



GUGGENHEIM PARTNERS' INVESTMENT FOCUS – VOLUME 1, 2011

Equity Macro-Themes

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Equity Macro-Themes



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Each quarter Guggenheim Partners selects an investment theme, asset class, or sector to highlight. In this issue of the Guggenheim Investment Focus, we offer our macro-perspectives on why we believe U.S. equities are well-positioned to sustain the current bull market advance for an extended period of time.

Overall, we believe economic growth in the United States will be stronger than the market is currently discounting. On a relative-value basis, compared with other global markets, the U.S. equity markets should prove to be one of the more attractive places to invest during this expansionary post-recession period.

From a fundamental standpoint, we see favorable dynamics in each of the core drivers of equity returns: earnings growth, valuation multiple expansion, portfolio flows, and dividend growth.

The combination of these factors constitute our equity macro-themes, which we believe point to long-run total returns for U.S. equity investors that are in line with the historic mean of 10 to 11 percent per annum.

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Introduction: The Macro-Economic Backdrop



BY SCOTT MINERD
Chief Investment Officer

Don't be surprised if long-term interest rates stay at historically low levels and inflation remains modest for some time. As the U.S. economic expansion continues, equities will be a primary beneficiary.

In the years leading up to the recent financial crisis, I gained a reputation for being permanently bearish. As I shared my macro-economic outlook with clients in 2005 and 2006, in particular, the most common response was something along the lines of, "Great, now that I'm totally depressed, what else is there to talk about."

Today, however, I'm starting to have the opposite problem – people think my outlook is far too sanguine, at least with regards to the United States.

For example, I'm bullish long-term on U.S. equities, I think U.S. GDP will beat consensus expectations, I don't believe interest rates are going through the roof, and I don't believe inflation is the problem that everyone advertises it to be, at least not today. (None of these statements are forever, mind you, but they apply to a period meaningful enough to make a real impact on asset allocation and annualized returns).

Neither sanguine nor cynical, I think Lawrence Strauss at *Barron's* did an exceptional job capturing the essence of my current take on the world. Following a recent interview where we discussed the current investment landscape at length, Lawrence boiled everything down to a single phrase, which ended up being the title of the piece he published:

"Enjoy the Good Times While They Last"

The "good times" relate to the fact that the U.S. economy is clearly in an expansionary portion of the business cycle with the majority of indicators moving in the right

direction. For example, in February, there were gains in 9 out of the 10 inputs to the Conference Board Leading Economic Index (LEI). This included solid improvements in employment, consumer expectations, and manufacturing. The lone drag came from the housing market, an area that should continue to lag the rest of the economy for some time.

Overall, I believe long-term growth in the United States will be even stronger than the market is currently discounting.

The vast amounts of monetary and fiscal stimulus that have been unleashed in the system have created a rising tide of liquidity that's lifting asset prices for just about everything except real estate. The equity markets have particularly benefited, as we have already seen.

Going forward, the burning questions seem to be: what will happen once the accommodative monetary spigots are turned off, and when will the specter of inflation reach the United States as it has begun to do in other global markets?

First off, I don't believe quantitative easing will be immediately inflationary. Nor do I believe that its expiration will lead to a meaningful increase in interest rates. To be sure, rates will bounce around, but they should trade in a band that stays around historically low levels for an extended period of time.

With regards to inflation, I believe current price pressures are specific and transitory, rather than structural and broad-based. While transitory price pressures may cause concern,

I expect the Federal Reserve will hold off on the tightening front until 2012.

Post QE2, support will remain from fiscal policy, as the current Obama Administration will likely remain committed to its pro-economic growth agenda through the 2012 presidential election. So far, this is all the good news.

The bad news is that there are massive structural problems in the United States that are not being addressed. Eventually, the nation will have to face its deficit spending addiction, and eventually inflation will sneak up on policymakers when they least expect it. But those periods are not today. And they are not immediately pending either.

The reality is that the whole world is in the midst of kicking the can down the road. For investors, the most important questions should be: where are the investment opportunities during this interim period of expansion, and how does the U.S. economy stack up relative to the rest of the world?

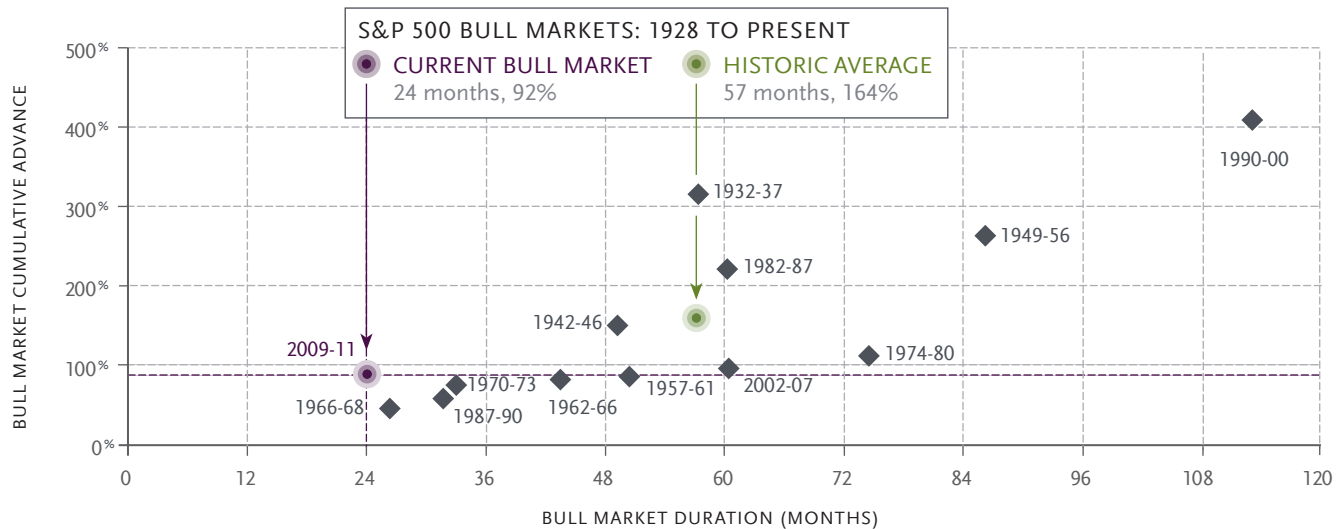
In this regard, I believe there is a chain of economic dominos that bodes well for capital flows to U.S. markets. Given the turmoil in the Middle East and North Africa, the overheating in the emerging markets, the debt crisis in Europe, and the disaster in Japan, the U.S. economy is well-positioned to attract an increasing share of global capital.

On a relative-value basis, the U.S. equity markets should prove to be one of the more attractive places to invest during this expansionary post-recession period. □

Introduction (continued): The Current Bull Market in Pictures

IF THE CURRENT BULL MARKET WERE TO END TODAY, IT WOULD BE THE SHORTEST ON RECORD

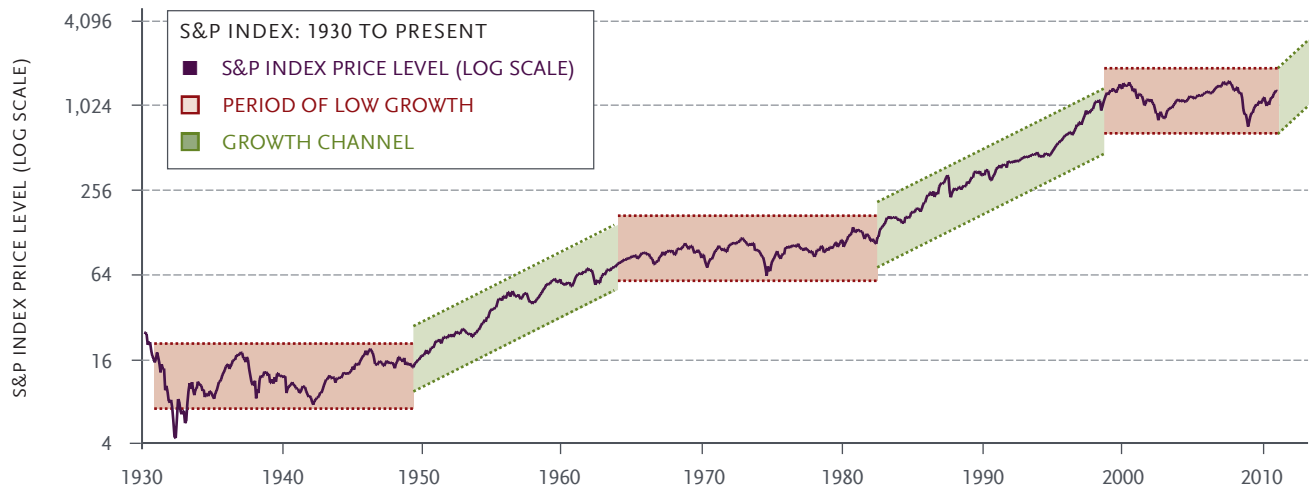
On March 9, 2011, the bull market in U.S. equities celebrated its second anniversary in rather dubious fashion by losing 5% in two weeks. We viewed this as a healthy pause since the current rally had extended far beyond its 200-day moving average. We do not, however, believe that the current bull market is at risk of being interrupted in a meaningful way. If fact, if it were to end today, it would be the shortest bull market on record. On a fundamental basis, we believe the macro-drivers are in place for continued growth.



Source: Strategas.

MULTI-YEAR RALLIES FOLLOWING EXTENDED PERIODS OF LOW ANNUALIZED RETURNS

Over the past 80 years, there have been only three periods of prolonged non-performance in the U.S. equity markets, all of which were tied closely to severe economic shocks and restructuring of the U.S. economy: the Great Depression, the period surrounding the recessions in 1969-1970 and 1973-1975, and the decade between the dot com recession and the recent financial crisis. Following the past experiences of severe recession and shock, once economic growth took root again there were multi-year rallies in the U.S. equity markets (see “The Case for Mean Reversion” section on pages 13-15 of this report for more information).



Source: Bloomberg, Guggenheim.

Drivers of Equity Returns

Equity returns are a function of corporate earnings, valuation multiples, portfolio flows, and dividends. In each of these areas, macro-fundamentals are in place for continued growth.

BY FARHAN SHARAFF
ASSISTANT CIO, EQUITIES

As has often been purported, 90 percent of value in a portfolio can be attributed to asset allocation. Determining the right asset allocation is a macro-driven process akin to drawing a road map of what the future looks like from a thematic standpoint.

Currently, our road map has a lot to say about the relative value we see in the U.S. equity market over the next several years. While there is a plethora of opinions on what may drive future returns, I prefer to conduct macro-analysis in terms of four fundamentals drivers of equity investment returns.

Ultimately, we are bullish on future equity returns due to our analysis of the following primary factors:

1. EARNINGS GROWTH

Earnings define the fundamental business performance that eventually accrues to shareholders. During the current bull market, reported earnings have beaten analyst expectations for eight consecutive quarters. We believe that a combination of resilient corporate profit margins and stronger-than-expected revenue growth should lead to profit levels that continue to exceed analyst expectations.

2. VALUATION MULTIPLE EXPANSION

Valuation multiples, most often defined by the price-to-earnings ratio, are a measurement of market sentiment. Higher P/E multiples reflect an increase in the relative premium investors are willing to pay for the privilege of ownership. Currently, valuation multiples remain modest,

with an average P/E for the S&P 500 that is 11 percent below its historic average. We expect a low-yield, low-inflation environment over the next several years. Against such a backdrop, we believe P/E multiples are poised to enter a cyclical expansion that will be an important driver of U.S. equity returns.

3. POSITIVE PORTFOLIO FLOWS

Portfolio flows are net changes in investor preference to hold one asset class relative to others. Portfolio flows are, in essence, a cyclical nuance that captures shifts in the aggregate behavior of investors. Currently, allocations to equities remain relatively low among retail and institutional investors. At a macro-level, we believe an asset-allocation shift toward equities is in its early stages. U.S. markets, in particular, are well-positioned to benefit from the influx of demand.

4. INCREASED DIVIDEND PAYMENTS

Dividends paid to shareholders have accounted for 35 percent of total return over the past 20 years. Dividend payments may increase as economic prospects brighten and corporations seek to deploy some of the \$2.4 trillion in cash that is currently sitting on their balance sheets.

We believe that the combination of favorable dynamics represented in each of these drivers should create a fertile landscape for U.S. equity returns over the next several years. We will explore why in the subsequent pages of this report. □

The Upside for Earnings

Corporate earnings have beat analyst expectations for eight consecutive quarters. We believe stable margins and greater-than-expected economic strength could allow this trend to continue.

BY SCOTT HAMMOND
PORTFOLIO MANAGER

There is an old marketing adage that says “Perception is reality.” When it comes to earnings performance and the public equity markets, this statement is actually quite powerful and true.

The market’s *perception* of a company’s future earnings potential translates into the *reality* of its stock price today. Thus, when reported earnings deviate from expectations, a stock’s price adjusts accordingly, be it up or down.

I rehash this rudimentary concept because exceeding or falling short of earnings expectations is an important factor in stock market returns. For example, earnings per share (EPS) for the S&P 500 Index fell short of consensus expectations for ten consecutive periods from the third quarter of 2006 to the fourth quarter of 2008. Consequently, during this period, the S&P 500 Index lost 40 percent of its value.

Conversely, the current bull market that began in March of 2009 has been fueled by eight consecutive quarters where EPS has exceeded consensus estimates (see the graph on the next page for historic EPS versus expectations).

When actual earnings are consistently above consensus expectations like this, it signals a recovery that is more robust than the market anticipated. This intuitively makes sense as we view the unprecedented balance sheet health of many companies less than two years after the most severe recession since the Great Depression. The question today, however,

remains whether or not future earnings can continue to surprise to the upside.

Looking forward, we believe there are several factors that could lead to higher-than-expected earnings per share for U.S. public companies.

First, corporate profit margins are near all-time highs. The general expectation is for margins to be squeezed by rising input prices. We believe that margins may prove more resilient than many anticipate.

Currently, manufacturing capacity utilization remains modest, worker productivity continues to rise, and per-unit labor costs are lower today than they were before the recession. These factors could act as profit margin buffers or stabilizers during periods of transient price pressures.

Next, we believe that future GDP growth will be above consensus expectations. Historically, the correlation between GDP and revenue per share for the S&P 500 is very strong (0.93). Therefore, it follows that if the U.S. economic growth exceeds expectations, revenues for the S&P 500 will surprise to the upside as well.

In the near term, a combination of resilient margins and stronger-than-expected top-line growth could lead to profit levels that exceed analyst expectations, which would in turn lead to increased equity returns. Even if one of these two assumptions plays out, it would likely still net out to be a positive driver for equity market returns. □

The Upside for Earnings *(continued)*

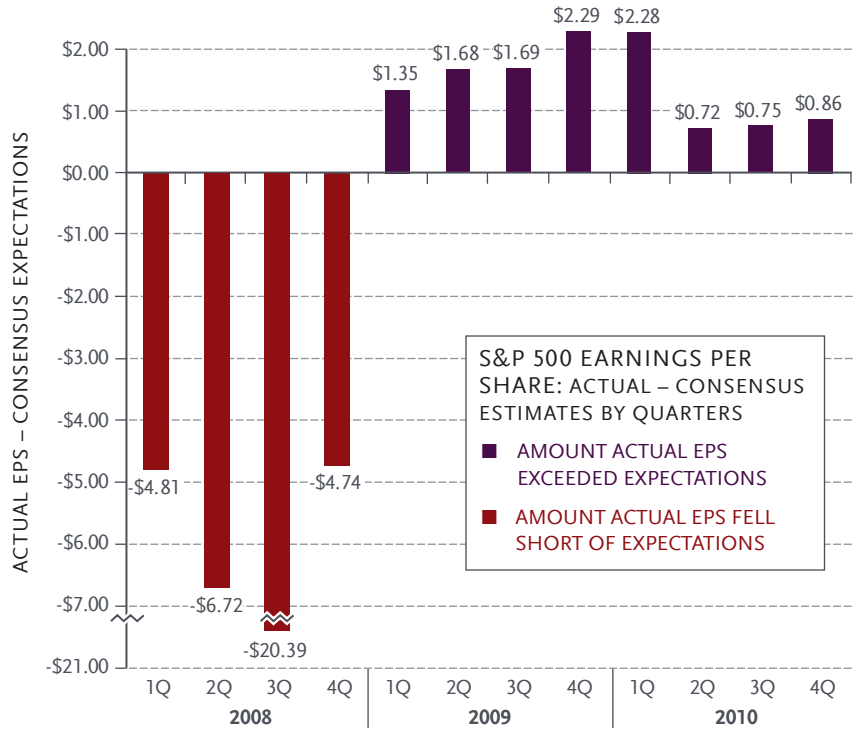
EARNINGS PER SHARE: ACTUAL VS. CONSENSUS ESTIMATES

During the current bull market in equities, earnings per share (EPS) for the S&P 500 have been more robust than analyst expectations.

In the fourth quarter of 2010, more than two-thirds of the S&P component companies beat analysts' estimates for revenues and just over 61 percent beat the consensus of earnings per share.

The continued upside surprise in revenue and profit is evidence that the economic recovery is going better than expected.

We believe future U.S. economic growth will also be more robust than consensus estimates, which should be another favorable variable for equities.



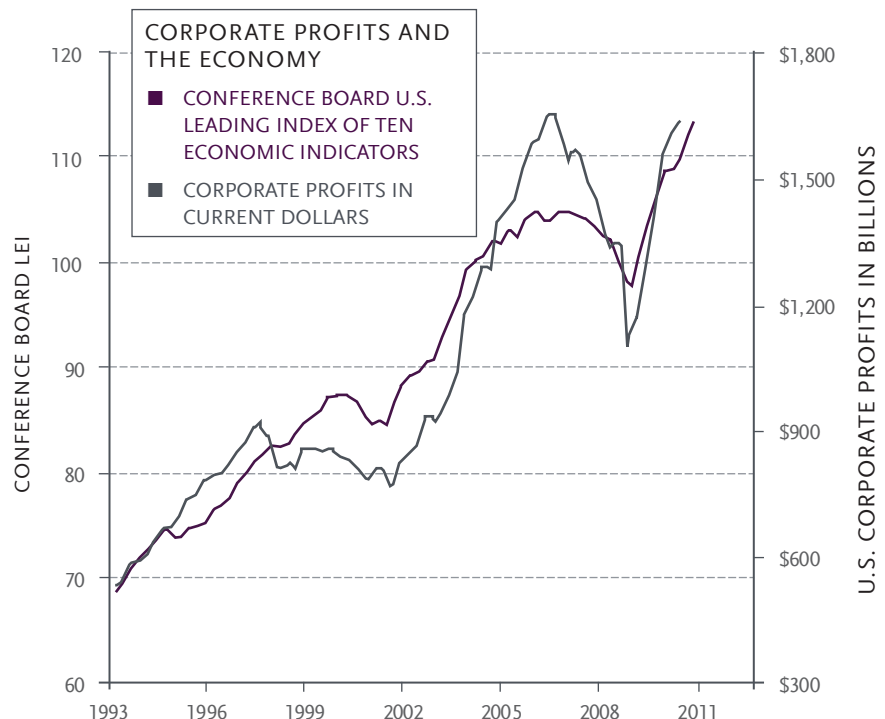
Source: Bloomberg, Standard and Poor's

EARNINGS GROWTH SHOULD CONTINUE TO BE FUELED BY GAINS IN THE OVERALL U.S. ECONOMY

There is a 95% correlation between the Conference Board's Leading Economic Indicator Index (LEI) and corporate profits.

During the financial crisis, the LEI turned the corner in March 2009, exactly at the start of the bull market in U.S. equities. More recently, the LEI notched its seventh straight monthly gain, and in February, nine of 10 indicators showed improvement. The only negative came from the housing market.

This broad base of improvement across sectors points to the sustainability of the current recovery, which should bode well for future corporate earnings.



Source: Standard and Poor's, Bloomberg

The Case for Multiple Expansion

Equity valuations remain modest. In the present low-yield, low-inflation environment, we believe P/E multiples are poised to enter a cyclical expansion that will be an important driver of returns.

BY FARHAN SHARAFF
ASSISTANT CIO, EQUITIES

Equity valuation experts can often lose sight of how macro changes in price-to-earnings multiples build over time. Valuation multiple advances and contractions often happen in cycles that can vary significantly in their relationship to underlying earnings.

For example, looking at data on the S&P 500 from 1960 to 2010 reveals that in some decades, such as the 1970s, the correlation between the S&P 500 Index and its P/E multiple was very strong (0.88). During other periods, however, including the 1990s and the 2000s, the relationship was much weaker (0.54), which signals a shift in expectations at a macro-level.

In the 1990s this shift was bullish as multiples expanded dramatically faster than earnings. In recent experience, however, the reverse has been true. Multiples have been in a long-term decline. Even during the recent bull market, earnings growth has outstripped market price appreciation, leaving P/E multiples in decline.

Currently, we believe U.S. equity valuations are poised to enter a prolonged period of expansion, which will be an important driver of equity returns over the next several years.

As of mid-March, the P/E ratio on the S&P 500 Index was approximately 15, or 11 percent below its historic average of 16.7. Based on consensus estimates of forward per-share earnings of \$109, the discount grows to approximately 30 percent, suggesting equities are attractive on an absolute basis.

The case for multiple expansion becomes more compelling given the macro-economic

backdrop that we anticipate will prevail over the medium term.

Specifically, we believe the U.S. economy is currently in an extended period of low long-term interest rates, which is historically favorable to equity multiple expansion. The current yield of 3.35 percent on the 10-year Treasury would normally warrant a P/E multiple closer to 20 than the current level of 15. Even if 10-year Treasury yields were to rise as high as 4 or 5 percent, the historic ratio would suggest that P/E multiples in the future should expand.

In addition to periods characterized by low yield, periods with low to moderate volatility in price levels are also historically favorable to multiple expansion. Inflationary pressures based on commodity price increases and surges in energy prices have made global headlines recently. However, it is our view that price pressures will be relatively transitory in the United States. The current slack in the labor market and in capacity utilization should be an important buffer to keep price pressures muted.

In our estimation, it will be several years before the economic expansion absorbs enough of the slack in the economy to support meaningful and sustainable inflation.

This low-inflation environment will coincide with a prolonged period of very low interest rates as the Fed continues to pursue an accommodative policy stance. Based on historical experience, all of these macro-dynamics point to equity multiples expanding over the intermediate term. □

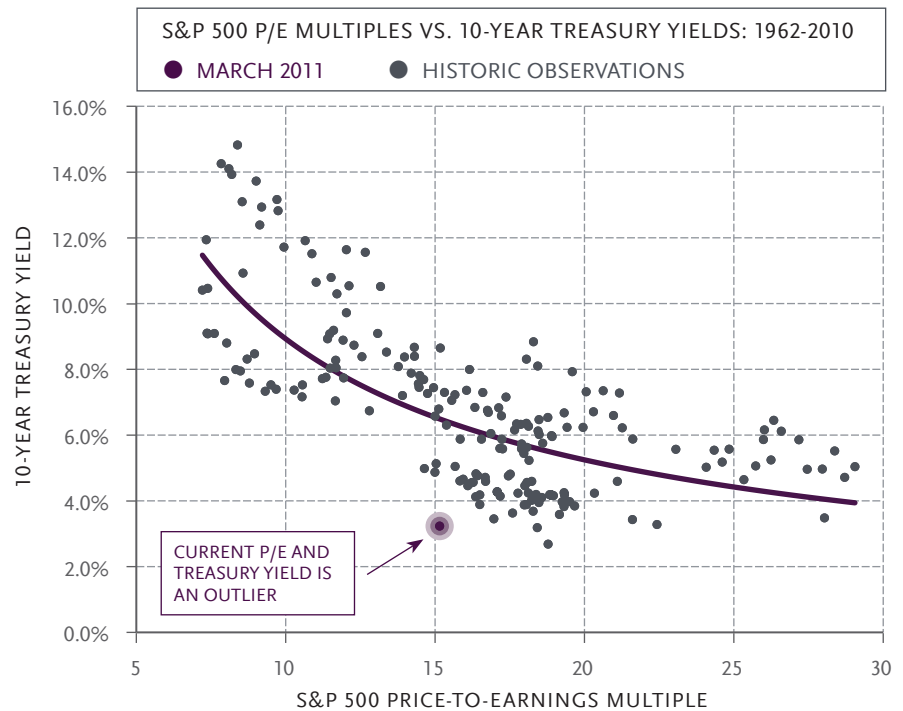
The Case for Multiple Expansion (continued)

A LOW INTEREST-RATE ENVIRONMENT BODES WELL FOR EQUITY VALUATIONS

There is a strong inverse correlation (-0.68) between the yield on the benchmark U.S. 10-year Treasury note and the price-to-earnings multiples for U.S. stocks.

We believe the U.S. economy is currently in an extended period of low long-term interest rates. The continuation of a low-yield environment is favorable to equity multiple expansion.

The current yield of 3.35 percent on the 10-year Treasury, would normally warrant a P/E multiple closer to 20 than the current level of 15. Even at yields as high as 4 or 5%, the historic ratio would still suggest that P/E multiples in the future should expand.

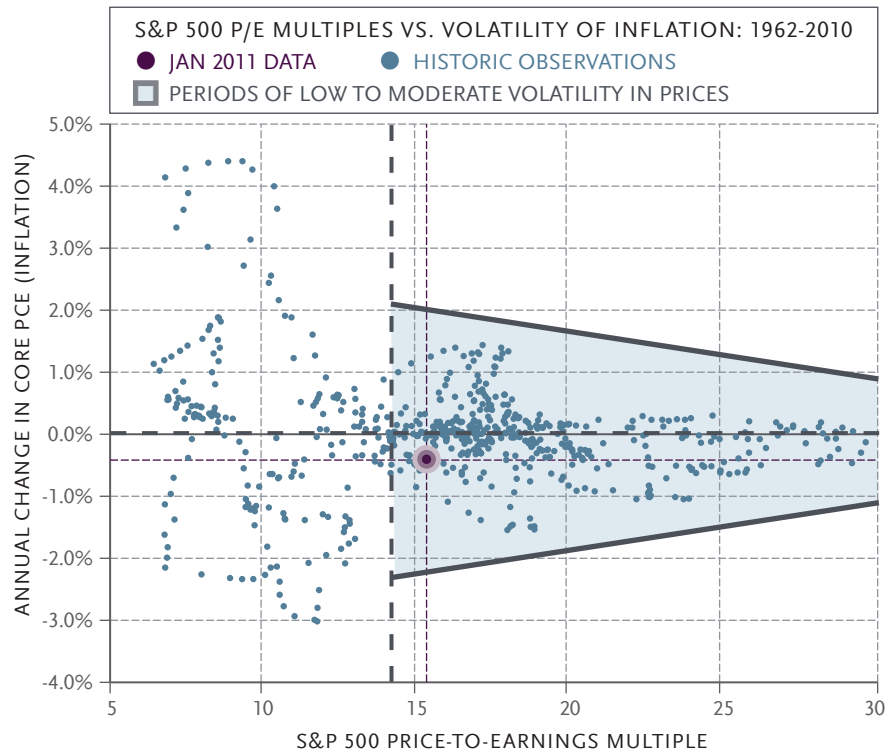


Source: Standard and Poor's, Bloomberg, Guggenheim.

MODERATE AND STABLE PRICE LEVELS FOSTER P/E MULTIPLE EXPANSION

During periods with low to moderate volatility in prices, multiples tend to expand. We expect price pressures from recent run-ups in commodities and energy to be relatively transitory in the United States. The current slack in the labor market and in capacity utilization will be important buffers to keep price pressures muted.

In our estimation, it will take time for the economic expansion to absorb enough of the slack in the economy to support meaningful and sustainable inflation. In the meantime, the upcoming period should witness only moderate price pressures, which should be favorable for U.S. equity multiple expansion.



Source: Bloomberg, Guggenheim. Volatility of inflation is calculated by the average trailing twelve month core PCE number compared on a year-over-year basis.

Portfolio Flows: Embracing Equities

Portfolio flows, or shifts in investor capital across asset classes, are a substantial factor in long-term returns. At a macro-level, we believe an asset-allocation shift toward equities is in its early stages. U.S. markets are well-positioned to benefit from the influx of demand.

BY JAYSON FLOWERS,
HEAD OF EQUITY
DERIVATIVE STRATEGIES

With an estimated \$138 trillion in investable assets worldwide, according to J.P. Morgan research, portfolio flows – or the reallocation of capital among asset classes and markets – can have a meaningful impact on market prices.

In 2009, there were significant inflows of capital to the global equity markets following the global financial crisis. In 2010, however, the return to equities was tamed. Fears of a double-dip recession, and uncertainty surrounding monetary and fiscal policy, weighed heavily on the minds of investors in U.S. equities.

The eruption of the debt crisis in Europe and the infamous “Flash Crash” in May 2010, didn’t help matters either. The market volatility spikes of this period in 2010 only served to deter capital from flowing into equities, adding to the systemic paralysis.

As a result, net capital flowing into the U.S. equity markets slowed dramatically in 2010 when compared to 2009. In fact, net fund flows into U.S. equity mutual funds remain negative for the three-year period from 2008 to 2010.

At a macro level, in 2011, there remains an enduring hangover effect from the 2008-2009 recession and the 2010 equity market volatility; however, we believe the aversion to equities is beginning to wear off and that a global shift toward equities is in its early stages.

The fact that equity market returns have proved resilient through the recent geopolitical storms speaks volumes about the foundation that has been built beneath the current bull market. This is not to say that the “risk on” trade is in full throttle, but we believe the clutch has been

engaged and a shift to a higher gear will become more evident in the near future.

In particular, we anticipate strong sentiment toward U.S. equities as investors juxtapose the strength and stability of the world’s largest economy against the turmoil happening across the globe.

We are starting to see this manifest itself in the fund flow data already. Thus far in 2011, the rate of money flows into global emerging market funds has declined for back-to-back months for the first time since 2008, according to data from EPFR Global. During the same period, fund flows to the U.S. equity markets have been gaining momentum.

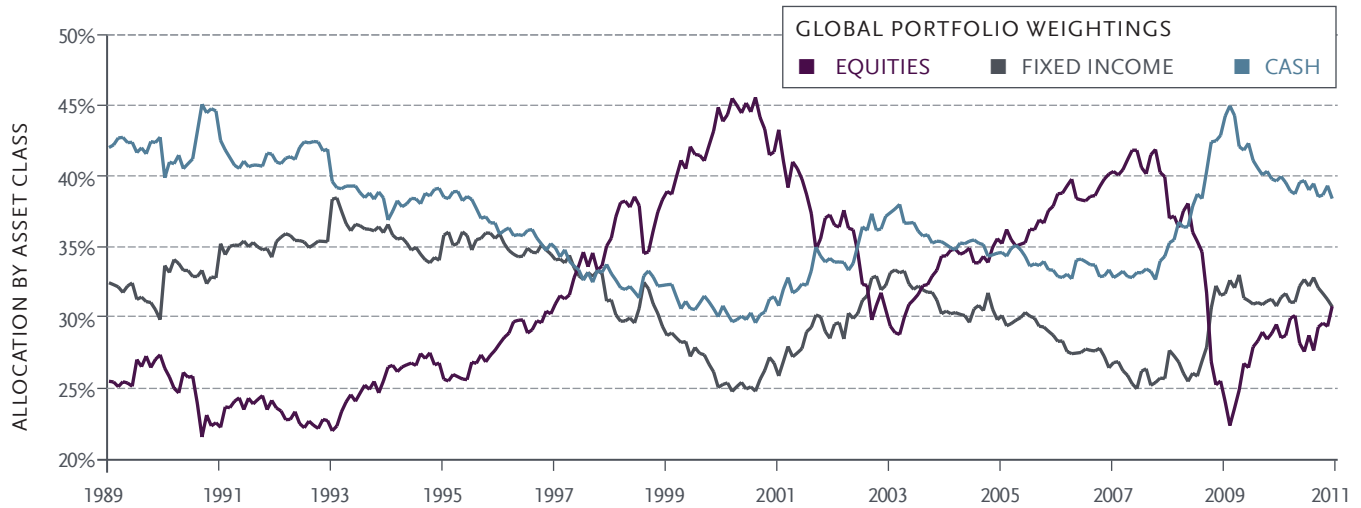
Another favorable long-term catalyst is the likelihood of increased equity allocations among institutional investors. Public pension funds are under pressure from local and state governments not to lower their return assumptions, even in light of historically poor total return performance and the historically low yield environment for fixed-income investments. Going forward, reaching return assumptions of 7 to 8 percent per year is a task that’s likely attainable only through further exposure to the equity risk premium. As the economic recovery continues, we believe many of these funds will view increasing their allocations to equities as the highest and best allocation of capital.

Portfolio flow trends like these can ultimately have strong momentum effects on markets. Even small changes in global preference for equities can translate into an important and impactful driver for equity market price appreciation in the coming periods. □

Portfolio Flows: Embracing Equities (continued)

GLOBAL PORTFOLIO FLOWS CONTINUE TO TREND TOWARD EQUITIES

According to research by J.P. Morgan, global portfolio weightings are shifting back toward equities in increasing measure. The data, which encompass an estimated \$138 trillion of investor assets, show that allocations to cash and cash equivalents are approximately 1.8% above historic averages, while equity allocations are 1.2% below historic averages. Mean reversion would translate into nearly \$1.7 trillion in new flows into the global equity markets.



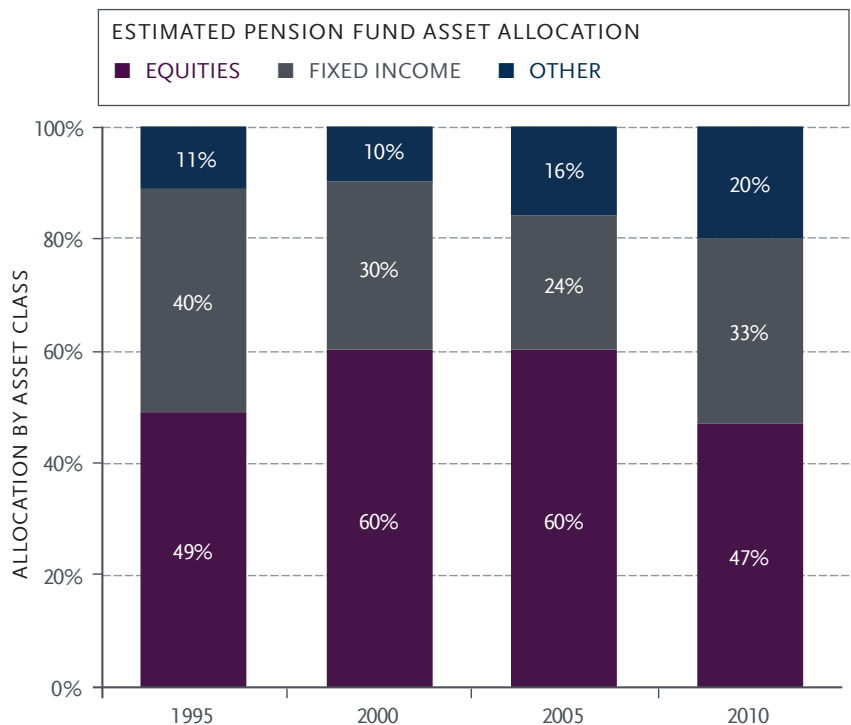
Source: J.P. Morgan

GREATER ALLOCATIONS TO EQUITIES ARE LIKELY FOR PENSIONS AND OTHER INSTITUTIONAL INVESTORS

According to industry estimates, U.S. pension funds have more assets (approximately \$15 trillion) than the U.S. has annual gross domestic product.

A recent study shows how pension fund asset allocation has changed over time. In 2000, the average pension fund held approximately 60% of its portfolio in equities. Following the 2001 recession, allocations dipped as low as 50% before returning to 60% in 2005.

At the end of 2010, pension fund allocations to equities remain at depressed levels (approximately 47% of assets). As in previous bull markets and business cycle expansions, over time pension funds and other institutional investors are likely to increase their equity allocations.



Source: Guggenheim and secondary sources.

A Note on Dividends

As economic prospects brighten, the \$2.4 trillion in cash currently sitting on corporate balance sheets is likely to translate into increased dividend payments to shareholders.

BY SCOTT HAMMOND
PORTFOLIO MANAGER

Yield is traditionally viewed as a fixed income consideration, but over the past 20 years dividend yields have accounted for approximately 35 percent of total S&P 500 returns. Were it not for the compounding effect of dividends, the return on the S&P 500 from 2000 to present would be negative. This is why dividends are an essential component of the equity valuation equation.

We believe dividend payments are likely to trend higher in the next few years, primarily due to the unprecedented levels of cash and short-term investments held on the balance sheets of U.S. companies. Currently, S&P 500 companies are sitting on approximately \$2.4 trillion in cash – a level that has only just begun to decline from the previous quarter's all-time record cash holding of \$2.5 trillion.

Dramatic cost-cutting measures during the recent financial crisis set the stage for record profit margins coming out of the recession; however, companies parked profits in cash and short-term investments in 2009 and 2010 due to uncertainty about the economic recovery, healthcare reform, and other regulatory changes.

As the growth outlook for the U.S. economy becomes clearer, corporations will eventually become more comfortable deploying cash. Inevitably, a portion of these funds will be returned to investors in the form of dividends or stock buybacks.

This dynamic is just beginning to unfold in 2011. In the first three months, there have been 115 dividend-related announcements from S&P

500 constituents. Of the 115 announcements, 114 were either dividend increases or the announcement of a first-time dividend. The median dividend increase was 12.5 percent, the average increase was 24.3 percent, and 12 of the announcements represented an increase of more than double the previous cash dividend.

Dividend yield increases for the S&P 500 will likely be driven by the technology and financial sectors. Currently, these sectors represent 66 percent of cash holdings, but only contribute 21 percent of dividends for S&P 500 companies.

Already, the dividend contribution of the technology sector in the S&P 500 has risen from 6.0 percent in 2007 to 9.4 percent as of March 2011. In financials, the easing of Federal Reserve restrictions on dividend payout ratios should lead to higher dividend payments, as we have already begun to witness in 2011. □

S&P 500 Cumulative Indicated Dividend Rate Changes

	Total Changes	Dividend Increases	Initial Dividends	Dividend Decreases	Dividend Suspensions
1Q 2011	115	104	10	1	0
4Q 2010	71	66	3	1	1
3Q 2010	48	47	0	1	0
2Q 2010	62	60	2	0	0
1Q 2010	80	70	8	1	1
4Q 2009	53	43	4	6	0
3Q 2009	30	23	0	7	0

Source: Standard and Poor's. Data as of March 15, 2011.

The Case for Mean Reversion

With annualized returns under 2% over the past decade, the “stocks for the long run” thesis hasn’t delivered as promised. Today, however, we believe the macro-fundamentals are in place to support the current bull market in U.S. equities for an extended period.

BY SCOTT MINERD
CHIEF INVESTMENT
OFFICER

I once had a finance professor at the University of Pennsylvania Wharton School who had an immutably bullish outlook on U.S. equities. He espoused that stocks were far and away the best asset class for long-term investors, regardless of market timing. In fact, he went on to gain notoriety for publishing a book entitled *Stocks for the Long Run*.

Without taking anything away from the impressive work of my old professor, Dr. Jeremy Siegel, the problem I always had with his thesis is that it’s highly dependent on your definition of “long run.” As John Maynard Keynes is famous for saying, “The long run is a misleading guide to current affairs. In the long run we are all dead.”

Even if we look at a holding period of 10 years—which I would venture to guess qualifies as “long run” for the vast majority of investors—we can see that there have been a number of periods where U.S. equities delivered annualized returns far lower than bonds.

The most recent decade ending in 2010 was one of these periods, which is why allocations to equities have generally declined across investor classes from where they were five or ten years ago.

Whether you have been burned by the “lost decade” in equities or not, it’s important to not throw the baby out with the bath water, especially at a time when returns are poised to revert back to historic norms.

THE POWER OF MEAN REVERSION

As I often say, mean reversion is one of the most powerful statistical forces in finance. The only markets that don’t eventually revert back to a well-established mean are those that are going out of existence.

If you think the U.S. equity markets will close their doors in the near future, then by all means, stop reading now. However, if you believe the U.S. stock market might stick around for another generation or two, then there’s a strong statistical case for long-term U.S. equity returns to average something on the order of 11 percent per year, which is the historic average for a 10-year holding period when you include dividend reinvestment.

To explore the precedence for mean reversion following extended periods of underperformance, the Guggenheim Equities Team recently studied data on the Standard and Poor’s Total Return Index as far back as 1926.

Looking at annualized returns on a rolling quarterly basis, we found that in only 7 percent of the periods did the S&P Index register annualized total returns of 2 percent or lower over a 10-year holding period (which is our proxy for a “long-term” investment horizon).

Each of the instances of dramatically low returns occurred around three distinct periods: the Great Depression, the 1973-1975 recession, and the recent 2008-2009 financial crisis.

The Case for Mean Reversion *(continued)*

Since the recent performance of U.S. equities ranks among the worst in modern history, the real question is what can we learn from the other periods of extremely poor performance that may provide insights into future returns?

Following the experiences of the Great Depression and the 1973-1975 recession, stocks returned anywhere from 7 to 15 percent annually over the course of the next 10 years (see the histogram on the next page). The average return of all the observations was 11 percent, which is essentially perfect reversion to the mean return of the entire data series.

The moral of the story is that following periods of abnormally low equity returns (similar to what we've experienced over the past decade), there is a strong historic tendency toward mean reversion, which is approximately 11 percent per year for a 10-year holding period.

I found this data exploration to be quite striking, especially in light of our analysis of the near-term fundamental drivers of equity returns, and the fact that the market has already made significant headway toward posting long-term

annualized returns in the ballpark of what this data set would predict.

From a fundamental standpoint, as we look ahead to what the future may hold, our view of the U.S. economic expansion, inflation, and the interest-rate environment are certainly central considerations.

In addition, there are the fundamental drivers that my colleagues have explored in the pages of this report, including the sustainability of corporate earnings growth, the case for cyclical valuation multiple expansion, why portfolio flow dynamics are poised for a shift back to equities, and the possibility of continued increases in dividend payments.

All of these are important factors that contribute to our big-picture outlook on the U.S. equity market, or what we're calling our equity macro-themes. The aforementioned fundamental drivers are, of course, the most important components of our macro-view. However, this striking data on the power of mean reversion is another confirmation of why we believe U.S. equities should continue their bull market run and post solid returns. □

A LOOK AT ANNUALIZED EQUITY RETURNS FOLLOWING PERIODS OF EXTREME UNDERPERFORMANCE

1.4%

is the annualized total return for the S&P 500 Index for the 10-year holding period ending December 31, 2010. This ranks in the bottom 7% of annualized returns for 10-year holding periods since 1926.

7-15%

is the range of annualized total returns for the 10-year holding periods that FOLLOWED any decade of exceptionally poor performance (similar to the experiences from 2001 to 2010).

11%

is the average annualized total return for the periods included in the 7-15% grouping. It is also the historic mean for all 10-year holding periods since 1926. This historic data points strongly to the case for mean reversion following periods of dramatic

The Case for Mean Reversion (continued)

PROVING FAMA AND FRENCH: DATA ON MEAN REVERSION

In 1988, Eugene F. Fama and Kenneth R. French proposed that stock returns are mean reverting and contain predictable components that are weak over shorter horizons but more powerful over longer horizons.

In support of this basic thesis, the table on the right presents data on S&P 500 Index returns broken down by various holding period lengths. On average, there is not a tremendous variability in the annualized return. What is most noticeable, however, is that the volatility of returns (measured by the standard deviation) declines dramatically as the holding period increases.

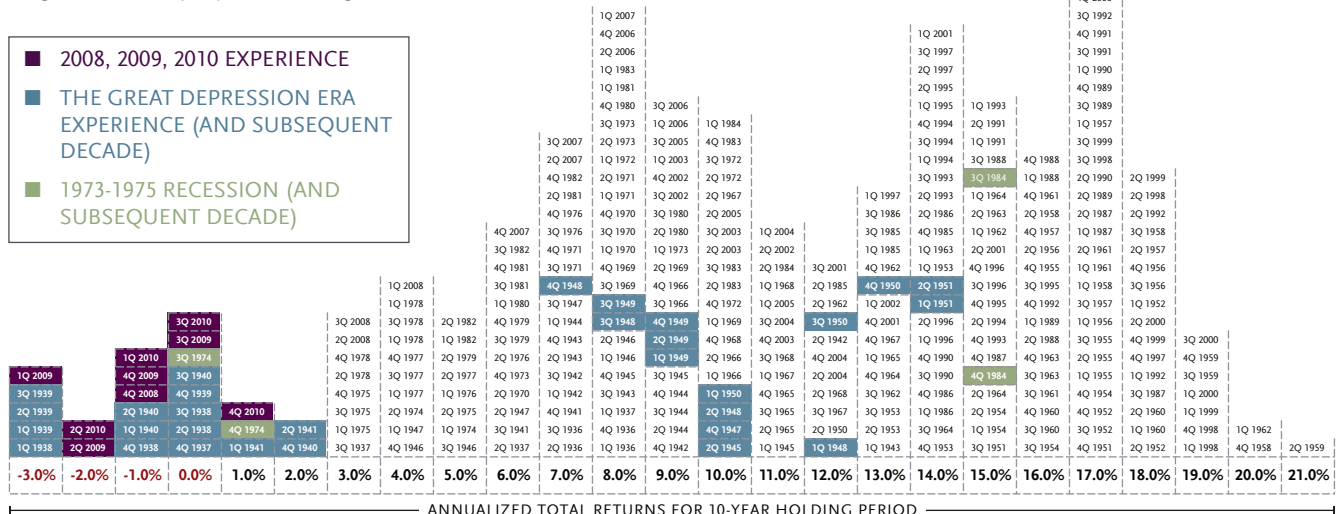
Looking at 10-year holding periods reveals that the “lost decade” from 2001 to 2010 was truly a long-tail event, with annualized returns approaching two standard deviations from the mean.

Annualized S&P 500 Total Returns (Dividend Reinvested Index, 1926 to 2010)							
	Holding Period						
	One Year	Three Years	Five Years	10 Years	25 Years	50 Years	75 Years
# of Observations since 1929	333	325	317	300	257	137	37
Median Return	11.92%	10.94%	10.72%	11.00%	11.77%	15.16%	10.92%
Average Return	12.24%	10.11%	10.14%	10.71%	11.38%	14.34%	10.83%
Standard Deviation of Returns	23.30%	12.17%	8.99%	5.64%	3.38%	2.38%	0.59%
High Return	147.75%	44.92%	34.67%	21.26%	18.24%	18.99%	12.29%
High Return Date	2Q 1933	1Q 1936	2Q 1937	2Q 1959	1Q 2000	2Q 1982	2Q 2007
Low Return	-64.22%	-41.44%	-18.38%	-3.50%	1.96%	9.74%	9.64%
Low Return Date	2Q 1932	2Q 1932	1Q 1933	1Q 1938	3Q 1949	4Q 2010	3Q 2004
% of Periods with Negative Returns	27.33%	17.85%	13.56%	5.00%	0.00%	0.00%	0.00%

Source: Standard and Poor's,

EXTENDED PERIODS OF LOW RETURNS ARE HISTORICALLY FOLLOWED BY PERIODS WITH 7-15% RETURNS PER ANNUM

The histogram below shows a frequency distribution for the annualized total return for the S&P 500 based on a 10-year holding period that's calculated on a rolling quarterly basis. The recent financial crisis ranks among the worst returns on record. If the experiences that followed the Great Depression and the 1974 recession are any indicator, then U.S. equity returns over the next decade should be in the range of 7 to 15% per year, including dividend reinvestment.



Source: Standard and Poor's, Bloomberg,

Actionable Ideas

With our equity macro-themes explained, here are a number of general strategies that we believe offer the potential for enhanced returns, reduced volatility, or, in some cases, both.

Sticking with our macro-theme concept, we conclude by offering several high-level strategies that have historically offered investors attractive risk-adjusted returns when compared with the Standard and Poor's 500 benchmark index.

For each idea, we chose a representative index that generally expresses the theme. The following page has a graphic summary of 10-year annualized returns and volatility for of the indexes selected. There are, of course, a number of different investment products that might be utilized with each theme that may further enhance the performance of the strategy expressed.

With that said, here are four ideas that we believe offer value to investors in 2011:

1. ACCESS THE BENEFITS OF EQUAL WEIGHT INDICES

The composition of the S&P 500 Index is calculated by market-cap weighting. Since market-cap is a function of price and size, market-cap weighting can result in disproportionate holdings of the biggest companies. An equal-weight index solves this problem by applying a strict percent weighting across all stocks, regardless of market capitalization.

In virtually every time period over the past 80 years, an equal-weighted version of the S&P 500 would have produced higher returns than the traditional market-cap weighted index.

Over the past 10 years, the annualized total return for the S&P 500 Equal Weight Index is more than three times that of the S&P 500

Index, but with only modestly higher volatility. For investors who want the diversification benefits of owning the broad market index such as the S&P 500, equal-weight products can be a tool to significantly improve total risk-adjusted returns.

2. LEVERAGE SMALL CAPS DURING AN ECONOMIC EXPANSION

Over the past decade the Russell 2000 Index generated 491 basis points of annualized excess return when compared to the S&P 500, with a substantially higher Sharpe ratio to boot (i.e., it offered much greater return for the same level of risk).

During the past 14 business cycles, the second half of an economic expansion has been a period where small cap stocks have dramatically outperformed large caps. For investors who are bullish on the U.S. economy, small cap investing provides access to middle-market companies that have higher-growth potential during cyclical expansions. For example, it's estimated that the Russell 2000 Index derives 80 percent of its revenues from the U.S. economy, compared to an estimated 60 percent for the S&P 500.

3. UTILIZE A BUY/WRITE STRATEGY TO HEDGE AGAINST VOLATILITY WITHOUT SACRIFICING RETURN

Buy/write (also referred to as a "covered call" strategy) is a strategy that "buys" a long position in an equity index such as the S&P 500 while simultaneously "writing" call options against the underlying securities.

Actionable Ideas *(continued)*

Compared to a buy/hold strategy, buy/write increases return by adding the potential for premium generated by selling call options. The primary function of the call options, however, is not to generate premium, but rather to limit the volatility in the portfolio. Downside protection exists in a buy/write strategy because it can exercise its call options by delivering the securities owned.

The most successful buy/write strategies generally utilize sophisticated, quantitative tools that effectively manage volatility as if it were a separate and distinct asset class from the underlying index. If done properly, the inclusion of the volatility overlay not only reduces risk, but also enhances total return.

Over the past decade, the CBOE S&P 500 BuyWrite Index not only produced annualized volatility that is one quarter lower than the S&P 500, it also provided higher annualized returns.

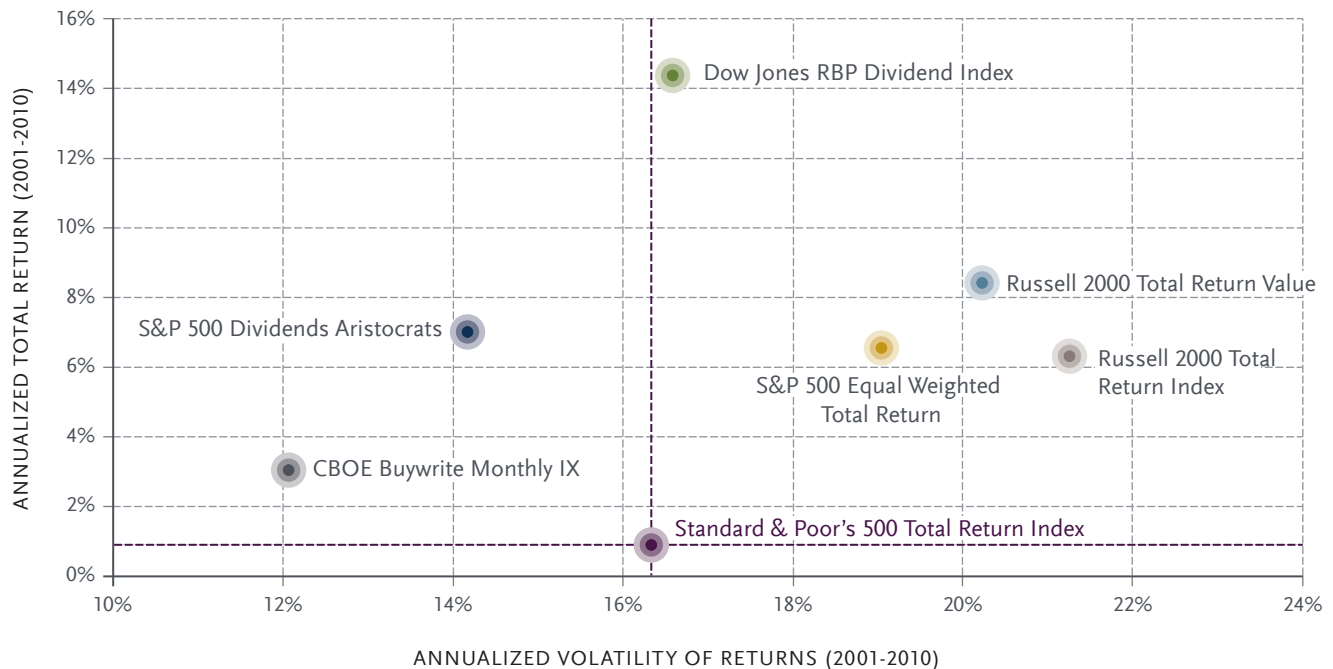
4. USE STOCKS AS A MEANS FOR CURRENT INCOME WITH APPRECIATION POTENTIAL

Historically low yields on fixed income assets have prompted some investors to satisfy their yield requirements by turning to the equity markets. If dividend payments continue the recent trend of increases, dividend-select strategies are likely to see positive capital flows, especially from baby boomers who have the need for a high level of current income with the secondary objective of long-term capital appreciation.

In terms of historic performance, during the “lost decade” in equities, dividend funds such as the S&P 500 Dividends Aristocrats or Dow Jones RBP Dividend Index have posted substantially better risk-adjusted returns than the S&P 500 Index. □

10-YEAR ANNUALIZED RETURNS AND VOLATILITY FOR SELECT STRATEGIES

Below are the annualized total returns and volatility of returns for select indices that are representative of the themes discussed. There are, of course, a number of different investment products that might be utilized to further enhance the performance of these strategies.



Source: Standard and Poor's, Bloomberg, Guggenheim. Data from January 1, 2001 to December 31,

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GUGGENHEIM PARTNERS INVESTMENT SOLUTIONS

Equities	Structured Products	Real Estate	Municipals	Corporate Investments	
Alternative Equity Strategies	Commercial Mortgage-Backed Securities	Direct Investments	Traditional Tax-Exempt/Taxable Municipals	LIQUID	NON-LIQUID
Enhanced Equity Income	Residential Mortgage-Backed Securities	REITs	Build America Bonds	Investment Grade	Distressed Investments
Preferred Stock	Asset-Backed Securities	Structured Real Estate	Qualified School Construction Bonds	High Yield Bonds	Structured Equity
Quantitative Equity Alpha Strategies	Event-Linked	Whole Loan Mortgages		Preferred Stock (Public)	Private Equity
RBP Strategies	Timeshare Financing	Alternatives			Directly Originated Bank Loans
Structured Equity	Structured Settlements	Asia Private Equity Fund of Funds			Purchased Bank Loans
		Aviation			Preferred Stock (Private)
		Commodities			DIP Financing
		Energy			Mezzanine Financing
		Private Equity			

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