualities above: 1) 6–8% coupons on investment-grade and just below-investment-grade credits; 2) wide credit spreads; 3) fixed-to-float structures with good call protection, such as new contingent capital instruments, or CoCos, which in Europe could grow to a \$200 billion market by the end of the decade; 4) in some cases, the potential to benefit from continued easy monetary policy in the region; and 5) the specific catalyst of the European Central Bank requiring much higher capital levels from the banks it regulates.

It is important to note that while European issues are an important part of our preferred securities strategies, as many issues offer

attractive yields and represent good relative value, we have become more selective in our investments and somewhat more cautious on Europe in general. This is largely because the region is becoming more unsettled politically following years of poor economic conditions, as most recently highlighted by Greece. We are closely monitoring the growth of anti-EU sentiment in other regions.

Considering the opportunities and risks that are presented on a global basis, we believe that preferred securities investors are best served by investing in a diversified, actively managed portfolio with the ability to pursue opportunities across the global preferred market, highlighting the importance of active management.

Bottom Line: Still Good Value and Income with Some Catalysts Remaining

As investors adjust the mix of their fixed income allocations with rates remaining exceptionally low and choices for income few, we continue to favor preferred securities. In our view, preferreds are well positioned relative to other credit sectors, with opportunities to invest in securities with high and tax-advantaged income rates, strong and improving credit fundamentals and the potential for further narrowing in yield spreads. Preferreds may also provide a good complement to high-yield or investment-grade corporate bonds within a fixed income allocation, as the industry overlap is modest, with preferreds notably higher in financials and essentially zero in energy.

For deeper discussions of our views on preferred securities, please see our recent Viewpoint, *When Interest Rates Rise: Opportunities and Risk Management Strategies in Today's Preferreds Market*; and our recent Case Study, *Investing in CoCos*, both available at the Cohen & Steers website at cohenandsteers.com/insights.

Index Definitions

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

BofA Merrill Lynch Capital Securities Index is a subset of the BofA Merrill Lynch U.S. Corporate Index including all fixed-to-floating-rate, perpetual callable and capital securities. BofA Merrill Lynch Corporate Master Index tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. BofA Merrill Lynch Fixed-Rate Preferred Securities Index tracks the performance of fixed-rate USD-denominated preferred securities issued in the U.S. domestic market. BofA Merrill Lynch High-Yield Master Bond Index monitors the performance of below investment grade USD-denominated corporate bonds publicly issued in the U.S. domestic market. BofA Merrill Lynch Municipal Master Index tracks the performance of USD-denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and an investment-grade rating (based on an average of Moody's, S&P and Fitch). 10-year Treasury is a debt obligation issued by the U.S. Treasury that has a term of more than one year, but not more than 10 years.

London Interbank Offered Rate. Duration of a Floating rate preferred security will be highly dependent on the reference rate (the rate that the floating rate security floats off of) being benchmarked to and if that reference rate is the rate that is moving.

Important Disclosures

Performance data quoted represents past performance. Past performance is no guarantee of future results. The views and opinions in the preceding commentary are as of the date of publication and are subject to change without notice. There is no guarantee that any historical trend presented in this commentary will be repeated in the future, and there is no way to predict precisely when such a trend will begin. There is no guarantee that a market forecast made in this commentary will be realized. This material represents an assessment of the market environment at a specific point in time, should not be relied upon as investment or tax advice and is not intended to predict or depict performance of any investment. We consider the information in this commentary to be accurate, but we do not represent that it is complete or should be relied upon as the sole source of suitability for investment. Investors should consult their own advisors with respect to their individual circumstances.

This commentary must be accompanied by the most recent Cohen & Steers Preferred Securities and Income Fund fact sheet if used in connection with the sale of mutual fund shares.