Five Reasons to Consider Preferred Securities if You Own Municipal Bonds

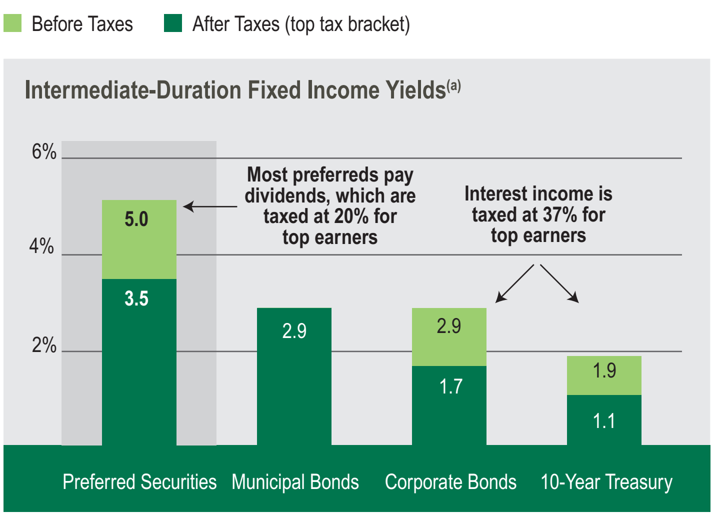
Many investors think of municipal bonds for tax-efficient income, often overlooking the higher after-tax yields of preferred securities. Here are a few reasons why we believe preferreds make a compelling complement to municipal bonds, especially with muni yields near historic lows.

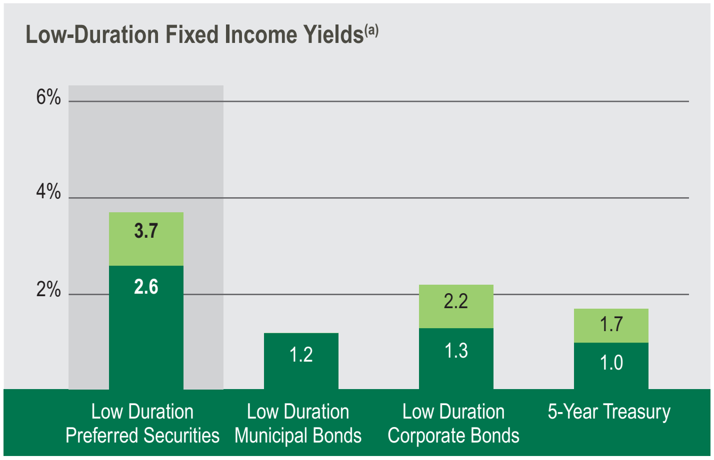
1. **High coupons from high-quality issuers.** Preferred securities are issued mostly by high-quality companies in the banking, insurance, real estate and utility sectors, many of them household names such as Bank of America, Prudential, AT&T and JPMorgan Chase. However, because preferreds sit lower 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 $50K per year in pre-tax income (see chart at left below). Assuming 65% QDI, that would translate to $35.1K per year after taxes for investors in the top tax bracket—providing $5.5K more in after-tax income than if it were fully treated as interest.[a] This compares favorably to municipal bonds, which potentially offer only $29K 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 consider low-duration preferred securities, which also offer attractive after-tax yields, as shown in the chart at right below.





At December 31, 2019. Source: Cohen & Steers, ICE BofAML.

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. 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 $5.5K based on $50K of income taxed as interest at the highest marginal rate of 40.8% ($29.6K after taxes), versus 65% of income assumed to be taxed as QDI, with an effective tax rate of 29.8% ($35.1K after taxes).

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.

Default rates: Long-term default rates for both preferreds and munis are comfortably below 1%, according to Moody's data going back decades. 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.

Maximum drawdowns: According to Morningstar, over the past five years, the preferred market's largest peak-to-trough decline was 4.2%, compared with 5.0% for municipal bonds. Preferreds may go through periods of volatility (as they did at the end of 2018), but have generally been stable due to financial reforms and the high-cash-flow, less cyclical nature of many preferred issuers.

5. **Better together.** Over the past five years, a 50/50 mix of municipal bonds and preferred securities would have delivered a higher return than municipals alone, with less volatility. 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.

Performance Characteristics, After Taxes

Five Years Ended 12/31/19

	Municipal Bonds	50/50 Mix	Preferreds
Annualized Return	3.6%	4.0%▲	4.4%
Standard Deviation	3.0%	2.5%▼	2.8%
Sharpe Ratio	0.83	1.17 ▲	1.17
After-Tax Yield	2.9%	3.2%▲	3.5%

At December 31, 2019. Source: Cohen & Steers.

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If you already own municipal bonds, talk with your financial advisor about shifting some of your allocation to preferred securities. This can broaden your portfolio's diversification—spreading risk across a wider range of issuers—while potentially enhancing take-home income.

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.

Index Definitions

An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes. Preferred Securities: ICE BofAML 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. **Municipal Bonds:** ICE BofAML 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 BofAML 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 BofAML 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 BofAML 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 BofAML 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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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.

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