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 potential, and other portfolio-enhancing characteristics. We believe improving fundamentals and the adoption of a new 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 production and throughput volume expectations, 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, industry fundamentals are strengthening amid rising North American energy production, healthy consumption trends and infrastructure bottlenecks. 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 6) 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 8).

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.
A New Era for Midstream Energy

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 100 companies and a total market capitalization of $400 billion (Exhibit 1). Approximately 40% 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.

### 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. 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

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Exhibit 1: Cohen & Steers Midstream Energy Universe

**Market Cap ($ billions)**

<table>
<thead>
<tr>
<th></th>
<th>MLPs</th>
<th>Non-MLPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>MLPs</td>
<td>$108</td>
<td>$158</td>
</tr>
<tr>
<td>Non-MLPs 60%</td>
<td>$133</td>
<td>$133</td>
</tr>
</tbody>
</table>

**Representative Companies**

- **MPLX**
  - A $40 billion enterprise value, growth-oriented MLP formed by Marathon Petroleum Corporation to own, operate, develop and acquire midstream infrastructure assets
  - Considered a best-in-class operator of NGL, crude and refined products logistics assets, with gathering and processing assets in the Marcellus and Utica shales, including almost 9 billion cubic feet per day of processing capacity

- **Targa Resources**
  - A $17 billion enterprise value midstream corporation with the largest gathering & processing footprint in the prolific Permian Basin
  - Currently developing the $1.3 billion Grand Prix NGL pipeline, which will offer producers a full midstream value chain solution for NGLs—gathering, processing and transporting energy from the wellhead to the company’s Gulf Coast export terminal

- **Pembina**
  - A $24 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

*At December 31, 2018. Source: Alerian and Cohen & Steers. See page 11 for additional disclosures.*
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

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.

At December 31, 2018. Source: Cohen & Steers
Estimated revenue sensitivities to volumes and commodity prices. See page 11 for additional disclosures.

Commodities and Counterparty Risk

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 securities prices. 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.
**Price Differentials May Be a Sign of Investment Opportunities**

The purpose of the midstream energy industry is simple: to provide safe, efficient and low-cost transportation for energy commodities. However, the global energy industry is dynamic, with supply regions, demand centers and infrastructure needs shifting as market conditions change. These shifts will cause regional pricing differentials—the difference in price of commodities between location A and B—which are often a meaningful sign of where infrastructure is sufficient, how flows are evolving, and what needs to be constructed.

Energy trends in North America can shift rapidly due to the short cycle nature of shale drilling and even seasonal changes. Price differentials often adjust as infrastructure is placed into service and energy trends evolve.

Below are a few recent examples illustrating the continued opportunities we see for midstream firms (see corresponding numbers in Exhibit 3).

1. **Crude oil.** The fastest-growing region for crude oil production in North America, and likely the world, is the Permian Basin in West Texas. With the U.S. dramatically increasing its crude oil exports, much of this Permian crude oil wants to get to East Houston on the Gulf Coast for sale to foreign buyers. On August 31, 2018, crude oil in East Houston was trading for $76 per barrel, compared with $52 in Midland (the hub for Permian oil), a $24 pricing differential. Since it typically costs ~$2 per barrel to ship crude via pipeline and ~$7 by rail across this 500-mile corridor, the market was indicating that production had overwhelmed both takeaway options and was being trucked to the coast, a costly and less safe transport option. This pricing differential represents an opportunity for companies, as those with existing pipelines and truck capacity can take advantage of the wide locational differentials in the short term, and pipeline developers can build new pipeline infrastructure over the medium and long term.

2. **Natural gas liquids.** Ethane, the ‘lightest’ NGL, is a byproduct of oil and gas drilling and is typically turned into ethylene by petrochemical companies to use in plastics and other chemical products. From late 2014 through mid-2018, ethane in Mont Belvieu, TX, traded in a tight range of 15–25 cents per gallon (cpg). However, in September 2018 the price of ethane soared more than 150% to 60 cpg, as a dramatic increase in petchem demand coincided with limited fractionation capacity to produce the energy molecules. At the same time, ethane ‘stranded’ in Conway, KS, was trading at just 12 cpg! We believe this variance is a strong indicator that incremental fractionation infrastructure and NGL pipelines are required as the Gulf Coast petchem buildout continues in earnest, presenting an opportunity for firms in the gathering & processing sector.
3. **LNG exports.** Natural gas import prices in Singapore and Japan are currently ~$11/MMbtu, while prices at the Henry Hub in Louisiana stand at ~$3.00/MMbtu. U.S. energy companies can liquefy their gas for ~$3/MMbtu and ship it to Asia for ~$1.50/MMbtu, delivering to Asian consumers for ~$8/MMbtu. This global differential represents a long-term opportunity for midstream firms to continue building LNG export and shipping infrastructure.

Exhibit 3: Changing Market Dynamics Require New Infrastructure

Why Midstream Now?

Fundamentals Are Improving After a Challenging 2018

Midstream energy stocks struggled in 2018 as a series of events overshadowed significant positive developments for the asset class. These events included rising interest rates, a Federal Energy Regulatory Commission ruling on the tax treatment of MLPs, some poorly received mergers and distribution cuts, a Colorado ballot initiative aimed at curtailing drilling activity, declining crude prices and, finally, tax-loss selling. At year's end, the Alerian MLP Index was still more than 50% below its 2014 peak.

Yet midstream energy fundamentals 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, made more economical by advanced technologies and drilling techniques, has put the U.S. on course to become a net energy exporter in the coming years. In 2018, the U.S. became the world's largest crude oil producer for the first time since 1973, and the Energy Information Administration projects that domestic production of crude oil and natural gas will rise roughly 20% and 25%, respectively, through 2022. NGL production growth is expected to increase by more than 30% in the same five-year period.

2. **Increasing domestic consumption.** The largest use for crude oil by far is as a transportation fuel, and though fuel efficiency is rising, global oil demand continues to grow in aggregate. 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, creating new avenues to fill demand gaps with key consumers like China and India. As more energy molecules destined for foreign markets flow through pipelines and export facilities, midstream firms can collect more fees.

4. **Tightening pipeline supply.** Shale basins are often found in locations that have not been historical supply centers, which leads to heightened demand for infrastructure to gather and process the energy hydrocarbons. Yet 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.

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**Exhibit 4: Pipeline Constraints a Catalyst for Midstream Returns**

<table>
<thead>
<tr>
<th>Energy Volumes = Pipeline Demand</th>
<th>Midstream Capital Expenditures = Pipeline Supply</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Production</td>
<td>Total Exports</td>
</tr>
<tr>
<td>Total Consumption</td>
<td>Total Midstream Capital Expenditures</td>
</tr>
<tr>
<td>Quadrillion British thermal units</td>
<td>USD Billions</td>
</tr>
<tr>
<td>2010</td>
<td>2010</td>
</tr>
<tr>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>40</td>
<td>20</td>
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<td>50</td>
<td>30</td>
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<td>60</td>
<td>40</td>
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<td>70</td>
<td>50</td>
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</tbody>
</table>


Monthly U.S. crude oil, natural gas and liquefied petroleum gas (LPG) energy production, consumption and exports from the Energy Information Administration (EIA) based on the latest data available as of the most recent quarter end. All data shown is in quadrillion British thermal units (Btu). Midstream capital expenditure data and forecasts from Wells Fargo. See page 11 for additional disclosures.
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. Over the last 24 months, companies 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. Such steps may include paying down debt, internally funding growth opportunities and even buying back stock.

Broader investor appeal. As part of the transition to Midstream 2.0 and 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>
</tr>
</thead>
<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.
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 6). 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 7 charts the returns of MLPs along with U.S. and global stocks since the Alerian MLP Index’s inception.

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**Exhibit 6: Midstream Offers Competitive Yields**

<table>
<thead>
<tr>
<th>Current Yield</th>
<th>REITs</th>
<th>MLPs</th>
<th>MLP and Midstream Companies</th>
<th>Utilities</th>
<th>S&amp;P 500</th>
<th>10-year U.S. Treasury</th>
<th>High-Yield Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>2%</td>
<td>4%</td>
<td>6.8</td>
<td>8.9</td>
<td>4.4</td>
<td>3.4</td>
<td>2.2</td>
<td>2.7</td>
</tr>
<tr>
<td>At December 31, 2018. Source: Bloomberg.</td>
<td>Data quoted represents past performance, which is no guarantee of future results. See page 11 for index definitions and additional disclosures.</td>
<td></td>
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<td></td>
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</tbody>
</table>

**Exhibit 7: Growth of $100 and Annualized Returns Since 1995**


Data quoted represents past performance, which is no guarantee of future results. Returns since the 12/31/95 inception of the Alerian MLP Index. See page 11 for index definitions and additional disclosures.

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Low correlations. Midstream energy stocks have historically exhibited a low correlation in returns with equities, U.S. Treasury bonds and energy commodities (Exhibit 8). 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 8: 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>2018</td>
<td>0.63</td>
<td>0.18</td>
<td>0.39</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>0.35</td>
</tr>
<tr>
<td>10 Year</td>
<td>0.58</td>
<td>0.33</td>
<td>0.43</td>
</tr>
</tbody>
</table>

At December 31, 2018. Source: Wells Fargo and Cohen & Steers. Data quoted represents past performance, which is no guarantee of future results. Correlations with the Alerian MLP Index. See page 11 for index definitions and additional disclosures.
A Pipeline to Better Portfolios

Midstream energy companies have enjoyed tangible benefits from adopting the 2.0 business model. The reformers’ cost of capital and need to tap the capital markets have fallen, while leverage and distribution coverage ratios have improved—changes that are attracting a broader universe of investors. Adoption of the new model occurs amid sweeping favorable fundamental developments, including increasing energy production and throughput volumes, healthy end-user demand, rising exports and tightening pipeline supply.

Advantageous investment characteristics further bolster the case for having a midstream allocation. We believe the asset class’s high current income, low correlations to other asset classes and history of outperforming the broader equity market in both late cycle and recessionary periods of the economic cycle accentuate the compelling investment opportunity that exists in this asset class—one that remains significantly below record highs.

**Reasons to Own Midstream**

- Potential for high income and attractive total returns
- Low correlations potentially provide portfolio diversification benefits
- Better fundamentals amid rising North American energy production, infrastructure bottlenecks and improved corporate governance
- Predictable, fee-based cash flows without overdependence on commodity prices

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**Cohen & Steers**

**INFRASTRUCTURE • The Listed Alternative**

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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. Midstream Energy: Alerian Midstream Energy Index, a capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities. 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. 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. High Yield Bonds: The ICE BofAML U.S. High-Yield Index, tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The MSCI World Index – Net, a free-float-adjusted index that measures performance of large- and mid-capitalization companies representing developed market countries and is net of dividend withholding taxes. 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.

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