Real Estate Securities

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REITs: Answering the Call for DC Plan Diversification

Thomas Bohjalian, CFA, Executive Vice President and Head of U.S. Real Estate
Jon Cheigh, Executive Vice President and Head of Global Real Estate

For fiduciaries looking to enhance diversification in defined contribution plans, we believe REITs can be a simple and effective addition to investment lineups, offering a long track record of benefiting investors and characteristics that may be well suited to the needs of DC plans.

Summary

- Real estate remains significantly under-represented in DC plans compared with the sizable allocations in most corporate and public pension plans.
- The $1.7 trillion global REIT market offers a wide range of opportunities to invest in different property cycles, macroeconomic trends and interest-rate environments.
- REITs have historically helped to enhance a portfolio's risk-adjusted returns due to low correlations with stocks and bonds, attractive total-return potential and inflation-hedging characteristics.

Real Estate in Retirement Portfolios

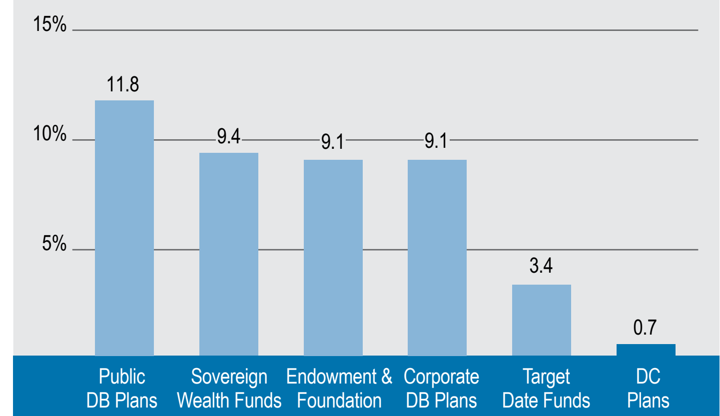
Institutional investors have long recognized real estate for its history of attractive returns, stable cash flows and low correlations with other asset classes. For these investors, real estate has typically been a significant long-term allocation, generally in the 5–15% range. By contrast, the defined contribution (DC) market has been slower to adopt real estate and other diversifiers, focusing predominantly on core equity and fixed income strategies.

According to financial data company Brightscope, only 45% of DC plans with at least 100 participants offer real estate in their investment menus. Among those that have it, allocations have averaged just 2% of plan assets. This is consistent with other data showing that overall real estate allocations across all DC plans are under 1%—well below levels found among institutionally managed defined benefit (DB) plans and other large investors (Exhibit 1).

We believe the low prevalence of real estate in DC plans presents an opportunity for providing both broader availability and greater participant education on the potential benefits of real estate exposure, bringing the best of DB practices to DC plans.

As the DC industry continues to evolve, many plan sponsors are recognizing the need to give participants access to more diversified investment choices to increase the chances of achieving their retirement income goals. This task has taken on greater urgency in recent years, as many participants are finding themselves behind in their savings targets, yet faced with the prospect of substandard market returns, low bond yields and higher volatility.

Exhibit 1. The DC Disconnect
Average Real Estate Allocation



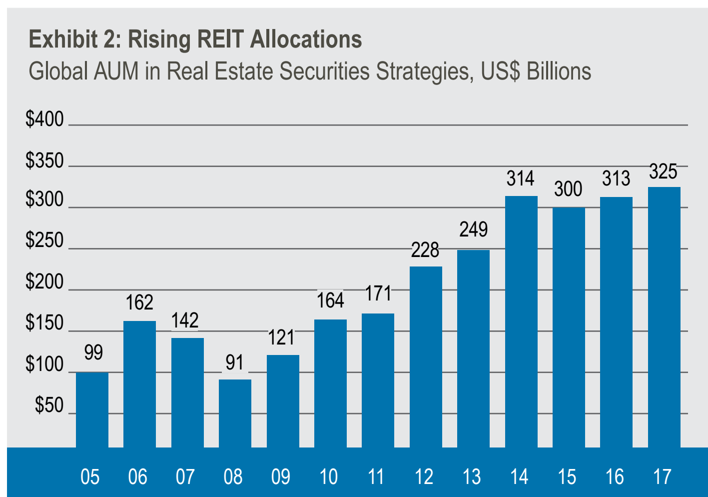
At December 31, 2017. Source: DC Plans: Greenwich Associates 2016 Institutional DC Trends (survey of the largest tax-exempt funds in the U.S.); Corporate DB Plans/Sovereign Wealth Funds/Endowment & Foundation/Public DB Plans: Cornell University and Hodes Weill & Associates, "Institutional Real Estate Allocations Monitor" (data represents average target real estate allocation among survey respondents, representing 244 institutions in 28 countries, with total assets under management of more than US$11.5 trillion and portfolio investments in real estate totaling approximately US$1.1 trillion across Target Date Funds: Morningstar, based on 20 largest 2030/2035 funds as of 9/30/2018.

See page 8 for additional disclosures.

Why REITs Are a Good Fit for DC Plans

To help address the need for broader diversification, many investors have turned to REITs and other real estate securities. Since 2005, global assets under management (AUM) in listed real estate portfolios have more than tripled, benefiting from increasing awareness of the historical benefits of REITs and a broader trend toward real return strategies (Exhibit 2).

Exhibit 2: Rising REIT Allocations
Global AUM in Real Estate Securities Strategies, US$ Billions



At December 31, 2017. Source: eVestment.
See page 8 for index definitions and additional disclosures.

We believe real estate securities are particularly well suited as a diversifier in DC plans for several reasons:

- **A long track record:** Most alternatives offer relatively little historical data, limiting the scope of risk-return analysis. By contrast, real estate securities indexes go back 45 years in the U.S. and 28 years globally, providing extensive evidence of the historical long-term benefits to investors.
- **Diversification potential:** REITs have historically helped to enhance portfolio efficiency over full cycles, providing strong, low-correlated returns relative to stocks and bonds.
- **Liquidity:** REITs trade on public stock exchanges, matching the daily liquidity and pricing needs of most DC plans.
- **Simplicity:** Compared with other alternatives, real estate investing is relatively straightforward and transparent, so participants may be more likely to understand and utilize real estate in their portfolio.

Market Overview

Real estate has seen a significant shift of capital from private investors to the public market over the past 30 years. This trend of real estate securitization has been driven largely by the emergence of the REIT structure as a viable and efficient way of gaining real estate exposure.

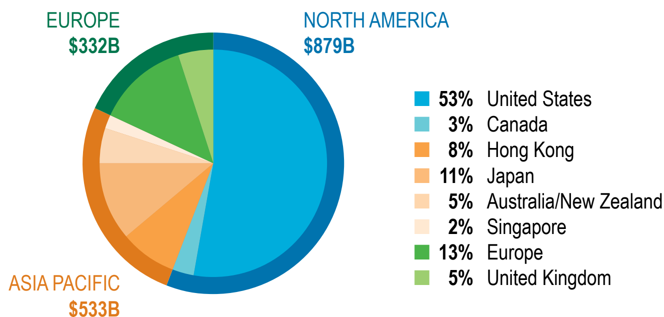
Today, 31 countries have REIT-like securities, and several more are considering REIT legislation (Exhibit 4 on next page). The widespread adoption of REITs has transformed the global real estate securities market, growing it from a $320 billion market in 2002 to $1.7 trillion today (Exhibit 3). About 75% of the market consists of REITs, with the remainder consisting of traditional real estate corporations.

With the globalization of listed real estate, investors have a wide range of opportunities in markets with meaningfully different characteristics. At any given time, property markets in each country may offer varying levels of risk and reward potential due to differences in their property cycles, macroeconomic conditions and interest-rate policies. There are also structural differences to consider, as discussed in Exhibit 4.

Furthermore, business models and supply-and-demand cycles can vary significantly across property sectors. A company that owns apartments will often have very different cash flow characteristics than one that owns offices. The reason has to do with differences in leasing terms, supply barriers and the specific economic drivers that affect a property's tenants (see sidebar at top of page 4).

Because of the diverse nature of real estate, there is often a wide spread between the best- and worst-performing country and sector over any given period (Exhibit 5). This dispersion creates opportunities for active fund managers to capitalize on different phases of each market's real estate cycle.

Exhibit 3: The Global Real Estate Securities Market

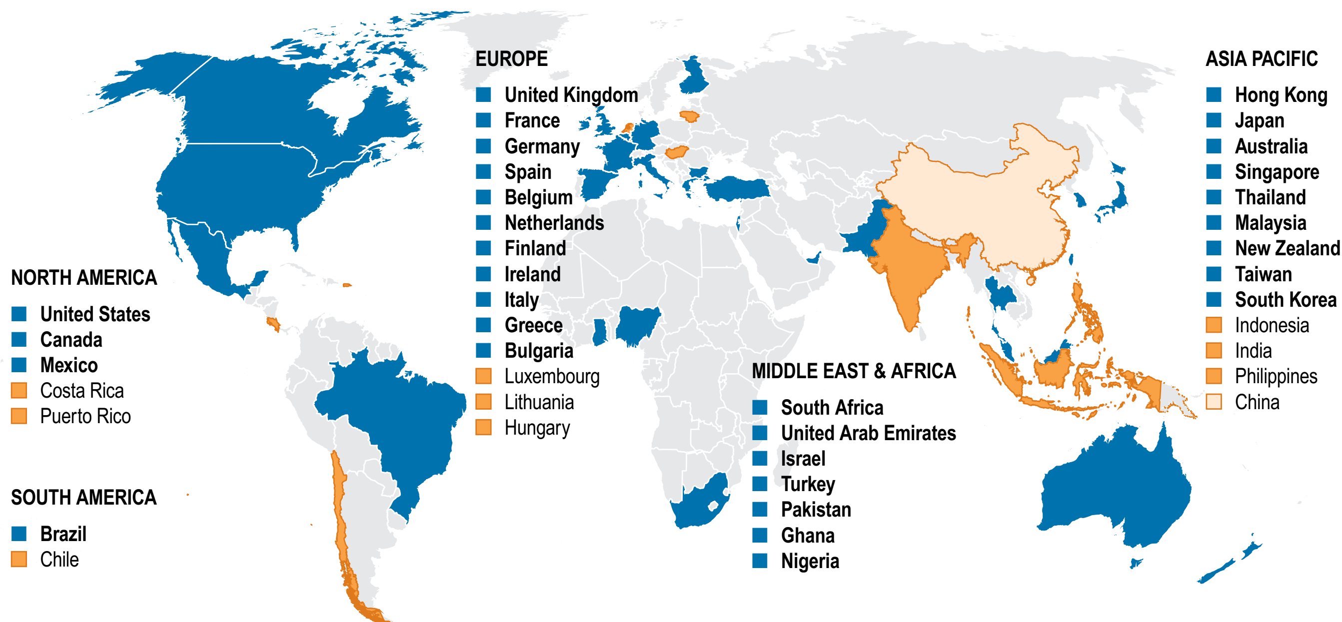


At September 30, 2018. Source: FactSet, Cohen & Steers.
As represented by the FTSE EPRA/Nareit Developed Real Estate Index. See page 8 for index definitions and additional disclosures.

Exhibit 4: Global REIT Adoption

Listed REITs | REIT Legislation in Progress | REITs Under Consideration

31 countries have REIT-like structures and several more are in the process of implementing REIT legislation



At September 30, 2018. Source: UBS, Cohen & Steers.

See page 8 for additional disclosures.

United States

The U.S. REIT structure has evolved into what we describe as the world's most efficient real estate operating model. A preponderance of strong corporate governance, transparency, sound business models and a history of effective use of capital has ensured ample access to public equity and debt markets at a generally low cost of capital. The breadth and depth of the U.S. market have made it easier for real estate companies to specialize, providing simple and efficient business models and encouraging market expansion into niche areas such as student housing and data centers.

Europe

European real estate companies tend to emphasize long leases that are fixed to inflation, resulting in relatively slow but stable cash flow growth. This steady income, combined with high barriers to new supply, has attracted strong investment demand for prime European assets. In recent years, European and U.K. REITs have begun to adopt important reforms, including simplified strategies involving less leverage, less development and a greater emphasis on cash flow. There has also been a shift toward more efficient capital raising, an issue that has somewhat constrained growth prospects in years past.

Asia Pacific

Due to broad economic expansion across the region and a greater emphasis on real estate development, Asia Pacific real estate companies tend to feature relatively high earnings growth. This characteristic is particularly evident in Hong Kong and Singapore. Changes to the Hong Kong REIT code have granted greater flexibility for investment companies to engage in development, although they remain less incentivized to form as REITs due to already-low corporate taxes. By contrast, Australia consists almost entirely of REITs that engage in very little development.

Distinct characteristics among countries and property sectors provide an opportunity for active fund managers to capitalize on different phases of each market's real estate cycle.

Differentiating Factors Among REIT Sectors

Lease Duration

Properties with shorter lease terms may benefit more from economic expansion, as landlords can adjust rents more quickly to capture rising demand. Properties with longer leases tend to have more predictable cash flows and may be more resilient in times of economic uncertainty.

Economic Drivers

Some aspects of the economy are more important than others in driving demand for a particular property type. For example, job growth directly affects the need for office space and apartments, but is less relevant to warehouses. Understanding these sensitivities helps inform fundamental analysis.

Construction Cycles

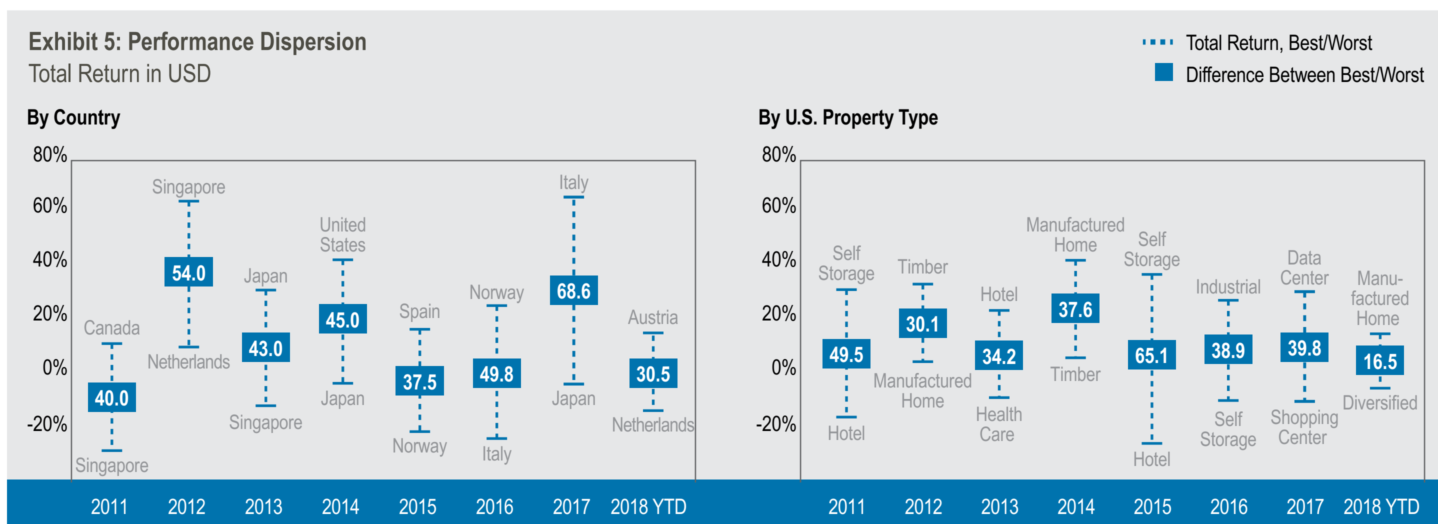
Sectors with shorter construction periods tend to have shorter property cycles, since developers can respond quickly to new demand. Construction lead times typically depend on the size and complexity of the building, the municipal approval process and infrastructure requirements.

Examples

Lease Duration	
Hotels	1 day
Self Storage	1 month
Shopping Centers	3–5 years
Health Care	8–10 years

Economic Drivers	
Apartment	Job growth/housing
Industrial	Exports/Manufacturing
Data Centers	Cloud computing
Office	Job growth/business outlook

Construction Cycles	
Self Storage	6 months
Shopping Center	1 year
Offices	1½–2 years
Hotels	2 years



At September 30, 2018. Source: Morningstar, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. Country and property type returns based on FTSE EPRA/Nareit Developed Real Estate Index and FTSE Nareit Equity REIT Index, respectively. See page 8 for index definitions and additional disclosures.

Investment Characteristics

The rationale for including REITs in DC plans is based on three historical benefits:

1. Diversification potential
2. Strong returns
3. Inflation protection

Diversification Potential

REITs have historically been effective diversifiers due to their tendency to react differently to market conditions than other asset classes and businesses. They share aspects of both stocks and bonds—responding to economic growth like equities, but with yield and lease-based cash flows that give them certain bond-like qualities. As an investment in tangible assets, REITs are subject to physical cycles based on supply and demand. They are also sensitive to credit conditions due to the capital-intensive nature of real estate. These distinct performance drivers have historically resulted in low correlations with other asset classes.

Over the past 25 years, U.S. REITs have been less tied to broad equities than most other sectors of the economy, with a correlation of 0.54 with the S&P 500 (Exhibit 6, lower table). Importantly, correlations have declined significantly since 2013 following a prolonged period of convergence during and after the global financial crisis (Exhibit 6, upper table).

Global REITs have also exhibited diversifying correlations—although to a more modest degree than the U.S. market, due largely to the higher correlations of Asia's real estate market with stocks in both Asia and the United States. As of September 2018, the global market had a 5-year correlation of 0.58 to global equities, consistent with its pre-crisis average.

Long-term correlations with bonds have generally been low as well despite the perception that REITs are among the more rate-sensitive assets. Over short time periods, sudden changes in bond yields can have a meaningful influence on REIT performance. However, over full cycles, we have found that rent growth tends to matter more to REITs than rising rates.

In recent years, worries over tighter monetary policies in the U.S. have led to higher bond correlations. This is not surprising to us considering that bond yields are coming off historical lows, which magnifies the percentage move of any change. As economic growth continues and interest rates return to "normal," we expect correlations to revert to lower typical levels.

Low correlations and strong historical performance indicate the potential of REITs to enhance risk-adjusted returns.

Strong Returns

Investing in REITs has historically produced compelling total returns, benefiting from stable business models typically focused on owning high-quality properties that generate a growing stream of cash flows, often with the added stability of corporate leases. Since the beginning of the modern REIT era in 1991, U.S. REITs have returned 11.5% per year—1.1% more than the S&P 500 and twice that of U.S. bonds (Exhibit 7). Compounded over those 27 years, REITs would have provided a 30% performance advantage over the broad stock market.

In fact, U.S. REITs have outperformed the S&P 500 in 18 of the 27 years over that time span. This includes the stretch from 2004 to 2006, when the Federal Reserve raised its benchmark rate 17 times against a backdrop of an accelerating economy and strong job growth. During that period, REITs had a cumulative return of 99.3% compared with 34.7% for the S&P 500, demonstrating that as long as real estate fundamentals are improving, REITs can perform well even if interest rates are rising.

Exhibit 6: Asset Class Correlations

5-Year Correlation Matrix (9/2013–9/2018)

	U.S. REITs	Global REITs	U.S. Stocks	U.S. Sm Cap	Global Stocks	Int'l Stocks	EM Stocks	U.S. Bonds	U.S. High Yield	Global Bonds
Global REITs	0.91									
U.S. Stocks	0.36	0.55								
U.S. Sm Cap	0.37	0.43	0.75							
Global Stocks	0.32	0.58	0.96	0.68						
Int'l Stocks	0.24	0.56	0.78	0.48	0.92					
EM Stocks	0.24	0.54	0.62	0.33	0.73	0.88				
U.S. Bonds	0.62	0.55	-0.09	-0.16	-0.07	0.01	0.14			
U.S. High Yield	0.33	0.52	0.64	0.52	0.73	0.77	0.69	0.21		
Global Bonds	0.37	0.53	0.12	-0.06	0.21	0.37	0.51	0.64	0.38	
Commodities	-0.07	0.10	0.23	0.20	0.31	0.41	0.45	-0.08	0.53	0.32

25-Year Correlation Matrix (9/1993–9/2018)

	U.S. REITs	Global REITs	U.S. Stocks	U.S. Sm Cap	Global Stocks	Int'l Stocks	EM Stocks	U.S. Bonds	U.S. High Yield	Global Bonds
Global REITs	0.82									
U.S. Stocks	0.54	0.69								
U.S. Sm Cap	0.62	0.69	0.81							
Global Stocks	0.56	0.76	0.95	0.80						
Int'l Stocks	0.53	0.77	0.83	0.74	0.96					
EM Stocks	0.45	0.73	0.71	0.68	0.80	0.86				
U.S. Bonds	0.19	0.21	0.03	-0.06	0.02	0.03	0.01			
U.S. High Yield	0.59	0.66	0.62	0.62	0.66	0.67	0.63	0.21		
Global Bonds	0.29	0.39	0.16	0.08	0.25	0.32	0.21	0.70	0.27	
Commodities	0.24	0.38	0.31	0.32	0.40	0.47	0.45	0.05	0.35	0.32

At September 30, 2018. Source: Morningstar, Cohen & Steers.

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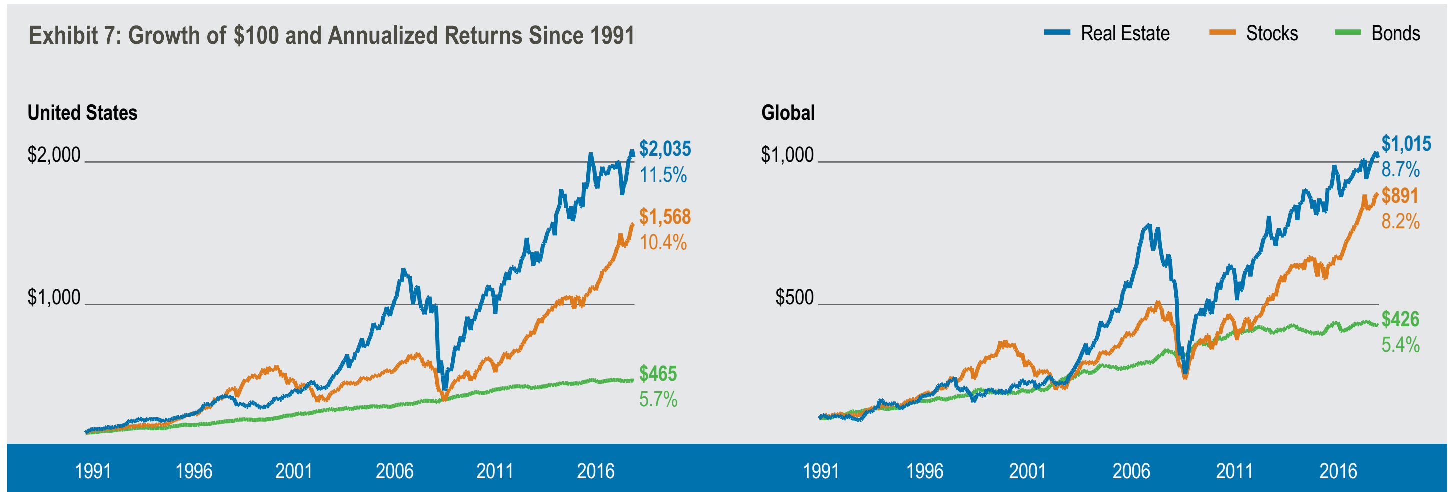
U.S. and global REITs have historically been among the top-performing asset classes over the long run.

Exhibit 7: Growth of $100 and Annualized Returns Since 1991



At September 30, 2018. Source: Morningstar, Cohen & Steers.

Exhibit 8: Asset Class Total Returns (%)

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	(2003–2017) Annualized Return	Volatility
EM Stocks 56.3%	Global REITs 38.0%	EM Stocks 34.5%	Global REITs 42.4%	EM Stocks 39.8%	U.S. Bonds 5.2%	EM Stocks 79.0%	U.S. REITs 28.0%	U.S. REITs 8.3%	Global REITs 28.7%	U.S. Sm Cap 38.8%	U.S. REITs 30.1%	U.S. REITs 3.2%	U.S. Sm Cap 21.3%	EM Stocks 37.8%	EM Stocks 12.7%	U.S. REITs 22.3%
U.S. Sm Cap 47.3%	U.S. REITs 31.6%	Global REITs 15.4%	U.S. REITs 35.1%	Global Stocks 9.6%	Global Bonds 4.8%	Global REITs 38.3%	U.S. Sm Cap 26.9%	U.S. Bonds 7.8%	EM Stocks 18.6%	U.S. Stocks 32.4%	Global REITs 15.9%	U.S. Stocks 1.4%	U.S. Stocks 12.0%	Global Stocks 23.1%	U.S. Sm Cap 11.2%	EM Stocks 21.4%
Global REITs 40.7%	EM Stocks 26.0%	U.S. REITs 12.2%	EM Stocks 32.6%	Global Bonds 9.5%	U.S. Sm Cap -33.8%	Global Stocks 30.8%	Global REITs 20.4%	Global Bonds 5.6%	U.S. REITs 18.1%	Global Stocks 27.4%	U.S. Stocks 13.7%	U.S. Bonds 0.6%	EM Stocks 11.6%	U.S. Stocks 21.8%	U.S. REITs 10.9%	Global REITs 18.8%
U.S. REITs 37.1%	U.S. Sm Cap 18.3%	Global Stocks 10.0%	Global Stocks 20.7%	U.S. Bonds 7.0%	U.S. Stocks -37.0%	U.S. REITs 28.0%	EM Stocks 19.2%	U.S. Stocks 2.1%	Global Stocks 16.5%	Global REITs 4.4%	U.S. Bonds 6.0%	Global REITs 0.1%	U.S. REITs 8.5%	U.S. Sm Cap 14.7%	Global REITs 10.4%	U.S. Sm Cap 18.2%
Global Stocks 33.8%	Global Stocks 15.2%	U.S. Stocks 4.9%	U.S. Sm Cap 18.4%	U.S. Stocks 5.5%	U.S. REITs -37.7%	U.S. Sm Cap 27.2%	U.S. Stocks 15.1%	U.S. Sm Cap -4.2%	U.S. Sm Cap 16.4%	U.S. REITs 2.5%	Global Stocks 5.5%	Global Stocks -0.3%	Global Stocks 8.2%	Global REITs 11.4%	U.S. Stocks 9.9%	Global Stocks 14.4%
U.S. Stocks 28.7%	U.S. Stocks 10.9%	U.S. Sm Cap 4.6%	U.S. Stocks 15.8%	U.S. Sm Cap -1.6%	Global Stocks -40.3%	U.S. Stocks 26.5%	Global Stocks 12.3%	Global Stocks -5.0%	U.S. Stocks 16.0%	U.S. Bonds -2.0%	U.S. Sm Cap 4.9%	Global Bonds -3.2%	Global REITs 5.0%	Global Bonds 7.4%	Global Stocks 9.5%	U.S. Stocks 13.2%
Global Bonds 12.5%	Global Bonds 9.3%	U.S. Bonds 2.4%	Global Bonds 6.6%	Global REITs -7.0%	Global REITs -47.7%	Global Bonds 6.9%	U.S. Bonds 6.5%	Global REITs -5.8%	Global Bonds 4.3%	EM Stocks -2.3%	Global Bonds 0.6%	U.S. Sm Cap -4.4%	U.S. Bonds 2.6%	U.S. REITs 5.2%	Global Bonds 4.2%	Global Bonds 5.7%
U.S. Bonds 4.1%	U.S. Bonds 4.3%	Global Bonds -4.5%	U.S. Bonds 4.3%	U.S. REITs -15.7%	EM Stocks -53.2%	U.S. Bonds 5.9%	Global Bonds 5.5%	EM Stocks -18.2%	U.S. Bonds 4.2%	Global Bonds -2.6%	EM Stocks -1.8%	EM Stocks -14.6%	Global Bonds 2.1%	U.S. Bonds 3.5%	U.S. Bonds 4.1%	U.S. Bonds 3.3%

At December 31, 2017. Source: Morningstar and Cohen & Steers.

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The story is similar for global indexes, with REITs and other real estate securities returning 8.7% compared with 8.2% for broad equities since 1991. Whether focusing on the U.S. or global markets, real estate has consistently been among the better performing asset classes (Exhibit 8), demonstrating the potential of real estate to enhance long-term returns.

One of the reasons for the REIT market's long-term outperformance has been its dividends. REITs are exempt from most corporate taxes, and in exchange, are required to distribute nearly all of their income in the form of dividends. For example, U.S. REITs must pay out at least 90% of their annual taxable net income to maintain their tax-advantaged status. As a result, REITs tend to pay higher dividend yields than other stocks with similar profiles. In addition, REITs must typically raise their dividends as cash flows grow in order to remain above the minimum level required by law.

Even though dividend income may not be relevant to plan participants in the accumulation phase, it can have a meaningful effect on total returns. Dividends tend to be a more stable source of returns than price appreciation, and reinvested dividends serve as a form of dollar-cost averaging, since a dividend check buys more shares when prices are lower and fewer shares when prices are higher.

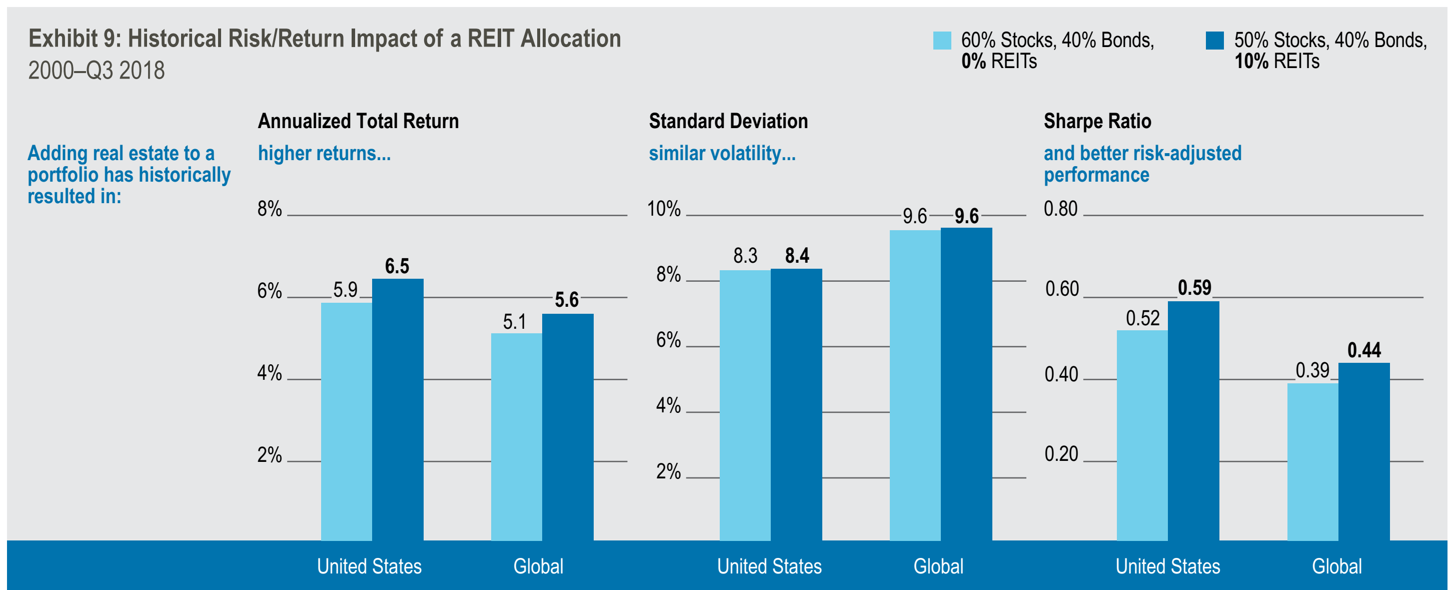
Due to the power of compounding, these dividends have historically added up to a sizeable advantage. Since 1991, dividends have accounted for more than half of the total returns for both U.S. and global REITs, whereas broad equity markets have generated only about a quarter of their returns from dividends.[1]

Inflation Protection

As an investment in hard assets, real estate has inherent inflation-hedging qualities that can help investors defend against the rising cost of living. An inflationary environment can drive up the cost of land, materials and labor, raising the threshold for new construction (constraining new supply) and enabling landlords to increase rents. Many commercial leases even have explicit inflation links, with rent escalators tied to a published inflation rate.

Implementing REITs in DC Plans

We believe adding REITs to DC investment lineups can be an effective way for fiduciaries to help plan participants diversify their portfolios and improve their potential outcomes. As shown in Exhibit 9 using data since 2000, shifting 10% of a stock and bond portfolio to REITs has historically led to higher total returns, similar volatility and better risk-adjusted performance.



At September 30, 2018. Source: Morningstar, Cohen & Steers.

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(1) Contribution of reinvested dividends is the difference between an index's price return and total return.

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Index Associations and Definitions

All returns and investment characteristics discussed in this report are based on the indexes below. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

Emerging market (EM) stocks: MSCI Emerging Market Index (net) is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Global bonds: Barclays Capital Global Aggregate Bond Index provides a broad-based measure of the global investment grade fixed-rate debt markets. Global real estate/ REITs: FTSE EPRA/Nareit Developed Real Estate Index (net) is an unmanaged market-capitalization-weighted total-return index, which consists of publicly traded equity REITs and listed property companies from developed markets. Global stocks: MSCI World Index (net) is a free-float-adjusted index that measures performance of large- and mid-capitalization companies representing developed market countries. International stocks: MSCI EAFE Index (net) is an equity index which captures large- and mid-capitalization companies in developed market countries excluding the U.S. and Canada. U.S. bonds: Barclays Capital U.S. Aggregate Bond Index is a broad-market measure of the U.S. dollar-denominated investment-grade fixed-rate taxable bond market, and includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities, and commercial mortgage-backed securities. U.S. High Yield: Barclays Capital U.S. Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt; Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EM countries are included; original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included. U.S. REITs: FTSE 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. small-cap stocks: Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe of the Russell 3000 Index. U.S. stocks: The S&P 500 Index is an unmanaged index of 500 large-capitalization stocks that is frequently used as a general measure of U.S. stock market performance.

Important Disclosures

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