

## Cohen & Steers Preferred Securities Strategy

We would like to share with you our review and outlook for the preferred securities market as of December 31, 2011. For the fourth quarter, the BofA Merrill Lynch Fixed Rate Preferred Index had a total return of +2.0% and the BofA Merrill Lynch Capital Securities Index returned +2.8%. For the year, the indexes had total returns of +4.1% and +0.4%, respectively.

### Investment Review

Preferred securities had a positive total return for the year despite concerns brought by fiscal strains in Europe and signs of a slowing global economy. The group's above-average income, compared with stocks and most fixed income classes, continued to attract yield-seeking investors amid low and declining interest rates. The income rate of generally 7% or so paid by preferreds also contributed directly to performance, as even securities that fell somewhat in price had positive total returns. Preferreds were further supported by technical factors related to anticipated Tier 1 capital regulatory changes (more securities being called or otherwise removed from the market, along with relatively limited new supply in the period).

Preferreds, and financial markets broadly, made gains through July, but encountered turbulence when it appeared that the global economic recovery was on a weaker trajectory than previously expected. Investor confidence was further eroded by the growing risk of a Greek default, sparking fears of heavy bank losses and fiscal contagion. In addition, the debate over raising the U.S. debt ceiling was followed quickly by a downgrade of the U.S. credit rating by Standard & Poor's.

Although preferred securities had price declines in August and September, they held up much better than stocks on a total return basis. The group then participated in the fourth-quarter recovery, as markets turned up on signs of improving U.S. economic data and progress in Europe. Adjustable-rate preferreds fared poorly, however, as expectations for interest-rate increases in the U.S. were pushed out to 2013 or beyond, reducing the demand for securities whose yields are tied to short-term interest rates.

Performance was positive across most sectors, with non-financial preferreds faring the best. Preferreds issued by real estate, telecommunications and utilities companies were particularly buoyant. Returns from bank preferreds were mixed and the securities more volatile. U.S. bank preferreds generally offered positive returns; they reported better-than-expected improvements in credit quality and capital ratios, although revenue trends generally remained weak, in part

reflecting slow loan growth. In addition, the potential for the issuers to buy back their preferreds due to regulatory reform kept issues well bid.

By contrast, European bank and insurance company issues generally declined—some significantly—hindered by fears of sovereign risk, including the potential dissolution of the European Union and related uncertainty over capital adequacy and funding. However, many of these issues, too, found footing late in the year as a number of foreign banks offered to buy back their securities at premiums to the market prices—albeit still at deep discounts to par.

### Index Performance (USD)

Period	BofA Merrill Lynch Fixed Rate Preferred Index	BofA Merrill Lynch Capital Securities Index
Q4 2011	2.0%	2.8%
1 Year	4.1%	0.4%
3 Years	12.4%	19.8%
5 Years	-1.2%	2.6%
10 Years	2.4%	5.5%

*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. Total returns of the BofA Merrill Lynch Fixed Rate Preferred Index, which includes investment-grade \$25-par preferred securities, and the BofA Merrill Lynch Capital Securities Index, which includes hybrid preferred securities. Periods greater than one year are annualized.

### New contingent capital securities were greeted with healthy demand

A significant development in the preferred market in the period was the large, successful issuance of contingent capital securities. These so-called "CoCos" may convert into common shares if a company's core Tier 1 capital ratio falls below a certain level. Another version of these securities would write down to a lower par figure under similar circumstances. Markets focused on this emerging asset class after Credit Suisse priced its large public deal at 7.875% and placed private transactions at the same time. With many existing preferreds destined to lose their Tier 1 status under Basel 3 (the next guidelines from a committee represented by the world's central banks), issuers may increasingly use CoCos as an alternative source of equity-like capital.

### Regulatory par call risk emerged

In May, regional bank Fifth Third exercised a par call on a trust preferred trading at a premium via "special event" language, taking the market by surprise. This awakened many to the risk that certain bank preferreds may be subject to near-term par calls as a result of changes to bank regulation that diminish

## Cohen & Steers Preferred Securities Strategy

the regulatory capital benefit of the securities. In this particular case, the issuer could call the security at par anytime following a proposed change of this nature. (Typically, there is a short, specified window in which to call such an issue after a special event.)

By paying close attention to prospectus language, we were well-aware of the special event call risk associated with certain premium issues and did not hold the Fifth Third issue when it was called. Later in the year, Wells Fargo also exercised regulatory call language to take out nearly \$6 billion of securities—again calling at par many securities trading at premiums. We did not own the premium securities and continue to avoid premium priced securities that have this risk.

### Investment Outlook

In terms of preferreds' broad performance potential, we note that bond yields are at or near historic lows, and that the Federal Reserve is likely to hold interest rates steady until 2013. In such an environment, the income offered by preferreds (7–8% or more) will be hard to come by, likely resulting in good investor demand in the year ahead. At the same time, the high income these securities produce is also likely to continue to factor meaningfully into their total return and dampen returns volatility.

The theme of new regulations defining Tier 1 capital will remain key in the coming year. In the U.S., the Collins Amendment to the Dodd-Frank Act phases out Tier 1 treatment for debt-structured “trust preferred” securities over a period of three years, beginning in 2013. Phase-out of Tier 1 benefits is also slated to take place for a large number of existing preferred instruments abroad. Once banks have clarity on exactly what will qualify as Tier 1 (based on final announcements from the U.S. Federal Reserve as well as the global Basel Committee), we expect to see an accelerating wave of refinancings via companies calling, buying back and tendering for their securities—ultimately involving hundreds of billions of dollars of preferred securities globally. This activity should continue to provide price support to existing issues while presenting new investment opportunities in the U.S., and globally as new preferreds—potentially with new formats—come to market to replace called issues.

Turning to the market macro-environment, the U.S. economic picture has brightened modestly in recent weeks, a positive for credit and preferreds. We expect slow but sustained growth. However, Europe remains a market risk. While recent fiscal, political and central bank initiatives to address the sovereign credit crisis in Europe are somewhat encouraging, the political landscape remains very uncertain there, and

economic austerity measures will weigh on growth. There is a long road ahead to get to the deeper fiscal union that markets seem to require. Importantly, the European Central Bank has been actively funding European banks via long-term repurchase operations, which has provided vital breathing room for banks seeking time to retrench and recapitalize. We are cautiously optimistic regarding the ability of Europe to find better footing and calm markets; however, we respect that the issues are difficult and complex and we continue to tread more lightly there.

Given global uncertainties, our portfolio remains more heavily weighted towards domestic issuers. Our preference for non-financials also remains in place. For instance, we favor REIT preferreds, which offer high income and generally attractive metrics, including lower leverage and decent cash flow growth. We also continue to like telecom and pipeline issuer preferreds.

In the financials space, our focus is on more traditional banking models, including Tier 1 issues of certain U.S. regional banks. We also have a generally favorable view of insurance company credit fundamentals. While we remain more defensive relative to credit, improvements in the U.S. economy as well as the steps taken in Europe to date have brightened the outlook for risk assets somewhat, and some valuations look compelling. Hence, we have added at the margin to more battered securities, including those of certain European issuers. Our core holdings will remain more conservative for the time being, but we will continue to look for value in beaten-down issues opportunistically and as we see economies and markets mending.

**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.*