When Interest Rates Rise

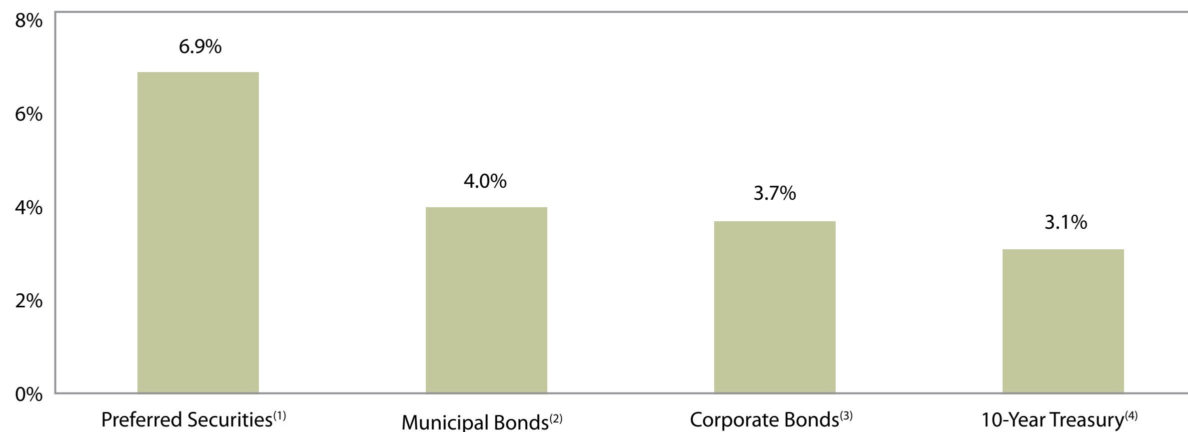
Opportunities and Risks in Today's Preferred Securities Market

Some investors have expressed concerns about how their preferred securities will perform in a rising interest rate environment. The simple answer is that preferreds, like other fixed-income securities, have posted positive returns in some interest rate cycles, and in others they haven't fared as well. However, while returns have been comparable to those of other fixed-income asset classes, there are now unusually high credit spreads between preferreds relative to corporates, municipals and Treasurys, which could provide a cushion in a rising rate environment.

Given this yield advantage, preferred securities have recently returned to popularity as a way to generate higher income when attractive yields are hard to find. The appeal is easy to see–the average yield on investment-grade preferred securities is currently more than 300 basis points higher than that of corporate bonds of comparable credit quality.

Preferred securities currently offer the highest yield in the investment-grade fixed-income market

EXHIBIT 1. YIELD TO MATURITY



As of May 31, 2011.
Source: Bloomberg.
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(1) BofA Merrill Lynch Fixed Rate Preferred Securities Index (2) BofA Merrill Lynch Municipal Master Index (3) BofA Merrill Lynch Corporate Master Index (4) BofA Merrill Lynch Current 10-Year U.S. Treasury Index. See page 7 for index definitions.

To help make sense of the risks and opportunities of this asset class, portfolio manager William Scapell addresses some of the most common questions from investors.

1. Now that the economy is growing again, when will interest rates start to rise?

Given slow economic growth and stubbornly high unemployment, we still see too much slack in the economy for interest rates to rise in the near term. There are some inflationary signs in higher food and energy prices, but they have yet to find their way into core inflation.

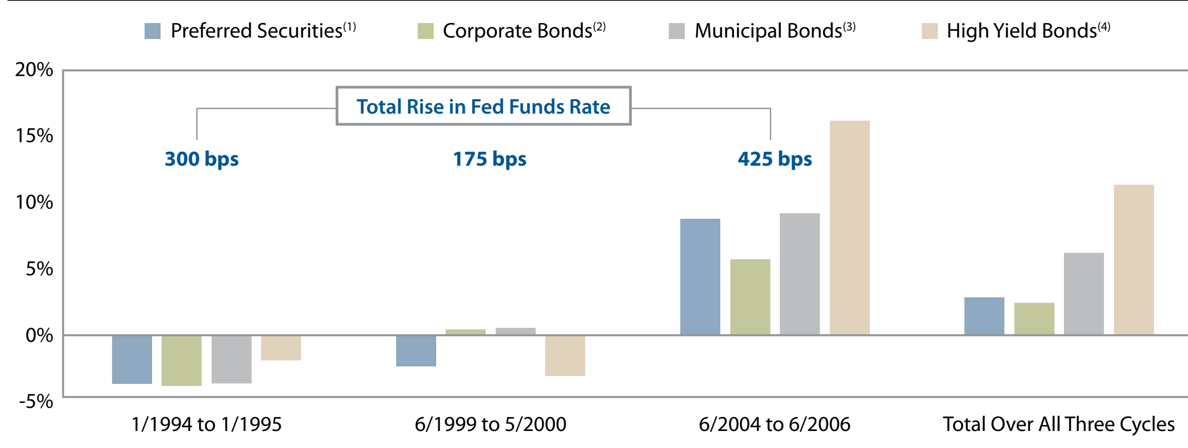
We expect growth to continue in 2011; however, the recovery still faces some headwinds from the pending rolloff of unemployment benefits this summer, and rising gas prices are of concern. At the same time, policy makers in Asia and Europe are attempting to stave off inflation with higher official rates, and this may lead to a slowing of growth in those regions. But at some point, we expect that fears of higher inflation could cause investors to demand greater yields, potentially driving 10-year Treasury rates higher. However, we believe interest rates won't see a sustained, meaningful rise until a stronger economy is underfoot.

2. How have rising rates affected preferreds in the past?

Climbing interest rates don't necessarily mean negative total returns for preferreds. Going back to the early 1990s, when modern preferred market indexes began, there have been three periods of extended rises in interest rates. In terms of total return, preferreds suffered mild losses in two of the periods and posted a gain in the third. Taken together over all three cycles, preferreds actually achieved positive total returns.

Over past rate hikes, preferred returns have been in the range of other fixed-income assets

EXHIBIT 2. AGGREGATE TOTAL RETURN



Source: Ned Davis Research, Inc., Cohen & Steers.
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(1) BofA Merrill Lynch Fixed Rate Preferred Securities Index (2) Barclays Capital U.S. Investment Grade Corporate Bond Total Return Index (3) Barclays Capital U.S. Municipal Bond Total Return Index (4) Barclays Capital U.S. High Yield Corporate Bond Total Return Index. See page 7 for index definitions.

3. Do yields on preferreds generally move in tandem with interest rates?

The yield on a preferred security can be thought of as a combination of 1) the yield on a U.S. Treasury security with a comparable maturity, and 2) an additional yield, called the "spread." The extra income compensates investors for the credit risk associated with owning the preferred security. This is similar to corporate bonds,

except that preferreds tend to carry higher spreads due to the fact that bond holders have priority when it comes to a company's income and assets.

These two components—interest rates and credit spreads—often respond in different ways to external conditions. The same economic growth that spurs interest rates to rise also tends to inspire greater confidence in an issuer's credit quality, causing the spread to contract. The wider the spread, the more it can contract toward its long-term average, providing a buffer to rising rates.

The example below shows what might happen if interest rates were to rise by 100 basis points (bps). Should the credit spread contract by 80 bps in response to an improving economic environment, the demanded yield on preferreds would rise by only 20 bps. Since prices fall as demanded yield rises, this spread contraction will soften the blow of higher interest rates on the prices of existing preferreds.

If rates rise, a contraction in the credit spread can dampen the impact on preferred yields

EXHIBIT 3. THE CREDIT SPREAD "CUSHION"

	Before Rate Hike	After Rate Hike	Change (bps)
Treasury Yield	3.5%	4.5%	+100 bps
Credit Spread	4.4%	3.6%	-80 bps
Demanded Yield	**7.9%**	**8.1%**	**+20 bps**

Source: Cohen & Steers.

4. How is today different from previous periods of rising interest rates?

In looking at the past, it's important to consider not just interest rates, but also credit conditions. When the Federal Reserve began hiking rates in 1994, 1999 and 2004, credit spreads on preferreds contracted over time as preferred yields rose less than Treasury yields. This helped buffer the impact on prices. However, spreads were much tighter then than they are today and more consistent with historical averages, giving them less room to contract. Eventually, demanded yields on preferred securities moved more in lock-step with Treasury yields.

Credit spreads are much wider now than at the start of past rate-hike cycles

EXHIBIT 4. HISTORICAL CREDIT SPREADS[1] (BPS)

	1/1994 to 1/1995	6/1999 to 5/2000	6/2004 to 6/2006	Current (5/31/11)
Average spread for six months prior to rate-hike cycle	+266	+296	+218	**+380**
Tightest spread during cycle	+91	+198	+164	

Source: Bloomberg, Cohen & Steers.

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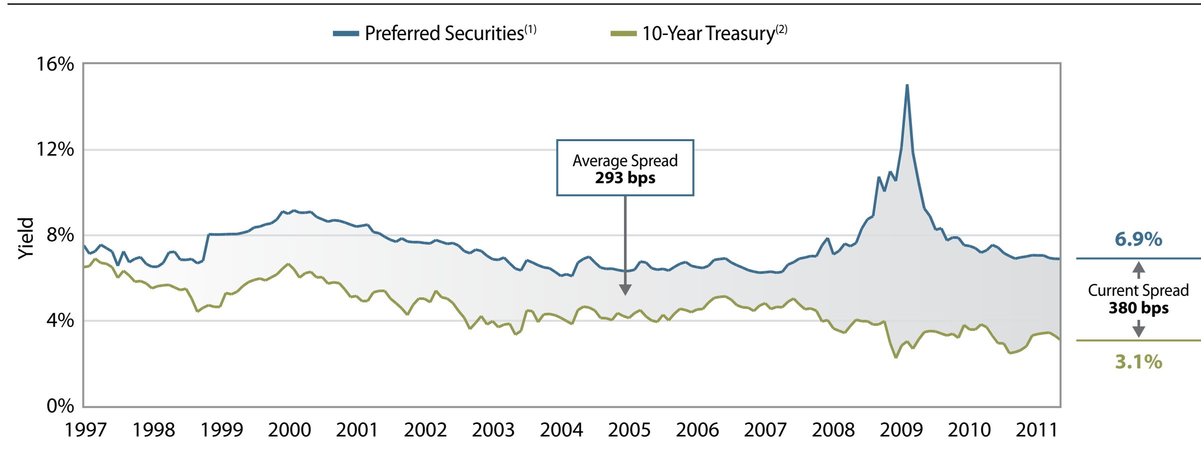
(1) Yield of BofA Merrill Lynch Fixed Rate Preferred Securities Index, less yield of BofA Merrill Lynch Current 10-Year U.S. Treasury Index. See page 7 for index definitions.

Today, the difference in yield to maturity between investment-grade preferreds and the 10-year Treasury is around 380 basis points—roughly 90 bps higher than its historical average. ***This means that Treasury yields could rise to 4% from the current 3.1%, and if preferred spreads returned to their normal level, there would be no meaningful rise in demanded yield.***

Unusually wide credit spreads may provide a cushion against rising rates

EXHIBIT 5. YIELD HISTORY

January 1997–May 31, 2011



Source: Bloomberg at May 31, 2011.

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5. In recent months, how have preferred securities performed relative to U.S. Treasurys?

During the fourth quarter of 2010 and the first quarter of 2011, the correlation between preferreds and Treasurys was generally negative—when Treasury yields rose, preferred yields fell, and vice versa.

Preferred prices rose in the first quarter of the year amid generally good earnings reports from the financials sector and an easing of sovereign debt concerns that had negatively influenced the market in the fourth quarter. As credit-sensitive instruments, preferreds also benefited from signs of strength in the global economy, such as job creation in the U.S. However, macro factors such as oil prices over $100/barrel and political instability outside of the U.S. presented challenges. Although Treasury yields reversed course and fell after the close of the first quarter, preferred securities had their sixth consecutive month of positive total returns in April, which was a good month for financial markets overall.

As the economic outlook changed, preferreds and Treasurys experienced different results

EXHIBIT 6. QUARTERLY TOTAL RETURNS

Index	Q4 2010	Q1 2011
10-Year Treasury(1)	-5.6%	-0.3%
Preferred Securities (exchange traded)(2)	-0.2%	+3.6%
Preferred Securities (over-the-counter)(3)	+1.7%	+3.1%

Source: Bloomberg.

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6. How far could prices fall if yields on preferreds rise?

The sensitivity of a security or portfolio to changes in demanded yield can be quantified through its "duration," which is roughly related to the average time-to-maturity, including all coupon payments.* A longer duration means that a security or portfolio will experience a greater price change in response to a rise or fall in yield.

For example, the benchmark for exchange-traded preferred securities (the BofA Merrill Lynch Fixed Rate Preferred Securities Index) currently has a duration of about 7.9 years. If demanded yield rose 100 basis points—say, from 7% to 8%—the price of the index would drop by roughly 7.9%.

Over-the-counter preferreds typically have even lower durations due to their different structures (explained in more detail on the following page), so their prices tend to be less sensitive to interest-rate risk. And since floating-rate preferreds are tied directly to interest rates, their duration is zero.

Of course, duration only looks at the immediate price change—income and reinvestment buoy the total return over time.

Preferred securities' sensitivity to rising yields is comparable to other fixed-income investments

EXHIBIT 7. AVERAGE DURATION OF FIXED-INCOME ASSETS

Index	Duration (in years)
10-Year Treasury[1]	8.5
Municipal Bonds[2]	9.3
Preferred Securities (exchange-traded)[3]	**7.9**
Corporate Bonds[4]	6.3
Preferred Securities (over-the-counter)[5]	**6.4**
5-Year Treasury[6]	4.8
Preferred Securities (floating rate)	**0**

Source: Bloomberg, Cohen & Steers at April 30, 2011.
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Duration measures an asset's price sensitivity to changes in demanded yield on that asset, not to changes in Treasury yields.

Total Return = Price Change + Income

When you think about potential gains and losses, remember to think in terms of total return. If demanded yield were to rise, the price of existing investments would drop, but the loss would be offset over time through coupon payments and higher-yielding reinvestment opportunities. This is partly why preferreds have produced positive returns on a fairly consistent basis over the years.

* Owing to call features, the durations of exchange-traded preferreds can change with demanded yields. If demanded yields were to fall, the durations would fall as well, as the likelihood of early redemption would rise. In contrast, higher demanded yields would cause their durations to increase.

7. How would you adjust a portfolio during a rising-rate environment?

The experienced portfolio management team at Cohen & Steers has a wide range of tools at its disposal to dampen the impact of rising yields and take advantage of opportunities across interest rate cycles. We have successfully used these tools during past periods of rising interest rates.

Increase allocation to preferred securities with lower credit quality. In today's market, high credit spreads are the first line of defense relative to rising interest rates—and the wider the credit spread, the stronger the defense. Since credit risk typically diminishes in an improving economic climate, below-investment-grade preferred securities tend to provide better relative returns as well as higher yields when interest rates rise.

Employ more fixed-to-float and/or floating-rate structures that are less sensitive to interest rates. Preferreds that trade on stock exchanges usually pay a fixed rate forever, giving them relatively high durations. In contrast, over-the-counter preferreds often pay a fixed rate for a certain number of years and then convert to a floating rate—at which point interest-rate risk goes to zero. Many of these fixed-to-float issues only have a few years left until they convert to floating rates, giving them relatively short durations. We may also invest directly in floating-rate preferred issues that have no interest-rate risk, although these tend to offer lower yields.

Favor higher-coupon 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.

Invest internationally. Interest-rate cycles in other areas of the world may not be in sync with those in the United States. By opening the investment pool to preferred securities denominated in foreign currencies, we're able to take advantage of yield environments that may be more attractive. Take Australia for instance—it may finish raising its rates before the U.S. even begins its rate hike cycle.

Seek opportunities in preferreds that may lose Tier 1 status. In the coming years, some types of preferreds will no longer qualify as part of a bank's Tier 1 capital as a result of regulatory changes specified by the Dodd-Frank Act and Basel III. When this happens, the issuing bank may have incentives to redeem the securities, causing the value to gravitate towards par in most environments. We seek to identify preferred securities that are likely to be redeemed, providing price appreciation and/or price stability from such issues. (For more detail, see our recent *Viewpoint* article on regulatory reform at cohenandsteers.com.)

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

8. How do the risks of preferred securities compare with fixed-income investments?

Risks associated with preferred securities differ from risks inherent with those of other investments, such as corporate bonds, municipal bonds and U.S. Treasury bonds. Corporate bonds sit higher in the capital structure than preferred securities, giving them a senior claim to company assets in the event of bankruptcy. 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. Treasury bonds are issued by the U.S. government and are 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.

Summary

In our view, rising interest rates are not imminent. However, it's prudent to be prepared. A key to taking advantage of the higher income that preferreds offer today and navigating the potential for higher rates tomorrow is active management of this risk. Financial advisors and investors should review their portfolios to ensure that their fixed income and preferred security holdings are sufficiently diversified and employ the expertise of an active manager with the skill to adjust to market conditions as they evolve.

Index Definitions

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

Barclays Capital U.S. High Yield Corporate Bond Total Return Index is an index covering the U.S. dollar-denominated, non-investment-grade fixed-rate, taxable corporate bond market.

Barclays Capital U.S. Investment Grade Corporate Bond Total Return Index is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least $250 million par amount outstanding. To qualify, bonds must be SEC-registered.

Barclays Capital U.S. Municipal Bond Total Return Index is a market value weighted index of investment-grade municipal bonds with maturities of one year or more.

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. Qualifying securities must have an investment-grade rating (based on an average of Moody's, S&P and Fitch) and an investment-grade-rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long-term sovereign debt ratings).

BofA Merrill Lynch Current 5-Year U.S. Treasury Index is a one-security index comprised of the most recently issued 5-year U.S. Treasury note. The index is rebalanced monthly. In order to qualify for inclusion, a 5-year note must be auctioned on or before the third business day before the last business day of the month.

BofA Merrill Lynch Current 10-Year U.S. Treasury Index is a one-security index comprised of the most recently issued 10-year U.S. Treasury note. The index is rebalanced monthly. In order to qualify for inclusion, a 10-year note must be auctioned on or before the third business day before the last business day of the month.

BofA Merrill Lynch Fixed Rate Preferred Securities Index tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market. Qualifying securities must be rated investment-grade (based on an average of Moody's, S&P and Fitch) and must have an investment-grade-rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long-term sovereign debt ratings).

BofA Merrill Lynch Municipal Master Index tracks the performance of U.S. dollar-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).

BofA Merrill Lynch U.S. 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.

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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, reinvestment risk and income 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.

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