GUGGENHEIM

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High-Yield and Bank Loan Outlook

The Pre-Recession Playbook for Up in Quality

Investment Professionals

Anne Walsh, JD, CFA
Chief Investment Officer,
Guggenheim Partners
Investment Management

Thomas J. Hauser
Senior Managing Director,
Portfolio Manager

Brian Smedley
Chief Economist,
Head of Macroeconomic
and Investment Research

Maria M. Giraldo, CFA
Managing Director and
Strategist, Macroeconomic
and Investment Research

Joseph Bowen, CFA
Vice President

Rebecca Curran
Vice President

Ravi Tamboli, CFA
Vice President

Brian McAuliff
Associate

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Summary

The failure of two banks with ties to the high-tech sector ignited concerns about the health of the banking system and worries that a contraction in bank lending will precipitate a slowdown. Meanwhile, as inflation continued to show few signs of abating, the Federal Reserve (Fed) maintained its rate-raising efforts. A recession and higher rates pose challenges for the high-yield and bank loan markets, in which pessimism has risen. Issuer fundamentals, however, are far less bleak than current sentiment would indicate, but they show signs of softening. We foresee a bumpy ride over the course of 2023, which, in our view, is likely to offer opportunities to take advantage of excessive pessimism.

Highlights from the Report

- Lending standards are likely to continue tightening following the regional banking sector-related stresses, which portends higher default rates.
- Interest coverage ratios and balance sheet cash remain robust but have declined ahead of a potential earnings recession. We expect coverage and leverage ratios to deteriorate further as the effect of tighter financial conditions takes its toll on the economy, causing corporate earnings to fall.
- We remain defensive and are staying up in quality in our portfolios, but the expression of this theme does not always translate into a preference for higher credit ratings, particularly when ratings are changing and are therefore less reliable. Other metrics we consider are debt seniority and business profile, which can sometimes make a B-rated credit more attractive than a BB-rated credit.

Leveraged Credit Scorecard
As of 3.31.2023

High-Yield Bonds

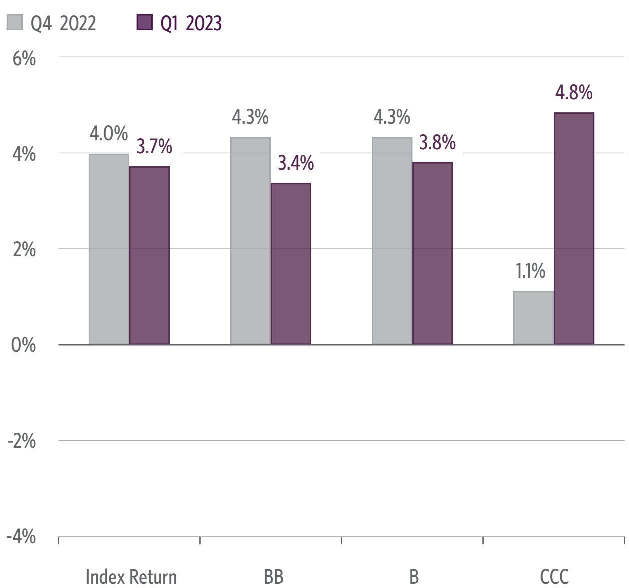
	December 2022		January 2023		February 2023		March 2023	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	491	9.0%	441	8.2%	435	8.7%	474	8.5%
BB	320	7.3%	293	6.7%	295	7.2%	306	6.8%
B	526	9.3%	470	8.5%	453	8.9%	509	8.9%
CCC	1,159	15.9%	1,037	14.2%	1,013	14.5%	1,131	15.2%

Bank Loans

	December 2022		January 2023		February 2023		March 2023	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	652	91.89	581	93.55	586	93.49	609	92.67
BB	363	97.64	306	99.16	326	98.62	331	98.57
B	691	92.25	597	94.58	596	94.69	623	94.02
CCC/Split CCC	1,605	74.35	1,568	74.23	1,545	75.02	1,545	74.50

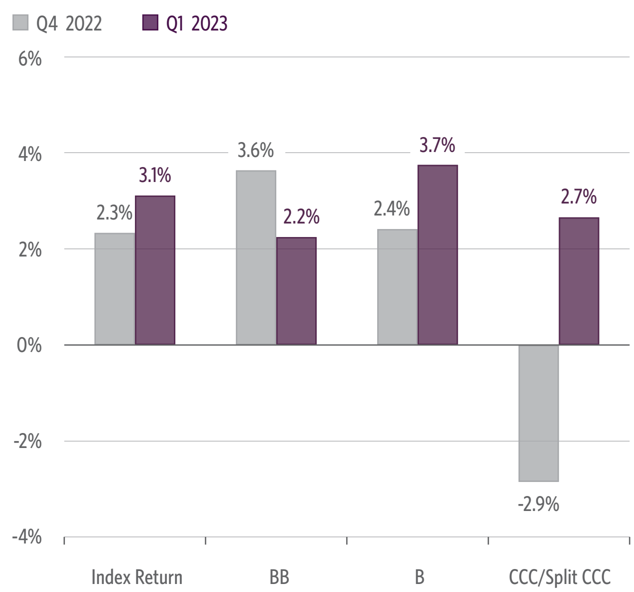
Source: ICE BofA, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE BofA High-Yield Index Returns



Source: ICE BofA. Data as of 3.31.2023. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 3.31.2023. Past performance does not guarantee future results.

> We expect this continued pressure on the banks to result in a further tightening in lending conditions.

Macroeconomic Overview

Fed Forges Ahead Despite Banking Turmoil

Notwithstanding market unease over stresses in the banking system, the Fed continued its inflation-fighting efforts in late March by raising the fed funds rate by 25 basis points to a range of 4.75–5.00 percent. The move was the latest in the Fed's recent maneuvering to achieve its mandate of supporting maximum employment and price stability while being mindful of potential financial stability pressures, which up until recently had not proven overly problematic. The failures of Silicon Valley Bank (SVB) and Signature Bank, the troubles at First Republic Bank, and the current general concerns about bank health illustrate that the Fed's multiple responsibilities are increasingly more difficult to manage.

The seeds of the problems at SVB, and banks more broadly, were planted by the government's efforts to contain the effects of economic dislocations in the wake of the COVID pandemic. Unprecedented stimulus in 2020 and 2021 filled the financial system with deposits (which are liabilities for a bank), which banks invested on the asset side by adding to holdings of securities given that loan demand was depressed. Many banks took the opportunity to increase the yield on those securities holdings by investing in long duration Treasurys and mortgage-backed securities (MBS), while others more presciently parked the excess liquidity in cash or short-term investments.

During the dramatic rise in interest rates in 2022, the banking system accumulated $620 billion of unrealized losses on its securities holdings while losing $465 billion in deposits. While those systemwide unrealized losses have been mitigated by the recent fall in interest rates, deposits continue to leave the banking system.

The Fed's new Bank Term Funding Program addresses part of the issues faced by banks, giving them a way to access liquidity without recognizing losses on their fixed-income securities holdings. They can now pledge Treasurys and MBS, among other high-quality securities, and receive a loan equal to the par value of the bonds. The Fed's discount window also allows for a broader range of collateral.

While helping prevent further panic-induced bank runs, the Fed's programs to the banks are unlikely to fully stem deposit outflows, which will likely continue as depositors burn through cash or move it to higher-yielding alternatives like T-bills or money market funds. While banks that failed had their unique issues, more seemingly idiosyncratic problems will likely pop up in the banking system and in other corners of the financial system. But these issues should not be a surprise, as they reflect an important transmission channel of the tightening in financial conditions that the Fed is trying to achieve.

We expect this continued pressure on the banks to result in a further tightening in lending conditions. One way to monitor this is via the Fed's quarterly Senior Loan Officer Opinion Survey, which asks banks if they are easing or tightening underwriting standards for various borrower categories. The latest survey, taken pre-SVB, already showed a net 45 percent of banks were tightening underwriting standards to large and medium-sized enterprises in the fourth quarter of 2022, which we have previously noted precedes an increase in credit defaults. This number will likely rise going forward.

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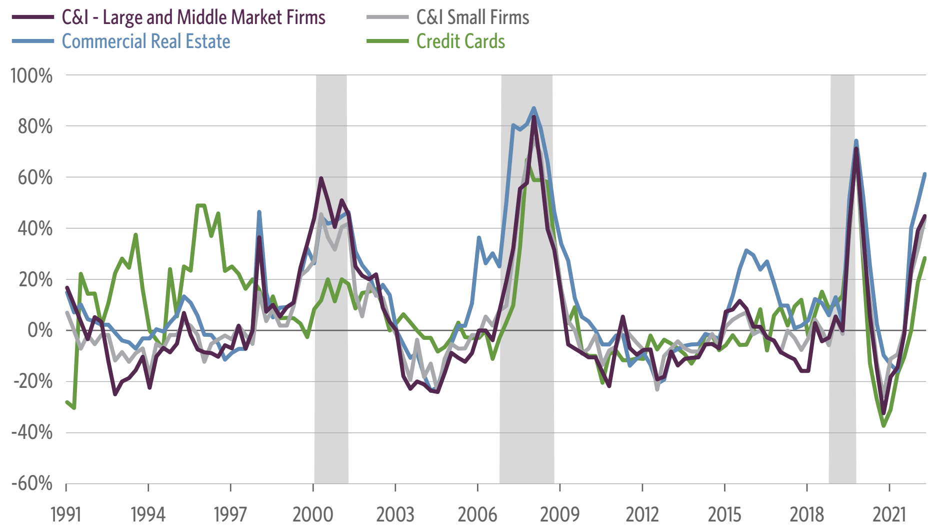
Lending Standards Had Already Tightened Substantially by the Fourth Quarter

Sr. Loan Officer Survey: Net % Banks Tightening Loan Standards by Type



Source: Guggenheim Investment, Bloomberg, Board of Governors of the Federal Reserve System. Data as of Q4 2022. Shaded areas represent recession.

Looking ahead at the rate hiking cycle, we reflect on Fed Chair Jerome Powell's statement in September that there is no painless way to get inflation behind us. This comment foreshadowed the Federal Open Market Committee's (FOMC) current predicament of balancing price stability with the risk of a disorderly flight of deposits from weaker and smaller banks. At the March FOMC press conference, Powell reiterated that the FOMC remains committed to its 2 percent inflation target while acknowledging that banking stress could be a substitute for one or more rate hikes.

The next FOMC decision is slated for May 3, giving the Fed an additional set of labor market and inflation data to digest, and lots of time for market developments. Another wave of bank failures or a severe market correction could force the Fed to pause, but a more gradual pullback in bank lending would not deter the Fed from acting on economic data that up until now have supported further rate hikes. In either case, we believe volatility will remain as market participants accept the reality that the goal of 2 percent inflation could be achieved from many different paths, some more painful than others.

Modest Weakening in Surface Fundamentals

It was a strong start to the year for leveraged credit even with the volatility in March. For the quarter, the ICE BofA High-Yield Index rose by 3.7 percent and the Credit Suisse Leveraged Loan Index gained 3.1 percent on a total return basis. High yield spreads tightened 17 basis points over the quarter, while bank loan discount margins tightened 43 basis points.

The situation in March shows how quickly the market outlook can turn. Prior to the banking sector stress, markets were moving toward a "no landing" outcome for this rate-hiking cycle. U.S. gross domestic product growth expectations were nudging higher, the equity market had rallied, and credit spreads had tightened by more than 80 basis points from Dec. 31, 2022, levels for bonds and loans.

We were not convinced that a recession would be avoided, but those brief animal spirits gave us reason to re-examine our prognosis for the credit market this year. As we outlined in our last report, we believe high-yield corporate bond and bank loan default rates will rise from around 1 percent in 2022 to 3.5 percent in 2023 and continue rising into 2024. But if borrower fundamentals and their credit lifelines remain resilient, defaults could take a little longer to materialize.

One such resilient lifeline is the collateralized loan obligation (CLO) market. There has been $30 billion in CLO issuance in 2023, running 13 percent above 2022's year-to-date pace. Netted against $5.7 billion in year-to-date outflows from bank loan mutual funds, there has been $24 billion in visible demand for loans for just $17 billion in institutional loan issuance excluding refinancing activity this year. Newly originated CLOs must therefore find assets to buy from other sellers, supporting loan prices.

We have also seen a substantial increase in amend-and-extend activity (A&E). This occurs when borrowers and lenders agree to extend the maturity of an existing loan, often in exchange for a slightly higher spread, new call protection, or stronger covenants. There has been more institutional loan A&E activity in the first quarter of 2023 than all of 2022, allowing many borrowers to push out 2024–2026 maturities. This can delay what may have otherwise been a liquidity squeeze due to a debt maturity.

As we assess our outlook for 2023 against a positive shift in sentiment and a supportive technical backdrop in the loan market, we turn to fundamentals for a view of leveraged credit health updated through the fourth quarter of 2022. On the surface, fundamentals support a constructive credit outlook, but weakening trends are notable.

The year-over-year growth of earnings before interest, tax, depreciation, and amortization (EBITDA) came in at 31 percent cumulatively for public leveraged credit issuers in 2022, and 29 percent excluding commodity-related sectors. This pace has been slowing quickly. Fourth quarter EBITDA growth was just 2 percent above the fourth quarter of 2021 for leveraged credit cumulatively, dragged down mostly by a 15 percent decline in technology and telecom sectors.

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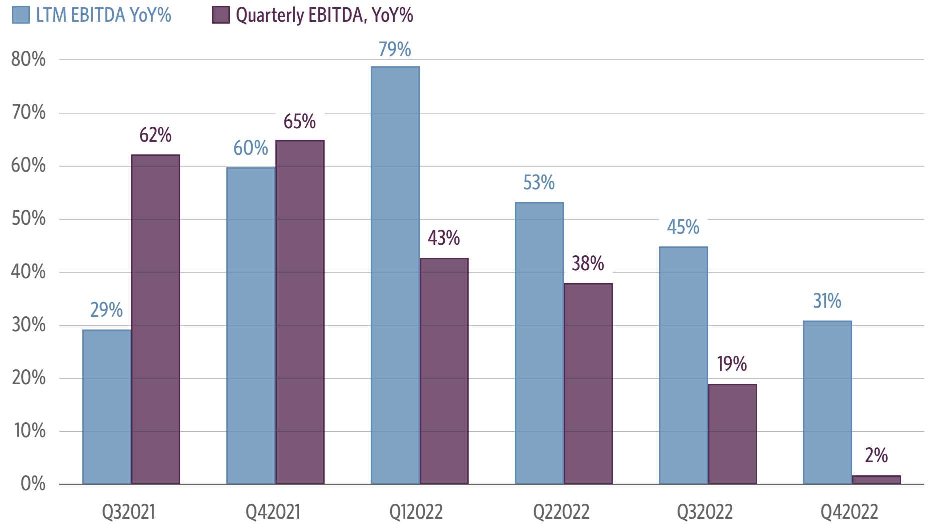
Corporate Earnings Growth Looks Strong but Is Slowing Quickly

Last 12 Months and Quarterly EBITDA, YoY%



Source: Guggenheim Investments, S&P Capital IQ. Data as of 12.31.2022.

The leveraged credit market in aggregate saw leverage ratios hold steady at 4.8x as earnings growth is no longer a tailwind for this metric. Interest coverage fell further from the recent high of 5.1x, and is now back at a mid-2019 level of 4.6x which we judge to be healthy. We are monitoring this ratio in bank loans closely given the more direct impact from rising short-term interest rates but have been

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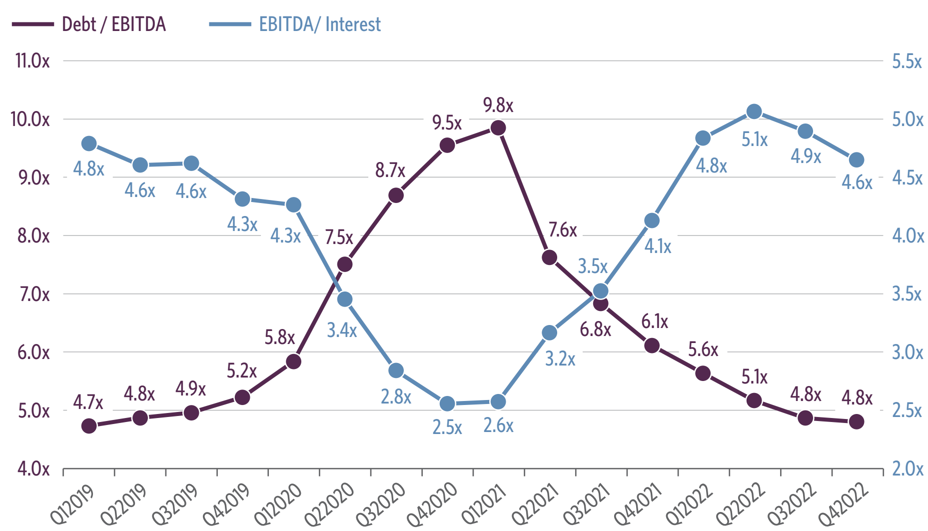
Interest Coverage Fell Further While Leverage Is No Longer Improving

Leveraged Credit Universe Gross Leverage and Interest Coverage



Source: Guggenheim Investments, S&P Capital IQ. Data as of 12.31.2022. EBITDA = Earnings before interest, tax, depreciation, and amortization.

more surprised to the upside than the downside on its trend. As of the fourth quarter of 2022, bank loan interest coverage was still a robust 5.0x on a weighted average basis according to S&P LCD.

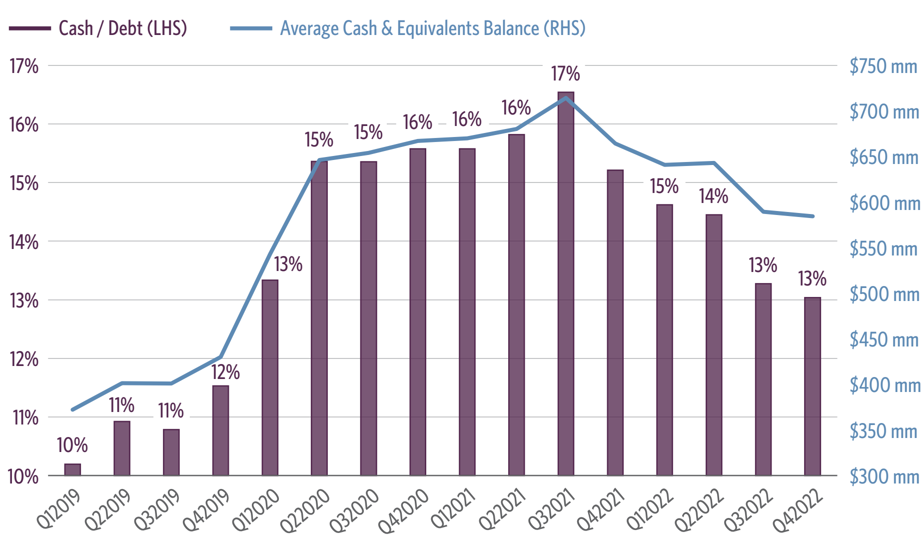
Our own deep dive into public data showed that public loan issuers have not seen a one-to-one pass-through of higher short-term interest rates to higher coupons. While short-term interest rates rose 400 basis points in 2022, the annualized average coupon rate paid by bank loan issuers in the fourth quarter rose just 160 basis points compared to the first quarter, to 5.8 percent from 4.2 percent. There is some lag effect in the coupon calculation, but a key reason that the interest coverage data appear more positive in bank loans than we would expect is due to the profile of data availability.

Public loan data is available for just 10–15 percent of the loan market, which itself is disproportionately weighted to BB-rated issuers since they constitute the majority of the public fundamental data but only represent 29 percent of the overall loan market. Among the small slice of loan issuer data that is public, many are also corporate bond issuers, with about 65 percent of their debt being fixed rate. We therefore take the average and median market data with a grain of salt and run our own internal stress tests on public and private issuers for tail risk monitoring.

Putting together our tests with the average stats of the public loan market, our takeaway is that there are varying degrees of interest rate sensitivity in a sector that many are generalizing to be vulnerable to rate hikes. One can find less interest rate sensitivity through diversified capital structures (issuers with a mix of bonds and loans) and stronger interest coverage starting points.

Cash and equivalent holdings in aggregate and on average are 18 percent below the post-COVID high, but still 36 percent above pre-COVID 2019 levels. The cash-to-debt ratio of 13 percent shows that borrowers are maintaining provisional liquidity compared to 2019, when the average was 11 percent, but it is dwindling from more robust levels from a few quarters ago.

Leveraged Credit Balance Sheet Cash/Debt Has Declined



Source: Guggenheim Investments, S&P Capital IQ. Data as of 12.31.2022.

A final note on a broader leveraged credit sector statistic is on balance sheet liquidity. Cash and equivalent holdings in aggregate and on average are 18 percent below the post-COVID high, but still 36 percent above pre-COVID 2019 levels. However, debt outstanding has continued increasing, so borrowers are using cash for reasons other than debt paydown. We believe cash is being used at least partially to fund capital expenditures: Capex was up $25 billion in 2022 while cash declined by $23 billion. The cash-to-debt ratio of 13 percent shows that borrowers are maintaining provisional liquidity compared to 2019, when the average was 11 percent, but it is dwindling from more robust levels from a few quarters ago, as we would expect.

To summarize our takeaways on credit fundamentals and the impact to the outlook, while interest coverage, cash balances, and leverage ratios look healthy overall, the trend is worth monitoring. These metrics deteriorated in 2022 as earnings growth slowed, and some metrics are now back to 2019 levels. A potential corporate earnings recession ahead would be an added headwind. As we highlight in the next section, defaults are on track to meet our year-end forecast already, so we would not revise our credit outlook at this stage.

The Pre-Recession Playbook for Up in Quality

It takes approximately two to three quarters for tighter lending standards to drive a notable increase in credit stresses, so the impact of the trend we highlighted in previous reports is arriving on schedule. Defaults have been rising and we believe they are on track to reach our 3.5 percent forecast for 2023. The three-month speculative-grade default rate was 0.8 percent at the end of February, or 3.2 percent annualized. This is an increase from 0.45 percent in the fourth quarter of 2022.

We remain defensively positioned and aim to stay in up in quality in our portfolios. However, "up in quality" does not always translate to avoiding CCCs and overweighting BBs. Although some of our decisions will reflect a preference for higher credit ratings, in practice our quality decisions are made at the individual credit level. For example, we may find a secured position attractive in a B-rated or CCC-rated issuer over its unsecured debt. Comparable opportunities may exist between a secured B-rated credit and an unsecured BB-rated credit given that ratings tend to migrate lower in recessions, making the higher credit rating less reliable than seniority. Even cyclical industries that others are avoiding are worthy of consideration as companies can have contracted revenue streams that make their business models more defensive than the riskiest competitor in a traditionally defensive sector like healthcare, which has led defaults in volume over the last four quarters.

Since there are many ways to execute an up-in-quality theme through our bottom-up credit selection process, we have several ways of measuring the outcome in portfolios. Our loan portfolios tend to be underweight CCC-rated debt, have a higher average price, and a lower share of distressed credits (loans trading below 80 percent

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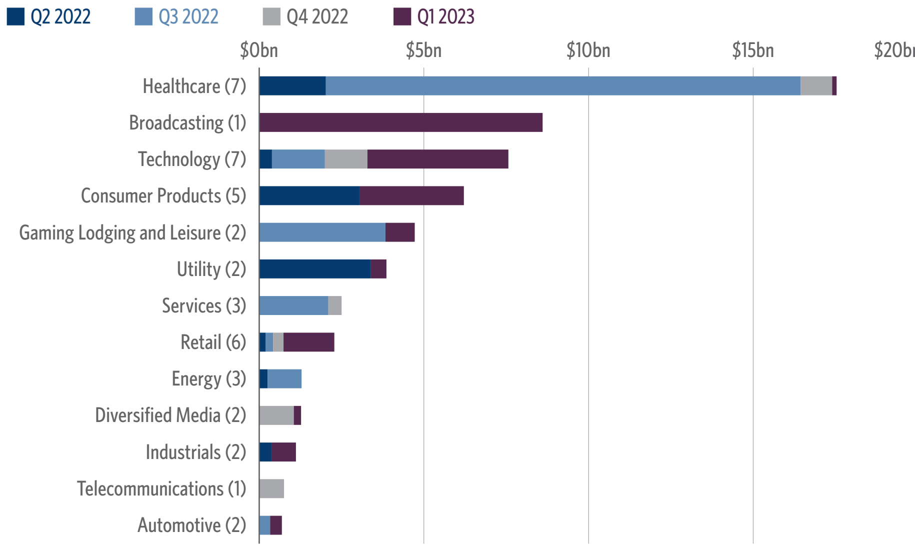
Healthcare Has Led Default Volume Over the Last Four Quarters

Total High-Yield Bond and Bank Loan Default Volume, $Bn



Source: Guggenheim Investments, J.P. Morgan Research. Data as of 3.31.2023

of par). Our high yield accounts tend to be underweight CCC-rated debt and have a lower share of distressed credits, but the average price relative to the index is less indicative of quality given that par prices can be impacted by duration risk.

We expect more volatility ahead, but the recent turmoil and lack of new issuance have already reset valuations to more appropriate levels. As of March 31, 2023, high-yield spreads were at 474 basis points and leveraged loan spreads at 609 basis points. Using assumptions for recovery rates and liquidity risk premiums, the implied default rate for bonds is 4.7 percent and 6.9 percent for loans. Since the market tends to overshoot, the sell-off could continue with spreads likely to widen as liquidity conditions worsen.

The market continues to struggle to differentiate credit risk, as evidenced by the lack of cross-industry spread dispersion. We view this as an opportunity for active management. Leveraged credit offers attractive pockets of relative value in names that have been oversold along with the broader market but that we view as cheap relative to underlying fundamentals. As we prepare to enter recessionary territory, we remain cautious on businesses that are highly levered and cyclical. Rigorous fundamental analysis is key.

INDEX AND OTHER DEFINITIONS

The referenced indices are unmanaged and not available for direct investment. Index performance does not reflect transaction costs, fees or expenses.

The **Credit Suisse Leveraged Loan Index** tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/ BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

The **ICE BofA U.S. High-Yield Index** tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million. In addition, qualifying securities must have risk exposure to countries that are members of the FX-G10, Western Europe or territories of the US and Western Europe. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway and Sweden.

A **basis point (bps)** is a unit of measure used to describe the percentage change in the value or rate of an instrument. One basis point is equivalent to 0.01 percent.

AAA is the highest possible rating for a bond. Bonds rated **BBB** or higher are considered investment grade. **BB, B, and CCC-rated bonds** are considered below investment grade and carry a higher risk of default, but offer higher return potential. A **split bond** rating occurs when rating agencies differ in their assessment of a bond.

The three-year **discount margin to maturity (DMM)**, also referred to as discount margin, 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.

Spread is the difference in yield to a Treasury bond of comparable maturity.

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.

Investors in asset-backed securities, including mortgage-backed securities and collateralized loan obligations ("CLOs"), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, such as credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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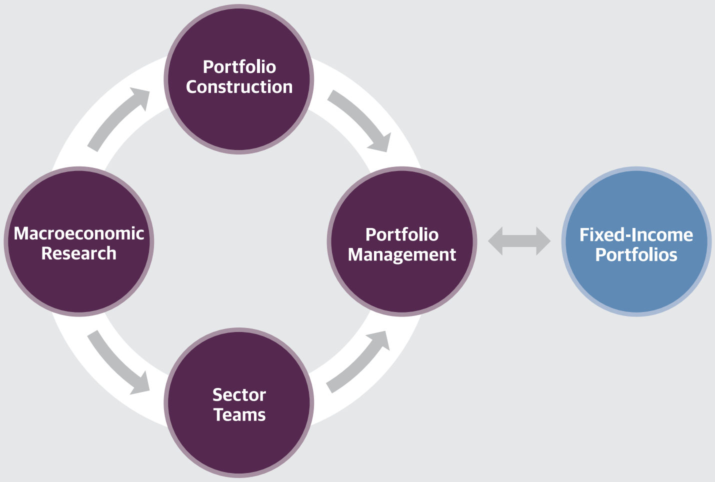
Guggenheim's Investment Process

Guggenheim's fixed-income portfolios are managed by a systematic, disciplined investment process designed to mitigate behavioral biases and lead to better decision-making. Our investment process is structured to allow our best research and ideas across specialized teams to be brought together and expressed in actively managed portfolios. We disaggregated fixed-income investment management into four primary and independent functions—Macroeconomic Research, Sector Teams, Portfolio Construction, and Portfolio Management—that work together to deliver a predictable, scalable, and repeatable process. Our pursuit of compelling risk-adjusted return opportunities typically results in asset allocations that differ significantly from broadly followed benchmarks.



Guggenheim Investments

Guggenheim Investments is the global asset management and investment advisory division of Guggenheim Partners, with more than $217 billion[1] in total assets across fixed income, equity, and alternative strategies. We focus on the return and risk needs of insurance companies, corporate and public pension funds, sovereign wealth funds, endowments and foundations, consultants, wealth managers, and high-net-worth investors. Our 250+ investment professionals perform rigorous research to understand market trends and identify undervalued opportunities in areas that are often complex and underfollowed. This approach to investment management has enabled us to deliver innovative strategies providing diversification opportunities and attractive long-term results.

Guggenheim Partners

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For more information, visit GuggenheimInvestments.com.

1. Guggenheim Investments assets under management as of 12.31.2022 and include leverage of $15.2bn. Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Partners Advisors, LLC, Guggenheim Corporate Funding, LLC, Guggenheim Partners Europe Limited, Guggenheim Partners Japan Limited, GS GAMMA Advisors, LLC, and Guggenheim Partners India Management.

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