October 2018

High-Yield and Bank Loan Outlook

Beneath the Tide of Rising Earnings

With the Federal Reserve (Fed) now targeting 2.00–2.25 percent on fed funds, tightening monetary policy is putting increasing pressure on corporate borrowers’ balance sheets across the leveraged credit landscape. We estimate that about 30–50 percent of the increase in short-term borrowing costs to date has passed through to the cost of debt for leveraged credit, depending on sector, and we expect this passthrough to increase over the next 12 months as the Fed raises rates.

Strong earnings growth is masking this rise in borrowing costs, as interest coverage has improved over the past eight quarters. However, factors that have contributed to strong earnings growth—a favorable base effect from weakness in 2016 and 2017, and fiscal stimulus from tax cuts and government spending—will fade in 2019 and turn into headwinds by 2020. At the same time, the factors compelling the Fed to raise rates are only growing stronger, which will lead to even higher cost of debt. Given existing drivers, the balance of risk is to the downside for credit.

Report Highlights

- According to our tracked universe of just over 600 issuers, median year-over-year growth in earnings before interest, tax, depreciation, and amortization (EBITDA) was 12 percent in the second quarter of 2018, the highest since 2011.
- Strong earnings growth is masking the rising cost of debt. With earnings expected to peak this year while the Fed forges ahead into restrictive territory, we expect that now is as good as it gets for interest coverage.
- The share of leveraged credit issuers that recorded trailing 12-month losses in the second quarter of 2018—so-called “zombie” companies—is at a decade low. In our universe of issuers, only six had negative 12-month trailing EBITDA.
- We estimate that roughly 30–50 percent of the rise in short-term interest rates has passed through to loan issuer cost of debt, and we expect this passthrough to increase in the next 12 months.
Leveraged Credit Scorecard
As of 9.30.2018

High-Yield Bonds

<table>
<thead>
<tr>
<th></th>
<th>December 2017</th>
<th>July 2018</th>
<th>August 2018</th>
<th>September 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Spread</td>
<td>Yield</td>
<td>Spread</td>
<td>Yield</td>
</tr>
<tr>
<td>ICE Bank of America Merrill Lynch High-Yield Index</td>
<td>373</td>
<td>5.84%</td>
<td>357</td>
<td>6.36%</td>
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<tr>
<td>BB</td>
<td>228</td>
<td>4.43%</td>
<td>244</td>
<td>5.27%</td>
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<tr>
<td>B</td>
<td>381</td>
<td>5.89%</td>
<td>376</td>
<td>6.54%</td>
</tr>
<tr>
<td>CCC</td>
<td>850</td>
<td>10.54%</td>
<td>711</td>
<td>9.86%</td>
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</tbody>
</table>

Bank Loans

<table>
<thead>
<tr>
<th></th>
<th>December 2017</th>
<th>July 2018</th>
<th>August 2018</th>
<th>September 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DMM*</td>
<td>Price</td>
<td>DMM*</td>
<td>Price</td>
</tr>
<tr>
<td>Credit Suisse Leveraged Loan Index</td>
<td>416</td>
<td>97.63</td>
<td>388</td>
<td>98.20</td>
</tr>
<tr>
<td>BB</td>
<td>268</td>
<td>99.97</td>
<td>259</td>
<td>99.91</td>
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<tr>
<td>B</td>
<td>428</td>
<td>98.93</td>
<td>409</td>
<td>99.12</td>
</tr>
<tr>
<td>CCC/Split CCC</td>
<td>1,208</td>
<td>84.02</td>
<td>980</td>
<td>90.77</td>
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</tbody>
</table>


ICE Bank of America Merrill Lynch High-Yield Index Returns


Credit Suisse Leveraged Loan Index Returns

Macroeconomic Overview
More Incentive for Rate Hikes

It is difficult to ignore the preponderance of positive economic data in the United States. Financial conditions, as measured by the Chicago Fed’s National Financial Conditions index, remain loose. On a net basis, more banks are easing standards on commercial and industrial loans to large- and medium-sized firms, similar to conditions that prevailed in 2013, 2011, and even throughout the last hiking cycle between 2004–2006. Headline and core inflation are both accelerating, with the year-over-year change in the core personal consumption expenditures index now meeting the Fed’s 2 percent target. Finally, with third quarter U.S. economic growth tracking another 3 percent or higher, the pace of job creation is above the level needed to keep the unemployment rate steady. In September 2018, the U.S. private sector added 201,000 jobs compared to expectations of 190,000. We estimate that a monthly pace of less than 100,000 jobs created is needed to keep the unemployment rate unchanged. The economy is firing on all cylinders, thanks in part to a temporary fiscal boost, belying the fact that we are in a period of tightening monetary policy. A few weeks after the strong jobs report, the Fed delivered its eighth rate hike in three years to close the third quarter of 2018 with a fed funds target of 2.00–2.25 percent.

The seeds of the next recession are sown during the height of economic prosperity, and this time is no different. For example, lending standards typically loosen late in the cycle, and we have seen high-risk companies take advantage of the opportunity to borrow more. In the leveraged loan market, 70 percent of new-issue institutional loan volume this year has been rated single-B, up from an average of 62 percent over the last five years. Most of that debt is being used to finance acquisitions (which include leveraged buyouts) at cycle-tight spreads. Meanwhile, the investment-grade corporate bond market’s seemingly insatiable appetite for BBB-rated debt will have predictable consequences given the history of negative ratings migration during downturns. We estimate that at least 40 percent of BBB-rated companies in the Bloomberg Barclays U.S. Corporate index carry debt loads greater than 4x EBITDA, which is above an average BB-rated company debt multiple. Today’s easy financial conditions encourage greed even as the data urge caution.

Rumblings of crises resonating in emerging markets only add to risk. Turkey’s banking system is suffering from deteriorating asset quality due to the Turkish lira’s decline of almost 30 percent against the U.S. dollar since the United States imposed sanctions. To prevent a currency crisis and to control high inflation, the Central Bank of the Republic of Turkey was forced to raise benchmark rates to 24 percent from 17.75 percent in September. In the same vein, Argentina’s central bank was also forced to raise interest rates to 60 percent in August 2018 to stem the collapse of its peso, choking borrowing in a country already facing recession. The pressing question now is what other countries will suffer from a currency collapse prompted by political scandal or protectionist American

“The reality of strong economic growth, wage gains, and inflationary pressure will overtake the theoretical abstraction of the neutral rate that serves as the relative benchmark for monetary policy. Expect the Fed to tighten to a level above a rising neutral rate.”

– Scott Minerd, Chairman of Investments and Global Chief Investment Officer
policies. China, which is engaged in a protracted trade war with the United States, is a likely candidate, as is Indonesia, where the central bank has drained nearly 10 percent from foreign reserves as part of currency intervention exercises. Mirroring the Asian crisis in the late 1990s, issues in emerging markets continue to pose significant tail risks. Emerging markets’ problems will only get worse as the Fed raises rates, attracting ever more global capital to invest in dollar-denominated assets. The market is ignoring these risks based on where investors are pricing equities and credit.

We believe the Fed will continue its quarterly hiking path until rates reach 3.50 percent by the end of 2019. In addition to strong economic data, rising inflation, and a tight labor market, the Fed’s rising estimate of the real neutral rate of interest (r*)—the level at which monetary policy is neither expansionary nor contractionary for the economy—is the latest such signal. The second quarter r* estimate from the Laubach-Williams model showed a sizable upward revision to the past several years, along with an uptick to 87 basis points in the second quarter of 2018. This revision puts the estimate more in line with the June Federal Open Market Committee projections, which put the neutral rate at 88 basis points. Governor Lael Brainerd, long regarded a policy dove, recently suggested that the near-term neutral rate may be even higher than this revision. Some may view this estimate as abstract, but we believe it sets a relative benchmark for policy rate setting, one which the Fed will feel compelled to exceed next year as it considers taking policy into restrictive territory to forestall further declines in unemployment and a pickup in inflation.

Restrictive monetary policy will have consequences, some of which we explore in this report by diving into leveraged credit borrower income statements and balance sheets. For now, we expect that foreign investors will continue to see the United States as a haven of opportunity, given strong economic growth and attractive rates. We agree that compelling opportunities still exist, but we caution investors not to take on too much risk at this point in the credit cycle and to take advantage of market exuberance to sell into strength and move up in credit quality.

The Rising Tide of Earnings

Earnings growth in the leveraged credit market has been significant. Among our coverage universe of approximately 600 issuers, median year-over-year EBITDA growth was 12 percent in the second quarter of 2018, the highest since 2011 (see chart, next page), and some 72 percent of issuers recorded positive growth. While the balance of issuers experiencing negative EBITDA growth appears high at 28 percent, it compares favorably to the past 12-quarter average of 41 percent. The last time 28 percent of issuers experienced negative EBITDA growth was in 2007; since then it has always been higher, according to our universe. The share of leveraged credit issuers that recorded losses, so-called “zombie” companies, is at a decade low. In our universe of issuers, only six had negative 12-month trailing EBITDA as of the second quarter of 2018, five of them in the consumer discretionary sector.
According to our universe of approximately 600 issuers, median year-over-year EBITDA growth was 12 percent in the second quarter of 2018, the highest since 2011. Some 72 percent of issuers recorded positive growth. Median interest coverage (12-month trailing EBITDA/rolling four-quarter interest expense) was 4.3x for all issuers in our tracked universe as of the second quarter of 2018. Only 13 percent of issuers have less than 2x interest coverage, a level we consider stressed and consistent with high-default periods (see chart below). This share also reflects the current makeup of the market in which CCC-rated borrowers comprise just 11 percent. In 2016, 20 percent of issuers had interest coverage below 2x, prompting a series of rating downgrades and some defaults.

The percentage of leveraged credit issuers reporting weaker interest coverage (those with coverage of less than 2x) has recovered to pre-crisis levels.

Earnings Growth Has Recovered Strongly Since 2016 Low

Source: ICE BofA Merrill Lynch, Credit Suisse, Factset, Guggenheim Investments. Data as of 6.30.2018. We use median statistics to smooth large swings in earnings growth, particularly in downturn and recovery phases. Data is only available for publicly traded issuers, or approximately 60 percent of the Credit Suisse Leveraged Loan index and 70 percent of the ICE BofA Merrill Lynch High Yield Bond index. Shaded area represents period of recession.

Median interest coverage (12-month trailing EBITDA/rolling four-quarter interest expense) was 4.3x for all issuers in our tracked universe as of the second quarter of 2018. Only 13 percent of issuers have less than 2x interest coverage, a level we consider stressed and consistent with high-default periods (see chart below). This share also reflects the current makeup of the market in which CCC-rated borrowers comprise just 11 percent. In 2016, 20 percent of issuers had interest coverage below 2x, prompting a series of rating downgrades and some defaults.

Tracking the Periphery: Few Issuers Report Poor Interest Coverage

Earnings growth and interest coverage look better for some sectors than others, but all look relatively healthy for now. The energy sector continues to lead growth, with median year-over-year EBITDA growth at 39 percent as of the second quarter 2018 (see chart below), a reflection of the industry’s high operating leverage. Median interest coverage for that same universe is 4.4x, with 95 percent of energy issuers reporting higher 12-month trailing EBITDA than one year of interest expense (i.e. interest coverage greater than 1x), although 16 percent of these issuers have less than 2x interest coverage. Nonetheless, this is a marked improvement from mid-2016 when a quarter of the energy market generated lower 12-month EBITDA than interest expense.

The utilities and communications sectors are the weakest, with 2 percent and 5 percent year-over-year earnings growth, respectively, and interest coverage below other sectors. These are not the only two metrics that our credit analysts review, but we find it concerning that despite weaker growth and lower coverage, the utilities sector trades at the tightest spread compared to other sectors in both high-yield and bank loan markets. Investors are simply not being compensated for risk. Meanwhile, energy looks the cheapest based on spread, and though median interest coverage in financials appears to be below average, it is typically not a ratio that applies to the industry as a measure of fundamental health, and 10 percent earnings growth is healthy.

In general, strong EBITDA growth and improved interest coverage pushed leveraged credit risk premiums to cycle tights as the market took note of strengthening fundamentals. Spreads currently stand at 339 basis points in the high-yield corporate bond market, and discount margins are 381 basis points in the bank loan market (see chart, next page), representing the ninth- and 20th percentile risk premium (0 percentile=historical tights), respectively, based on all
Strong EBITDA growth and improved interest coverage pushed leveraged debt risk premiums to cycle tights of 360 basis points in high-yield corporates, and discount margins of 388 basis points in the bank loan market.

### Spreads and Discount Margins Set Cycle Tights

<table>
<thead>
<tr>
<th></th>
<th>High-Yield Corporate Bond Spreads</th>
<th>Average</th>
<th>Bank Loan Three-Year Discount Margin</th>
<th>Average</th>
<th>Recession</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spread (basis points)</td>
<td>2,000</td>
<td>1,500</td>
<td>1,000</td>
<td>500</td>
<td></td>
</tr>
</tbody>
</table>


available historical data. Given the average maturity in each market is between five and seven years, this suggests that investors have an unrealistically positive credit outlook in the face of the Fed’s planned policy tightening. A more balanced view incorporates the positive tailwind of strong earnings growth against the headwind of the rising cost of debt.

### The Countercyclical Impact of Monetary Policy

The market is responding more to the rising tide of earnings than it is to tightening monetary policy. Commercial and industrial loans outstanding grew 5.7 percent year over year in July 2018, compared to almost flat growth at the same time last year. Consumer loans issued by commercial banks are up almost 9.0 percent year over year as of August 2018, compared to 4.4 percent growth in August 2017. The cost of borrowing is rising as monetary policy tightens, however, and this is increasingly evident in corporate income statements.

It is easier to see how the Fed raising interest rates leads to higher borrowing costs in the bank loan market. The increase in the London interbank offered rate (Libor) of about 180 basis points since December 2015 has led to a rise in cost of floating-rate loan debt. The median annual cost of debt troughed at 4.9 percent in 2015 but is averaging 5.7 percent as of June 2018, according to a loan-issuer universe we track internally. A back-of-the-envelope calculation suggests that about 58 percent of the rise in short-term interest rates has passed through to loan issuers’ cost of debt, and we expect this passthrough to increase in the next 12 months due to the shift from refinancing activity to adding new debt.
Fixed coupons are common in most of the high-yield market, which means the effect of rising short-term interest rates is less obvious for corporate debt issuer borrowing costs unless the issuer is raising new debt or rolling over maturing debt at higher yields. In our universe of issuers, we found that total balance sheet debt has increased by 17 percent among publicly traded high-yield corporate bond issuers. Another passthrough channel has been floating-rate debt that already sits on crossover issuer balance sheets (those that issue in both bond and bank loan markets). For example, of the top 20 issuers in the ICE BofA Merrill Lynch High Yield index, 13 have a mix of first- or second-lien loans outstanding in addition to varying levels of bonds and notes. More broadly, 36 percent of issuers in the ICE BofA Merrill Lynch High-Yield Corporate Bond index have bank loans outstanding, representing 46 percent of debt par value (see chart below).

Of the top 20 issuers in the ICE BofA Merrill Lynch High Yield index, 13 have a mix of first- or second-lien loans outstanding in addition to varying levels of bonds and notes. More broadly, 36 percent of issuers in the ICE BofA Merrill Lynch High-Yield Corporate Bond index have bank loans outstanding, representing 46 percent of debt par value.

Most Issuers’ Debt Portfolios Contain Both Loans and Bonds
Share of total Indexed Leveraged Credit Market Debt Outstanding

The cost of debt has been rising for almost every subset of the leveraged credit market. For bond-only issuers, the median cost of debt troughed at 5.3 percent in 2015 and was 5.8 percent in the second quarter of 2018. For the broader leveraged credit market, including bond-only issuers, loan-only issuers, and crossover issuers, the cost of debt troughed at 5.3 percent in 2015 and was most recently 5.6 percent (see chart, next page). We believe this trend is somewhat overlooked by investors who focus on narrowing spreads over Treasurys or Libor, historically low portfolio yields, and exceptional earnings growth.
For the broader leveraged credit market, including bond-only issuers, loan-only issuers, and crossover issuers, the cost of debt troughed at 5.3 percent in 2015, and was most recently 5.6 percent.

Median Cost of Debt in Leveraged Credit Is Rising

![Line chart showing the median cost of debt for different types of issuers over time.]

Source: ICE Bank of America Merrill Lynch, Credit Suisse, Factset, Guggenheim Investments. Data as of 6.30.2018. Based on a universe of 607 publicly traded issuers where we could obtain income statement and balance sheet data. Guggenheim estimates assume there is a 50 percent passthrough from the Fed raising interest rates to cost of debt, according to Guggenheim’s expectations of Fed hikes over the next five quarters. Guggenheim estimates are intended to be illustrative.

Investment Implications

Strong earnings growth, healthy interest coverage, and easy access to financing leads us to expect default volume will remain low over the next 12 months, but the tide will start to turn in 2019. Factors that have contributed to strong earnings growth—a favorable base effect from weakness in 2016 and 2017, and fiscal stimulus from tax cuts and government spending—are expected to fade in 2019 and turn into headwinds by 2020. Earnings growth also faces tail risks from unintended consequences of trade wars, namely lower exports for some and rising import costs for others. Meanwhile, the factors compelling the Fed to raise rates—such as inflationary pressures from strong economic growth and a very low unemployment rate—are only growing stronger.

We expect another rate hike in 2018, and four more rate hikes in 2019, translating into at least another 125 basis-point increase in short-term borrowing costs over the next 12-15 months. If we assume only 50 percent passthrough onto median cost of debt across the 10 major Global Industry Classification Standard industries in leveraged credit, half of those industries would have to generate equal or stronger EBITDA growth in the next 12 months than they did in the second quarter of 2018 in order to maintain interest coverage at current levels (see chart, next page). Given the multitude of headwinds and fading fiscal stimulus, we do not see a catalyst for such strong earnings growth next year. This means that interest coverage and debt multiples are likely to worsen next year. The key will be to identify which credits are outliers in this scenario, and that can only be done using a bottom-up fundamental approach.
Five of the 10 major Global Industry Classification Standard industries in leveraged credit will have to generate equal or higher earnings growth next year to maintain current interest coverage. Given the multitude of headwinds and fading fiscal stimulus, we do not see a catalyst for such strong earnings growth next year.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Increase in Median Cost of Debt from Cycle Lows</th>
<th>Q2 2018 Median Cost of Debt</th>
<th>Q2 2018 Median Interest Coverage</th>
<th>Q2 2018 YoY LTM EBITDA Growth</th>
<th>Earnings Growth Needed to Stabilize Interest Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Materials</td>
<td>0.29%</td>
<td>5.83%</td>
<td>5.3x</td>
<td>16.2%</td>
<td>8.6%</td>
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<tr>
<td>Communications</td>
<td>0.40%</td>
<td>6.00%</td>
<td>3.1x</td>
<td>4.9%</td>
<td><strong>8.3%</strong></td>
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<tr>
<td>Consumer, Cyclic</td>
<td>0.36%</td>
<td>5.42%</td>
<td>4.6x</td>
<td>9.3%</td>
<td><strong>9.2%</strong></td>
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<tr>
<td>Consumer, Non-cyclical</td>
<td>0.41%</td>
<td>5.43%</td>
<td>4.3x</td>
<td>6.5%</td>
<td><strong>9.2%</strong></td>
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<td>Energy</td>
<td>1.07%</td>
<td>6.53%</td>
<td>4.4x</td>
<td>38.7%</td>
<td>7.7%</td>
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<tr>
<td>Financial</td>
<td>0.34%</td>
<td>4.88%</td>
<td>3.1x</td>
<td>9.8%</td>
<td>10.2%</td>
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<tr>
<td>Industrial</td>
<td>0.53%</td>
<td>5.75%</td>
<td>4.9x</td>
<td>13.6%</td>
<td><strong>8.7%</strong></td>
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<tr>
<td>Technology</td>
<td>0.95%</td>
<td>5.32%</td>
<td>5.5x</td>
<td>11.2%</td>
<td><strong>9.4%</strong></td>
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<tr>
<td>Utilities</td>
<td>0.21%</td>
<td>5.75%</td>
<td>3.0x</td>
<td>1.8%</td>
<td><strong>8.7%</strong></td>
</tr>
</tbody>
</table>

Source: ICE BofA Merrill Lynch, Credit Suisse, Guggenheim Investments. Data as of 6.30.2018. Assumes 50 percent passthrough impact on median cost of debt from Guggenheim’s projection of Fed rate hikes over the next 12 months. Red font indicates sectors that will need to generate equal to or higher earnings growth next year compared to the second quarter 2018 in order to keep interest coverage unchanged, all else equal.

Our interest-rate outlook suggests the balance of risks for credit is skewed to the downside. We expect investors will recognize the negative balance of risks building next year and price it into spreads. This explains why, on average, credit spreads tend to widen a year in advance of a recession, based on our analysis of the past three cycles (see chart below).

On average, credit spreads tend to widen a year in advance of a recession. This presents an opportunity for our Sector teams to continue finding value across the credit universe. We prefer less cyclical, more cash-heavy borrowers because they will be better equipped to survive the coming downturn.

For Guggenheim, this presents an opportunity for our Sector teams to continue finding value across the credit universe even as they maintain a more defensive approach than earnings trends alone might suggest. We prefer less cyclical, more cash-heavy borrowers because they will be better equipped to survive the coming downturn. Now is not the time to chase yield, but to take advantage of exuberant markets to move up in quality and position for the recession in early 2020, which means positioning for spread widening to begin next year.
High-Yield and Bank Loan Outlook

The discount margin, also referred to as discount margin to maturity (dmm), is the yield-to-refunding of a loan facility less the current three-month Libor rate, assuming a three-year average life for the loan.

The London Interbank Offered Rate (Libor) is a benchmark rate that a select group of banks charge each other for unsecured short-term funding. Spread is the difference in yield to a Treasury bond of comparable maturity.

Ebitda, which stands for earnings before interest, taxes, depreciation and amortization, is a commonly used proxy for the earning potential of a business.

RISK CONSIDERATIONS

Fixed-income investments are subject to credit, liquidity, interest rate and, depending on the instrument, counter-party risk. These risks may be increased to the extent fixed-income investments are concentrated in any one issuer, industry, region or country. The market value of fixed-income investments generally will fluctuate with, among other things, the financial condition of the obligors on the underlying debt obligations or, with respect to synthetic securities, of the obligors on or issuers of the reference obligations, general economic conditions, the condition of certain financial markets, political events, developments or trends in any particular industry. Fixed-income investments are subject to the possibility that interest rates could rise, causing their values to decline.

Bank loans are generally below investment grade and may become nonperforming or impaired for a variety of reasons. Nonperforming or impaired loans may require substantial workout negotiations or restructuring that may entail, among other things, a substantial reduction in the interest rate and/or a substantial write down of the principal of the loan. In addition, certain bank loans are highly customized and, thus, may not be purchased or sold as easily as publicly-traded securities. Any secondary trading market also may be limited, and there can be no assurance that an adequate degree of liquidity will be maintained. The transferability of certain bank loans may be restricted. Risks associated with bank loans include the fact that prepayments may generally occur at any time without premium or penalty. High-yield debt securities have greater credit and liquidity risk than investment grade obligations.

High-yield debt securities are generally unsecured and may be subordinated to certain other obligations of the issuer thereof. The lower rating of high-yield debt securities and below investment grade loans reflects a greater possibility that adverse changes in the financial condition of an issuer or in general economic conditions, or both, may impair the ability of the issuer thereof to make payments of principal or interest. Securities rated below investment grade are commonly referred to as "junk bonds." Risks of high-yield debt securities may include (among others): (i) limited liquidity and secondary market support, (ii) substantial market place volatility resulting from changes in prevailing interest rates, (iii) the possibility that earnings of the high-yield debt security issuer may be insufficient to meet its debt service, and (iv) the declining creditworthiness and potential for insolvency of the issuer of such high-yield debt securities during periods of rising interest rates and/or economic downturn. An economic downturn or an increase in interest rates could severely disrupt the market for high-yield debt securities and adversely affect the value of outstanding high-yield debt securities and the ability of the issuers thereof to repay principal and interest. Issuers of high-yield debt securities may be highly leveraged and may not have available to them more traditional methods of financing.

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