

Five Reasons to Consider Preferred Securities if You Own Municipal Bonds

Preferred securities can be a compelling complement to municipal bonds for investors seeking high, tax-efficient income, especially with muni yields near historic lows.

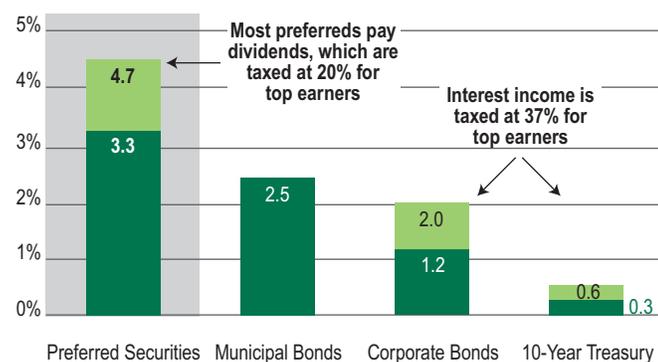
- 1. High coupons from blue chip issuers.** Preferred securities are issued mostly by high-quality companies in the banking, insurance, real estate and utility sectors, many of them household names such as Bank of America, Prudential, AT&T and JPMorgan Chase.⁽¹⁾ However, because preferreds sit lower in the capital structure than senior and subordinated debt, they tend to pay higher income rates than similarly rated bonds.
- 2. Tax-advantaged income.** Typically, distributions from most preferreds are treated as qualified dividend income (QDI), taxed at a top rate of 20%, versus 37% for interest income (plus a 3.8% Medicare surcharge). If we conservatively assume that 65% of preferreds are QDI eligible, the effective top tax rate would be 29.8%—an 11% tax savings.

- 3. Higher current income potential than munis, before and after taxes.** Using current index yields, a \$1 million investment in preferred securities would potentially generate \$47K per year in pre-tax income (see chart at left below). Assuming 65% QDI, that would translate to \$33K per year after taxes for investors in the top tax bracket—providing \$5.2K more in after-tax income than if it were fully treated as interest.^(a) This compares favorably to municipal bonds, which potentially offer only \$25K per year in tax-free income. Preferreds' yield advantage may be narrower versus municipal bonds that are exempt from state and local income taxes for investors who purchase the bonds issued by their state or municipality of residence.

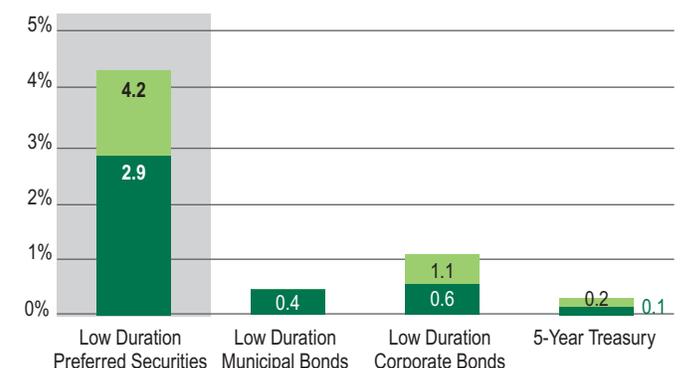
Investors emphasizing capital preservation over appreciation may want to consult with their investment professional about low-duration preferred securities, which also offer attractive after-tax yields, as shown in the chart at right below.

■ Before Taxes ■ After Taxes (top tax bracket)

Intermediate-Duration Fixed Income Yields^(a)



Low-Duration Fixed Income Yields^(a)



At July 31, 2020. Source: Cohen & Steers, ICE BofA.

Data quoted represents past performance, which is no guarantee of future results. An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. 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. See page 3 for index representations and definitions.

(a) Yields represented on a yield-to-maturity basis for intermediate-duration securities and a yield-to-worst basis for low-duration securities. After-tax income calculations based on current yields, do not include state and local taxes or Fund expenses, and assume taxation at the highest marginal Federal income tax rates. Preferred securities assumed to be taxed as 65% QDI-eligible and 35% interest income. Tax advantage of \$5.2K based on \$47K of income taxed as interest at the highest marginal rate of 40.8% (\$27.8K after taxes), versus 65% of income assumed to be taxed as QDI, with an effective tax rate of 29.8% (\$33K after taxes).

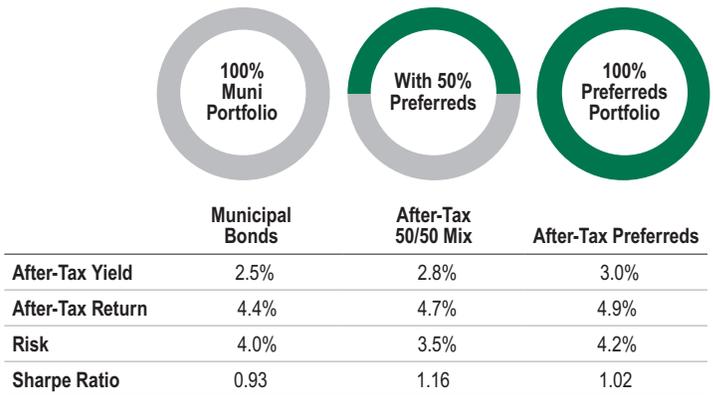
(1) Although a company's senior debt rating may be rated investment grade by S&P, Moody's and Fitch, an underlying security issued by such company may have a below investment grade rating.

4. A track record of comparable (and often lower) risk.

While municipal bonds are often perceived as being lower-risk securities than preferreds, preferreds have historically compared favorably on key risk factors. Both have a history of low default rates, according to Moody's data going back decades.⁽¹⁾ We believe preferreds have the potential to maintain low default rates, viewing them as well positioned to withstand periods of slowing or negative economic growth. Regulators annually subject financial companies—the leading issuer of preferreds—to rigorous economic “stress tests” aimed at ensuring adequate capital reserves. The preferred market is also well represented by high-cash-flow, less cyclical companies that investors trust to make regular payments.

5. Better together. Over the past 10 years, a 50/50 mix of municipal bonds and preferred securities would have delivered a higher return than municipals alone. The mix also appears attractive from an after-tax yield perspective, generating 30 basis points of extra yield over standalone municipal bonds, as shown in the chart to the above right.

10-Year Statistics



At July 31, 2020. Source: Cohen & Steers.

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Adding preferred securities to a portfolio of municipal bonds may help investors achieve better risk-adjusted performance while maintaining a focus on high-quality issuers.

(1) Preferreds: 2.0% average annual dividend impairment based on Moody's study of annual dividend impairments, including default events and dividend omissions, for non-trust preferred securities from 1980–2012. Munis: 0.09% for the entire study period of municipal default rates over a five-year horizon for all public finance issuers from 1970–2017.

Index Definitions

An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. **Preferred Securities:** ICE BofA Fixed Rate Preferred Securities Index (Credit quality: BBB) tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market. Exhibit 2: 50% ICE BofA Fixed Rate Preferred Securities Index and 50% ICE BofA Capital Securities Index through December 31, 2016, 60% ICE BofA US IG Institutional Capital Securities Index, 30% ICE BofA Core Fixed Rate Preferred Securities Index and 10% Bloomberg Barclays Developed Market USD Contingent Capital Index through 12/31/2018, and 60% ICE BofA US IG Institutional Capital Securities Index, 20% ICE BofA Core Fixed Rate Preferred Securities Index and 20% Bloomberg Barclays Developed Market USD Contingent Capital Index for periods thereafter. ICE BofA Capital Securities Index is a subset of the ICE BofA US Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities. ICE BofA US IG Institutional Capital Securities Index tracks the performance of US dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the US domestic market. 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. **Municipal Bonds:** ICE BofA Municipal Master Index (Credit quality: AA-) 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. **Corporate Bonds:** ICE BofA Corporate Master Index (Credit quality: A-) tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. **Low Duration Preferred Securities:** ICE BofA 8% Constrained Developed Markets Low Duration Capital Securities Custom Index (Credit quality: BBB-) tracks the performance of select U.S. dollar-denominated fixed and floating-rate preferred, corporate and contingent capital securities, with remaining term to final maturity of one year or more, but less than five years. **Low Duration Municipal Bonds:** (1-5 Year) ICE BofA Municipal Master Index (Credit quality: AA-) tracks the performance of U.S. dollar-denominated investment-grade tax-exempt debt (with maturities of 1-5 years) publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. **Low Duration Corporate Bonds:** (1-5 Year) ICE BofA Corporate Master Index (Credit quality: A-) tracks the performance of U.S. dollar-denominated investment-grade corporate debt (with maturities of 1-5 years) publicly issued in the U.S. domestic market.

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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 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 commentary we will make comparisons of preferred securities to corporate bonds, municipal bonds and Treasury securities. 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. Treasury securities are issued by the U.S. government and are generally considered the safest of all bonds since they are backed by the full faith and credit of the U.S. government as to timely payment of principal and interest; additionally, U.S. Treasury interest is generally free from state and local income taxes.

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.

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.

No representation or warranty is made as to the efficacy of any particular strategy or the actual returns that may be achieved.

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