GUGGENHEIM

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High-Yield and Bank Loan Outlook

Are High-Yield Markets Misjudging Evergrande Risk?

Investment Professionals

Scott Minerd
Chairman of Investments and
Global Chief Investment Officer

Kevin H. Gundersen, CFA
Senior Managing Director,
Portfolio Manager

Thomas J. Hauser
Senior Managing Director,
Portfolio Manager

Brian Smedley
Chief Economist,
Head of Macroeconomic
and Investment Research

Maria M. Giraldo, CFA
Managing Director,
Investment Research

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Summary

Global credit fundamentals remain strong overall, notwithstanding concerns about rising interest rates and stubbornly persistent inflation. The steady, if now less dramatic, economic rebound from the pandemic shock continues to build issuers' credit muscle. Defaults remain at historically low levels, corporate liquidity is more than ample, leverage ratios are declining, interest coverage is improving, and aggregate leveraged-credit cash flow has recovered to pre-COVID levels.

However, the unfolding debt repayment problems facing overextended Chinese property companies like Evergrande have raised yellow flags. Potentially troubling in our view is that credit markets in general, and high-yield markets in particular, have displayed an historically unusual lack of response in the face of great uncertainty. A couple of reasons for the market's seemingly blind eye to potential risks may be abundant market liquidity and investor confidence in the Chinese government's ability to choreograph a hitch-free unwinding of Evergrande debt and other Chinese property companies showing distress. In this report, we draw out certain technical and fundamental links between high-yield credit and Asia, and encourage investors to be mindful of them as they make investment decisions going forward.

Highlights from the Report

- While the Asia high-yield sector reflects concerns over Evergrande, other credit markets—which usually exhibit positive correlation—have not demonstrated indications of worry. To us, this unusual situation represents the market's faith that China will successfully manage the unwinding of Evergrande's debt, but we think they are dismissing the long-term effects of Beijing's crackdown on overleveraged industries.
- The U.S. high-yield market is no longer the domestic island many participants perceive it to be. Our research shows the typical high-yield issuer has 27 percent exposure to non-U.S. sources of revenue, with one sector showing as much as 44 percent exposure. This interconnectedness means that issuers in the U.S. high-yield index are susceptible to a potential China growth slowdown through second or third-order effects.
- Abundant central bank-driven liquidity may also be causing U.S. high-yield investors to become complacent about risk. We expect central banks to withdraw some accommodation in the next 12 months, including the U.S. Federal Reserve (Fed) through a tapering of asset purchases.
- Very strong corporate fundamentals and the improving economy lead us to remain constructive on the U.S. high-yield market, but we are mindful of the risks as we move along stages of the cycle.

Leveraged Credit Scorecard

As of 9.30.2021

High-Yield Bonds

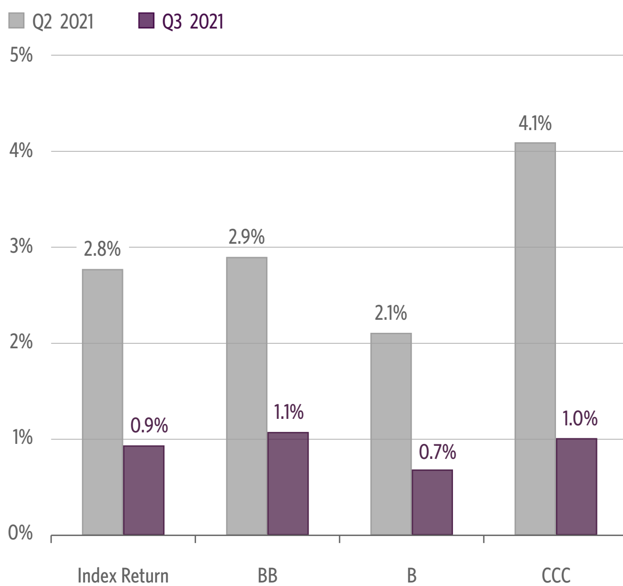
	December 2020		July 2021		August 2021		September 2021	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	390	4.2%	345	4.0%	333	4.0%	331	4.1%
BB	281	3.2%	245	3.1%	232	3.0%	232	3.2%
B	422	4.5%	403	4.5%	387	4.4%	383	4.5%
CCC	804	8.3%	661	7.0%	670	7.2%	666	7.3%

Bank Loans

	December 2020		July 2021		August 2021		September 2021	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	486	95.73	453	97.69	447	97.91	438	98.42
BB	305	98.88	315	99.10	309	99.22	302	99.53
B	469	98.55	452	99.03	449	99.08	444	99.35
CCC/Split CCC	1,167	84.28	900	92.17	922	91.30	892	92.04

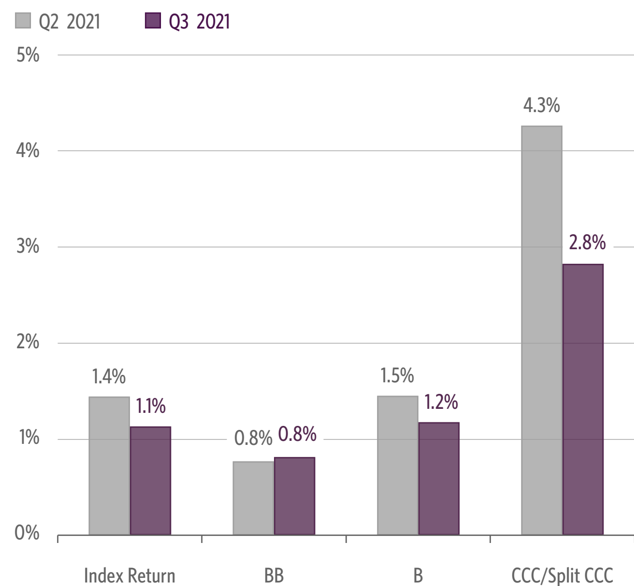
Source: ICE BofA, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE BofA High-Yield Index Returns



Source: ICE BofA. Data as of 9.30.2021. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 9.30.2021. Past performance does not guarantee future results.

> “When you have the second largest economy in the world hit with something like this, you know the repercussions are going to be global.
>
> – Scott Minerd,
> *Chairman of Investments and Global Chief Investment Officer*

Macroeconomic Overview

Controlled Fire: Inside the Evergrande Meltdown

Reports circulating in September about the inability of Evergrande, China’s second largest real estate development company, to repay an installment on its approximately $300 billion in debt sparked panic in credit markets in Asia. There was chatter about an Evergrande bankruptcy, a la Lehman Brothers, that would ignite a conflagration that could ravage China’s debt-reliant economy and spread across the world, triggering another global financial crisis. Others saw in the crisis echoes of the collapse of Long-Term Capital Management, the highly leveraged hedge fund that blew up in 1998 and required a Fed-managed bailout and debt rewind to quell fears of a global financial meltdown.

In an attempt to rein in the real estate sector through a “three red lines” policy, China policymakers triggered Evergrande’s recent liquidity crisis. That policy requires Chinese developers to maintain a cash-to-short-term-debt ratio of greater than one, keep liabilities below 70 percent of assets, and not carry debt that exceeds assets. If developers cross the red lines, regulators restrict their ability to raise more debt. Having crossed all three red lines last year and still crossing two of them, Evergrande’s status set off the company’s scramble for funds to meet its obligations.

Tensions eased as the Chinese government stepped in with liquidity and behind-the-scenes pressure on state-owned and state-backed enterprises to purchase Evergrande assets as the month progressed, but the question remains as to what ultimately will become of Evergrande. The most likely outcome is a “controlled fire” approach in which the government attempts to limit the contagion of Evergrande’s woes by propping up the company until its debts are restructured and reshuffled, its projects completed by others, and its properties sold off.

As Evergrande troubles captured the world’s attention, the September Federal Open Market Committee (FOMC) meeting made it clear that the U.S. central bank was not overly worried, at least not enough to push back its forecasted rate hikes. Then in November, the FOMC announced that it would begin tapering asset purchases but left open the possibility of changing the amount by which it would reduce purchases in 2022.

Core inflation readings have remained stubbornly above the Fed’s 2 percent target, which must make the FOMC nervous given multiple signals that also show a tight labor market. In the latest Summary of Economic Projections, the median FOMC participant saw 6.5 cumulative hikes through 2024, which is roughly what the market has priced into the Eurodollar futures market as well. Given recent data, we believe the Fed will get underway with policy normalization in 2022. However, the China situation poses a risk to the Fed’s hiking cycle later on if there are unforeseen consequences and cross border spillovers that become difficult for Beijing to contain.

Market Outlook

Watching for Correction Catalysts

Credit markets behaved unusually in the face of the uncertainty concerning Evergrande. The high-yield and the bank loan sectors both delivered their sixth consecutive quarter of positive returns in the third quarter of 2021, with a return of 0.9 percent for high-yield bonds and 1.1 percent for loans. Spreads remained range-bound, ending the quarter at 331 basis points for the ICE BofA High Yield Index and a three-year discount margin of just 438 basis points for the Credit Suisse Leveraged Loan Index.

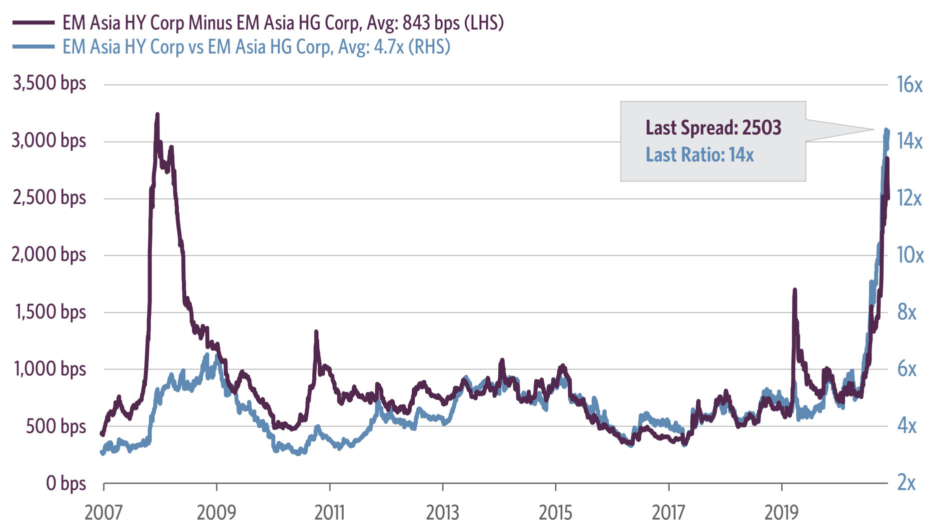
Meanwhile overseas, Evergrande's U.S. dollar-denominated bonds are trading at less than 30 cents on the dollar, effectively pricing them for the company's default, and 36 percent of the Asia U.S. dollar-denominated high-yield index is trading at less than 80 cents on the dollar, a level we consider to be distressed. In sharp relief, the U.S. high-yield market's continuing tight spreads and low volatility signal that investors do not believe that any of China's real estate problems will spill over. We see several reasons, both technical and fundamental, why high-yield investors should be paying more attention.

The Technical Case

One worrisome technical sign is the disconnect between the Asia high-yield and higher-rated Asia markets. Typically, the latter would reflect changes in the former. But as Asia high-yield corporate spreads have widened, Asia corporates rated AAA through BB (a representative index we will refer to as "high-grade") have remained steady. Currently, Asia high-yield spreads are 14x high-grade spreads, well above the ratio during the Great Financial Crisis (GFC).

Instead of reflecting concerns in the high-yield market, spreads in the Asia high-grade market have changed little. As a result, the gap between the two markets has grown larger.

Unusual Lack of Spillover Within Asia Credit Markets

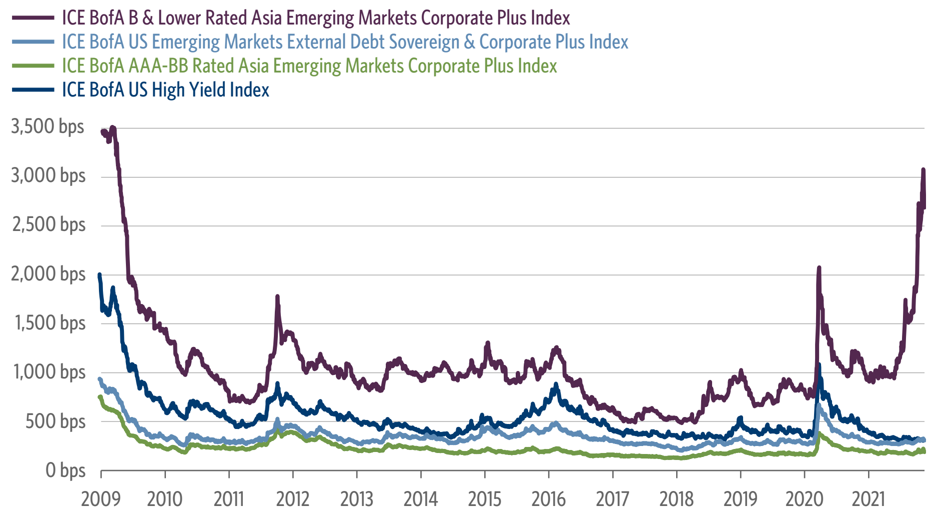


Source: Guggenheim Investments, Bloomberg, ICE Index Services. Data as of 11.15.2021.

While we typically do not dive into emerging markets in this report, it is worth examining what is keeping the Asia high-grade market so immune to the problems plaguing the high-yield sector. The most obvious reason is industry composition. While 68 percent of the Asia high-yield corporate index is of issuers in the real estate sector, it only represents 11 percent of the high-grade index. Instead, the high-grade index is 25 percent banks and financial services, which are generally considered as having some form of government support. We do not believe the Asia banking system should be this immune, however, for reasons we cover in our fundamental discussion in a later section.

Pricing in the Asia high-yield market has become detached from other credit markets to a degree rarely seen. The absence of a positive correlation implies that markets expect spillover effects from the Evergrande situation will be minimal.

Credit Stress Is Limited to High Yield Asia Only



Source: Guggenheim Investments, Bloomberg, ICE Index Services. Data as of 11.15.2021.

Unusual Performance Divergence Between EM and U.S. Sectors

YoY % Return

Source: Guggenheim Investments, ICE Index Services. Data as of 11.15.2021.

Another technical anomaly is a lack of spillover into broader emerging market credit risk premiums. In fact, market pricing is suggesting the distress will be limited exclusively to Asia high yield, a form of isolation that only occurred around the Asian Financial Crisis of 1997–1998 before stress spread to broader markets. While Asia high-yield spreads are now at their widest level since 2009, broader emerging market corporate spreads are trading inside of the 2019 average.

We suspect that a large factor driving these divergences in pricing is Beijing's involvement. Markets believe that in addition to having the willingness, the Chinese government has the ability to successfully direct the unwinding of Evergrande. Regardless of what the government may say about its role, Chinese officials will not allow Evergrande's problems to cascade out of control. Part of that confidence stems from the liquidity the Chinese government is directing at the problem.

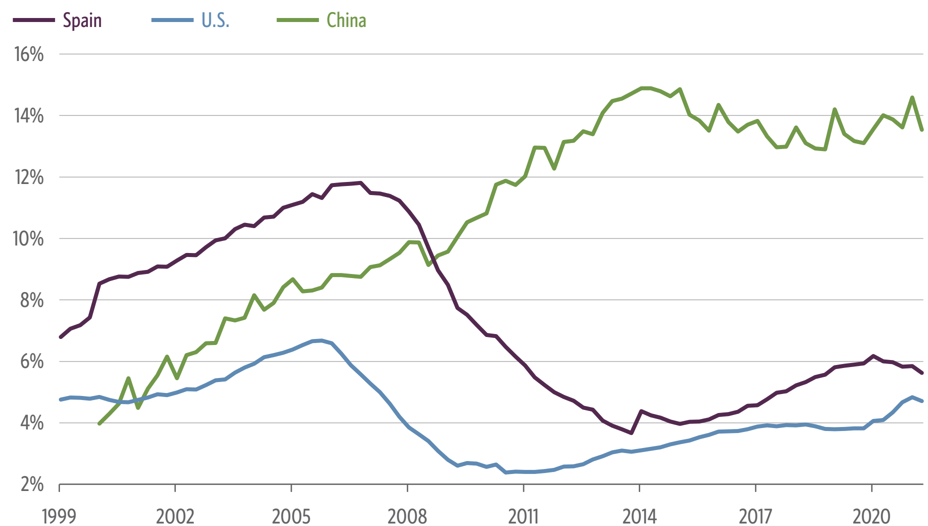
The Fundamental Case

Markets may be missing the broader implications of China's policy changes, chief among which is a move to slow the growth of the real estate sector. As of 2021, China's investment in real estate development represented 14 percent of China's gross domestic product (GDP), well above other major economies. The level even exceeds the share of real estate in the U.S. or Spain during the housing bubble of the mid-2000s. Adding other indirect contributions to the broad real estate category, we estimate the sector amounts to 29 percent of China's total output.

Even at its peak during the buildup to the GFC, real estate's share of the U.S. economy—roughly 7 percent—never reached the levels China has experienced in recent years. Property and ancillary activities now account for about 29 percent of China's GDP.

Real Estate Represents a Large Share of China's Economy

Real Estate Investment as % of GDP



Source: Guggenheim Investments, China National Bureau of Statistics, Haver Analytics. Data as of 9.30.2021.

So much investment flowing to one sector inevitably creates beneficiaries outside the sector. One sector that has benefitted has been suppliers of construction materials like cement, steel, aluminum, and copper. For example, about 35–40 percent of total cement demand in China comes from the property sector. As a result, a government-engineered slowdown in real estate and construction will reverberate through the economy and be felt in China's construction demand for materials.

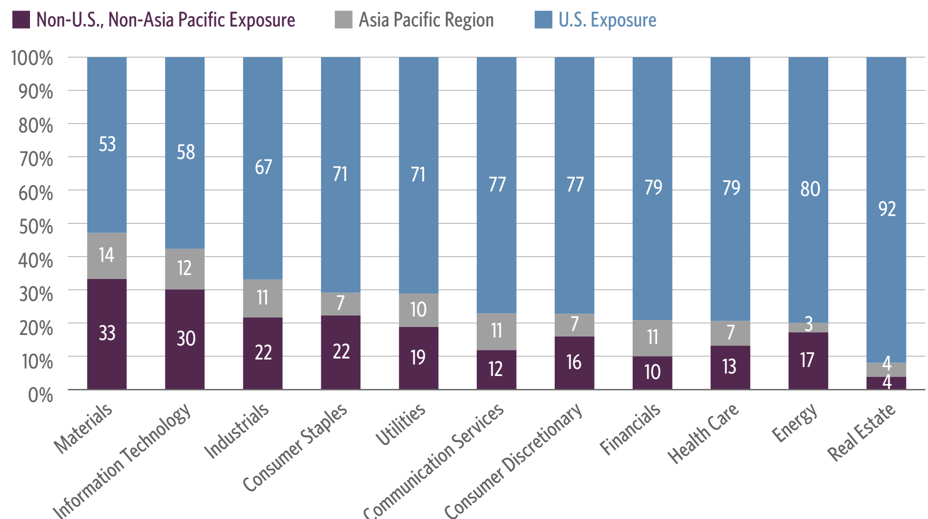
This is already happening: When construction demand started its recent decline, weekly cement shipments fell to their lowest levels since 2015. Now Bank of America Merrill Lynch research estimates that cement, steel, and glass demand will drop 10-20 percent year over year in the fourth quarter of 2021, and another five to six percent in 2022.

How does this affect U.S. high-yield investors specifically? The typical high-yield company in the ICE BofA High Yield Index has 27 percent exposure to non-U.S. sources of revenue. In the materials sector, some of which may be suppliers of construction activity, the average issuer's foreign revenue exposure is 47 percent, with 14 percent coming from Asia. In short, U.S. high-yield investors may be more exposed to international risk than they think.

A large share of the revenue generated by high-yield corporate issuers comes from outside the United States, contrary to what investors may expect and demonstrating the likely underappreciated internationalization of high-yield issuers.

U.S. High-Yield Companies Generate Significant Revenues Overseas

Average U.S. High-Yield Company Annual Sales Exposure Abroad by GICS Sector



Source: Guggenheim Investments, Factset, ICE Index Services. Revenue exposure data based on 2020 annual sales. Based on the ICE BofA High-Yield Index constituents as of 9.30.2021.

As raised earlier in this report, there are second order effects that a pullback in real estate investment will have. While Evergrande alone may not trigger a financial crisis, a nationwide decline in home prices caused by a slowdown in land sales and pullback in real estate investment could. China's banks are

exposed through lending channels. Among some of the largest banks in China, loans to developers average less than 1 percent, but real estate related loans average 27 percent of loan books.

Local government finances would be affected as well through a slowdown in land sales to developers, and China household balance sheets could be impacted through a slowdown in net worth appreciation, employment, or the delayed delivery of finished apartments. Any negative impact on these sectors could precipitate an even bigger economic slowdown that would rattle countries and industries that have directly or indirectly benefited from China's consumption growth. Once the effects spills into broader emerging markets, we would expect rising risk premiums abroad to weigh on U.S. high-yield valuations.

Investment Implications

Given the magnitude of the distress pricing in high-yield Asia and the high-yield sector's historical relationship with emerging markets, why is the U.S. high-yield market apparently so complacent in the face of Evergrande-related concerns? We believe there are several reasons.

The first we have noted several times in the report, is Beijing's efforts to prevent spillover effects. Were it not for government involvement, markets would be more worried about Evergrande's suppliers, their unfinished construction units, and the impact to Chinese consumers and other developers. However, we believe it may not be until the second half of 2022, or even later, before the full repercussions of the crisis brewing in China becomes clear.

Drawing parallels to the Asian Financial Crisis in 1997, it took over a year for the devaluation of the Thai baht in July 1997 to spread through Asia in a rolling currency crisis. This eventually led to Russia defaulting on its domestic debt, stock markets plummeting in the U.S., and the failure of Long Term Capital Management which necessitated a Fed-organized bailout. These connections were not initially evident when the Thai baht was devalued because consequences take time to work through the financial system and overlevered participants are often lodged in the unregulated shadows of the market. A year from now, we could be faced with a similar series of events that only in hindsight will show the first domino to be China clamping down on its real estate sector. While those consequences need not be a full blown crisis, it could be negative enough to cause deep losses for investors and a tightening in financial conditions.

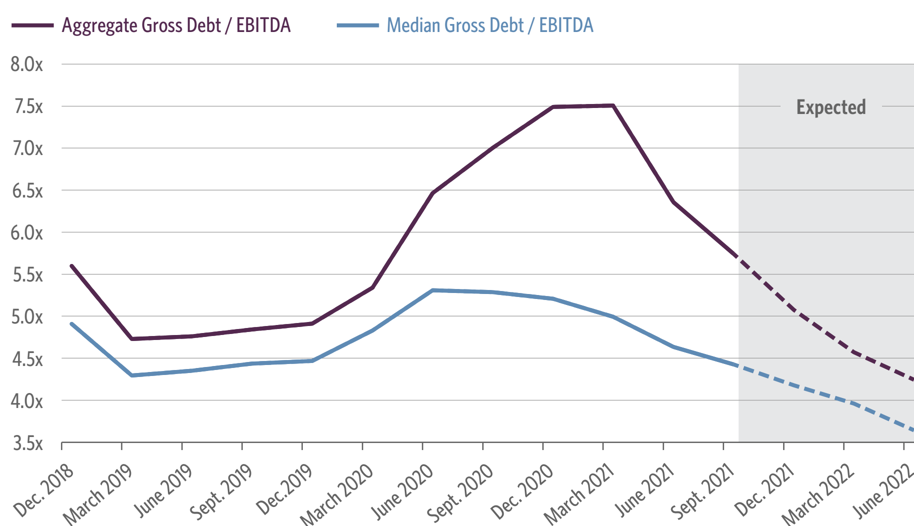
Since a China slowdown story is a much slower moving train, investors are focused on more immediate drivers of credit returns. For example, commodity prices which have weighed on the high-yield sector in recent years are now at multi-year highs and lifting valuations. Oil and natural gas prices are at their highest levels since 2014 just as we head into the winter season when demand rises, while several other commodities prices, like copper and steel, are near

multi-year highs. This is also contributing to the lack of distressed pricing in emerging market credit, a sector whose revenues tend to be very commodity-linked. In the ICE BofA Emerging Markets Diversified Corporate Index, 49 percent of the index is energy and basic industry.

Another factor pulling investor attention is that improving fundamentals are supporting a sanguine credit outlook for U.S. companies. As noted in the previous high-yield report, there is abundant liquidity on corporate balance sheets with cash and equivalents representing several quarters of liquidity runway. Leverage ratios are declining, interest coverage is improving, and aggregate leveraged-credit cash flow and revenues have recovered to pre-COVID levels. According to bottom-up analyst estimates, the high-yield sector should see further reductions in leverage ratios through 2022.

The high-yield sector should see further reductions in leverage ratios, despite some negative impact from the Delta variant on corporate earnings in the third quarter.

Leveraged Credit Fundamentals Are Expected to Further Improve



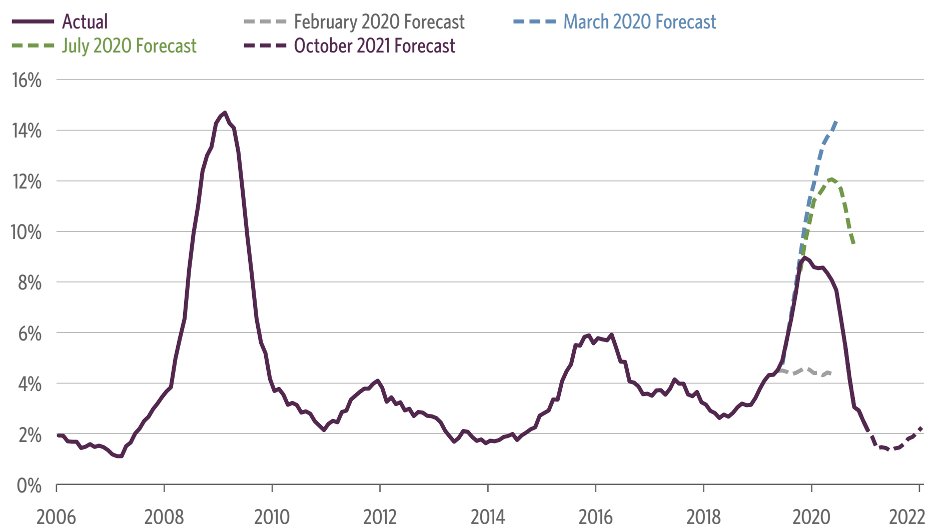
Source: Guggenheim Investments, S&P Capital IQ. Data as of 9.30.2021. Based on 430 companies rated BB+ or below with analyst expectations available through Q2 2022. "Exp." represents consensus analyst expectations.

Measures of U.S. financial conditions show that although they tightened in the final weeks of the third quarter, they remain easier than at any point before the COVID-19 pandemic. Periods when financial conditions are easy tend to be characterized by low corporate default volumes. Indeed, improving fundamentals and easy financial conditions have led to Moody's default rate forecast for the next 12 months to fall below their expectations before the pandemic.

Abundant central-bank driven liquidity is leaving investors with few options to meet return targets, causing them to wave away certain warning flags until they're more of an immediate concern with a high degree of certainty. However, market liquidity is expected to shrink over the next 12 months as the Fed

Improving fundamentals and easy financial conditions have led to Moody's default rate forecast for the next 12 months to fall below their expectations before the pandemic.

Moody's Forecasts a Lower High Yield Default Rate Than Pre-Pandemic Levels



Source: Guggenheim Investments, Moody's. Data as of 10.31.2021.

marches forward with plans to taper asset purchases and other central banks take steps to scale back pandemic-era accommodation. In emerging markets, several central banks have already hiked rates to combat high inflation.

We expect that the cycle has at least a few more years to run before we see another wave of defaults, but an important shift that is coming is that credit performance will be increasingly differentiated by fundamentals, rather than liquidity, as we move into later stages of the cycle. Given that spreads are already very tight, we see this as a good opportunity to take stock of global growth drivers, re-evaluate foreign exposures, assess the balance of risks, and take some gains in lower quality credits. We have been primarily focused on credits rated single-B minus or better, and some industries where we have seen opportunities in recent months with solid fundamentals are in healthcare, media and entertainment, technology, certain industrials, food and beverage, and suppliers of building materials with a focus on U.S. construction.

Important Notices and Disclosures

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 **Intercontinental Exchange (ICE) Bank of America Merrill Lynch High-Yield Index** is a commonly used benchmark index for high-yield corporate bonds.

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks, actively traded in the U.S., designed to measure the performance of the broad economy, representing all major industries.

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%.

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.

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.

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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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2. Guggenheim Partners under management are as of 9.30.2021 and include consulting services for clients whose assets are valued at approximately $78bn.

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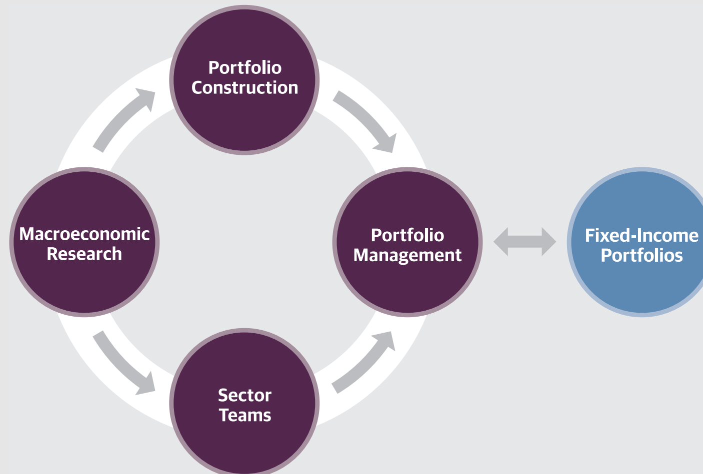

Guggenheim Investments

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Guggenheim Partners

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For more information, visit GuggenheimInvestments.com.