

Sizing Up the Preferred Market: The World Beyond Investment-Grade Exchange-Traded Issues

Opportunities may await investors willing to consider below-investment-grade, over-the-counter and foreign preferreds.

As more investors turn to preferred securities as a means of earning higher yields, many are limiting their selections to what they can find on stock exchanges, either through exchange-traded funds or investment-grade \$25 par securities. This approach targets just a fraction of the \$750 billion global preferred securities market. More important, it offers little ability to navigate changing market conditions, such as rising interest rates or new regulations that will change how financial institutions use preferreds to meet capital requirements.

We believe investors are better served through an active manager with the skill and resources to access the full spectrum of preferreds, including securities that trade over the counter, have lower credit ratings or are denominated in foreign currencies. Not only does this offer a broader opportunity set for finding value, but it also offers the flexibility to adapt to shifts in the market—something that will be crucial in the coming years.

To help investors get a complete picture of today’s preferred securities market, we examine some of the areas they may be overlooking.

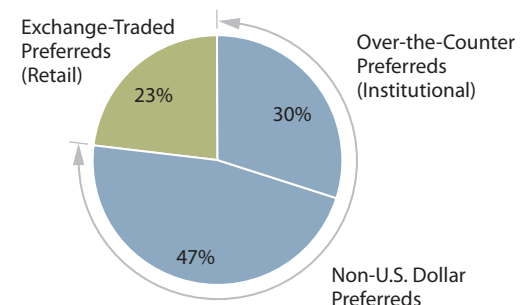
Below-Investment-Grade Issues

Preferreds have historically been mostly investment-grade quality. However, many issuers were downgraded during the recent financial crisis. As a result, there has never been a larger market of below-investment-grade securities than exists today.

Why consider below-investment-grade? We believe there is great opportunity in many of these “fallen angels,” as reflected by the fact that over one-third of the securities that recently fell to below-investment-grade have returned to investment-grade status since the beginning of the year.⁽¹⁾ As issuers continue to rebuild their capital and demonstrate sustained profitability

in the coming quarters, we expect to see more of these securities return to investment-grade status.

EXHIBIT 1. THE \$750 BILLION GLOBAL PREFERRED SECURITIES MARKET
Estimated Market Capitalization



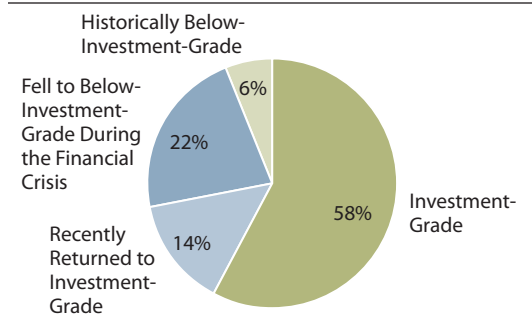
Source: BofA Merrill Lynch Fixed Rate Preferred Securities Index, BofA Merrill Lynch Capital Securities Index, Bloomberg and Cohen & Steers.

Through active management, investors can access an additional 77% of the market.

(1) Source: Bloomberg.

EXHIBIT 2. AS THE ECONOMY IMPROVES, MANY RECENTLY DOWNGRADED ISSUES MAY RETURN TO INVESTMENT-GRADE STATUS

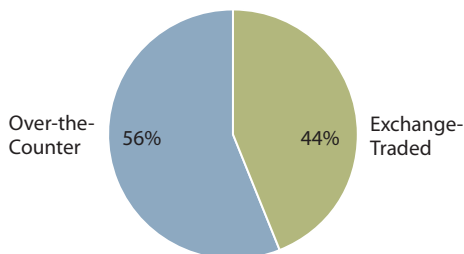
U.S. Preferred Securities, by Credit Quality



Source: BofA Merrill Lynch Fixed Rate Preferred Securities Index, BofA Merrill Lynch Capital Securities Index, Bloomberg and Cohen & Steers.

EXHIBIT 3. OTC ISSUES MAKE UP MORE THAN HALF OF THE \$400 BILLION U.S. MARKET

U.S. Preferred Securities, by Market



Source: BofA Merrill Lynch Fixed Rate Preferred Securities Index, BofA Merrill Lynch Capital Securities Index, Bloomberg and Cohen & Steers.

Over-the-Counter Securities

Of the roughly \$400 billion of securities that comprise the U.S. dollar preferred market, about \$225 billion are in over-the-counter (OTC) issues, traded predominantly by institutional investors.

Exchange-traded and OTC preferreds are “pari passu” (at the same level) from a credit standpoint, but differences in their structures can have important investment implications.

Most exchange-traded issues pay a fixed rate for the life of the security, either in perpetuity or until a given maturity date. These preferreds

generally have call features that allow the issuer to redeem the security five years after the date of issue.

In the OTC market, “fixed-to-float” structures are the norm. These securities pay a fixed rate until a specified date in the future, and then convert to a floating rate tied to LIBOR. They generally can be called by the issuer on or after the float date, which may be 25 years or more down the road. Long-term “bullet” issues (30-year maturities with no calls) also exist in the OTC market.

Why consider both markets?

Different sensitivities to interest rates. Fixed-to-float structures tend to have lower durations as they approach their floating-rate period. An active manager can use this fact to manage interest-rate risk by increasing allocation to lower-duration OTC preferreds in a rising rate environment.

Protection from callability. Depending on the amount of call protection, the price of a preferred generally won’t rise far above its call price, because the issuer could redeem it at par once the call protection had expired. Since OTC preferreds typically have a much longer period before they can be called, they may offer more potential for price appreciation in the interim.

Same issuer, better opportunity. Better values sometimes exist for the same name in one market relative to the other. For instance, utility preferreds are often cheaper in the OTC market, while bank preferreds may offer better value in exchange-traded preferreds.

Broader investment universe, including new issues. Some companies, such as REITs, issue

Exchange-traded and OTC preferreds tend to have different characteristics that can benefit investors.

EXHIBIT 4. TYPICAL SECURITIES FOUND IN EXCHANGE-TRADED AND OVER-THE-COUNTER MARKETS

Issuer	Market	Maturity	Coupon	Callable Date (on or thereafter)	Modified Duration (years)	Investment Implication
1) U.K. bank	NYSE	Perpetual	7.1% fixed	12/15/2012	13.9	Longer durations due to fixed coupon
2) U.S. bank	NYSE	3/1/2033	6.25% fixed	11/18/2011	11.8	
3) French insurer	OTC	Perpetual	6.38% fixed until 12/14/2036, then floats at LIBOR + 225 bps	12/14/2036	11.7	25 years until floating period means longer duration, but also more upside price potential from call protection
4) U.S. utility	OTC	6/30/2066	7.5% fixed until 6/30/2016, then floats at LIBOR + 282 bps	6/30/2016	4.1	Relatively short duration since only a few years remain until the floating period

preferreds only in the exchange-traded market, while others issue only in the OTC market. We expect new-issue volume in the OTC market to increase: potential changes in bank regulations may lead to a whole crop of new types of preferred issues, many of which will be available only in the OTC market.

Foreign Preferreds

Investing in foreign securities opens up a whole new market for finding the best value. As a global institutional investor with offices in Hong Kong, London and Brussels, Cohen & Steers has the added advantage of being able to participate in securities issued into foreign markets, which may not be available in the U.S. on the offering.

Foreign issuers. More than a quarter of the \$400 billion U.S.-dollar preferred market consists of securities issued by non-U.S. companies.

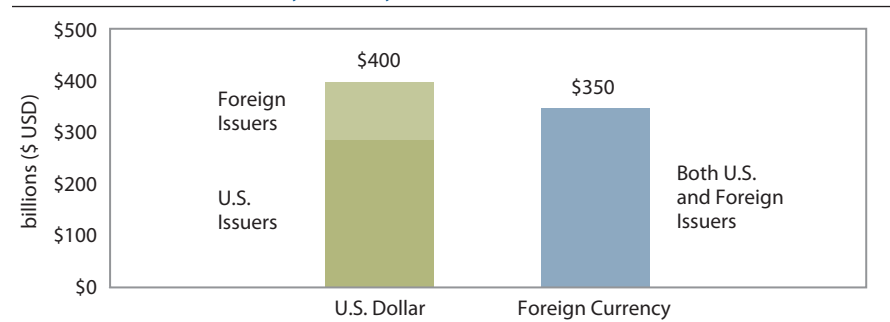
While these include both exchange-traded and OTC preferreds, some companies issue only in the OTC market to avoid the filing requirements associated with U.S. exchange listing. Most foreign issues come from developed markets, particularly Europe, but there are also emerging market issuers, such as Mexican and Brazilian banks.

Foreign currencies. Companies may also issue preferreds denominated in non-U.S. currencies (euros, pounds, yen, etc.). At an approximate

value of \$350 billion, the foreign-currency preferred market is nearly as large as the U.S.-dollar market. Issuers may include U.S. companies, but most are European banks and insurers. Companies from Asia Pacific are also well represented.

Why consider foreign preferreds? New banking regulations are transforming the preferred landscape around the world. As companies begin to issue new types of preferreds, many of these securities will be placed in foreign currencies.

EXHIBIT 5. ADDING FOREIGN CURRENCY PREFERREDS NEARLY DOUBLES THE AVAILABLE OPPORTUNITY SET
Global Preferred Securities, by Currency



Source: BofA Merrill Lynch Fixed Rate Preferred Securities Index, BofA Merrill Lynch Capital Securities Index, Bloomberg and Cohen & Steers.

Summary

To take advantage of all that preferreds have to offer, we believe investors should consider an approach that allows them to participate in the widest possible range of securities. At Cohen & Steers, our experienced portfolio managers look at the full scope of the preferred market to take advantage of opportunities wherever they exist.

The views and opinions in the preceding commentary are as of the date of publication and are subject to change. 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. Investors should consult their own advisors with respect to their individual circumstances.

The U.S. preferred securities estimated market capitalization was calculated by taking the market cap of the BofA Merrill Lynch Fixed Rate Preferred Securities Index to represent the exchange-traded preferreds, the BofA Merrill Lynch Capital Securities Index to represent the over-the-counter preferreds and adding the preferred securities that have fallen to below investment grade and thus out of these indexes since 2006. Using Bloomberg, the non-USD preferred securities market was estimated by calculating the market cap of U.S. and foreign preferreds that are issued in non-USD. These estimates are as of September 30, 2010.

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 Capital Securities Index—Is a subset of The Merrill Lynch Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities.

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.

Special risks of investing in foreign securities include (i) currency fluctuations, (ii) lower liquidity, (iii) political and economic uncertainties, and (iv) differences in accounting standards. Some international securities may represent small- and medium-sized companies, which may be more susceptible to price volatility and less liquid than larger companies.

An investment in the Fund is subject to investment risk, including the possible loss of the entire principal amount that you invest. The value of these securities, like other investments, may move up or down, sometimes rapidly and unpredictably.

Past performance is no guarantee of future results. There is no guarantee that any historical trend presented in this commentary will be repeated in the future, and no way to predict precisely when such a trend will begin. Index performance is not representative of the performance of any Cohen & Steers account and no such account will seek to replicate an index. You cannot invest directly in an index.

This article 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.

About Cohen & Steers

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