The Case for Preferred Securities

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Preferred securities are fixed-income investments, but with certain equity characteristics such as deeper subordination in the capital structure. Investors are compensated with notably high rates of income. Despite preferreds’ long stated lives, abundant fixed-to-floating-rate preferred instruments can significantly diminish interest-rate risk in diversified portfolios. Since many preferreds pay legal dividends, preferreds can also offer significant tax advantages.

Highlights

• **A large and liquid asset class.** Globally, the approximately $970 billion preferred securities universe is represented mainly by large, regulated companies with high, stable and transparent cash flows.

• **Attractive income opportunities.** Investment-grade preferred securities typically have offered among the highest income rates in high-grade fixed-income markets, with yields that have recently been competitive with high-yield bonds.

• **Potential tax advantages.** Since many preferred securities pay dividends, net income rates may be higher than those available in other taxable and even tax-exempt markets.

• **Improving credit fundamentals.** Banks and insurance companies, the primary issuers of preferreds, have seen stronger balance sheets and better asset quality due to changes in regulations following the financial crisis. New regulations are driving a market-altering refinancing wave globally, creating potential for alpha generation by active managers with a deep understanding of the preferreds market.

• **Tools for managing interest-rate risk.** Preferred securities can help mitigate interest-rate risk, given the large number of low-duration structures found in the asset class.
Introduction

Market Overview and Key Features

A Unique Role and Asset Class
Preferred securities play a unique role in capital markets. Preferreds are a form of equity for issuers, helping them reach capitalization goals for regulatory and credit rating-agency purposes. However, from an investment standpoint, preferreds act like bonds, not stocks, simply offering a fixed or floating rate of income. Yet investors are compensated for preferreds’ equity features, like subordination, with the potential for much higher yields and wider credit spreads than they would receive on normal corporate bonds. While preferreds may look and often act much like corporate bonds, it is important to understand the ways in which they differ. Preferreds have unique investment attributes.

Key Features Overview
Investors first examining the preferred asset class may be surprised by the high income rates they pay relative to corporate bonds; investment-grade preferreds may offer income rates close to those of high-yield bonds. However, preferreds do offer additional, equity-like risks that normal bonds do not have.

Please refer to Exhibit 1 below, which shows a simplified corporate capital stack. We explain the differences between traditional and hybrid preferreds in another section, but for now, suffice it to say that all forms of preferred securities rank above common stockholders, yet below senior and even normal subordinated-debt holders. This deep subordination means that preferred holders have lower claims to company assets and therefore would be in a worse position in the event of bankruptcy.

Another important feature to consider is that preferred payments are subject to deferral or outright omission. While an extremely rare occurrence in practice, typically only taking place in cases of great corporate stress, the fact that payments can be stopped makes preferreds quite different from normal debt instruments like corporate bonds. On the other hand, as we discuss in the tax section, many preferred distributions are in the form of legal dividends, which are taxed at more attractive, lower rates for U.S. individual investors and C corporation buyers.

Exhibit 1: Credit Class Rankings

<table>
<thead>
<tr>
<th>Highest to Lowest</th>
<th>Possible Equity Treatment</th>
<th>Payment Format</th>
<th>Typical Term</th>
<th>Ratings Examples (Moody’s/S&amp;P)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Debt</td>
<td>No, debt only</td>
<td>Non-deferrable interest</td>
<td>Short- to long-term</td>
<td>A3/A, A3/A-</td>
</tr>
<tr>
<td>Subordinated Debt</td>
<td>No, debt only(a)</td>
<td>Non-deferrable interest</td>
<td>Medium- to long-term</td>
<td>Baa1/A-, Baa2/BBB+</td>
</tr>
<tr>
<td>Hybrid Preferreds</td>
<td>Limited(a)</td>
<td>Deferrable interest</td>
<td>Long-term</td>
<td>Baa2/BBB-, Baa3/BBB-</td>
</tr>
<tr>
<td>Traditional</td>
<td>Yes</td>
<td>Dividend</td>
<td>Perpetual</td>
<td>Baa3/BBB-, Ba1/BBB-</td>
</tr>
<tr>
<td>Common Equity</td>
<td>Yes</td>
<td>Dividend</td>
<td>Perpetual</td>
<td>N/A, N/A</td>
</tr>
</tbody>
</table>

Hybrid and traditional preferred securities are deeply subordinated instruments. They are above common equity in a company’s capital structure, but subordinated to normal debt instruments. Deep subordination is a key reason why they pay high rates of income.

At June 30, 2018.
(a) Other, more modest regulatory benefits may apply. See page 16 for risks of investing in preferred securities.
A final important equity-like aspect of preferreds is that they are either perpetual (traditional preferred securities) or long-term (hybrid preferred instruments). Investors must be compensated for this as well. However, as we discuss on page 14, certain structures in the preferred market can greatly diminish the interest-rate-risk aspect of preferreds’ long lives.

Credit rating agencies place ratings on preferreds, just as they do on corporate bonds. However, recognizing preferreds’ subordination and other equity-like features, the agencies normally place ratings on them that are two or more credit notches below the issuer’s senior-debt rating. The extent of the credit differential will depend on the specific preferred structure and circumstances of the company in question. As an example, in Exhibit 1 we show the ratings of J.P. Morgan and Bank of America obligations.

A Diverse Regional and Global Investment Universe

As shown in Exhibit 2, the U.S. dollar preferred market accounts for roughly 65% of the market. This includes U.S. domestic issuers, as well as many large foreign companies that issue in U.S. dollars. The remaining 35% is foreign-currency-denominated securities. Issuers of preferreds are mostly domiciled in the developed markets of the United States, Canada, continental Europe, the United Kingdom, Australia, New Zealand and Japan. However, the market also includes emerging-market issuers such as companies located in Mexico and Brazil. Recently, Chinese corporations have also begun issuing preferreds.

As an institutional investor with trading desks in New York, Hong Kong and London, Cohen & Steers accesses the entire preferred securities marketplace, including the global OTC market, which offers the potential for investments in an evolving variety of new securities. The OTC preferred securities market is an important aspect of investing in preferreds, as recent market expansion has largely occurred outside domestic exchange-based markets. This growth has been driven by foreign-based issuers that issue in both U.S. dollars and foreign currencies, offshore and within the U.S.

Institutional investors, including active asset managers, may have access to the entire preferred securities marketplace, including the global OTC market, which offers the potential for investments in an evolving variety of new securities.
Two Distinct Markets: Exchange-Traded and Over-the-Counter

There are two distinct trading markets for preferred securities. Exchange-traded preferred securities are, for the most part, issued directly to household investors by large U.S. brokerages. They are designed for retail investors, typically with $25 per shares that pay quarterly dividends and offer the trading ease of an exchange, predominantly the New York Stock Exchange (NYSE).

While the U.S. exchange-traded market is large (around $175 billion), the institutionally traded preferred OTC market is far larger (around $800 billion across currencies). OTC preferred securities are traded just like the bonds of institutional markets, normally in $1,000 par increments and generally in $1 million blocks. Many are in 144A and Regulation-S (offshore) format, requiring institutional status and/or a local presence for purchase.(1) Like bonds, OTC preferred securities typically pay dividends semiannually, though conventions differ around the globe, with some paying quarterly and others annually.

Generally speaking, the OTC preferred market is dominated by lower-duration fixed-to-floating-rate securities. Conversely, the exchange-listed market is dominated by issues that pay fixed rates of income for their lives. We discuss the differences between these structures in greater detail on page 14, but for now it is worth noting that the OTC market tends to offer a lower level of interest-rate risk. The OTC market may also offer superior levels of call protection for investors (longer periods for which the security cannot be redeemed by the issuer), since many new-issue OTC securities have ten or more years of call protection, compared with the five-year norm in the exchange-listed market.

While the U.S. exchange-traded market is large (around $175 billion), the institutionally traded preferred OTC market is far larger (around $800 billion across currencies).

The Companies That Issue Preferred Securities

It is no coincidence that the issuers of preferred securities are mainly large, highly regulated institutions and/or companies with high, stable and transparent cash flows—such as banks, insurance companies, utilities, telecommunications companies and real estate investment trusts (REITs). Since preferred payments can be deferred or omitted in times of stress, investors demand high-quality, tested and stable business models to provide an adequate comfort level around payments.

As mentioned, companies issue preferreds to seek equity balance-sheet treatment from regulators and credit rating agencies. Up to a point, preferred securities can substitute for common equity and help companies meet regulatory and rating-agency goals, while keeping common equity levels—normally a much more expensive capital source—to a minimum.

A great appeal of preferreds for highly regulated financial issuers like banks and insurance companies is that they may count towards regulatory equity requirements. A large majority of banks in developed countries issue preferreds, as do most insurance companies, making banks and insurance companies among the most ubiquitous issuers.

Companies that own hard assets, such as utilities, telecommunications companies and REITs, are also sizable issuers of preferreds. Some utility companies implement preferred securities to improve corporate results, as in some jurisdictions they are included in equity bases on which a regulated rate of return is allowed. However, many utility, telecom and other issuers chiefly seek equity treatment from credit ratings agencies, as it can help them maintain or improve their credit ratings, thereby potentially lowering the cost of their senior debt and ultimately their total funding costs. For hard-asset companies, like REITs, preferred securities can also help better match liabilities with their long-lived assets, diminish debt rollover risks and provide for funding without encumbering assets.

Exhibit 3 shows the largest issuers of preferreds by sector. In par-value terms, banks are by far the largest issuers, representing more than half of the market, followed by insurance companies, which represent close to 20%. Yet the high proportion that financial issuers represent also reflects their very large typical deal sizes; banks and insurance companies frequently issue deals of $1 billion or more. This compares with utility or REIT issues, which are more typically $200–500 million in size. The market is more balanced across sectors when viewed based on the number of issuers in each sector, as reflected in the chart on page 5.

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(1) 144A is a Securities and Exchange Commission rule allowing qualified institutional investors to buy and trade unregistered securities. Regulation S applies to security offerings made outside the United States by both U.S. and foreign issuers, and provides an exclusion from the Section 5 registration requirements of the Securities Act of 1933. A securities offering, whether private or public, made by an issuer outside of the United States in reliance on Regulation S need not be registered under the Securities Act.
Types of Preferred Securities

A Variety of Flavors

As shown in Exhibit 1 on page 2, preferred securities come in different formats. While there are nuances across geographies, the primary formats today include traditional perpetual securities and hybrid debt preferreds. Later, we also discuss contingent capital securities, or CoCos, a new type of preferred with special features that can be either traditional or hybrid in format.

Traditional Perpetual Preferred Securities

Traditional perpetual preferred securities are the oldest type, dating back to the 19th century. Like common shares, they are a form of stock. However, they do not carry voting rights or participate in the growth of distributable profits, as common shares normally do. Rather, like bonds, the payments they make are set as terms of the instruments for their lifetimes and may be fixed, floating, or a combination, such as fixed-to-floating (a security that pays a fixed rate for a certain term—for example, 10 years—and thereafter resets at regular intervals). We discuss these structures on page 14.

Like common stock, traditional preferred securities pay dividends, not interest. Since dividends are discretionary by nature, issuers have the option to halt payments without invoking a default. However, payment interruptions historically have been very rare, as cutting the dividend on common shares is generally regarded as a sign of stress. Cutting payments on preferreds would normally be considered a much more dire action; such a signal could potentially greatly increase a company’s general borrowing costs and even bar them from capital markets. We note that preferred payments could also be stopped by regulators concerned about a company’s stability. Since preferreds are above common shares in the capital stack, preferred securities normally have preferential claims to corporate income over common stockholders and typically must be paid in full before common stockholders can receive any distributions.1)

Traditional preferreds can offer either cumulative or non-cumulative dividends. Cumulative security payments can be deferred, typically for long periods of time, but the dividends will be owed and normally must be paid in full before common stockholders can receive any dividend distributions. Non-cumulative securities, the more common type today, pay dividends that can simply be omitted. In both cases, after a certain period of time (typically six quarters), preferred holders gain seats on the company’s board of directors, a measure designed to help them protect their interests.

Like common shares, traditional perpetual preferreds are a form of stock, but typically do not carry voting rights or participate in the growth of distributable profits.

Companies that issue preferred securities typically do so for the equity balance-sheet treatment they receive from regulators and credit ratings agencies.

Exhibit 3: Market by Sector and Issuer Count

Sector allocations are as of the date of publication and are subject to change without notice.
(a) Other includes energy, pipeline and agency.

Types of Preferred Securities

1) While inconsistently applied across the globe, changes in bank regulation stemming from Basel 3, which defines the regulatory requirements that govern banks, allow banks to continue to pay common dividends even if preferred dividends have been stopped. Regulators have argued that continuation of common dividends may be necessary to maintain investor confidence. During the financial crisis regulators allowed most large U.S. banks to pay common dividends of one cent.
Hybrid Preferred Securities

Hybrid preferred securities were designed to achieve the equity capital benefits that issuers receive on traditional preferreds, but in a cheaper format. As junior subordinated deferrable debt, rather than stock, the distributions hybrid preferreds pay are characterized as interest from a tax standpoint, not as dividends. Hence, the issuer can treat payments on these securities as an interest expense, offering a tax-shield benefit that lowers the net cost. From an investment standpoint, however, hybrid preferred securities do not offer the tax advantages of traditional issues.

To achieve the equity benefits of traditional preferreds, hybrid issues have features that mimic those of traditional preferreds. Referring again to Exhibit 1, note how hybrid preferreds are deep in the capital structure, albeit above traditional preferreds. In addition, hybrid preferreds feature defeerrable coupons, and their maturities are typically quite long, normally 30 years or more. As with traditional preferreds, payment stoppage historically has been quite rare and will typically occur only if a company is in financial distress. Since these securities are higher in the capital structure, typically both common and traditional preferred holders would have to go without payments in order for the coupons on a hybrid preferred to be deferred. Hybrid preferreds are issued in fixed, floating and fixed-to-float payment formats, just like perpetual preferreds.

Hybrid preferred securities are a form of debt, not equity. Therefore, distributions are characterized as interest, not dividends.

Changes in bank regulation have set in motion a massive refinancing wave of preferred securities that is ongoing across the globe. Readers may be familiar with the term “trust preferred.” This is a special form of hybrid preferred that was widely used by U.S. banks before the financial crisis. Arranged as a trust that had as its only asset junior subordinated defeerrable debt of the issuer, such securities were constructed in this manner to comply with the peculiarities of U.S. bank regulation. Post the financial crisis, these securities were deemed to be not equity-like enough to be considered Tier 1 capital, and hence, they have been largely phased out by bank issuers in favor of traditional preferred securities. Many other forms of hybrid and traditional preferred securities issued by foreign banks have been also losing their Tier 1 status over time. While banks no longer claim equity benefits from hybrid preferreds, these securities remain popular with insurance companies and non-financial issuers such as utilities and telecom companies, which continue to benefit from favorable rating-agency treatment of these issues.

Contingent Capital (CoCo) Securities

CoCos were created to comply with the requirements of the Basel 3 guidelines issued by the Basel Committee on Banking Supervision that were drafted after the financial crisis. They are forms of traditional or hybrid preferred securities that typically sit above common equity and below senior debt in the capital structure. As such, and like other preferred securities, they are designed to absorb losses in bankruptcy before senior creditors, and ultimately depositors, are affected. What is different about CoCos is that the loss-absorbing mechanism is spelled out, typically by means of a trigger based on regulatory capital levels. In the event the trigger is breached, the par value of the security may be written down, potentially to zero, or it may convert to common stock of the issuer. As well, in certain jurisdictions, a breach of minimum capital requirements could result in dividend payment restrictions.

As a relatively new asset class with complex features and without representation in normal bond indexes, CoCos offer...
high yields and have gained investor attention amid historically low interest rates. CoCos are used by banks in various formats, with European and Asian banks representing the largest issuers to date. First issued in late 2009, the CoCo market has grown quite rapidly, as shown in Exhibit 4.

CoCos already comprise roughly 23% of the $973 billion global preferred securities universe and we expect rapid growth of bank-issued CoCos to continue. What is more, expected changes to insurance regulations affecting many developed economies (Solvency II framework) could elicit CoCo issuance from insurance companies in years to come as well.\(^{(1)}\)

**Attractive Investment Characteristics**

**Investment Benefits of Preferreds**

In our view, preferred securities offer many benefits and make sense as a dedicated, long-term investment in a well-rounded fixed-income portfolio. Potential benefits include:

- Enhanced income, both gross and net of taxes
- Portfolio diversification
- Attractive relative value compared with other fixed-income asset classes
- Catalysts for strong performance, notably from bank preferreds
- A tool for mitigating interest-rate risk

**Enhanced Income, Both Gross and Net of Taxes**

Investment-grade preferred securities have typically offered among the highest income rates in high-grade fixed-income markets. Many preferred issues have the added advantage of paying quarterly (in their case, dividends), rather than semiannually like bonds. Over time, this high and frequent income can help mitigate the effect of price fluctuations on total returns, while dampening total-return volatility.

Exhibit 5 highlights the yield advantage of preferreds by comparing the current yields of various fixed-income asset classes. Since many preferred securities pay dividends taxed at a lower rate for U.S. individuals and C corporations, their net after-tax income may be even higher than that available from other taxable and even tax-exempt bond markets. Income from below-investment-grade and non-rated issues can be higher still.

Exhibit 5 also compares the current yields of various fixed-income categories with their respective average yields over the five years leading up to the 2008 financial crisis. Notably,
today’s preferred income rates look better on a relative basis, as the yields of corporate bonds, municipals and Treasuries have generally fallen much further. Moreover, current fixed-income yield ratios, compared with preferred securities, have mostly dropped relative to their pre-crisis averages. In our view, this is indicative of the good relative value offered by preferred securities.

Potential for Tax Advantaged Income

Individual Investors

When tax advantages are considered, the income advantage of preferred securities may exceed that of corporate bonds and even tax-exempt instruments like municipal bonds. The reason is that, for individual U.S. investors, the dividends paid by both U.S. and many foreign preferred issues are treated as qualified dividend income (QDI) for tax purposes, and are therefore taxed at lower rates than ordinary income.

The QDI tax rate, which is aligned with long-term capital-gains tax rates, is generally a maximum of 18.8% for individual investors with annual adjusted taxable income of less than $479,000, and 23.8% for investors with income of $479,000 or more. The graphic below compares potential after-tax income rates, assuming that half of the income paid on a preferreds portfolio is QDI eligible. Please note that professional tax advice may be necessary to ensure receipt of these benefits, particularly when investing in the OTC market.

Corporate Investors (U.S. C Corporation)

Institutions that file taxes as C corporations in the U.S. may garner tax benefits to U.S. investors from preferred securities investments. Dividends issued directly from one tax-paying C corporation to another are generally eligible for the Dividends Received (tax) Deduction (DRD) for the dividend recipient. This would include a taxable institution that owns the preferred securities of (and hence has an ownership stake in) a taxable C corporation. The DRD is intended to offset triple taxation of dividends. The extent of the tax deduction depends on the ownership stake, with a minimum of a 50% deduction of dividends received and a maximum of 100% if the corporation owns more than 80% of the dividend-paying company.

Investing in preferred securities for DRD benefits became more difficult in the late 1990s and into the 2000s, because the market shrank as issuers heavily favored hybrid preferred securities, which pay interest rather than dividends. However, since many preferred securities pay dividends taxed at a lower rate for U.S. individuals and C corporations, their net after-tax income may be even higher than that available from other taxable and even tax-exempt bond markets.

Exhibit 6: Fixed-Income Index Yields

<table>
<thead>
<tr>
<th></th>
<th>Before Taxes</th>
<th>After Taxes (income &lt;$479,000) (a)</th>
<th>After Taxes (income &gt;$479,000) (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Securities</td>
<td>5.6</td>
<td>4.0</td>
<td>3.9</td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>3.4</td>
<td>3.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>4.1</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>10-Year Treasury</td>
<td>1.7</td>
<td>1.7</td>
<td></td>
</tr>
</tbody>
</table>

At June 30, 2018. Source: Cohen & Steers, BofA Merrill Lynch. Yields shown on a yield-to-maturity basis. State and local taxes are not included in these calculations.

Data quoted represents past performance, which 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 or any way to know in advance when such a trend may begin.

(a) For individuals (married, jointly filing) with income exceeding $400,000 but less than $479,000, 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 (married, jointly filing) with income exceeding $479,000 but less than $600,000, qualified dividend income is taxed at 23.8% and the marginal tax rate used was 38.8%. Both rates include the Medicare surcharge of 3.8%. (c) ICE BofAML Fixed Rate Preferred Securities Index. (d) ICE BofAML Municipal Master Index. (e) ICE BofAML Corporate Master Index. (f) ICE BofAML High Yield Master Bond Index. (g) Preferred Income Advantage after tax calculations assumes preferred securities income is taxed at the respective qualified dividend 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 page 16 for index definitions.
we believe this is a good time to re-examine the opportunity, as changes in bank regulation have resulted in a significant resurgence in traditional DRD-eligible preferred issuance. Today, the DRD market is approximately $170 billion in size and contains a wide array of investment options in bank, insurance and utility preferred securities, including those in lower-duration formats. We believe U.S. Property & Casualty insurers with investment portfolios taxable at the C corporation level are amply improved after-tax book income rates even by investing in high-quality preferred issues.

Portfolio Diversification Benefits
Since the correlations of preferreds with other fixed-income and equity assets have been somewhat modest historically, they may have the potential to improve the risk-adjusted returns of diversified portfolios. As noted previously, banks and insurance companies are among the largest issuers of preferred securities—companies that may not be well represented in other fixed-income strategies, like high-yield bonds.

Despite the benefits of preferred securities, they are often overlooked, even by well diversified fixed-income investors. In our view, the low allocations to preferred securities are largely due to a lack of understanding or expertise in the preferred securities market. For most, choosing preferred investments means going outside of an index, normal mandate and/or investment purview. The lack of focus on the asset class leaves it rife with opportunity for active management, but even index returns suggest value, in our view.

To illustrate the diversification potential of preferred securities, Exhibit 7 shows that adding preferred securities to a diversified fixed-income allocation improved overall total returns, while helping to contain portfolio volatility: in other words, better portfolio efficiency. This reflects the modest correlations between preferred securities and other fixed-income asset classes, together with good returns generated by preferred securities over the five-year holding horizon. Portfolio diversification is a time-proven method for potentially reducing risk and enhancing total return. Investing in asset classes with low or negative correlations can enhance the benefits of portfolio diversification.

Attractive Relative Values Compared With Other Fixed-Income Asset Classes
Wide Spreads Relative to Treasuries
We show the attractive income profile of preferreds relative
to other fixed-income asset classes in Exhibits 8–10. Note again how preferred yields have generally not fallen by as much as other fixed-income assets. This relationship can also be expressed in historical spread terms. As seen in Exhibit 8, preferred securities trade at a wide spread over Treasuries. In considering spreads today, it is worth noting that the average credit quality of the investment-grade preferred index shown below is lower today, at BBB, than it was prior to the financial crisis, when it averaged A-. The lower rating today suggests a wider spread than historically may be appropriate. However, we note too that this index contained no lower-duration fixed-to-float instruments (which typically offer lower yields) until 2008, whereas it contains nearly 40% today. Incorporating these factors, we find the spread relationship to be attractive.

Wide Spreads Relative to Corporate and High-Yield Debt as Well

As seen in Exhibits 9 and 10 on page 11, preferred spreads relative to investment-grade bonds and high-yield debt are also attractive.

Catalysts for Strong Performance: Opportunities Post Financial Crisis

The financial crisis had a profound impact on the preferred market. Ripple effects are still being felt today. This has resulted in important performance catalysts and numerous opportunities.

- Profound fundamental credit improvements of bank balance sheets have taken place and are set to continue apace under new regulatory edicts being implemented globally around Basel 3 and Systemically Important Financial Institution (SIFI) requirements.\(^{(1)}\)

Wide credit spreads over investment-grade bonds can suggest good relative value, as can relatively narrow spreads against high-yield debt.

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**Exhibit 8: Yield Comparison—Preferred Securities vs. 10-Year Treasury History**

January 1997–June 2018

Wide yield spreads may diminish interest-rate risk\(^{(c)}\)

<table>
<thead>
<tr>
<th>Year</th>
<th>Preferred Securities (credit quality: BBB)(a)</th>
<th>10-Year Treasury</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>16%</td>
<td>4%</td>
</tr>
<tr>
<td>1998</td>
<td>12%</td>
<td>8%</td>
</tr>
<tr>
<td>1999</td>
<td>8%</td>
<td>12%</td>
</tr>
<tr>
<td>2000</td>
<td>4%</td>
<td>16%</td>
</tr>
<tr>
<td>2001</td>
<td>4%</td>
<td>21%</td>
</tr>
<tr>
<td>2002</td>
<td>4%</td>
<td>26%</td>
</tr>
<tr>
<td>2003</td>
<td>4%</td>
<td>31%</td>
</tr>
<tr>
<td>2004</td>
<td>4%</td>
<td>36%</td>
</tr>
<tr>
<td>2005</td>
<td>4%</td>
<td>41%</td>
</tr>
<tr>
<td>2006</td>
<td>4%</td>
<td>46%</td>
</tr>
<tr>
<td>2007</td>
<td>4%</td>
<td>51%</td>
</tr>
<tr>
<td>2008</td>
<td>4%</td>
<td>56%</td>
</tr>
<tr>
<td>2009</td>
<td>4%</td>
<td>61%</td>
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<td>2010</td>
<td>4%</td>
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<td>2011</td>
<td>4%</td>
<td>71%</td>
</tr>
<tr>
<td>2012</td>
<td>4%</td>
<td>76%</td>
</tr>
<tr>
<td>2013</td>
<td>4%</td>
<td>81%</td>
</tr>
<tr>
<td>2014</td>
<td>4%</td>
<td>86%</td>
</tr>
<tr>
<td>2015</td>
<td>4%</td>
<td>91%</td>
</tr>
<tr>
<td>2016</td>
<td>4%</td>
<td>96%</td>
</tr>
<tr>
<td>2017</td>
<td>4%</td>
<td>101%</td>
</tr>
<tr>
<td>2018</td>
<td>4%</td>
<td>106%</td>
</tr>
</tbody>
</table>


Data quoted represents past performance, which 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 or any way to know in advance when such a trend may begin.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. (a) ICE BofAML Fixed Rate Preferred Securities Index. (b) Historical average starts 1/31/97 and ends 6/30/18. (c) Treasury yields may rise in the future, and that could have a negative spillover effect on other fixed-income securities with relatively narrow spreads over Treasuries. As shown in the chart, the spread between preferred securities and Treasuries is well above the pre-crisis average. Preferred securities’ wide spreads to Treasuries may cushion the impact of a rising-rate environment. See page 16 for index definitions.
Exhibit 9: Yield Comparison—Preferred Securities vs. Corporate Bonds
January 1997–June 2018

Preferred Securities (credit quality: BBB)(a)
Corporate Bonds (credit quality: A-)(b)

Current Spread
153 bps
5.6%
Wide yield spreads indicate value
4.1%

Historical Average Spread (1997–2018): 190 bps(c)

At June 30, 2018.
Source: Morningstar. Yields shown on a yield-to-maturity basis. *Year-to-date data.
Data quoted represents past performance, which 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 or any way to know in advance when such a trend may begin.
(a) ICE BofAML Fixed Rate Preferred Securities Index. (b) ICE BofAML Corporate Master Index. (c) Historical average starts 1/31/97 and ends 6/30/18. See page 16 for index definitions.

Preferreds currently offer attractive yields compared with a range of alternatives.

Exhibit 10: Yield Comparison—Preferred Securities vs. High-Yield Bonds
January 1997–June 2018

Preferred Securities (credit quality: BBB)(a)
High-Yield Bonds (credit quality: B+)(b)

Current Spread
99 bps
6.6%
High-yield bond spreads vs. preferred securities relative to historical average
5.6%

Historical Average Spread (1997–2018): 224 bps(c)

At June 30, 2018.
Source: Morningstar. Yields shown on a yield-to-maturity basis. *Year-to-date data.
Data quoted represents past performance, which 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 or any way to know in advance when such a trend may begin.
(a) ICE BofAML Fixed Rate Preferred Securities Index. (b) ICE BofAML High-Yield Master Bond Index. (c) Historical average starts 1/31/97 and ends 6/30/18. See page 16 for index definitions.
Case Study: Preferred Securities and High-Yield Bonds

Preferred securities and high-yield bonds are asset classes that offer among the highest income rates available in liquid fixed-income markets today. Recall that preferred securities are deeply subordinated instruments and typically have discretionary or deferrable payments. By contrast, high-yield bonds are normally senior debt issues with mandatory payments. Yet high-yield bonds frequently bear much lower credit ratings, an indication of higher default risks. This is because high-yield issuers tend to be smaller, more leveraged and/or less time-tested companies.

Given these attributes, preferreds may be a good complement to high-yield bonds. As shown in Exhibit A, adding preferred securities to an investment portfolio that includes high-yield bonds has the potential to diversify the portfolio because there is scant sector overlap. The high-yield market contains very little bank and insurance paper, and the preferreds market contains very little cyclical industry paper.

- Insurance companies are also improving balance sheets with impetus from global insurance standards and Solvency II, an EU Directive that may have more global influence.
- The preferred market was nearly 90% investment grade before the financial crisis, but it is about 60% investment grade today. This shift has altered market dynamics and resulted in both income and total-return opportunities. Considering fundamental improvements, credit upgrades may also occur over time.
- Regulatory changes to the required format for preferred capital continue to drive a massive refinancing wave of existing preferreds. New types of preferreds are being issued, notably CoCos, without a dedicated buyer base.

Exhibit A: Low Sector Overlap With Other Fixed Income Classes

<table>
<thead>
<tr>
<th>Sector</th>
<th>Preferred Securities</th>
<th>High-Yield Bonds</th>
<th>Corporate Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking</td>
<td>49%</td>
<td>3%</td>
<td>23%</td>
</tr>
<tr>
<td>Insurance</td>
<td>26%</td>
<td>1%</td>
<td>4%</td>
</tr>
<tr>
<td>Utilities</td>
<td>8%</td>
<td>2%</td>
<td>8%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>4%</td>
<td>1%</td>
<td>2%</td>
</tr>
<tr>
<td>Energy</td>
<td>3%</td>
<td>16%</td>
<td>11%</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>1%</td>
<td>9%</td>
<td>4%</td>
</tr>
<tr>
<td>Media</td>
<td>0%</td>
<td>11%</td>
<td>3%</td>
</tr>
<tr>
<td>Basic Industry &amp; Capital Goods</td>
<td>0%</td>
<td>17%</td>
<td>9%</td>
</tr>
</tbody>
</table>

At June 30, 2018. Only key sectors are shown. Sector allocations may vary over time.
(a) 60% ICE BofAML U.S. IG Institutional Capital Securities Index, 30% ICE BofAML Core Fixed Rate Preferred Securities Index and 10% Bloomberg Barclays USD Developed Market Contingent Capital Index. (b) ICE BofAML High-Yield Master Bond Index. (c) ICE BofAML Corporate Master Index.

Regulatory Reform Driving Improved Fundamentals at Financial Institutions

The credit fundamentals of financial companies, particularly banks, have improved dramatically since the financial crisis. Under new rules recommended by the Basel Committee on Bank Supervision, i.e., Basel 3, the regulatory requirements that govern banks have become far more stringent around the globe. As well, the largest institutions are held to still higher standards under SIFI rules. Insurance companies have also been affected, by both SIFI requirements and Solvency II, new EU rules that most directly impact European insurers, but which could have echo effects in other jurisdictions. In several locations, local regulators have imposed harsher requirements than the new global standards affecting financial institutions.

There are numerous ways in which harsher regulations have improved bank credit fundamentals, but one key measure to consider is the Tier 1 Common (common equity as a percentage of risk-weighted assets) regulatory capital ratio, shown in Exhibits 11A/B. Since common equity is below preferreds in the capital structure, this additional capital is a benefit to preferred security holders. By this measure, capitalization has improved dramatically since the financial crisis. In fact, capital requirements have become considerably more onerous than this measure suggests, as risk weights attached to the asset side of the ratio have increased while certain intangibles have been deducted from equity.

As much as bank capital has grown to date, banks around the globe will continue to retain capital, enhancing the buffer below preferreds as effective capital minimums continue to increase. This is just one of myriad new requirements imposed on banks designed to make them safer. We view the harsh new regulatory environment as positive for bank creditors:

(1) In accordance with Basel 3, financial regulators deem certain companies to be SIFIs based on these firms’ size, complexity, interconnectedness and cross-jurisdictional activity, among other factors.
arguably preferred securities benefit the most, because they are the deepest creditors in the capital stack. However, while high capital may reduce the likelihood of losses for preferred holders, regulators may be more willing than in the past to stop dividend payments or even impose losses on preferreds and other creditors in tenuous situations.

Special Value Opportunities in Below-Investment-Grade Issues

A majority of the preferred market today is investment grade, but many preferred securities are split-rated, having at least one below-investment-grade rating. As well, there is a sizable and growing market of below-investment-grade issues that offers exceptionally high income rates and the potential for strong total returns. Notably, the senior debt ratings of a great majority of issuers are still investment grade.

Before the financial crisis, the vast majority of the preferred market was investment grade. In its wake, rating agencies cut the senior ratings of many financial institutions and increased the credit notching between senior and preferred ratings, effectively cutting the preferred ratings even more. Additionally, regulatory driven redemptions of somewhat higher-rated hybrid preferred issues, together with the many new perpetual and CoCo preferreds issued to replace those being redeemed, has also increased the proportion of below-investment-grade securities.

One reason why even senior bank debt ratings suffered so much after the financial crisis is that rating agencies have changed their methodologies to diminish any expectations for sovereign support in times of crisis. This follows from the basic tenet of Basel 3, which is that creditors should “bail in” banks (i.e., suffer losses) rather than having governments bail them out. While rating agencies are notoriously slow to provide credit upgrades even amid significant fundamental improvements, there have been some upgrades in recent months, and we see scope for more over time, potentially benefiting preferred holders.

Potential for Alpha from Heavy Refinance Activity

As mentioned above, Basel 3 regulatory changes have spurred a massive preferred refinancing wave. Due to the regulatory changes, a large proportion of bank preferreds that existed prior to the financial crisis have lost or will be losing their status as equity, or Tier 1 capital. Hence, they are being redeemed and replaced by new issues that do get equity credit under the new rules that exist today. This refinancing wave already sums into the hundreds of billions of dollars globally. However, much more is left to do, particularly outside of the U.S., where the new CoCo asset class has been growing exceedingly rapidly. As well, Solvency II could elicit a somewhat similar, though likely much smaller, refinancing wave at insurance companies.
The global refinancing wave provides ample opportunity for active investors to generate solid returns. Investors can potentially capture value in older issues being redeemed as well as in new securities being issued. In our view, this opportunity is very research driven and requires deep experience as well as a global investment reach to execute well.

Security Structures That May Help Mitigate Interest-Rate Risk
Preferred securities offer the potential for attractive total returns that can be resilient even in a rising-interest-rate environment. While many issues are long term or perpetual, lower-duration fixed-to-float structures dominate the OTC market and are available on a more limited basis in the exchange-traded market. Such structures have proven to help cushion the impact of a rising-interest-rate environment.

We can measure the potential interest-rate risk by examining a security's duration—a mathematical calculation of the average life of a fixed-income or preferred security that measures the security’s price risk with respect to changes in interest rates (or yields). Generally, the higher the duration, the greater the price change response will be to a given rise or fall in the demanded yield of the security. There are different structures in the preferred market with very different duration (interest-rate risk) profiles. Diagrammatic examples are shown in Exhibit 12. The first example is a security that has a fixed rate in perpetuity. Normally only found in the exchange-listed preferred securities market, the security in this hypothetical example has a duration of 14.1 years. While duration is an imperfect measure, it implies a rough potential price loss of 14.1% should the market yield rise by 100 basis points (from 6.5% to 7.5%).

Now consider the dominant structure in the institutional preferred market, a fixed-to-floating-rate issue, similar to the second example. The security in this example begins to float in 10 years. Note how much lower the duration is. At 7.2 years, this security would fall by far less in price for the same change in demanded yield, roughly 7.2% for a 100-basis-point rise. As well, securities that reset sooner—for instance, in five years—will have still lower duration measures and may be still less subject to interest-rate risk. There are a great many securities with shorter resets that can be used to build portfolios that will be less subject to interest-rate risk.

Aside from fixed-to-float issues, as illustrated in the example, floating-rate securities also exist and offer exceptionally low duration measures, as they may reset frequently with the changing level of interest rates.

As a quick reference, our Portfolio Manager’s Toolkit below summarizes some of the tools professional managers use to help manage interest-rate risk. For a more complete discussion, please refer to our white paper Meeting the Rising Rates Challenge, available at cohenandsteers.com/insights.

Conclusion

Our Closing Perspective
Preferred securities offer a number of unique features and benefits, including high income (potentially with tax advantages) and good relative value, along with catalysts for performance stemming from regulatory reforms. Preferred securities can complement, diversify and improve a fixed-income investment allocation. Despite being perpetual or long lived, many issues have fixed-to-float structures, significantly lessening their interest-rate risk.

Exhibit 12: Potential to Manage Interest-Rate Risk

Hypothetical Examples

A preferred security’s duration is largely determined by its structure.

Fixed-Rate Security: Retail (exchange-traded) fixed rate; 6.5% coupon, callable in 2023 at par

<table>
<thead>
<tr>
<th>2018</th>
<th>2023 Call</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Duration: 14.1

Fixed-to-Floating-Rate Security: Institutional (OTC) fixed-to-floating rate; 6.5% coupon, callable in 2028 at par (or resets to a floating rate in 2028)

<table>
<thead>
<tr>
<th>2018</th>
<th>2028 Call</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Duration: 7.2

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

<table>
<thead>
<tr>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

Duration: ~0.2

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 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. 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.
Managing Interest-Rate Risk: The Portfolio Manager’s Toolkit

Increase allocations to preferred securities with lower credit quality and wider credit spreads. In today’s market, high credit spreads are a first line of defense relative to rising interest rates—and the wider the credit spread, the stronger the defense potential. Since credit risk typically diminishes in an improving economic climate, wide spreads can provide a cushion. In a rising-rate environment, below-investment-grade and non-rated preferred securities with wide credit spreads tend to provide better relative price returns as well as higher income rates, both of which tend to protect investors when interest rates rise.

Employ more fixed-to-float or floating-rate structures that are less sensitive to interest rates. Preferred securities that trade on stock exchanges typically pay a fixed rate forever, potentially making them highly sensitive to changes in demanded yields. By contrast, the standard structure for OTC perpetual preferred securities is a fixed-to-float instrument. Many have only a few years left until they convert to floating rates, giving them quite short durations. Moreover, floating-rate preferred issues with income rates that reset most typically with changes in short rates, like LIBOR, have almost no interest-rate risk.

Favor higher-coupon/higher-income securities. Securities that pay higher coupons or trade at a premium tend to perform better than lower-coupon issues in a rising-rate environment, benefiting from high current income rates. Income in and of itself also provides a total-return defense over time. Additionally, high-coupon securities that are callable in the near term tend to trade very close to par, as the market prices in a high probability of redemption at par.

Invest in foreign-currency-denominated securities where interest-rate cycles may not be in sync with those in the United States. For instance, due to a much weaker economy, Europe is far less likely to see rising rates in the near future. In fact, Europe has embarked upon quantitative easing, even as the U.S. has exited that form of economic stimulus and is contemplating tightening monetary policy. By investing in preferred securities denominated in foreign currencies, we are able to take advantage of yield environments that may remain low for a longer period of time.

Use derivatives to hedge interest rates directly. For many strategies, a last and important line of defense is the direct hedging through options, interest-rate swaps and futures based on the manager’s view of when and by how much yields will rise.

Active managers have the means to make portfolio adjustments to address interest-rate risk.

In our view, preferred securities can be an appealing investment in a quality, high-income asset class. Yet these instruments are complicated, and the preferred market itself is undergoing massive changes. In today’s context, we believe active management based on preferred-securities-specific research, together with a global reach, is the best formula for pursuing desired results.
Index Definitions

The ICE BofAML US IG Institutional Capital Securities Index is a subset of the ICE BofAML US Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities. The Bloomberg Barclays Developed Market USD Contingent Capital Index includes hybrid capital securities in developed markets with explicit equity conversion or write-down loss absorption mechanisms that are based on an issuer’s regulatory capital ratio or other explicit solvency-based triggers. Barclays US MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). ICE BofAML Adjustable-Rate Preferred Securities Index tracks investment grade floating rate preferred securities publicly issued in the U.S. domestic market. ICE BofAML Australia Corporate Index tracks the performance of AUD-denominated investment grade corporate debt publicly issued in major domestic and euro-bond markets. ICE BofAML Fixed-Rate Preferred Securities Index tracks the performance of fixed-rate USD-denominated preferred securities issued in the U.S. domestic market. ICE BofAML High-Yield Master Bond Index monitors the performance of below investment grade USD-denominated corporate bonds publicly issued in the U.S. domestic market. ICE BofAML Japan Corporate Index tracks the performance of JPY denominated investment grade corporate, securitized and collateralized debt publicly issued in the Japanese domestic market. ICE BofAML UK 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. ICE BofAML REIT Preferred Securities Index is a subset of the ICE BofAML Fixed-Rate Preferred Securities Index including all real estate investment trust issued preferred securities. ICE BofAML USE Composite Agency Index tracks the performance of US dollar denominated investment grade US agency debt issued in the US domestic market. ICE BofAML U.S. Inflation-Linked Treasury Index tracks the performance of U.S. Treasury Inflation Protected Securities with at least $1 billion in outstanding face value and a remaining term to maturity greater than one-year. ICE BofAML US Treasury Index tracks the performance of US dollar denominated sovereign debt publicly issued by the U.S. government in its domestic capitalization. 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. The S&P 500 Index is an unmanaged index of 500 large-cap, publicly traded stocks representing a variety of industries.

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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 noted above, preferred securities have issuer call options, cash call 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 particular, in the event of bankruptcy, a company’s preferred securities are senior to common stock but subordinated to all other types of corporate debt. Throughout this presentation we will make comparisons of preferred securities to corporate bonds, municipal bonds and 10-Year Treasury bonds. It is important to note that corporate bonds sit higher in the capital structure than preferred securities, and therefore in the event of bankruptcy will be senior to the preferred securities. Municipal bonds are issued and backed by state and local governments and their agencies, and the interest from municipal securities is often free from both state and local income taxes. 10-Year Treasury bonds are issued by the U.S. government and are generally considered the safest of all bonds since they’re backed by the full faith and credit of the U.S. government as to timely payment of principal and interest.

Preferred funds may invest in below investment-grade securities and unrated securities judged to be below investment-grade by the Advisor. 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.

Contingent capital securities (sometimes referred to as “CoCos”) are debt or preferred securities with loss absorption characteristics built into the terms of the security, for example a mandatory conversion into common stock of the issuer under certain circumstances, such as the issuer’s capital ratio falling below a certain level. Since the common stock of the issuer may not pay a dividend, investors in these instruments could experience a reduced income rate, potentially to zero, and conversion would deepen the subordination of the investor, hence worsening the investor’s standing in a bankruptcy. Some CoCos provide for a reduction in the value or principal amount of the security under such circumstances. In addition, most CoCos are considered to be high yield or “junk” securities and are therefore subject to the risks of investing in below-investment-grade securities. No representation or warranty is made as to the efficacy of any particular strategy or fund or the actual returns that may be achieved.

Duration Risk. Duration is a mathematical calculation of the average life of a fixed-income or preferred security that serves as a measure of the security’s price risk to changes in interest rates (or yields). Securities with longer durations tend to be more sensitive to interest rate (or yield) changes than securities with shorter durations. Duration differs from maturity in that it considers potential changes to interest rates, and a security’s coupon payments, yield, price and par value and call features, in addition to the amount of time until the security matures. Various techniques may be used to shorten or lengthen the Fund’s duration. The duration of a security will be expected to change over time with changes in market factors and time to maturity.

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

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