

# Cohen & Steers Preferred Securities Strategy

JUNE 30, 2010

INVESTMENT COMMENTARY

*We would like to share with you our review and outlook for the preferred securities market as of June 30, 2010. In the quarter, the BofA Merrill Lynch Fixed Rate Preferred Index had a total return of -0.9% and the BofA Merrill Lynch REIT Preferred Index returned +1.8%. Year to date, the BofA Merrill Lynch Fixed Rate Preferred Index and the BofA Merrill Lynch REIT Preferred Index had total returns of +4.7% and +6.9%, respectively.*

## INVESTMENT REVIEW

Preferred securities modestly declined in the second quarter amid increased economic uncertainty, although they held up much better than the broader stock market and maintained positive year-to-date total returns.

Uncertainty regarding reforms aimed at the U.S. financial industry influenced performance, particularly in the brokerage and banking subsectors (which had total returns of -3.5% and -1.4%, respectively).<sup>1</sup> The likelihood of higher capital requirements and the possibility that some companies would have to divest or reduce profitable trading and derivatives operations weighed on these securities in May. June saw some relief, however, as passage of a reform bill drew closer and it appeared that the impact on banks might be less than previously feared. There was even some perception that the bill would prove to be beneficial for fixed income investors over time, due to banks' taking less risk and holding more capital.

A spate of weaker economic readings in the U.S. also weighed on riskier assets in the quarter, with lower credit quality bonds and preferreds generally lagging the highest quality assets. Economic slowdown concerns were compounded by significant volatility in European markets as investors began to scrutinize European sovereign debt rollover risk and even the viability of the European Union. A rescue package for Greece and creation of another fund meant to backstop other European sovereigns improved sentiment, but the preferreds of many European issuers were volatile and dragged lower over the quarter. Asian growth concerns also weighed on markets as China began to take measures to cool its housing market. In the quarter, U.S. Treasury yields tumbled, expectations for Federal Reserve rate hikes were pushed out and the dollar spiked as investors sought the perceived safe haven of the U.S.

First quarter earnings, meanwhile, most announced early in the quarter, were generally good and indicated that large banks could be close to seeing a peak in their loan loss provisioning. Net interest margins and profits continued to improve. Regional banks showed some earnings improvement, although their higher exposure to commercial real estate loans remains a challenge. In general, bad debt trends compared favorably with regulatory stress tests, and capital remained sound.

Many insurance preferreds (-2.6%) underperformed. Bermuda-based reinsurance issues struggled, in part due to expectations of an active hurricane season; the Gulf oil spill did not appear to be a factor, as these companies carry little of that liability. Certain life insurance issues declined as falling markets once again brought focus on annuity liabilities and other market-sensitive life insurance products.

The media (+1.6%) and telecommunications (+2.0%) sectors outperformed. The sectors include less-cyclical companies with relatively stable cash flows and are seen to benefit from a turnaround in advertising sales. Real estate preferreds (+1.8%) were another bright spot. This reflected positive returns from Public Storage, which dominates the sector and whose performance was consistent with the outperformance of higher-quality preferreds in the quarter. The company has an exceptionally strong balance sheet.

In news, HSBC completed a \$3.8 billion preferred new issue in June, a sign that the preferred market is active and remains open to new offerings.

## INDEX PERFORMANCE

Period	BofA Merrill Lynch Fixed Rate Preferred Index	BofA Merrill Lynch Capital Securities Index
Q210	-0.9%	-2.0%
YTD	4.7%	6.4%
1 Year	22.4%	32.0%
3 Years	-5.9%	0.7%
5 Years	-1.9%	1.5%
10 Years	3.0%	6.7%

Total returns of the BofA Merrill Lynch Fixed Rate Preferred Index, which includes investment-grade \$25 par preferred securities, and the BofA Lynch Capital Securities Index, which includes hybrids preferred securities. Periods greater than one year are annualized. Past performance does not guarantee future results. This information is not representative of any Cohen & Steers account and no such account will seek to replicate an index. You cannot invest directly in an index.

(1) Sector returns as measured by the Bank of America Merrill Lynch Fixed Rate Preferred Index.

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## INVESTMENT OUTLOOK

A bill to reform the U.S. financial system is now before Congress and appears likely to pass. Particularly relevant for preferreds is an amendment that phases out debt-structure hybrid preferred securities, which are issued by bank holding companies. Because they are a form of debt, rather than equity, hybrid preferreds will be phased out of banks' Tier 1 capital over time (they will still qualify as Tier 2 capital).

These issues—there is over \$100 billion worth of bank hybrid preferreds outstanding—likely will be retired via call or tender activity, or replaced via exchange offers, most likely with incentives for those holding the hybrids. The transition phase may take years to fully run its course, but over time these securities are likely to grow in value as they become scarcer. In addition, investors may find a new range of opportunities as new securities come to market and banks tender and exchange for old ones.

Looking forward to second quarter earnings, U.S. banks appear to be in decent shape, and earnings should reflect this. Troubled loans have receded from their peak in the last quarter of 2009, and we believe they will continue to decline, with the exception of those at some smaller regional banks. Past-dues on monthly credit card bills are likewise coming down. One concern ahead of earnings is a recent slowdown in bond trading and underwriting activities, which have contributed significantly to large banks' profits over the past year.

While we believe the current economic expansion will continue, it is clear that growth has moderated. Moreover, the deleveraging of balance sheets around the globe—sovereign as well as in the private sector—is likely to be a long process, and risks of policy errors and more bouts of market volatility surrounding issues in Europe and elsewhere remain present.

Further price appreciation for preferreds may be constrained in the current credit-constricted environment, but we believe their total-return prospects remain attractive. The group had an average yield of 7.4% as of June 30, compared with yields of 4.3% for comparably rated corporate bonds and 3.0% for the 10-year Treasury. With interest rates likely to remain exceptionally low for an extended period, preferreds should remain extremely appealing to investors seeking high and stable levels of income. For the near term we expect most return to come from their very high income; however, as balance sheets continue to improve in the months ahead we look for catalysts for stronger performance.

*Past performance is no guarantee of future results. The performance information in the preceding commentary does not reflect the performance of any fund, product or account managed or serviced by Cohen & Steers. 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 any market forecast set forth in this presentation will be realized. This material should not be relied upon as investment advice, does not constitute a recommendation to buy or sell a security or other investment and is not intended to predict or depict performance of any investment.*