

GUGGENHEIM

Portfolio Strategy Research

The Core Conundrum

Q3 2015



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Introduction

Despite the end of quantitative easing by the U.S. Federal Reserve, global monetary policy continues to impact bond investors. Artificially depressed yields on government-related securities make traditional core fixed-income strategies less effective in achieving total-return objectives. Compounding this issue is the flagship U.S. fixed-income benchmark, the Barclays U.S. Aggregate Bond Index, which continues to be heavily concentrated in government and agency debt. As benchmark yields languish near historical lows, the chasm between investors' return targets and current market realities deepens, creating a conundrum for core fixed-income investors.

Addressing this challenge—without assuming undue credit or duration risk—requires a shift away from the traditional view of core fixed-income management in favor of a more diversified, multi-sector approach. An increased tolerance for tracking error provides the flexibility to increase allocations to undervalued, yet high-quality, credits across sectors. We believe the Guggenheim approach to constructing diversified core fixed-income portfolios offers a more sustainable way to generate income and improve risk-adjusted returns in today's low-rate environment.

Report Highlights

- The combined impact of U.S. monetary and fiscal policy has created the core conundrum: How can core fixed-income investors meet their yield objectives while maintaining low tracking error to the Barclays Agg, which has become approximately 70 percent concentrated in low-yielding government-related debt?
- The benign credit environment is encouraging some investors to take investment shortcuts to generate yield, such as increasing credit and duration risk. Investors may be underestimating these risks, particularly as the accommodative policy environment slowly draws to an end.
- In the current environment, we believe the surest path to underperformance is to remain anchored to the past. Investors must develop a new, sustainable, long-term strategy to generate attractive returns. Opportunities exist beyond the Barclays Agg, where robust credit work can uncover a world of investment-grade, fixed-income securities with higher yields and lower durations than government and corporate bonds.
- Accessing short-duration, high-quality investment-grade securities with considerable yield pickup relative to government and corporate bonds may be the investment blueprint needed to navigate the current low-rate environment and hedge against interest-rate risk.

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The Core Conundrum

In an environment where the benchmark index is heavily concentrated in low-yielding government and agency securities, maintaining low tracking error and pursuing total-return targets have seemingly become contradictory objectives. In the following section, we discuss how recent monetary and fiscal policy has created this conundrum for core fixed-income investors.

Monetary Policy Has Distorted Government and Agency Markets

In 2008, the U.S. Federal Reserve (the Fed) reached its conventional monetary policy limit when it dropped the federal funds target rate to a range of 0-0.25 percent for the first time in history. With U.S. economic growth stagnant and credit markets frozen, the Fed launched quantitative easing (QE) programs to directly purchase Treasuries and mortgage-backed securities (MBS) in an effort to inject liquidity into the financial system and stimulate growth. Three rounds of QE were needed before the Fed deemed U.S. growth sustainable. As a result, the Fed's balance sheet grew from \$869 billion in 2007 to over \$4 trillion in 2014. With the Fed essentially buying Treasuries and MBS at any cost, fixed-income market distortions were inevitable.

Fed purchases of Treasuries and agency MBS since 2008 have artificially suppressed yields and increasingly distorted value in both asset classes. The end of QE has left these asset classes overvalued and they remain overvalued even as the Fed's role as an uneconomic buyer becomes limited only to reinvesting income on its \$4.2 trillion bond portfolio—a rate

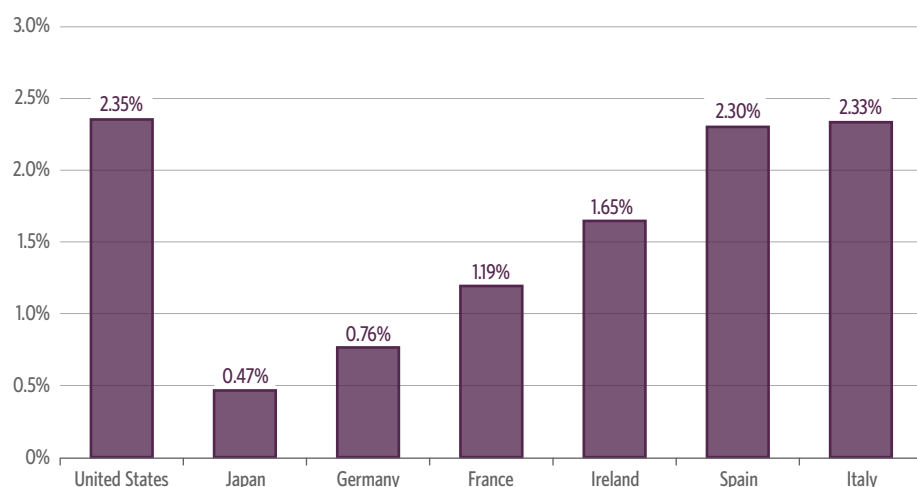
of purchases that is estimated to be approximately \$20 billion to \$25 billion per month until the Fed begins raising interest rates, after which it plans to taper reinvestments as well.

Despite the Fed withdrawing its purchases of government-related securities, the low-rate environment may persist for longer than investors expect. Treasury yields typically rise ahead of the Fed's tightening cycle as the market anticipates higher interest rates, but stimulus injected by foreign central banks, which is expected to continue over the next couple of years, is suppressing yields globally and partially offsetting the Fed's actions.

For example, the January 2015 announcement of the European Central Bank's (ECB) open-ended program to purchase €60 billion per month of primarily investment-grade-rated euro zone government, agency, and institutional debt, as well as covered bonds and asset-backed securities (ABS), is depressing European sovereign yields to levels that make U.S. Treasury yields look comparatively attractive. The ECB's program is expected to last at least until September 2016, totaling €1.1 trillion in planned purchases. In Japan, the announcement of an expanded QE program, which will

Attractive Relative Value in U.S. 10-Year Treasuries

10-Year U.S. Treasury Yields vs. Select 10-Year Sovereign Bond Yields



Source: Bloomberg, Guggenheim. Data as of 6/30/2015.

As a result of global stimulus from foreign central banks, many sovereign bonds around the world yield less than U.S. Treasuries of comparable duration. The relative attractiveness of Treasuries compared to German bunds or Japanese government bonds (JGBs) means international capital flows into Treasuries should remain strong. Treasury rates could remain low for an extended period of time, despite the conclusion of the Fed's QE program.

purchase ¥80 trillion of government bonds in 2015 with no pre-determined end date, caused the Japanese 10-year sovereign bond yield to decline to just 0.3 percent by the end of 2014. In China, continued signs of weakness forced the central bank to cut benchmark interest rates four times between October 2014 and the end of June 2015. In addition to foreign investors searching for yield, U.S. Treasuries also attract those seeking a safe haven from continued geopolitical uncertainty in Greece, Ukraine, Russia, Syria, and Libya.

The confluence of global factors that are continuing to suppress yields globally begs the question—what are the long-term return prospects for U.S. government-related assets? At best, U.S. Treasuries remain overvalued for a prolonged period as overwhelming global demand offsets the Fed's tightening actions and investors continue to earn low, but positive, yields. The worst-case scenario is that Treasuries undergo a material sell-off if investors fail to properly estimate the impact of rising rates, which as we show later in this report, occurred the last time the Fed intervened to keep long-term Treasury yields artificially depressed. In either scenario, the outlook for government-related assets appears bleak, leading many to call U.S. Treasuries “return-free risk,”

rather than the traditional label of “risk-free return.”

Under any nickname, these assets currently represent around 70 percent of the Barclays U.S. Aggregate Bond Index (Barclays Agg). Due to its concentration in government-related securities, the Barclays Agg, to which the majority of core fixed-income strategies are benchmarked, yielded only 2.1 percent on average between 2012 and 2014, and its low yield persists in 2015.

Fiscal Policy Is Reconfiguring Composition of the Barclays Agg

Since its creation in 1986, the Barclays Agg has become the most widely used proxy for the U.S. bond market, with over \$2 trillion in fixed-income assets managed to it. Inclusion in the Barclays Agg requires that securities are U.S. dollar-denominated, investment grade, fixed rate, taxable, and meet minimum par amounts outstanding. In 1986, the Barclays Agg was a useful proxy for the universe of fixed-income assets, which primarily consisted of U.S. Treasuries, agency bonds, agency MBS, and investment-grade corporate bonds—all of which met these inclusion criteria. However, the fixed-income universe has evolved over the past 30 years with the

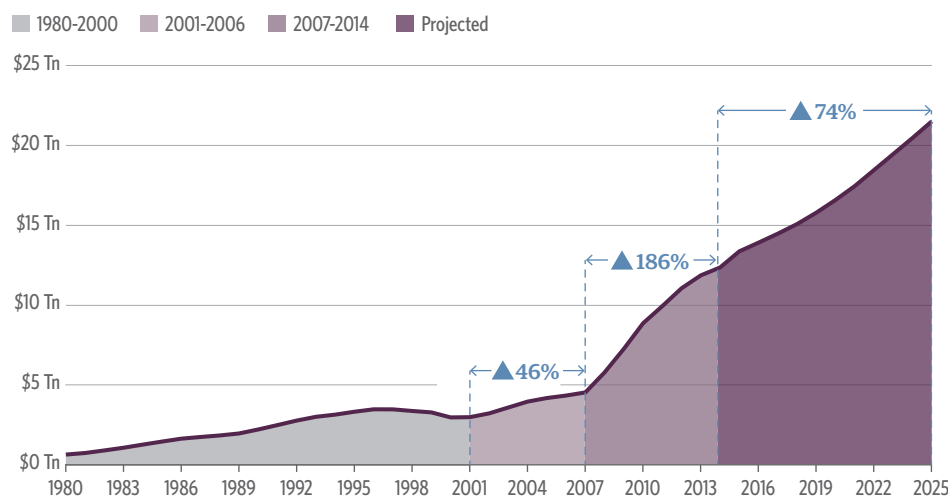
growth of sectors, such as ABS, non-agency MBS, originally issued high-yield bonds, leveraged loans, and municipal bonds. While the fixed-income universe becomes more diversified in structure and quality, the composition of the Barclays Agg is increasingly concentrated in Treasuries due to the massive issuance volume since the financial crisis.

The sheer glut of Treasuries and their dominant representation in the Barclays Agg is a trend unlikely to reverse anytime soon. The need to fund government shortfalls—present and future—is astonishing. The U.S. Treasury debt balance totaled \$4.5 trillion in 2007. By the end of 2014, it had skyrocketed to \$12.3 trillion (a compounded annual growth rate of 15.5 percent) and it is projected to go even higher, hitting \$21.5 trillion by 2025 according to estimates from the Congressional Budget Office (CBO).

As Treasuries climbed from 19 percent of the U.S. fixed-income universe in 2007 to 40 percent in 2015, the market-capitalization weighted Barclays Agg has followed suit. Treasuries comprise 36 percent of the Barclays Agg which, when combined with agency securities, brings the total U.S. government-related debt to nearly 70 percent. This is problematic for core bond investors as this dominant portion of the Index is also among the lowest yielding in the fixed-income universe. Government-related assets (specifically Treasuries, agency MBS, and agency bonds) in the Barclays Agg yielded only 2.0 percent as of June 2015, which, adjusted for inflation based on the Personal Consumption Expenditure Core Price Index, equates to a real yield of only 0.8 percent.

The Impact of the Financial Crisis

Rise in U.S. Treasury Debt Outstanding Since the Financial Crisis



Source: SIFMA, Congressional Budget Office. Data as of 12/31/2014.

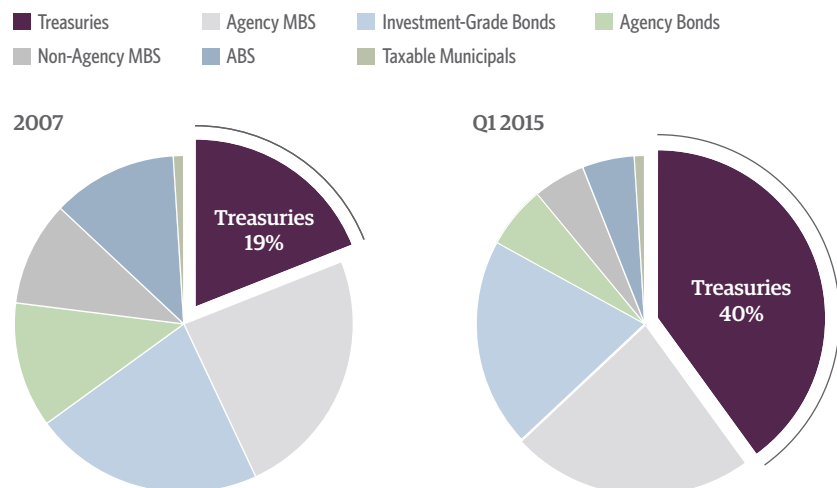
Fiscal deficit spending in the U.S. in response to the financial crisis resulted in a significant rise in Treasury issuance. Treasury debt outstanding grew by 186 percent from \$4.5 trillion in 2007 to \$12.3 trillion by the end of 2014. Although the annual fiscal deficit has steadily declined to \$484 billion in 2014 from its peak of \$1.4 trillion in 2009, the CBO projects that it will return to over \$1 trillion by 2025. As a result, Treasury debt outstanding is projected to increase by another 74 percent to \$21.5 trillion over the next 10 years, further skewing the profile of the Barclays Agg toward low-yielding U.S. government debt.

Being anchored to a benchmark heavily allocated to sectors where real yields are dangerously close to becoming negative has forced investors to reassess the traditional, benchmark-driven approach to core fixed-income management. Historically, core strategies have had almost no exposure

to higher-risk segments of the fixed-income universe, such as leveraged credit, emerging-market debt, and non-agency structured credit. This aversion to riskier assets, however, appears to be waning given the need for yield as investors adjust to new market realities.

Fiscal Deficits Have Reshaped the Core U.S. Fixed-Income Universe

Reweightings of the Universe Toward U.S. Government and Agency Bonds

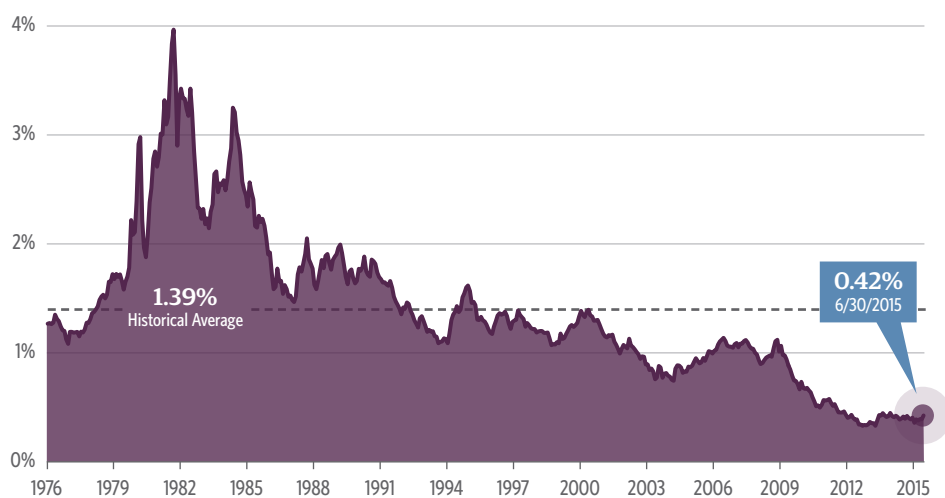


Source: SIFMA, Credit Suisse, Barclays. Data as of 3/31/2015.

The massive increase in Treasury debt since the financial crisis has reshaped the core fixed-income universe. Since bottoming in 2007 at 19 percent of core U.S. bonds outstanding, Treasuries have more than doubled to 40 percent of the universe in 2015. Combined with agency debt, U.S. government bonds now comprise approximately two-thirds of the core fixed-income universe, and around 70 percent of the Barclays Agg.

Assessing the Relative Value of the Barclays Agg

Historical Yield per Unit of Duration



Source: Barclays. Data as of 6/30/2015.

The Barclays Agg continues to look historically unattractive as measured by yield per unit of duration. As of June 2015, investors closely tied to the Index earned only 0.42 percent yield for every year of duration they were exposed to. Given the current environment and its concentration in government and agency debt, the Barclays Agg's historically low yield is likely to persist.

Coping with New Market Realities

An industry-wide rethinking of tracking error appears to be emerging as institutional investors evaluate their need to generate yield and meet total-return objectives.

Traditional yield enhancement techniques, such as increasing duration and lowering credit quality, may boost total returns in the near term, but at what cost?

The historically benign credit conditions prevailing today may be masking the potentially deleterious, long-term effects of higher credit and interest-rate risk.

Prioritizing Return Targets

Achieving return targets is of utmost importance for institutional investors who service their cash liabilities through an income stream, such as insurance companies, pension funds, and endowments. Lowering return targets to reflect the meager 2.7 percent average annual return of the Barclays Agg between 2012 and 2014—a period when the Barclays Agg's yield fell below 2 percent for the first time in history—fails to solve for the investment shortfall that has resulted from the current and persistent low-rate environment.

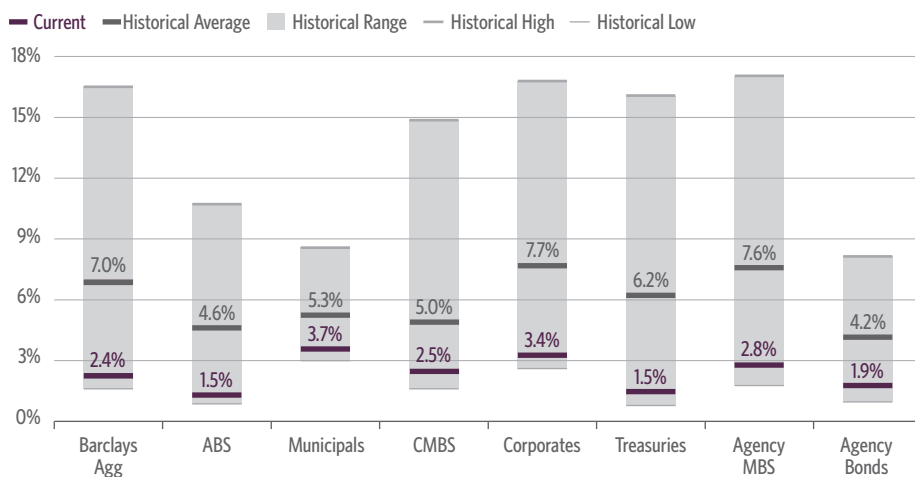
The real issue lies in the scarcity of yield across the fixed-income sectors represented within the Barclays Agg. The weighted-average yield of the Barclays Agg was only 2.4 percent at the end of June 2015, which is 66 percent lower than the historical average yield of 7.0 percent since inception, and far below the highest yield of 16.8 percent. To address the more pressing need for income, many investors have been assuming greater investment risks to generate incremental yield.

One example has been taking on additional credit risk, which has precipitated a relaxation in underwriting standards. In addition to record levels of issuance in both investment-grade and high-yield bond markets following the financial crisis, the market has witnessed a significant increase in deals lacking covenant protection, high levels of debt issued by lower-rated, first-time issuers, and an increase in aggressive deal structures. The negative long-term impact of these worsening trends in new issuance is currently being obscured by the benign credit environment that is a byproduct of the Fed's unprecedented monetary accommodation. For long-term investors with investment horizons exceeding a couple of years, taking greater credit risk in the reach for yield may culminate in principal losses from rating downgrades or even bankruptcies in the future.

Implications of the Fed tightening cycle are also negative for investors who have opted to take greater duration risk to capture incremental income. Investors may find that extending maturity targets to 20 years or beyond provides for some yield pick-up, but risks must be carefully measured.

The Scarcity of Yield Across the U.S. Fixed-Income Landscape

Historically Low Yields Across Traditional Core Sectors

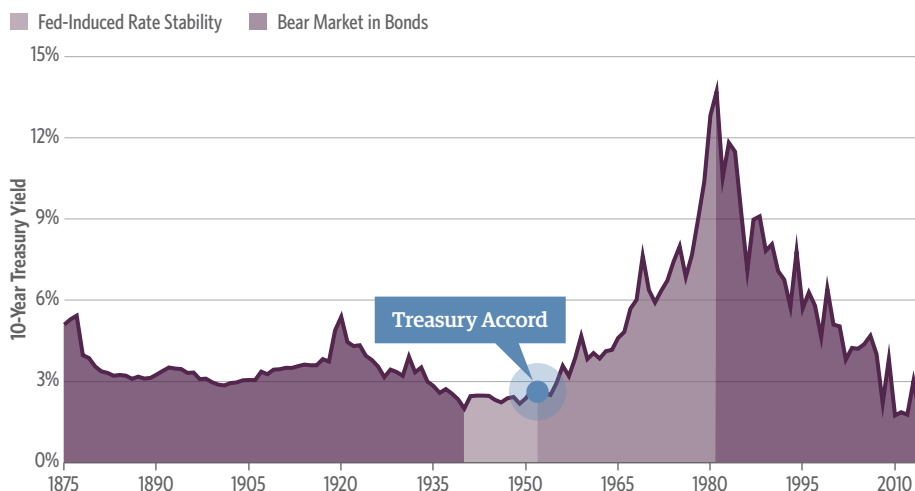


Source: Barclays. Data as of 6/30/2015. Historical average based on available Barclays data: for Barclays U.S. Aggregate and Agency MBS since January 1976; Treasuries and Corporates since January 1973; ABS since December 1991; Municipal and Agency Bonds since January 1994; and CMBS since July 1999.

The historical average yield of the Barclays Agg is 7.0 percent, well above its recent 2.4 percent yield at the end of June 2015. With each Index subsector yielding less than 4 percent, investors are faced with scarcity of yield across the fixed-income landscape. Extending duration or increasing credit risk to meet yield objectives may prove successful in the near term, but utilizing these investment shortcuts carries significant long-term risks.

Historically, the End of Fed Intervention Is Bad News for Bonds

U.S. 10-Year Treasury Yields Since 1875



Source: Bloomberg. Data as of 6/30/2015.

For an extended period of time during the 1940s and early 1950s, the Fed intervened in the bond market to keep long-term interest rates artificially low. The removal of Fed support of long-term bond prices in 1951 set off a bear market in bonds that lasted 30 years. Could history repeat itself once the current period of low rates ends? If it does, portfolios that extended durations in the present environment in order to pick up yield will be left painfully exposed.

A review of the last time the Fed ended a similar program that artificially suppressed long-term Treasury yields suggests that a prolonged bear market lies ahead for long-duration fixed-income assets.

Asymmetric Risk in Treasuries

During the 1940s, the Fed, acting in concert with the Treasury Department, fixed interest rates on short-term Treasury bills while committing to buy long-term Treasury bonds in order to ensure cheap and adequate financing for both World War II and the attendant recovery. The end of this practice under the Treasury Accord of 1951 led to a tumultuous sell-off in longer-duration bonds as the market failed to anticipate the shift in monetary policy.

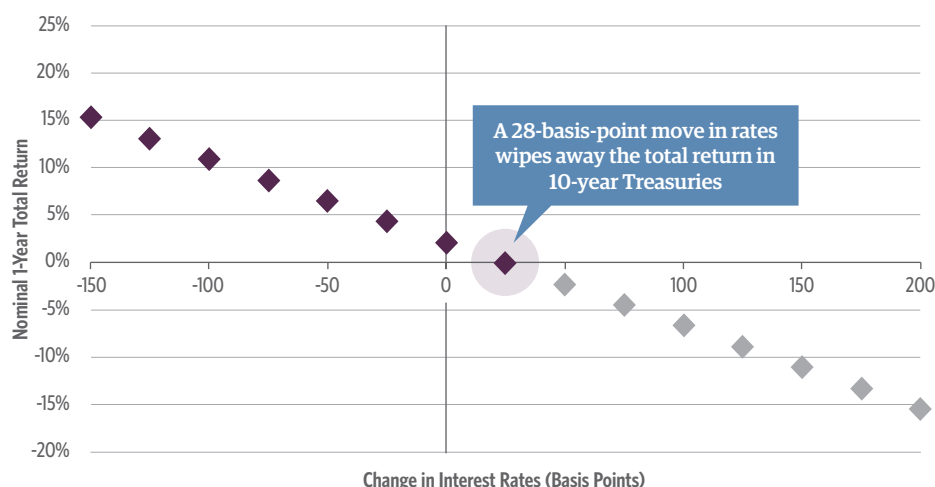
Today, the Fed seeks to avoid a similar experience by carefully signaling its intent to raise interest rates, but the consequences may be inevitable even with full transparency

from the Fed. In May 2013, for example, Fed Chairman Ben Bernanke signaled the possibility that the Fed might soon taper its purchases of Treasuries and agency MBS as it wound down its QE program. This early indication did not involve any immediate action by the Fed. Nevertheless, bond markets sold off dramatically, with the 10-year Treasury yield spiking from 1.7 percent to 3.0 percent over the course of 20 weeks (an experience now referred to as the “taper tantrum”).

Investors may be underestimating these risks because, as highlighted earlier in the report, foreign demand may avert a sell-off in the near term, but it would not take a significant upward move in rates to generate losses for core fixed-income investors once this demand subsides. At a coupon rate of 2.125 percent, it would only take a 28-basis-point rise in rates for 10-year U.S. Treasuries to earn a negative total return over a one-year holding period. When investors look at Treasuries from this perspective it is easy to see them as effectively becoming “return-free risk.”

Era of Return-Free Risk

U.S. 10-Year Treasury One-Year Holding Period Returns



Benchmark-driven investors face significant interest-rate risk. It would only take a 28-basis-point increase in rates for the 10-year Treasury note issued in May 2015 to earn a negative total return over a one-year holding period. With the risk in Treasuries heavily skewed to the downside, we believe Treasuries have gone from offering “risk-free return” to now effectively becoming “return-free risk.”

Source: Bloomberg. Data as 6/30/2015. The total-return scenario is calculated based on a yield to maturity of 2.41 percent and an effective duration of 9.0 years.

Future Investment Blueprint

It may seem that increased credit and duration risk have become prerequisites for some core bond investors to generate yield. We believe there is a more sustainable, long-term strategy that relies on the ability to uncover high-quality, investment-grade opportunities outside of the traditional benchmark-driven framework.

Increasing Yield without Adding Credit and Rate Risk

As investors prepare for a rising interest-rate environment, the typical core fixed-income portfolio response is to simply shorten portfolio duration, rather than to focus on more innovative solutions. Shortening duration offers a buffer against rising rates, but this generally comes at the expense of yield, particularly in corporate credit securities. The presumed positive correlation between yield and duration in the investment-grade universe has driven demand down the credit spectrum into lower-rated, high-yield bonds.

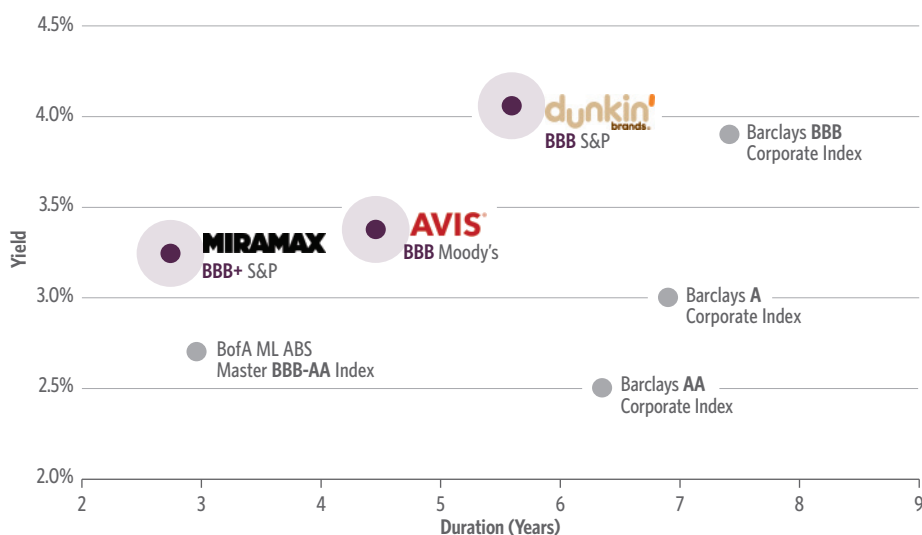
A broader investment focus beyond the traditional core fixed-income framework demonstrates that lowering duration, maintaining an investment-grade portfolio, and producing attractive yields do not necessarily have to be competing investment objectives. Outside of traditional benchmarks lie high-quality assets that can produce attractive portfolio yields comparable to similarly rated corporate bonds—with significantly less interest-rate risk. In this section we highlight two of those asset classes: commercial ABS and collateralized loan obligations (CLOs).

Commercial ABS is typically backed by cash flows from the receivables generated by businesses. Some examples include leases on shipping containers, aircraft, vehicles, and medical equipment. CLOs are a subset of a broader ABS category of corporate ABS. CLOs are investment vehicles that primarily invest in a diversified pool of bank loans.

In addition to comparable, or even higher, yields and lower durations, several characteristics make both commercial ABS and CLOs attractive. While corporate bond investors are exposed to the credit risk of one specific issuer or entity, idiosyncratic risks are mitigated in commercial ABS and CLOs through large, diversified collateral pools. These securities also generally offer significant downside structural protection during stressed economic environments through overcollateralization, excess spread, reserve accounts, and triggers that cut off cash flows to subordinated tranches. In addition, the amortizing structures of many asset-backed securities reduce credit exposure over time as a portion of the principal is paid down with each cash flow payment. Conversely, risks remain constant in corporate bonds due to the fact that their principal typically all comes due at the scheduled maturity date.

Discovering Yield in the Investment-Grade Universe

New-Issue Commercial ABS Can Provide Yield Without Increasing Credit and Rate Risk



The chart to the left compares a few investment-grade-rated commercial ABS transactions completed in 2014 against the average yield and duration of similarly rated corporate bond indices. These transactions offered higher or comparable yields, but with less duration exposure, making them more suitable investments to protect against rising rates.

Source: Guggenheim, Bank of America Merrill Lynch, Barclays. Data as of 6/30/2015. The securities mentioned are provided for informational purposes only and should not be deemed as a recommendation to buy or sell.

Liquidity Myth

If the ABS sector can offer such attractive solutions to core fixed-income investors, why don't more core bond funds invest in these securities? One reason is that the ABS subsectors where we find the most value are generally not represented in broadly followed fixed-income benchmarks, such as the Barclays Agg, because they remain a small portion of the fixed-income universe (although they are growing). The ABS subsectors represented in the Barclays Agg are traditional securitizations backed by credit-card receivables, student loans, and auto loans. Despite the generally improving credit fundamentals in these traditional sectors, their weighted-average yield in the Barclays Agg is only 1.5 percent, which decreases their attractiveness.

Our conversations with institutional investors suggest that the inability to readily access financial statement information on ABS securities inhibits their participation, ultimately prohibiting them from benefiting from the attractive yields and high-quality credit profiles. Many investors also

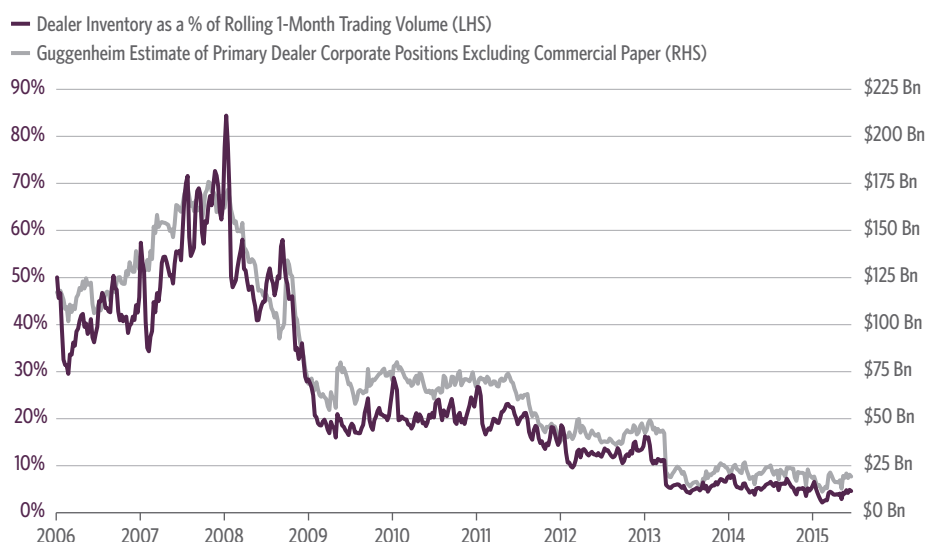
inaccurately believe that securities that do not appear in an index are automatically less liquid, thereby categorizing ABS sectors as such. We believe that the new regulatory landscape born from the financial crisis will eventually force investors to redefine liquidity and reassess the premiums that ABS securities carry.

Bank restrictions and requirements that have arisen from Basel III and the Volcker Rule have effectively removed banks as trading intermediaries by forcing dealers to reduce the amount of assets held on balance sheets for purposes of market-making, as they now have to hold more capital against assets. Heavy post-crisis regulation already appears to be impacting corporate bond and Treasury liquidity. The misperception that reduced liquidity applies exclusively to ABS is a myth based on a preconception of market-maker behavior.

Primary dealer net inventory of corporate securities, including investment-grade corporate bonds, high-yield corporate bonds, and commercial paper, has declined from a peak of

The Disappearance of Traditional Liquidity Providers

Primary Dealer Net Inventories of Corporate Bonds and Share of Trading Volume



Source: Federal Reserve Bank of New York, Bloomberg, Guggenheim. Data as of 6/30/2015. LHS = Left hand side. RHS = Right hand side.

\$286 billion in October 2007 to \$31 billion as of June 2015. Prior to the financial crisis, dealer inventories were sufficient to cover at least 40 percent of one-month corporate bond trading volume, but this has since declined to only 5 percent as of June 30.

Corporate bond market volatility at the height of the financial crisis may foreshadow the volatility lurking beneath credit markets in the absence of banks acting as intermediaries. In 2008, when investors were most eager to exit credit, primary dealer trading volume of investment-grade and high-yield corporate bonds fell to a seven-year low of \$786 billion, down 40 percent from \$1.3 trillion in 2007. In the four weeks that followed the Lehman Brothers bankruptcy filing in September 2008, investment-grade and high-yield corporate bonds declined by 8 percent and 20 percent, respectively, their largest four-week price decline on record based on the Barclays Investment Grade and High Yield Corporate Bond indices.

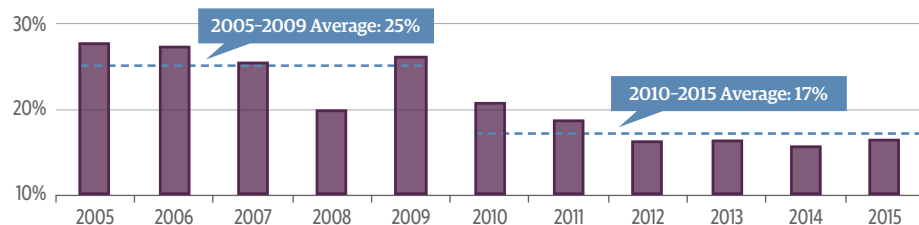
Reductions to bank balance sheets have resulted in a 91 percent decline of primary dealer inventory of corporate bonds (excluding commercial paper) since its peak in October 2007. Prior to the financial crisis, primary dealer inventory represented at least 40 percent of monthly trading volume in corporate bonds. As of June 2015, primary dealer net inventory represented only 5 percent of corporate bond monthly trading volume.

Even though we remain in a relatively benign environment for credit—one where both buyers and sellers can readily be found—the turnover rate of the corporate bond market has declined precipitously since 2007. In the first quarter of 2015, \$953 billion of publicly traded investment-grade bonds were reported to the Financial Regulatory Authority (FINRA) through the Trade Reporting and Compliance Engine System (TRACE), or approximately 17 percent of the investment-grade market. In the five years preceding the emergence of post-crisis macroprudential policies (between 2005 - 2009), 25 percent of the investment-grade market was typically traded in a single quarter, on average. Given that dealers generally reduce risk during volatile periods, as evidenced by lower dealer trading volumes during the financial crisis, the implications are that liquidity conditions may deteriorate further in future times of distress.

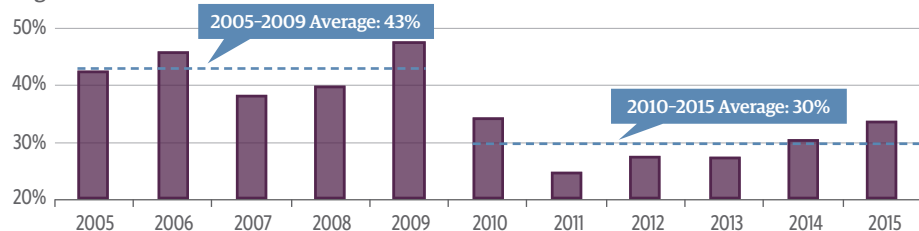
Corporate Bond Market Turnover Has Declined

High-Yield and Investment-Grade Corporate Bond 90-Day Trading Volume as a Percent of Market Size

Investment-Grade Bonds



High-Yield Bonds



Source: Bloomberg, Bank of America Merrill Lynch, Guggenheim. Data as of 6/30/2015.

Quarterly trading volume as a percentage of market size, also known as market turnover, has declined in both investment-grade and high-yield bond markets since the introduction of a slew of post-crisis regulation in 2010.

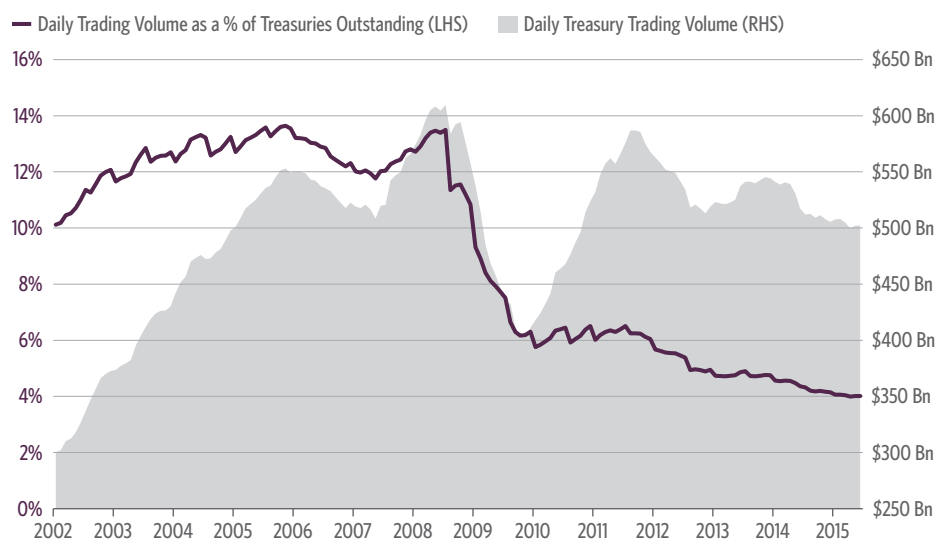
The Treasury market, considered highly liquid due to its size, history, and partly due to its government guarantee, has itself undergone periods of illiquidity in the post-crisis era. In June 2013, repo rates for specific Treasury collateral turned negative for Treasuries in short supply. Negative repo rates for Treasury collateral meant that participants who typically acted as cash lenders (thereby earning interest) were willing to pay interest in order to obtain specific Treasury securities. The fact that these events occurred in a fairly benign environment suggests that, all else being equal, diminished liquidity awaits investors when heightened fears or a potential Black Swan event escalate demand for Treasuries. Similar to the corporate bond market, we have also seen trading activity as a percentage of Treasuries outstanding decline materially in the post-crisis era.

In our view, there is a liquidity myth plaguing fixed-income markets. The myth is that under the new regulatory regime,

traditionally liquid fixed-income assets will remain just as liquid during times of financial distress as they were pre-financial crisis. Intermediaries that have provided liquidity in the past by fulfilling the role of market-makers are now disappearing. In the current, highly regulated environment, it is unlikely that traditional intermediaries will put capital at risk during times of heightened volatility. We believe that the unintended consequence will be that historically liquid assets no longer carry the same liquidity profile as they did under the old regulatory regime. The misperception of greater liquidity in the corporate bond market causes investors to willingly accept lower returns in corporate bonds than they would in equally rated ABS securities. However, investors would gain more from capturing the premium in ABS, a reward available to managers who have the resources and expertise to conduct rigorous credit analysis on securitized assets.

Daily Turnover in the Treasury Market Has Declined Since the Financial Crisis

Average Daily Treasury Trading Volume and as a Percent of All Outstanding



Source: SIFMA, Guggenheim. Data as of 6/30/2015. *Note: Trading volume is based on a rolling 12-month average.

We estimate that less than half of the total Treasury market is truly available to investors for trading and investment, with the remainder of the market held by the Fed, foreign central banks, and U.S. banks—holders who typically own Treasuries to manage currency reserves or to meet regulatory requirements. The consequence has been lower turnover. Historically, more than 10 percent of the Treasury market would trade on a daily basis. In the post-crisis era, turnover has declined to only 4 percent of the Treasury market trading on a daily basis, on average.

Monetizing Complexity

Commercial ABS requires sophisticated investment teams with a deep understanding of the structural and collateral complexities specific to each security. With over 90 investment professionals actively analyzing these investments, Guggenheim is well positioned to uncover this value. Guggenheim also has a dedicated legal staff to review the extensive documentation that generally accompanies structured credit. We believe this deep level of due diligence is well worth the reward. In 2014, many newly issued commercial ABS offered yields in excess of 100 basis points over similarly rated corporate bonds with far less interest-rate risk.

CLOs are benefiting from over four years of low bank loan default rates, a trend that historically continues two years after the Fed begins raising interest rates. In addition, rating agencies have been restoring the credit ratings of CLOs originated before the financial crisis (CLO 1.0) to their original ratings, or better, recognizing that they had unfairly lumped the asset class with other structured securities with weaker protections. However, the heterogeneous nature of

the underlying investments in a single CLO also demands significant credit and legal expertise. CLOs are typically backed by over 100 bank loans, each of which must be reviewed as part of the structural analysis that evaluates the extent to which junior CLO tranches, which protect senior tranches from losses, could experience principal loss in the event of widespread defaults.

Even with an improving credit profile, record new-issue volume in CLOs has kept spreads in the sector well above historical averages. Single-A-rated CLO 1.0 debt offered 200 basis points over London Interbank Offered Rate (LIBOR) in the first half of 2015, on average, compared to their average spread of 118 basis points before the financial crisis, despite the fact that they now only have about two to three years remaining to maturity. Unlike many bank loans, CLOs do not have LIBOR floors, which allow investors to enjoy rising coupons soon after LIBOR rises. As a result, CLOs have virtually no interest-rate risk. New-issue CLO spreads look attractive as well, with newly issued AAA-, AA-, A-, and BBB-rated CLO debt offering 152, 217, 316, and 427 basis points over LIBOR in the first half of 2015, on average.

Barbell Strategy for Long-Duration Investors

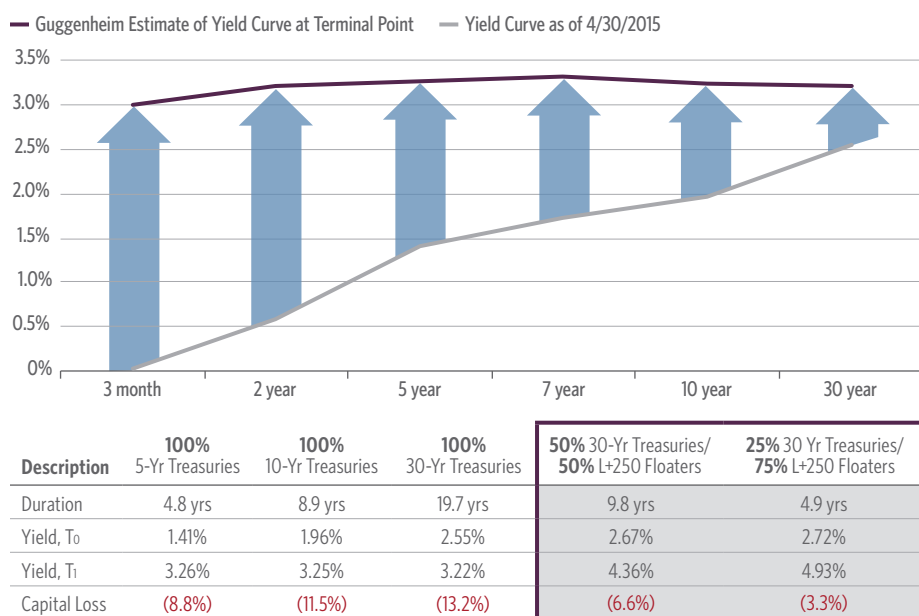
To further mitigate the potential risks associated with a rising interest-rate environment, particularly for investors who need to maintain longer-asset durations in order to match their liabilities, we recommend a barbell strategy, which structures a portfolio with both short- and long-duration securities. Shortening portfolio duration alone is an optimal defensive strategy if rates are rising equally across the curve. However, in a rising rate environment where the Fed is tightening monetary policy, rates do not typically rise in parallel fashion across the yield curve. Instead, short-term rates rise more than long-term rates. In prior Fed tightening cycles, long-term rates have actually ended lower than short-term rates as future growth expectations decline. The implication for investors is greater rate volatility at the short-end of the curve compared to the long-end. A barbell strategy that complements an allocation to long-dated bonds with floating-rate assets dually benefits from greater price stability and rising income from its floating-rate investments.

The behavior of the yield curves in the past three tightening cycles suggests that if the Fed raises short-term interest rates to 3 percent in the upcoming tightening cycle, then the 3-month Treasury yield should rise by approximately 300 basis points, the 10-year Treasury yield should rise by approximately 129 basis points, and the 30-year Treasury yield should rise by approximately 67 basis points from their levels as of March 30, 2015. Assuming an instantaneous shift in rates, a portfolio that is 100 percent invested in 10-year Treasuries with a duration of nine years would lose 11.5 percent in principal value (nine-year duration * 1.29 percent rate change * 100 percent allocation). A portfolio that is 100 percent invested in 30-year Treasuries with a duration of approximately 20 years would lose 13.2 percent in principal value, slightly more than a portfolio invested in 10-year Treasuries, without accounting for the higher coupon earned in longer-dated bonds.

A barbell strategy that allocates 75 percent in floating-rate assets earning 250 basis points over LIBOR and 25 percent

Greater Change in Short-Term Yields as the Fed Tightens

Guggenheim's Estimate of the Yield Curve at the Terminal Point



Source: U.S. Department of the Treasury, Guggenheim. Current yield curve is based on the curve as of 3/30/2015, 6 months before the start of the Fed tightening cycle, assuming the Fed raises interest rates in September 2015. Increase in interest rates and terminal yield curve are based on the average increase in rates across the curve over the past 3 tightening cycles, which began in 1994, 1999 and 2004.

Historically, the yield curve flattens as the Fed tightens monetary policy by raising short-term interest rates. A flattening yield curve suggests that there is higher rate volatility in short and intermediate fixed-rate bonds than in longer-dated bonds. Given greater volatility at the short and intermediate end of the curve, we believe a barbell strategy is the best approach for fixed-income investors who must maintain longer portfolio durations while managing rising rates in a flattening yield curve environment.

in 30-year bonds would achieve a duration target of approximately five years and lose only 3.3 percent in principal value.

In reality, yield curve shifts are gradual, and if we incorporate the impact of bond convexities, we would illustrate a more realistic example of bond price movement. However, our hypothetical example demonstrates that shortening duration alone is not the best strategy when rates are rising more dramatically at the short and intermediate points of the curve compared to the long end. A barbell strategy can mitigate the negative impact of a flattening yield curve. In our view, investors who allocate to floating-rate CLOs and commercial ABS as part of a barbell strategy also capture yield advantages while meeting a portfolio duration target.

To complement the short duration of commercial ABS and CLOs in the barbell strategy, we continue to find long-dated taxable municipal bonds attractive. Fundamentals across a number of municipalities have been improving over the past several years, with state and local tax receipts rebounding from a dip in 2013 and with many states enjoying surplus revenues, allowing them to replenish their politically sensitive “rainy day” funds. Additionally, most state and local governments have made progress fixing major structural problems, such as rising healthcare costs and pension shortfalls. As political and headline risks subsided and fundamentals strengthened, the municipal market was the best-performing fixed-income asset class in 2014.

Our outlook for the municipal bond market in 2015 is cautiously optimistic, with rigorous credit analysis and selectivity remaining key to our investment strategy. Some of the issues that plagued the municipal market in 2013 and in the first half of 2014 may re-emerge over the next 12 months. Among those is the federal government debt-ceiling debate, which creates political uncertainty and may cause volatility. Although fundamentals have improved in a number of states, negative headline risk also continues to exist for historical names such as Detroit, Puerto Rico, and Illinois. Traditionally, the municipal market has had a large retail investor base that does not have the skill to differentiate between headline risk and the quality of individual credits. Therefore, negative headlines can reduce retail demand for certain high-quality

municipal credits, leaving room for better pricing and allocations to credit managers with the experience to discern signal from noise.

While we remain positive on our overall outlook for the municipal market, the continued potential for political uncertainty and headline risk across troubled issuers further strengthens our conviction that no investment decision can be made by shortcutting due diligence. Our approach in security selection within the municipal market is no different than for sectors that have historically carried greater credit risk. With diligent credit analysis by experienced and dedicated professionals, we see a barbell strategy utilizing taxable municipal bonds as a potential solution to the core conundrum for investors requiring longer-duration exposure.

The Future of Core Fixed Income

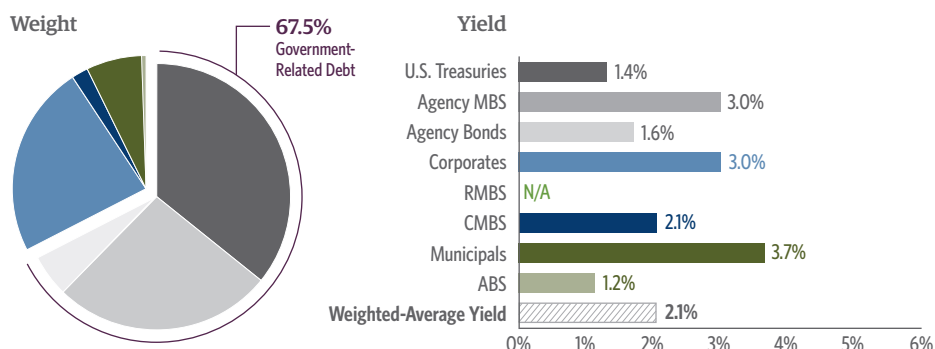
The traditional core fixed-income strategy is overly confined by a benchmark that no longer accurately reflects the opportunities that exist in the fixed-income landscape today. It restricts portfolios from shifting toward more attractive opportunities that emerge from changing markets, and perhaps most importantly, it fails to incorporate active duration management, which could result in real losses. As the chasm between investors' income targets and obtainable market yields deepens, it is apparent that the traditional view of core fixed-income management requires innovation.

We believe the future of any core fixed-income strategy lies in the ability to break from the reliance on benchmark weights in determining how to allocate a fixed-income portfolio. Fixed-income managers must actively identify where real value lies, shifting when markets shift, and leveraging their expertise to find opportunities outside of the benchmark where value remains largely unexploited. For core investors, achieving yield targets is obtainable in high-quality investments, but it requires more credit work and diligence than a portfolio that is largely constructed based on each sector's weight within an index. Achieving yield targets without assuming undue risk has proven extremely difficult under the traditional framework, but we believe it is achievable under a broadened investment framework backed by specialized credit professionals.

The Changing of the Guard

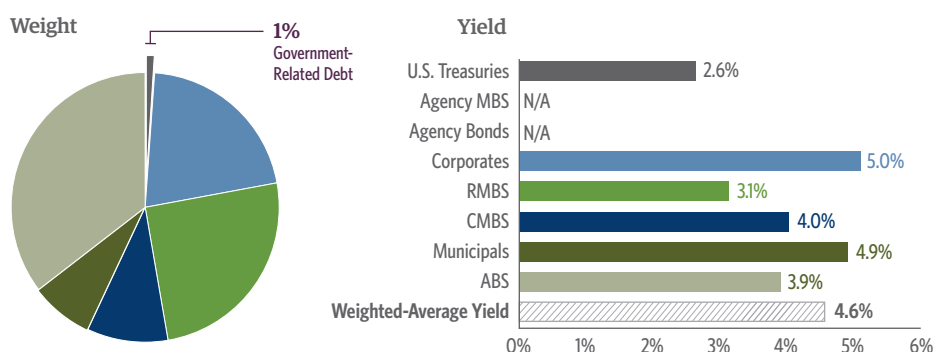
The Future of Core Fixed-Income Management

Traditional View: Barclays U.S. Aggregate Index



With the traditional view of core fixed-income management quickly becoming antiquated in the current and persistent low-yield environment, investors must begin looking toward the future. Rigorous and specialized credit analysis can uncover attractive duration and yield in otherwise underappreciated asset classes, such as commercial ABS and CLOs, thus delivering strong performance independent of the Barclays Agg.

Future View: Guggenheim Core Fixed Income



Source: Barclays, Guggenheim Investments. Data as of 4/30/2015. Sector allocations are based on the representative account of the Guggenheim Core Fixed-Income Strategy and excludes cash. The representative account was chosen since, in our view, it is the account within the composite which, generally and over time, most closely reflects the portfolio management style of the composite.

Accommodative policies by global central banks may continue to support a benign credit environment, but current conditions are likely masking a comprehensive, market-wide under-appreciation of investment risks. Investors must remain vigilant in identifying the risks involved in reaching for incremental yield, since not all yield is created equal. Employing investment shortcuts, such as increased credit or interest-rate risk solely to generate yield, may come at the expense of future performance.

By remaining tightly aligned to the Barclays Agg, which is currently bloated with low-yielding government-related debt, investors are giving up the flexibility to take advantage of undervalued sectors and to limit exposure to unattractive ones. In a market coping with unprecedented monetary conditions, we believe the surest path to underperformance is to remain anchored to outdated core fixed-income conventions of the past. An approach that is not confined by a traditional benchmark may be the investment blueprint needed to meet current and future investment objectives.

Important Notices and Disclosures

Past performance is not indicative of future results.

The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

A Black Swan event is a highly unexpected event that has an extreme and unpredictable impact on external factors, which may include financial and global markets.

The London Interbank Offered Rate (LIBOR) is a benchmark rate that a select group of banks charge each other for unsecured short-term funding.

The Barclays AA Corporate Index, the Barclays A Corporate Index and the Barclays BBB Corporate Index are all subcomponents of a broader Barclays U.S. Corporate Investment Grade Index, which is comprised of publicly issued and SEC-registered U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

The Barclays BB Corporate Index is a subcomponent of the Barclays U.S. High Yield Index, which covers the universe of fixed rate, non-investment grade debt. Original issue zeroes, step-up coupon structures, 144-As, and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The BofA Merrill Lynch AA-BBB US Fixed Rate Asset Backed Index is a subset of The BofA Merrill Lynch US Fixed Rate Asset Backed Securities Index including all securities rated AA1 through BBB3, inclusive. The BofA Merrill Lynch US Fixed Rate Asset Backed Securities Index tracks the performance of U.S. dollar-denominated investment-grade fixed-rate asset-backed securities publicly issued in the U.S. domestic market.

Fixed-income investments are subject to credit, liquidity, interest rate and, depending on the instrument, counterparty 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 and changes in prevailing interest rates.

Investing in bank loans involves particular risks. Bank loans 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. 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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²Assets under management are as of 6.30.2015 and include consulting services for clients whose assets are valued at approximately \$49 billion.

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