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Education and Innovation in the Leveraged Index Market

A Discussion Paper from Direxion Funds

As examples of eye-popping performance, leveraged index (LI) funds are hard to beat. An investment in a Latin America bull 2x fund, which aims to achieve a daily return of 200% of the S&P Latin America 40 Index, would have returned just under 150% in the 12-month period ended October 31, 2007.

Performance can be equally stunning in the opposite direction. Take an emerging markets bear 2x fund, where the objective is 200% of the opposite of the daily return of the MSCI Emerging Markets Index. In the month of October 2007 alone, an investment in this fund would have lost more than 22%.

It is hardly surprising, then, that LI funds frequently capture the headlines since they often show up in performance tables, for better or worse. However, the attention given to the performance of these funds obscures their less-obvious benefits. LI funds offer the opportunity to: 1) effectively manage risk and return; 2) smooth volatility in both bull and bear markets; and 3) hedge a portfolio with maximum efficiency.

This paper begins with some background on the LI sector and moves on to discuss the critical role of education in explaining exactly how LI funds work. The paper then describes how to use these funds in executing some key strategies. Finally, we analyze some of the new tools recently introduced to help advisors understand how they can implement LI funds in their clients' investment portfolios.

Background

LI funds have been in existence for approximately 15 years. Although they represent approximately \$30 billion of the total \$12 trillion mutual fund market (as of November 30, 2007), they are growing much faster than the overall market.

Several key factors are likely to promote further expansion of the LI sector. First, financial advisors are increasingly introducing novel, active strategies to manage client portfolios. Second, there is clear evidence of broader acceptance and use of alternative asset class investments as a means of managing risk. And third, the number of baby boomers who need to boost their retirement savings and protect their assets against declines in the market is steadily rising.

These trends will drive even greater participation in the LI market by financial intermediaries. Currently, several thousand registered investment advisors are using LI products; these active allocators, as we call them, manage their clients' portfolios closely and have a clear point of view on the direction of the markets. Yet the potential audience is significantly wider, embracing the remainder of the nation's 27,000 RIAs, the 75,000 or so broker/dealers from independent firms (already the fastest-growing channel) and the approximately 150,000 brokers employed by regional firms.

However, in our experience, advisors and investors need help in translating the theory of LI investing into practice, which is why we believe that education holds the key to the sector's future growth. (Visit www.direxionfunds.com and view the article, "Understanding Expected Performance of Leveraged Index Funds," on the Educational Literature page of the Education Center).

In using these products to manage the risk/return profile more efficiently and at the same time reduce volatility, participants should recognize that LI funds can be used as a component of, and an enhancement to, current investment strategies. The funds can be added to a core portfolio in small amounts – 10% to 20% – to provide substantial potential benefits. A few strategies are discussed on the following pages.

Using LI Funds in Practice

In the investment world, these funds allow the investor to pursue a number of different strategies, depending on market circumstances and required objectives.

Following are four examples:

1 Partial Leveraging

Looking for increased exposure without deploying additional capital? Our investor in this example has a bullish one-year outlook on stocks in the S&P 500 Index. He currently has a diversified portfolio containing a modest allocation to a popular S&P 500 mutual fund. He would like to increase his exposure to the Index, but does not want to commit additional capital to achieve his objective.

How can this be done? He should consider a partial leveraging strategy that raises exposure to an underlying investment through the use of a leveraged investment. Leverage can allow an investor to maintain existing exposure or achieve additional exposure to a position with the same or a reduced amount of capital.

Our investor has \$100,000 of his portfolio invested in a popular S&P mutual fund. By selling \$10,000 of the fund and investing the proceeds in an S&P bull 2.5x leveraged index fund, \$25,000 of exposure is created. The total exposure to the S&P 500 has now increased from \$100,000 to \$115,000 without contributing additional capital.

2 Hedging

An advisor gets a call from a client who has been happy with the recent performance of her portfolio, but is concerned about the prospect of a *market correction which could reduce or eliminate her gains*. She is inclined to sell her portfolio and move the proceeds to cash. The advisor warns her about the disadvantages of this approach – including the impact of capital gains taxes and the possibility of missing out on future market rallies.

Hedging – the strategy of purchasing an inversely related investment to reduce the risk of adverse price movements – could be the solution to the client's dilemma. A hedge can help protect gains and reduce volatility in a declining market. It can provide the ability to stay long and still profit if the market continues to rally without having to incur taxable gains.

Our advisor recommends applying a hedge to his client's otherwise well-diversified, yet long only portfolio. He does this by reallocating his client's portfolio to include a 20% allocation to an S&P 500 Bear 2.5x index fund. The primary benefit of this new allocation is a general reduction in the portfolio's risk levels – a vital goal during this uncertain market. Key metrics such as beta, standard deviation and ulcer index¹ should all be reduced under this strategy.

¹This index factors in the depth and duration of drawdowns from recent peaks. A large value indicates that the security represents undue risk.



3 Portable Alpha

How about more diversification without adding more capital?

Another investor is generally satisfied with the performance of her investments, but recent volatility in the market is making her nervous. She believes further diversification would be a benefit, but because she has no additional capital to invest and she wants to maintain her core positions, she is faced with a dilemma.

The solution? Consider a portable alpha strategy, typically used by institutional investors to add diversification to a portfolio while maintaining equivalent exposure to the original allocation.

When leverage is employed to free up capital, proceeds are typically invested in alpha-generating assets that are also non-correlated, thereby decreasing volatility.

Let us examine a portfolio representative of a common diversified growth allocation. It has \$50,000 in large-cap equities, \$20,000 each in mid- and small-cap, and \$10,000 in international. We reallocate the large-cap portion, which has a high correlation with the S&P 500 Index, investing \$20,000 in an S&P 500 bull 2.5x fund and \$15,000 each in real estate and utilities.

The result? The original portfolio exposure to large caps remains constant, since the 2.5x bull fund seeks 250% exposure to the S&P 500 and a \$20,000 investment has the purchasing power of \$50,000. By moving \$30,000 into real estate and equities that have a low correlation to more traditional investments, we are attempting to increase diversification and lower volatility.

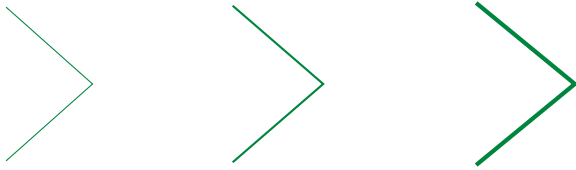
4 Long/Short Relative Value

Looking for a certain strategy for uncertainty? One experienced advisor moved his client's assets to cash during a recent market correction. While out of the market, a recovery took place, leaving him reluctant to go long, for fear of buying in at the top of the market. Although he is uncertain about the general direction of the market, he has come across some investment opportunities he thinks are sensible. He would like to have some selective participation in the market, while being protected against excessive volatility.

A long/short relative value approach would make sense here because it can be independent from the direction of the broader market. It is used to take advantage of a perceived mismatch between the relative value of two investments, where a long position is taken in the instrument deemed to be stronger and a short position in the one thought to be weaker.

Our advisor sees some opportunities in large-cap stocks that he believes are likely to outperform small caps. But he is hesitant to buy large caps because he is uncomfortable with the downside risk. Given his uncertainty about market direction but his relative expectation for large versus small caps, what should he do?

He might consider applying a long/short strategy to his \$100,000 of cash as follows: buy \$70,000 of a Dow 30 bull 1.25x fund (providing \$87,500 of long Dow Jones Industrial Average exposure) and buy \$30,000 of a small-cap bear 2.5x fund (providing \$75,000 of short Russell 2000 Index exposure). This strategy would also be expected to exhibit low volatility because the Dow and the Russell are highly correlated.



Innovation through new tools

We firmly believe that, beyond a basic understanding of leverage, advisors appreciate the availability of customized tools to help them execute strategies such as those outlined previously. Providers have a clear opportunity to offer data-based tools that will enable advisors not only to give top-quality service to their clients, but also to help them enhance returns and manage risk effectively.

Correlation Calculator

In 2006, we introduced our Correlation Calculator as a product-neutral application that can help to analyze any portfolio. The tool helps advisors assess the correlation levels of the investments within their clients' portfolios and model various strategies and investment options that may increase returns and reduce volatility. This correlation analysis is a crucial step towards identifying the right asset mix for a modern diversified portfolio. To access the Correlation Calculator, visit www.direxionfunds.com, view the Tools page, then the Correlation Center.

Volatility Tool

Another tool that Direxion offers allows advisors to better understand the volatility of their investments and how volatility changes over time. The Direxion Volatility Tool shows the volatility measure for each of our funds over various rolling periods. To access this tool, visit www.direxionfunds.com, view the Tools page, then the Volatility Tool.

Both of these tools are good examples of the innovation we believe the LI industry needs in order to remove the mystique that surrounds it. But these are just the beginning. Direxion continues to work toward providing advisors with additional tools and resources to help them learn about the value that LI funds can offer their clients.

Exposure Targeting Application

Shortly, we will be introducing another innovation that promises to have a significant impact on LI funds and bring them further into the mainstream of the mutual fund industry. The impact of what we call the Exposure

Targeting Application (ETA) stems from its goal of reducing the impacts of daily compounding, which may result in unanticipated changes in market exposure.

The ETA strives to minimize volatility by allowing investors and advisors to customize and maintain a stated level of exposure to an underlying index over a period of time. Investment positions that utilize ETA should be able to track more consistently the underlying index. First, the investor is asked to define the following parameters:

- Target index or benchmark
- Desired principal investment
- Desired exposure to the target index or benchmark (which is generally in excess of the principal allocated to the strategy)

Based on the investor's choices the ETA will:

- 1) make an initial allocation recommendation between the relevant Direxion fund and a money market fund; and
- 2) create a model account designed to track the performance of an independent portfolio that is seeking index exposure equivalent to the investor's initial request.

The model account is designed to serve as a road map that the investors will be able to follow in order to ensure that their exposure to the target index remains in line with their original request. In this way, the ETA has the potential to create greater predictability and stability, helping investors understand how they can build strategies around LI funds. They may also realize that monitoring and managing positions using the ETA could allow them to maintain a position in an LI fund for the long term.

In conclusion, we believe that innovation of this kind provides the driving force behind the essential educational effort that, until now, has been largely lacking in the LI fund industry. As the wave of innovation continues, the value of the partnerships it creates between providers and advisors will become readily apparent.

An investor should consider the investment objectives, risks, charges, and expenses of the Direxion Funds carefully before investing. The prospectus contains this and other information about Direxion Funds. To obtain a prospectus, please contact the Direxion Funds at 800.851.0511. The prospectus should be read carefully before investing.

Investing in index funds may be more volatile than investing in broadly diversified funds. The use of leverage by a mutual fund increases the risk to the fund. The more a fund invests in leveraged instruments the more the leverage will magnify gains or losses on those investments.

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