A New Era for Midstream Energy

The Case for Allocation

Tyler Rosenlicht, Head of Midstream Energy & MLPs

MLPs and other midstream energy companies provide a unique way to participate in the continued growth in North American energy production, offering the potential for high, inflation-linked income, total return and other portfolio-enhancing characteristics. We believe improving fundamentals and the adoption of a more sustainable business model strengthen what was already a compelling investment opportunity.

Executive Summary

Understanding the midstream market
Midstream companies play a vital role in the energy value chain, generating relatively predictable, fee-based cash flows. Though commodity prices can indirectly impact revenues by altering energy throughput volume expectations and counterparty risk, most contracts have limited direct sensitivity to energy prices. Evolving energy market dynamics are also creating new investment opportunities.

Why midstream now?
Despite the disappointing performance of midstream energy securities in 2018 and persistent volatility in 2019, industry fundamentals are strong amid rising pipeline volumes and improving asset utilization. Improved corporate governance, stronger balance sheets and a focus on long-term shareholder returns have resulted in better risk-return profiles for the equities, in our view.

Midstream energy as a long-term allocation
Midstream companies offer current yields of 6%+ (Exhibit 7) with limited overlap to the broad equity market and low correlations to other asset classes (0.55 to the S&P 500 over the last three years, Exhibit 9).

Data quoted represents past performance, which is no guarantee of future results. See respective exhibits for notes, and page 11 for index associations, definitions and additional disclosures.
Understanding the Midstream Market

Between the upstream producers that extract oil, natural gas and natural gas liquids (NGLs) and the downstream companies that refine and market gasoline and other products to consumers lies the midstream energy sector. Midstream energy companies own and operate infrastructure assets that facilitate the flow of energy as it moves from supply regions to demand centers. An allocation to midstream energy provides investors with a way to participate in the continued growth in domestic energy production volumes as North America continues on its path to greater energy independence.

The midstream energy sector is large and diverse, with more than 80 companies and a total market capitalization of $600 billion (Exhibit 1). Approximately 45% of the midstream universe by market capitalization consists of companies organized as publicly traded master limited partnerships (MLPs), a structure that is not taxed at the entity level and has the potential to deliver high income. The rest of the market consists mostly of U.S. and Canadian corporations that own midstream assets but do not utilize the partnership structure.

Exhibit 1: Cohen & Steers Midstream Energy Universe

Market Cap ($ billions)

<table>
<thead>
<tr>
<th>MLPs</th>
<th>Non-MLPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>$153</td>
<td>$73</td>
</tr>
<tr>
<td>$173</td>
<td>$92</td>
</tr>
</tbody>
</table>

REPRESENTATIVE COMPANIES

Enterprise Products Partners, LP
- An $89 billion enterprise value growth-oriented MLP providing midstream energy services to producers and consumers of natural gas, NGLs, crude oil, refined products and petrochemicals
- Assets include approximately 49,000 miles of pipelines; 260 million barrels of storage capacity for NGLs, crude oil, refined products and petrochemicals; and 14 Bcf of natural gas storage capacity

The Williams Companies
- A $53 billion enterprise value midstream corporation with gas pipeline and gathering & processing operations spanning the U.S.
- A prime beneficiary of natural gas displacing heating oil and coal, with strategic assets in the deepwater Gulf of Mexico, the Rockies, the Pacific Northwest and the Eastern Seaboard

Pembina
- A $19 billion enterprise value Canadian infrastructure company with diverse and integrated assets across multiple basins and markets throughout North America
- $20 billion project backlog with key opportunities in LNG and petrochemicals

See page 11 for additional disclosures.

Business Characteristics

Midstream businesses generally own assets that have contracted revenues, often with inflation protection. The assets are generally long lived and have embedded competitive advantages due to high barriers to entry. In the current environment, we see very challenging conditions for new project approvals, which improves the competitive positioning of incumbents. Pipelines can stretch for thousands of miles and, once built, throughput capacity can often be increased at low cost, creating a defendable economic moat against potential competitors and new entrants. We believe these businesses are capable of generating high income and attractive returns on capital over the long term.

Gathering: Infrastructure ‘close to the wellhead’ that onboards energy production into the infrastructure system

Processing/fractionation: Assets that clean and transform energy commodities into pipeline-ready form and purity products (e.g., separating natural gas from associated natural gas liquids, such as ethane, propane and butane)

Pipelines: The primary mode of transportation for moving crude oil and natural gas from production basins to demand centers, particularly over long distances

Storage: Facilities that store energy commodities for future use, often for operational or seasonal demand changes

Export: Refrigeration systems and loading docks that prepare energy commodities for export

Other: Additional midstream assets, such as railcar loading facilities, trucking transfer stations, LNG vessels and more
Contract Type Affects Sensitivities to Energy Volumes and Commodity Prices

Companies in the midstream value chain tend to generate relatively predictable, fee-based cash flows and income. However, midstream contracts can vary in length from 30 days to 20 years, with revenues determined by factors such as regulation (allowed returns), throughput volumes and commodity prices. Much of a company’s sensitivity to volumes and/or commodity prices depends on the types of contracts it employs, resulting in businesses that can perform very differently throughout the commodity cycle (Exhibit 2).

Exhibit 2: Midstream Revenue Sensitivities

Companies may have a range of contract types with varying sensitivities across the commodity cycle, underscoring the potential benefit of active management in midstream investing.

FERC-adjusted tariff: The Federal Energy Regulatory Commission (FERC) sets tariff rates on liquids pipelines, which have formulas to determine inflation-based contract escalators; revenues derived from these contracts are not affected by commodity price swings and can directly pass through inflation of costs.

Cost of service: Provides for the recovery of operating expenses and a fixed capital charge, resulting in no commodity or volumetric sensitivity; utility-like cash flows.

Minimum volume commitments (MVCs): The customer is obligated to pay a set fee, regardless of the actual volumes that pass through a pipeline system; very stable but has volume sensitivity once a contract expires, at which point market rates may apply.

Contango storage: Some storage contracts have minimum rents, but revenues can increase based on the level of contango in the commodity markets; often shorter term.

Percentage of proceeds: Some companies gather and process natural gas for producers, sell the resulting gas and NGLs at market prices and retain a percentage of the proceeds, sharing the commodity price risk with the producer.

Marketing: Certain companies may also separately engage in marketing activities, buying and selling products to capitalize on regional price differentials.

Commodity prices generally don’t affect midstream revenues from day to day, but they do indirectly matter in the long term. In our view, two key factors for midstream energy companies are energy volumes and counterparty risk. To the extent that commodity price movements alter volumetric expectations, midstream companies may see their cash flow expectations change, affecting cash flow growth prospects, leverage and trading multiples. High energy prices that increase upstream capital expenditures should result in increasing expectations for midstream companies, just like sustained low prices that slow upstream capital spending and drilling activity may subdue cash flows in the long run.

Also, since midstream companies typically rely on long-term contracts to underpin cash flows, counterparty risk is critically important when evaluating appropriate discount rates and risk premia for the asset class. If commodity prices decline to a level that calls into question an exploration & production company’s (E&P’s) or refiner’s ability to meet payment obligations, this may weigh on midstream security prices. This was readily on display in 2014–16, when oil prices declined from more than $100 a barrel to $30 and raised genuine concerns about the E&P industry’s solvency, and reappeared in 2019, particularly for companies closely aligned to natural gas producers.
Changing Energy Landscape Redirecting Flows

Robust overseas demand for U.S. crude oil, refined petroleum products, liquefied natural gas (LNG), and natural gas liquids (NGLs) requires a retooling of domestic infrastructure. We believe that improving existing assets, as opposed to building new ones, will be a boon for midstream company returns. The coming “Capline Reversal” is a good illustration of the investment opportunities ahead (Exhibit 3).

Since 1981, Capline—one of the largest oil pipeline systems in the U.S.—has served as a conduit for crude imports to reach Midwest refineries. But Capline’s flows have slowed to a trickle as foreign imports have been displaced by rising North American production. Midwest refineries are now supplied from the Mid-Continent and Canada, and price differentials have made the Gulf Coast a desired destination for crude oil rather than an entry point, rendering the Capline system obsolete in its current configuration.

In years past, when the midstream industry was awash in cheap capital, a new pipeline might have been built to move oil from north to south to serve the evolving market. But the environment has changed. Cost of capital is higher, access to capital is worse and pipeline approvals are challenging. Reversing the pipeline's flow and expanding its capacity can be done significantly cheaper, better and faster than building a new one, providing low-cost access to the eastern Gulf’s refineries and oil export terminals. The Capline system's owners (Plains All American Pipeline, Marathon Petroleum and BP) have started contracting space in the pipeline, targeting an in-service date of late 2020, although the full reversal is not expected until 2022.

Railroads may provide a roadmap. With the midstream industry ripe for consolidation and managements focused increasingly on returns, we expect more companies to seek capital-efficient growth opportunities by repurposing underutilized assets. We believe a useful parallel can be seen in freight rail operators.

In 1975, there were 73 Class 1 railroads (based on revenues) in the U.S. Today there are just seven. Rail track mileage has also declined, by approximately 40%. Having rationalized its assets, the railroad industry now routinely earns a return on invested capital in the low double digits (5-year average: 12%). We believe the midstream energy industry, currently with more than 80 participants, will experience a similar consolidation in the years ahead, while also enjoying stronger returns on invested capital. While there are unique factors specific to the railroad industry that led to their success, we would note that railroad equities have considerably outperformed the broad stock market over the last 3-, 5-, 10- and 20-year periods.

Exhibit 3: Changing Market Dynamics Require New or Repurposed Infrastructure
Why Midstream Now?

Fundamentals Are Improving

Fundamentals for midstream energy appear to be steadily improving amid firmer energy prices and rising throughput volumes, which are leading to greater pipeline system utilization and opportunities for companies to generate higher cash flows (see corresponding numbers in Exhibit 4).

We see four primary factors contributing to this fundamental improvement:

1. **Rising energy production.** The continued development of vast North American reservoirs of oil, natural gas and NGLs from shale formations has put the U.S. on course to become a net energy exporter by 2020.

2. **Increasing domestic consumption.** Natural gas is seeing significant demand growth from the power generation sector, as environmental regulations are driving higher utilization of cleaner-burning, cheaper-to-build and more flexible gas plants.

   One byproduct of rising North American crude oil and natural gas production is greater quantities of NGLs, such as ethane, propane and butane, which are feedstocks in many industrial processes. Relatively low NGL prices are the reason why U.S. companies are among the most competitive global manufacturers of chemicals and are fueling the country’s petrochemical manufacturing renaissance.

3. **Exports opening up new markets.** Sharply rising U.S. exports of oil, LNG and petroleum products such as gasoline are redefining global markets. The production cost advantage and speed to market of U.S. oil and natural gas have made the country one of the world’s critical sources for new supply. As more energy destined for foreign markets flows through pipelines and export facilities, midstream firms can collect more fees. Tariffs may slow export growth in the near term, but we believe the global economy requires continued growth from U.S. shale.

4. **Tightening pipeline supply.** Shale basins are often in locations that have not been historical supply centers, which leads to heightened demand for infrastructure to gather and process the hydrocarbons. This mounting infrastructure demand comes at a time when pipeline construction is expected to slow, as a rising cost of capital and challenging regulatory and political environments lead midstream companies to scale back on capital expenditures, enhancing the value of existing pipelines.
Transitioning to Return-Oriented Business Models

The midstream energy business model has evolved considerably in the past few years, leading to improved governance, stronger balance sheets and a focus on long-term shareholder returns. The result has been better risk-return profiles for the industry overall (Exhibit 5).

Under the old model, in place for most firms through 2017, publicly traded master limited partnerships were managed by outside general partners. The separate share class structure worked well initially but ultimately resulted in weak corporate governance, with management incentives misaligned with shareholder interests. For example, incentive distribution rights (IDRs) paid to general partners encouraged MLP management teams to maximize distribution growth and distributions paid, minimize excess distribution coverage, tolerate high leverage and accumulate assets even when they weren’t complementary to the core business—all while funding the growth via repeated equity offerings.

Enter “Midstream 2.0.” With worsening access to capital, many firms were forced to adopt a new business model, which initially acted as a headwind for returns. Since 2017, many companies have adapted, removing the dual share class structure, eliminating burdensome IDRs and aligning the board of directors around one set of investors. The result is improved corporate governance, with a focus on returns on invested capital. Although this has often come with a distribution cut and MLPs’ income potential may be modestly reduced under Midstream 2.0, the long-term return opportunity remains very attractive, in our view, with the better-managed, more stable business models that motivate companies to make better capital allocation decisions. Companies, generally, have strengthened their balance sheets and are internally funding growth opportunities, moves that potentially open the door for future dividend increases and share buybacks.

Broader investor appeal. Post corporate tax reform, some firms have elected to abandon the MLP structure and reorganize in corporate form. This potentially opens these companies to a broader set of investors, particularly those that cannot own securities that generate a K-1 tax filing. Though we continue to believe in the merits of the MLP structure for many midstream businesses, these restructurings into corporations have helped to attract additional capital to the sector, with institutional ownership now at 42%, up from 30% in 2011.

Exhibit 5: The New Business Model

<table>
<thead>
<tr>
<th>Midstream 1.0</th>
<th>Midstream 2.0</th>
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<tbody>
<tr>
<td>Complex structure (GP/LP with IDRs)</td>
<td>Simplified structure (no IDRs)</td>
</tr>
<tr>
<td>Weak alignment of shareholder interests</td>
<td>Greater shareholder alignment</td>
</tr>
<tr>
<td>High leverage</td>
<td>Lower leverage</td>
</tr>
<tr>
<td>Maximized distribution growth / greater risk of distribution cuts</td>
<td>Higher distribution coverage / lower risk of distribution cuts</td>
</tr>
<tr>
<td>Asset buying to drive IDR payouts</td>
<td>Focus on core assets and return on invested capital</td>
</tr>
<tr>
<td>Frequent, dilutive equity issuance</td>
<td>Stock buybacks</td>
</tr>
</tbody>
</table>

(1) Incentive distribution rights allot an increasing share of an MLP’s distributions paid to the general partner.

With strengthened balance sheets and improved corporate governance, the stage is set for potential dividend increases and share buybacks.
Attractive Valuation Metrics

The midstream asset class is trading at discounted valuations following a multi-year period of weakness. While the broad stock market is near all-time highs, midstream equities remain nearly 50% below their 2014 peak—despite rising cash flows and steadily improving industry fundamentals. Consequently, midstream as a whole is attractively valued on multiple metrics. Exhibit 6 provides a few examples.

In addition to appearing favorably priced, relative to historical averages, using industry-specific metrics such as distributable cash flow, midstream companies compare well to the broad market on more commonly applied valuation approaches, such as price-to-earnings.

One example of the numerous instances today of large-capitalization, investment-grade midstream companies that are trading at substantial discounts to the broad market is Plains All American Pipeline, LP. Based on Bloomberg data, as of August 31, 2019, the MLP, which features a solid balance sheet, traded at less than 9x earnings and had a 6.7% yield—a yield that we believe is well covered by the company’s cash flow.

We believe such attractive valuations relative to the broad market may further help to draw generalist investors to the asset class.

Exhibit 6: Valuations in Context

<table>
<thead>
<tr>
<th>Valuation Method</th>
<th>Historical and Current Levels</th>
<th>Difference from Long-Term Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>EV/EBITDA(a)</td>
<td>8.5x 8.9x 11.6x 12.3x 15.8x</td>
<td>28% Discount</td>
</tr>
<tr>
<td>P/E(b)</td>
<td>8.8x 10.5x 20.1x 21.1x 32.9x</td>
<td>50% Discount</td>
</tr>
<tr>
<td>Yield</td>
<td>1.9% 5.3% 7.4% 9.9% 11.0%</td>
<td>34% Premium</td>
</tr>
</tbody>
</table>

At August 31, 2019. Source: Bloomberg, partnership reports, FactSet, and Wells Fargo Securities estimates. 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. 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.

(a) EV/EBITDA refers to the ratio of enterprise value to earnings before interest, taxes, depreciation, and amortization using current fiscal year estimates, based on Wells Fargo MLP universe. (b) P/E refers to the ratio of price to earnings, represented by Alerian MLP Index. Midstream yields based on Wells Fargo MLP universe. Long-term average refers to the 10-year average for EV/EBITDA, P/E and yield based on quarterly data. See page 11 for index representations, definitions and disclosures.
Midstream Energy as a Long-Term Allocation

Midstream energy and MLP securities feature several characteristics that we believe make them compelling long-term investments.

High current income. Yields on midstream securities are considerably greater than what is currently offered on other income investments, such as utilities and U.S. Treasury bonds (Exhibit 7). MLPs are pass-through tax vehicles that pay no tax at the corporate level. This tax efficiency and the relatively stable nature of the midstream business allow MLPs to distribute a high percentage of their cash flow to shareholders, providing an excellent source of current income, in our opinion. While midstream companies structured as corporations are subject to taxation at the entity level, they distribute a high percentage of their cash flow—which at current share/unit prices often results in high dividend yields. With coverage for distributions vastly improved with the shift to Midstream 2.0, we believe a high-quality portfolio of midstream companies can comfortably distribute 6–7% annually.

Following several years of distribution cuts, we believe midstream companies offer sustainable current income with strong distribution coverage.

History of attractive long-term returns. The long-term performance of midstream energy has been outstanding. Exhibit 8 charts the returns of MLPs along with U.S. and global stocks since the Alerian MLP Index’s inception.

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Low correlations to other assets indicate potential to enhance a portfolio's risk-adjusted returns.

Low overlap with broad equity indexes. Just three midstream companies are represented in the S&P 500, for a combined weighting in the index of less than 0.4%. Midstream companies compose a very modest 0.8% weighting in the broader-based Russell 3000 Index as well.

Low correlations. Midstream energy stocks have historically exhibited a low correlation in returns with equities, U.S. Treasury bonds and energy commodities (Exhibit 9). The low correlations to other assets provide portfolio diversification benefits, potentially enhancing risk-adjusted returns.

The high-yield credit market historically has had a relatively high correlation to midstream energy, since the capital-intensive businesses have traditionally relied on the debt market to fund growth projects. Also, as we saw in 2015 and again in 2018, when energy prices and capital markets become volatile, midstream correlations to both crude oil prices and credit spreads tend to rise in the short term. Changes in commodity prices generally have no direct bearing on the long-term contracts between pipeline operators and upstream and downstream companies, but they can affect energy volumes and risks for midstream counterparties. As commodity prices become more volatile, energy volumes become less predictable, increasing uncertainty in midstream revenue forecasts. Furthermore, movements in credit spreads can make counterparty risk a larger factor for investors (see page 3). However, we believe correlations to the high-yield bond market may subside over time as midstream businesses improve their balance sheets and self-fund their capital programs.

Exhibit 9: Midstream Energy Correlations Provide Diversification Benefits

<table>
<thead>
<tr>
<th>MLPs vs:</th>
<th>Equities</th>
<th>Fixed Income</th>
<th>Commodities</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>Utilities</td>
<td>REITs</td>
<td>10-Year U.S. Treasury</td>
</tr>
<tr>
<td>YTD</td>
<td>0.60</td>
<td>0.06</td>
<td>0.21</td>
</tr>
<tr>
<td>3 Year</td>
<td>0.55</td>
<td>0.10</td>
<td>0.35</td>
</tr>
<tr>
<td>5 Year</td>
<td>0.51</td>
<td>0.15</td>
<td>0.31</td>
</tr>
<tr>
<td>10 Year</td>
<td>0.58</td>
<td>0.33</td>
<td>0.43</td>
</tr>
</tbody>
</table>

At August 31, 2019. Source: Factset and Wells Fargo.

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Correlations with the Alerian MLP Index. Correlations data for fixed income products based on the average of monthly price changes. All other correlations are based on daily percentage changes. See page 11 for index representations, definitions and additional disclosures.
A New Era for Midstream Energy

All Three Drivers Aligned for Midstream

<table>
<thead>
<tr>
<th>Year</th>
<th>Secular</th>
<th>Valuation</th>
<th>Cyclical</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>✔️</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>The secular case for midstream energy has been building since 2016, as producers have reduced their breakeven cost of production and domestic- and export-driven energy demand has risen.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>✔️</td>
<td>✔️</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Midstream valuations cheapened in 2017 amid widespread distribution cuts and have yet to recover—despite improving fundamentals. In addition to screening attractively on industry-specific valuations, companies now compare well to the broad market on more commonly applied valuation approaches.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2019+</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td></td>
<td>Today, cyclical factors appear to be at an inflection point. Positive benefits of improving governance and business models, and clear signs of cyclical greenshoots for midstream assets, set the industry on course for favorable performance.</td>
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</table>

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Index Definitions

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

Global Stocks: The MSCI World Index – Net, a free-adjustable index that measures performance of large- and mid-capitalization companies representing developed market countries and is net of dividend withholding taxes.


Midstream Energy: Alerian Midstream Energy Select Index, a capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities.

MLPs: Alerian MLP Index (Total Return), a capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total MLP float-adjusted market capitalization.

REITs: The Nareit Equity REIT Index contains all tax-qualified REITs except timber and infrastructure REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria.

U.S. Stocks: The S&P 500 Index, an unmanaged index of 500 large-capitalization stocks that is frequently used as a general measure of U.S. stock market performance.

Utilities: The S&P 1500 Utilities Index, an unmanaged market-capitalization-weighted index of 60 companies for which the primary business involves the generation, transmission and/or distribution of electricity and/or natural gas.

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Risks of Investing in MLP Securities

An investment in MLPs involves risks that differ from a similar investment in equity securities, such as common stock, of a corporation. Holders of equity securities issued by MLPs have the rights typically afforded to limited partners in a limited partnership. As compared to common shareholders of a corporation, holders of such equity securities have more limited control and limited rights to vote on matters affecting the partnership. There are certain tax risks associated with an investment in equity MLP units. Additionally, conflicts of interest may exist among common unit holders, subordinated unit holders and the general partner or managing member of an MLP; for example, a conflict may arise as a result of incentive distribution payments.

MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment, including the risk that an MLP could lose its tax status as a partnership. MLPs may trade less frequently than larger companies due to their smaller capitalizations, which may result in erratic price movement or difficulty in buying or selling. MLPs may have additional expenses, as some MLPs pay incentive distribution fees to their general partners. The value of MLPs depends largely on the MLPs being treated as partnerships for U.S. federal income tax purposes. If MLPs were subject to U.S. federal income taxation, distributions generally would be taxed as dividend income. As a result, after-tax returns could be reduced, which could cause a decline in the value of MLPs. If MLPs are unable to maintain partnership status because of tax law changes, the MLPs would be taxed as corporations and there could be a decrease in the value of the MLP securities.

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