Market Review

Recent U.S. economic data demonstrate that the expansion is being helped by lower rates. New homes sales have risen at a double-digit year-over-year pace for four consecutive months since August, spurred by lower mortgage rates but also base effects. Manufacturing production rose in both November and December, corroborating the signal seen in improving manufacturing surveys. Nonfarm payroll gains averaged 184,000 in the fourth quarter, above underlying labor force growth. Income gains and a positive wealth effect are also flowing through into retail sales, where “core” sales recovered in December after three months of declines.

The latest evidence suggests that the Federal Reserve’s (Fed’s) easing efforts have given the U.S. economy the extra gas it needed to extend the cycle. Furthermore, the new year kicks off with some clarity on U.S.-China trade policy.

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Market Review (Continued)

The eleventh-hour Phase 1 U.S.-China trade agreement may give U.S. companies some comfort that they can expect tariffs on either side to remain where they are for now. This should help support U.S. manufacturing activity, especially if China steps up purchases of U.S. goods as promised.

Over the next several months, we expect the Fed will stay on hold as it watches incoming data to ensure that the current level of fed funds remains appropriate. Monetary policy acts on the economy with a lag, so the effects of the last rate cut in October 2019 might not be apparent until mid-2020. More economic data improvements may come as low rates flow through to consumers and to the credit markets.

Encouraged by positive data, market participants welcomed the new decade with cautious optimism. Credit spreads are near historical tights, but the CCC-BB spread in high-yield corporates and bank loans remains above their five-year averages. 10-year Treasury yields, while off their 2019 lows, have failed several times to rise above 2 percent. This reminds us that while the Fed has successfully pushed off a recession, 2020 arrives with many risks worth watching, including the U.S. presidential election, U.S.-Europe trade negotiations, the potential for a military conflict between the U.S. and Iran, and rising corporate and local government defaults in China.

Much of the global growth in this cycle has been driven by an accumulation of debt, which has a declining marginal return. Without a down cycle to deflate some of the bubble, easy credit availability at this stage keeps the weakest companies on life support as low rates force investors to provide capital to borrowers teetering on the brink of downgrade or default. In this environment, even if the CCC-BB spread compresses back to historical tights, it is not a credit rally we would chase.

Economic data suggest the Fed has successfully pushed off a recession by cutting rates and injecting significant amounts of liquidity. After tightening notably at the end of 2019, we expect credit spreads to move sideways over the next quarter. We remain concerned that credit excesses will balloon as a result of global central bank liquidity that is pushing on a string. Given tight spreads and high prices, it remains prudent to invest where we assess creditworthiness to be solid and where spreads adequately compensate for risk.

Summary:
- Recent U.S. economic data demonstrate that the expansion is being helped by lower rates. New homes sales have risen at a double-digit year-over-year pace for four consecutive months since August, manufacturing production rose in both November and December, and nonfarm payroll gains averaged 184,000 in the fourth quarter. Income gains and a positive wealth effect are also flowing through into retail sales.

- The eleventh-hour Phase 1 U.S.-China trade agreement may give U.S. companies some comfort that they can expect tariffs on either side to remain where they are for now. This should help support U.S. manufacturing activity, especially if China steps up purchases of U.S. goods as promised.

- The Fed’s easing efforts have given the U.S. economy the extra gas it needed to extend the cycle. Over the next several months, we expect the Fed will stay on hold as it watches incoming data to ensure that the current level of fed funds remains appropriate.

- Credit spreads are near historical tights, but the CCC-BB spread in high-yield corporates and bank loans remains above their five-year averages. 10-year Treasury yields, while off their 2019 lows, have failed several times to rise above 2 percent. While the Fed has successfully pushed off a recession, risks remain.

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Market Review (Continued)

- Much of the global growth in this cycle has been driven by an accumulation of debt. Without a down cycle to deflate some of the bubble, easy credit availability keeps the weakest companies on life support. In this environment, even if the CCC-BB spread compresses back to historical tights, it is not a credit rally we would chase.

Performance Review

The fund returned 0.33 percent for the fourth quarter, driven by the portfolio’s carry. Most asset categories rallied over the quarter as global central bank easing, balance sheet expansion, and a flood of liquidity drove prices higher. The fund’s income focus and low duration led to positive absolute performance over the quarter. While defensive positioning – including lower corporate credit exposure and greater than normal liquidity reserves – limited the fund’s upside as spreads tightened, it serves to help mitigate drawdown risk as investment grade credit spreads ended 9 basis points (bps) from their post-crisis tights at year-end.

Strategy and Positioning

The Fed with its shift in policy has decreased the odds of a recession near-term and has likely extended the expansion. Within the U.S. economy weakness in manufacturing data looks to be bottoming, the consumer is in good shape, and the labor market remains extraordinarily resilient. The recovery in the U.S. is also helping to drive a pickup in global economic activity.

Fed Chair Jerome Powell referred to the first cut as a brief “mid-cycle” rate adjustment, as opposed to the beginning of a lengthy cutting cycle. The Fed’s 1998 mid-cycle adjustment resulted in a liquidity-driven rally that caused the Nasdaq index to double within a year before the bubble finally burst. It also led to a significant widening of credit spreads, well in advance of the economy rolling over.

With that in mind and with corporate credit spreads near cycle tights, the fund continued to focus on income and capital preservation in a market where the risk/reward trade-off looks unattractive in many credit sectors. Low volatility and reducing drawdown risk remained a priority for the fund. As such, the fund continued to invest in assets classes that have a low likelihood of default and are expected to exhibit minimal spread volatility with stable returns under a variety of credit and rate environments.

Within our credit exposure we continued to favor structured credit over corporate credit given what we view as a compelling spread pickup to similarly rated corporates, while providing defensive positioning through shorter spread duration profiles.

Over the longer-term, our relatively defensive credit positioning should help the fund to weather a risk-off environment and give the Fund the opportunity to add below investment grade credit exposure at more opportune spread levels.

Asset-backed securities (ABS), which constituted 15 percent of the fund at year’s end, generated positive total returns as the investor base for structured credit, including aircraft securitization and other commercial ABS, continues to grow. Lease and renewal rates for midlife aircraft (those securitized in aircraft ABS) are expected to be supported by new aircraft supply disruptions and relatively low fuel prices.

Non-agency residential mortgage-backed securities (RMBS), which constituted 14 percent of the fund at year’s end, also contributed positively, as lower rates and improving credit fundamentals drove higher prepayments for discounted dollar price holdings. Limited home inventory and improving labor market conditions should support home prices and mortgage credit performance. Pre-crisis RMBS investment has benefited from a supply shortfall caused by ongoing paydowns and a lack of new issuance.

Collateralized loan obligations (CLOs), which constituted 12 percent of the fund at year’s end, contributed to performance despite minor spread widening over the year. New issue supply and intermittent weakness in the loan market led the sector to underperform other credit sectors. However, spreads remain considerably wider than many other asset categories, particularly those with a similar credit profile or spread duration. We continue to favor senior CLOs with short spread durations, as they offer a compelling spread pickup to similarly rated corporates.

Bank loans, which constituted 5 percent of the fund at quarter’s end, generated a positive total return as income earned outweighed minimal spread widening over the period. The fund has steadily reduced its loan exposure throughout this year’s rally.

The remainder of the fund was invested across other credit sectors including short investment grade corporates, high yield, CMBS and short-term investments. These categories exhibited positive total return for the period.
Definitions Carry: The difference between the cost of financing an asset and the interest received on that asset. Basis point: One basis point is equal to 0.01%.

Risk Considerations This fund may not be suitable for all investors. Investments in fixed-income instruments are subject to the possibility that interest rates could rise, causing the value of the Fund’s holdings and share price to decline. • Investors in asset-backed securities, including 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. • High yield unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. • The intrinsic value of the underlying stocks in which the fund invests may never be realized or the stock may decline in value. • When market conditions are deemed appropriate, the fund may leverage to the full extent permitted by its investment policies and restrictions and applicable law. Leveraging will exaggerate the effect on net asset value of any increase or decrease in the market value of the fund’s portfolio. • The use of short selling involves increased risks and costs. You risk paying more for a security than you received from its sale. Theoretically, stocks sold short have the risk of unlimited losses. • The fund may invest in derivative instruments, which may be more volatile and less liquid, increasing the risk of loss when compared to traditional securities. Certain of the derivative instruments are also subject to the risks of counterparty default and adverse tax treatment.

• Instruments and strategies (such as borrowing transactions and reverse repurchase agreements) may provide leveraged exposure to a particular investment, which will magnify any gains or losses on those investments.

• Investments in reverse repurchase agreements expose the fund to the many of the same risks as investments in derivatives. • The fund’s investments in other investment vehicles subject the fund to those risks and expenses affecting the investment vehicle. • The fund’s investments in foreign securities carry additional risks when compared to U.S. securities, due to the impact of diplomatic, political, or economic developments in the country in question (investments in emerging markets securities are generally subject to an even greater level of risks). • Investments in syndicated bank loans generally offer a floating interest rate and involve special types of risks. • A highly liquid secondary market may not exist for the commodity-linked structured notes the fund invests in, and there can be no assurance that a highly liquid secondary market will develop. • The fund’s exposure to the commodity markets may subject the fund to greater volatility as commodity-linked investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity. • The fund’s investments in municipal securities can be affected by events that affect the municipal bond market. • The fund’s investments in real estate securities subject the fund to the same risks as direct investments in real estate, which is particularly sensitive to economic downturns. • The fund’s investments in restricted securities may involve financial and liquidity risk. • You may have a gain or loss when you sell your shares. • It is important to note that the fund is not guaranteed by the U.S. government. • Please read the prospectus for more detailed information regarding these and other risks.

Index Definitions The ICE® BofAML® 3-Month U.S. Treasury Bill Index is an unmanaged market index of U.S. Treasury securities maturing in 90 days that assumes reinvestment of all income.

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