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THE SCOTT LETTER is intended to educate global investors about closed-end funds. Closed-end funds can be a valuable and profitable investment tool. To learn about closed-end funds, visit our web site, www.CEFAdvisors.com, and in particular, read our article, *What Are Closed-End Funds*. Feel free to forward this newsletter to anyone who you believe could benefit from information on closed-end funds or global portfolios.

– George Cole Scott
Editor-in-Chief

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Cohen & Steers Sees Material Improvement in U.S. Commercial Real Estate Markets

Cohen & Steers Quality Realty Income Fund, Inc.

Cohen & Steers, which held assets under management of $31.2 billion as of September 30, 2010, is a manager of portfolios specializing primarily in U.S. and international real estate securities. Cohen & Steers Quality Income Fund has total assets of approximately $1.5 billion and seeks high current income through investing worldwide in real estate securities.

Income dividends are paid quarterly. As of October 29, 2010, the distribution rate was 8.49%. The recently raised distribution amount is now $0.18, payable quarterly. RQI has leveraged its total assets of approximately $985 million at 30%, down from 40.30% at the end of 2009. The investment mix hasn't changed materially since the end of the June 30, 2009 quarter.

The top five holdings, as of June 30, 2010, were Simon Property Group Inc., 8.71%; Public Storage, 3.00%; ProLogis, 2.89% and Vornado Realty, 2.84%, for a total of 18.15% of the portfolio.

Tom Bohjalian

Thomas N. Bohjalian, CFA (45) is senior vice president and the lead portfolio manager for the Cohen & Steers U.S. Quality Realty Income portfolios. He is assisted by William J. Scapeli and Joseph M. Harvey. Tom has over 21 years of investment experience.

Prior to joining the firm in 2002, Tom was a vice president and REIT analyst for five years at AEW Capital Management. He obtained his B.S. degree and MBA from Northeastern University and is based in New York.

We spoke to Tom on October 26, 2010.

SL: You have outperformed your index, particularly the important NAREIT Equity REIT index and the BAC Merrill REIT index. How useful are these measurements?

Bohjalian: For internal purposes, we use a blended benchmark that is 80% NAREIT Equity index and 20% BAC Merrill REIT Preferred index.

SL: How do you measure and justify the investment risks in your portfolio?

Bohjalian: We have a risk committee that reviews the Fund's leverage and holdings several times a year. I also review daily reports that measure our leverage and exposure to countries, sectors and stock positions.

We look for the best value and income companies with the strongest balance sheets and growth prospects. Companies that have high leverage and greater risks associated with cash flows are deleted.

Regarding investment risks, you have to look at the leverage and holdings of the Fund. I don't think that we are taking outsized risks relative to our return expectations, but that ultimately is in the eyes of the beholder.

SL: What views do you have on the state of the commercial real estate market now, and have you seen much improvement in recent months?

Bohjalian: We have seen a material improvement, particularly in supply and demand. On the demand side, the job market has stabilized as job losses have declined. Jobs have been added, although at a slower pace than we had anticipated, growing at about 1%.

The most important thing is the supply side of the equation which is very benign for commercial real estate. There is virtually no new supply being delivered over the next few years. That's very good, as excess supply is usually what kills most real estate cycles.

As the economy was peaking, the best use of land was residential. We did not have the overbuilding that we saw in prior cycles. The demand side is a little below trend, coming out of an economic recession, but we expect it to re-accelerate in 2011 and 2012. That will translate into better occupancies and longer term, higher rental rates.

SL: What about occupancy rates?

Bohjalian: Occupancy has bottomed across all property types, with short lease duration property types, like apartments and hotels, improving first. This is where we have also seen the most rental growth as they mark their leases to market very quickly.

Rent growth, for the most part, still remains benign. However, higher occupancy and rental growth are expected in 2011, and that should translate to bottom line cash flow growth.

The longer lease duration assets like office or industrial companies are marking-to-market their rents slower, with loss rollover every year. You are still seeing rents in some cases roll down from prior levels.

Markets like New York, Washington, D.C. and southern California have seen good demand as market rates have stabilized, and there is less negative mark-to-market.

Suburban markets are still seeing declining rents. This situation will most likely not stabilize and improve until the latter half of 2011. From a big picture standpoint, occupancies across all property types have stabilized. In shorter lease durations, occupancies have increased, but it will be the back half of 2011 before we see rent growth in most other property types, including suburban office, retail or industrial properties.

[**Editor's Note:** U.S. shopping malls have arrested their declines in occupancy and lease rates. It has been a slow recovery, but retail landlords caution that a stronger rebound will depend on job gains and renewed consumer confidence. (Source: *The Wall Street Journal)]*

Bohjalian: It is important to understand how fund valuations differ from the valuations of the underlying assets. In terms of the real estate securities of the funds, stocks in the U.S. are trading at roughly 10% premiums to their asset values.

To illustrate, if the cap rates (the metric used to evaluate the going-in yield for a real estate investment) continue to decline, the net asset values of our properties could rise. For example, the net asset values of Boston Properties or Vornado Realty could increase over the next 1-3 years by a combination of net operating income and lower cap rates.

For example, if you buy an asset for $100, for a yield of 7% (your cap rate), the Net Operating Income (NOI) divided by the cap rate equals the "value" of your investment. If you earn $7 of NOI and divide it by the 7% initial return, your value would be $100. Investors, on average, are looking for income. Ownership of real estate is income plus the potential growth associated with it.

Investors look at a 7% return on real estate, plus the potential for cash flow growth. They are more likely to buy if they think there is an attractive return profile relative to other investment alternatives. We have seen investors making more acquisitions in real estate as an alternative to lower yielding investments, e.g., corporate bonds or Treasuries. We also think that real estate values will continue to increase as cash flows grow, and the appeal of higher income plus growth occurs.

The discounts on our funds have recently shrunk. We announced that we would buy back our shares when the discounts got too wide. As they approached double-digit discounts in August, we repurchased shares in the third quarter.

[**Editor's Note:** On October 12, Cohen & Steers announced the number of shares repurchased for five of its funds during the quarter ended September 30, 2010. Of the five, RQI acquired 678,154 shares during the quarter and 1,068,654 shares since inception of the program.

Cohen & Steers purchased a higher number of shares for RQI than for the other four funds for the two periods, probably due to the larger capitalization of RQI.

The managers of Closed-End Fund Advisors are strong advocates of share repurchases on a regular basis. We have advised many funds of its importance, not just to try to reduce the discounts but also because it is in the shareholders' best interest. Most funds use a discount of 10% as a starting point for these programs. Prior to the year 2000 and to a lesser extent more recently, some managers have told us that it doesn't reduce discounts, which is untrue if they continually repurchase shares. Repurchases also raise investment returns as well as put a floor under the price of the fund, especially important in down markets.

We prefer investing in funds with discounts deeper than 10%, but over 20%, we avoid them as an indication that something isn't right. When discounts narrow to close to net asset value, we try to find another fund in the same sector with a deeper discount.]

Bohjalian: We also raised the distribution level. A portion of the distribution will be either taxable as ordinary income or as return of capital. A portion of the Fund's capital loss carryforward is available to offset the Fund's capital gains that are generated t hroughout the year.

Another important factor is the decreased leverage on the funds. At 30%, it is significantly lower, and we do not anticipate adding any more leverage to our funds as real estate values increase. These actions shrunk discounts, but they remain wide, based on the underlying real estate securities.

SL: We wonder how you define a wide discount. On September 8, RQI traded at a -19.18% discount, but it has since traded below 10%. When investors see good investment performance followed by dividend increases, they know that discounts will narrow magnifying their returns. We watch and monitor this very closely.

If we see that there may be a large return of capital from closed-end funds, we become very concerned. After we inquired about this, Doug Bond referred us to a press release (dated September 15, 2010) which indicated the boards of directors of Cohen & Steer Closed-End Funds said:

"The funds announced on September 15, 2010 that they will begin paying regular quarterly cash distributions to

common shareholders at a level rate, which may be adjusted from time to time, based on the projected performance of the fund. At times, to maintain a stable level of distributions, a fund may pay out more than its net investment income, possibly resulting in a return of capital which may be taxable as ordinary income. Return of capital includes distributions paid by a fund in excess of its net investment income and such excess is distributed from the fund's assets.

Under federal regulations, some or all of the return of capital may be taxed as ordinary income. In addition, distributions for funds investing in real estate investment trusts may be later characterized as capital gains and/or a return of capital, depending on the character of the dividends reported to each fund after year-end by REITs held by a fund.

The amount and composition of each fund's distribution is disclosed quarterly at www.cohenandsteers.com; however, this information may change at the end of the year because the final tax characteristics of all fund distributions cannot be determined with certainty until after the end of the calendar year. Final tax characteristics of all fund distributions will be provided on Form 1099-DIV, which is mailed after the close of the calendar year."

Cohen & Steers Quality Income Realty Fund (RQI)
Taxation of Historical Distributions: 2005 to 2009

Below are the classifications of the taxation of historical distributions and the return of capital for RQI from 2005 to 2009. (All figures are per share.)

Year	Total Distribution	Total Ordinary Income	Total Long-Term Capital Gain	Total Return of Capital
2005	$2.702	$0.802	$1.279	$0.621
2006	$3.805	$1.087	$2.156	$0.562
2007	$3.185	$0.879	$1.539	$0.768
2008	$1.800	$0.345	$0.000	$1.455
2009	$0.410	$0.262	$0.000	$0.148

SL: If the above isn't clear to our investors, Cohen & Steers recommends they consult their tax advisors.

Tom, how much of RQI is now invested in U.S. REIT equities and how much in fixed income?

Bohjalian: We hold roughly 75% equities and 25% fixed income. Of the fixed income, we are roughly 20% preferred and 5% long-term debt.

SL: We have mixed reports from such firms as Green Street Advisors that say real estate investment trusts hit bottom in mid-2009. Moody's Investors Service advises caution because it is still too early to call a bottom. This has perplexed investors who are trying to make investment decisions about their real estate investments. What are your views?

Bohjalian: We agree with Green Street that real estate values bottomed in mid-2009. The difference between the two services is that one follows unlevered and the other levered returns. To illustrate this point with a recent transaction, Boston Properties recently purchased the John Hancock Tower in Boston for about $900 million which, 12 months earlier, had sold for approximately $675 million.

Boston Properties believes that their internal rate of return (IRR), the unleveraged return on that asset, will be close to 7%, leveraged about 10%.

This sale may be on the low end for historical returns on an unlevered basis. Remember, the cost of capital is the lowest it has ever been. The John Hancock Tower is one of the three top assets in Boston. Boston Properties owns two other assets which should give them an advantage versus their office peers.

SL: What other properties do they own?

Bohjalian: One is 510 Madison Avenue in Manhattan, bought from a distressed seller, that will bring a 7.50% and 8.00% unlevered internal rate of return (IRR). The other was a suburban asset on Route 128 outside Boston, bought from another distressed seller. The return on the latter, we think, will be an unlevered IRR in the low teens.

SL: What are the right indexes for real estate valuations?

Bohjalian: The most efficient measure of value is the NAREIT Equity REIT index, which shows you where the valuations are going. This index typically rises before the underlying values increase and often goes down later. Green Street also does a very good job looking at unlevered returns for real estate. The Morgan Stanley REIT index and the NAREIT Equity index are available on the internet and are probably the best ones for your readers to use.

SL: Where do you think real estate valuations are going now?

Bohjalian: The values may not decline from here, unless we have some hiccuping in the global economy. We believe, and maybe this is a consensus view, that the U.S. economy will continue to grow at a modest 2.0% to 2.5%.

SL: Do the real estate prices reflect reality, and have valuations reflected estimates from market participants?

Bohjalian: There will be continued increasing growth in cash flows for the values of the REITs. Our view about total returns is that they will be more modest going forward over the next several years. There will probably be less multiple expansions, and returns will be more in line with cash flow plus dividend growth.

We expect dividends on REITs could increase about 50% over the next 4-5 years. Dividends could rise dramatically as companies normalize their payout ratios, coupled with cash flow growth.

SL: Please update us on your largest sector – apartments – which had a total return of 16.3% for the period.

Bohjalian: The apartment REITs have been one of the best performing sectors in the universe as they are early cyclical companies. There has been very good job growth (2.5%) in the age 18-35 cohort which is most important to the rental market, and there has also been a decoupling of households.

For example, in 2009, two guys who lived together in an apartment, because

neither was sure about their employment, found in 2010 that they would keep their jobs. As they wanted to be on their own, they "decoupled".

Public apartment companies are 90%-95% occupied and are pushing rates, translating into better numbers for apartment REITs. Growth in this sector should be mid-single digit, and growth is a function of supply as well as job growth.

SL: Please update us on your largest holding, Simon Property Group.

Bohjalian: Simon Properties is the nation's largest shopping mall owner. They offered to buy out rival General Growth Properties, which had filed for bankruptcy, but were rebutted. General Growth has now just emerged from bankruptcy and is splitting the company in two. One will be a core mall portfolio, comparable to Simon Property Group, and the other will hold lower quality retail assets and land.

SL: You have been overweight in the industrial sector, as you hold a large position in Prologis, a Denver-based owner of one of the world's largest distribution centers. This property recently sold a portfolio of commercial properties to Blackstone Real Estate Advisors for $1.02 billion to repay debt. How well has Prologis done for the portfolio?

Bohjalian: We have now lowered our position in the industrial sector. Prologis is attempting to raise about a billion dollars or about 20% of its market cap of new equity in order to continue to expand their business plan.

SL: We have an interesting sideline on Prologis. As there is not yet a green closed-end fund and green companies are on a fast track to growth, we have invested in the mutual fund, Winslow Green Growth Fund, for our clients. Winslow holds one million shares of Prologis.

Bohjalian: Really! We are aware that Prologis has some newer assets that are potentially leed-certified and that they are putting solar panels on top of their industrial buildings.

[**Editor's Note:** LEED certification is recognition that a construction project or building utilizes environmentally friendly practices. LEED stands for Leadership in Energy and Environmental Design. It was developed by the U.S. Green Building Council.]

Cohen & Steers Quality Income Realty Fund (RQI)

Average Annual Returns as of September 30, 2010

	3Q10	1 Year	3 Year	5 Year	Since Inception (2/28/2002)
RQI Market Price	26.95%	42.73%	-15.93%	-4.17%	4.65%
RQI NAV	18.96%	45.61%	-13.12%	-4.32%	6.64%
FTSE NAREIT Equity REIT Index	12.83%	30.28%	-6.05%	1.88%	9.76%
S&P 500 Index	11.29%	10.16%	-7.14%	0.64%	2.34%

Past performance is no guarantee of future results. The rate of return will vary and the principal value of an investment will fluctuate and shares, if sold, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Returns are historical and include change in share price and reinvestment of all distributions. The investment manager has contractually agreed to waive a portion of its management fee. Absent such waiver, NAV returns would have been lower. Performance results reflect the effects of leverage resulting from the Fund's issuance of preferred shares.

Leverage Facts as of September 30, 2010

Leverage (as of managed assets)	32.0%
% Fixed Rate	45.0%
% Variable Rate	55.0%
Weighted Average Rate on Swaps	3.5%
Weighted Average Term on Swaps	2.9 Years

While we do not attempt to predict what future interest rates will be, it has been our philosophy to utilize interest rate swap transactions to seek to reduce the interest rate risk inherent in our utilization of leverage. The use of leverage increases the volatility of the Fund's net asset value in both up and down markets.

SL: One reason we chose to interview you about RQI is because of its foreign holdings which have performed well over the years. Do you still have holdings in Australia?

Bohjalian: Today, we have a very small exposure to the foreign sector, about 1%. The economy of Australia continues to expand, but they have the headwind of rising interest rates as they try to dampen growth and inflation. The names that we own are "best in class" and have high dividend yields and better valuations than we can get in the U.S.

SL: With that scenario, we hope that you will again invest overseas for higher growth. Will you be expanding your overseas holdings as global growth continues?

Bohjalian: No, and we have minimal other international holdings. We have an office in Hong Kong, where we do our Australian and Asian work as well as offices in London and Brussels.

[**Editor's Note:** Last year, besides having large holdings in Australia, Cohen & Steers also held REITs in Japan and the U.K. After the merger with three of its REIT funds, this foreign exposure was diminished.]

We hope that the managers will again expand their foreign holdings as the world's economic engine in the developed markets returns to normal growth.

SL: We note that the expense ratio as of June 30, 2010 for RQI is quite high, even though assets have grown. Management fees are 1.26% and other expenses are 0.11%. Therefore, baseline expenses before interest is 1.37%, and interest expense is 0.65%, for a total of 2.02%.

Bohjalian: You have to be careful about the pure expense ratio because when we went from auction rate preferred to using a line of credit, the interest expense is included in our expense ratio. When we merged RWF, RPF and RLF into RQI in 2009, we created greater efficiencies. As RQI has grown over the last year, the operating costs have continued to decline. The figure you gave also includes the financing costs on the leverage.

To conclude, we are in the second inning of an economic and fundamental real estate recovery. The recapitalization that happened with REITs as they raised capital has put their balance sheets in great shape.

The second phase is acquisitions that should add to cash flow growth. Their cheaper cost of capital should aid companies' cash flows and growth.

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Finally, the fundamentals are getting better, and we think that the underlying holdings of RQI will show good dividend growth as REITs normalize their dividends after having cut them quite dramatically. ■

For more information please contact Cohen & Steers at 1-800-330-7348 or go to their website at www.cohenandsteers.com.

Disclosure: George Cole Scott and his family hold shares of Cohen & Steers Quality Income Realty Fund.

Portfolio Manager's Review

The interview on the real estate sector covers an important part of our portfolio diversification. Cohen & Steers manages four relatively high performing real estate funds which invest in REITs, primarily in the U.S. but with some overseas exposure as well. RQI absorbed three funds last year to make management more efficient. The result was a lower exposure to the foreign sector.

We were disappointed in their lower foreign allocation, because historically, this is where they often had the highest growth. While the domestic sector has performed very well in the last 12 months, we hope management returns to the global universe in a larger way as global growth resumes. Cohen & Steers still has three strong overseas offices whose aim is to find REITs with a record of providing outstanding returns.

We also think it is necessary to examine the issue of funds like Cohen & Steers that give back to their shareholders a return of capital. Their funds are leveraged, but at a lower rate (30%) than previously. In order to provide their shareholders with a steady cash flow of distributions on a regular basis, sometimes a portion of the invested capital is paid back to shareholders. Management rightly points out that some of this may be taxable, more in good times than bad, as economies go through the ups and downs of economic cycles. We, therefore, see the wisdom in what the management is doing, even when there is a possibility that some of the invested capital may be returned to shareholders.

The Value of Rebalancing

Closed-End Fund Advisors is now rebalancing client portfolios using Ameritrade which is more efficiently as it automatically sets the percentages for each investment category to fit the client's investment objectives. The goal of rebalancing is to avoid overweighting funds that have high performance assets and underweighting those with weaker performance.

In his classic book, *Unconventional Success,* David Swenson writes, "Investors who fail to rebalance portfolios to long-term targets end up with outsized exposure to recently appreciated assets that prove most vulnerable to poor future results. Only by regularly rebalancing portfolios to long-term targets do investors realize the results that correspond to the policy asset allocation decision."

David Swenson has a brilliant investment record as Yale's chief investment officer and best selling author of *Pioneering Portfolio Management.* He is one of our mentors and is the reason that we rebalance clients' portfolios in our endeavors to improve performance and mitigate investment risks.

In our next issue, we plan on again interviewing Dr. Mark Mobius, portfolio manager of Templeton Emerging Markets Fund, which covers the whole universe of the emerging markets. It will be sent to subscribers on February 1.

The editor of *The Scott Letter* would like to have feedback from our many readers as this helps us to serve you better. The best way to contact us is by writing, gscott@cefadvisors.com. ■

George Cole Scott

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