

Understanding the Impact of Changing Market Exposure on Leveraged ETFs

Know When to Hold 'Em; Know When to Fold 'Em

The aggregate return of an investment over a particular period depends in part on whether an investor decides to expose investment gains from early in the period to investment performance later in the period. Consider Mary and Tom, who each put \$100 in an equity investment which proceeds to gain 25% per year for each of the subsequent five years. Mary does not touch her investment, while Tom decides to remove his gains at the end of each year. As a consequence, Tom starts each year with \$100 in the investment.

		Mary Principal & Gains	Tom Principal	Tom Gains
	Return	\$100	\$100	
Year 1	25%	\$125	\$100	\$25
Year 2	25%	\$156	\$100	\$25
Year 3	25%	\$195	\$100	\$25
Year 4	25%	\$244	\$100	\$25
Year 5	25%	\$305	\$100	\$25
Mary's Total		\$305	\$100	\$125
			Tom's Total	\$225

Because Mary left her gains in the fund, and because the fund continued to gain, she benefited from gains on her gains (commonly referred to as compounding) and ends up with more money. Although Mary's decision proved wise because of the path of the security, if the market had declined in the later years, Tom would likely have had better returns than Mary because her gains were exposed to market risk.

In essence, leveraged ETFs respond to gains by becoming more aggressive while they respond to losses by becoming more defensive. In markets which are directional this can be an advantage; in markets which lack direction, this can be a disadvantage.

In essence, Mary's passivity allowed her market risk to increase while Tom's withdrawals reduced his risk. Decisions on how to modify a portfolio in response to gains (or losses) have enormous implications for investment performance. Unfortunately, the ultimate wisdom of such decisions can be evaluated only in hindsight.

Leveraged ETFs

Leveraged ETFs seek to provide daily returns which are a multiple of the return of the relevant benchmark. In practice, this means that leveraged ETFs react to gains by increasing market exposure and react to losses by decreasing market exposure. Why? Unlike Tom and Mary, who likely make decisions based on some combination of rational thinking and emotions, a leveraged ETF's exposure is a product of its target magnification and its net assets. Favorable moves in the benchmark push net assets higher, which translates into an increase in exposure by a multiple of the gain in net assets. Conversely, unfavorable moves in the benchmark leads to a decline in net assets, which results in a reduction of exposure in an amount which is a multiple of the decline in the net assets.

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Scenario 1: Market Trends Steadily

If the benchmark moves in a direction favorable to the fund (meaning up for a Bull Fund and down for a Bear Fund) in a linear trend, the fund's gain for the period may be larger than the product of (a) the index move and (b) the fund's stated multiple or beta. This is so because the fund's assets rise in response to index moves favorable to the fund. As a consequence, market exposure rises, which amplifies gains on the subsequent favorable index movements.

Index Value	Index Daily Return	Index Total Return	Index Total Return X 3.0	3.0 Beta Fund Daily Return	Fund NAV	Total Fund Return
100					\$20.00	
105	5.00%	5.00%	15.00%	15.00%	\$23.00	15.00%
110	4.76%	10.00%	30.00%	14.28%	\$26.28	31.40%
115	4.55%	15.00%	45.00%	13.65%	\$29.86	49.30%
120	4.35%	20.00%	60.00%	13.05%	\$33.75	68.75%
125	4.17%	25.00%	75.00%	12.51%	\$37.97	89.85%
				Return Difference:		14.85%

Index Value	Index Daily Return	Index Total Return	Index Total Return X 3.0	3.0 Beta Fund Daily Return	Fund NAV	Total Fund Return
100					\$20.00	
95	-5.00%	-5.00%	-15.00%	-15.00%	\$17.00	-15.00%
90	-5.26%	-10.00%	-30.00%	-15.78%	\$14.32	-28.40%
85	-5.56%	-15.00%	-45.00%	-16.68%	\$11.94	-40.30%
80	-5.88%	-20.00%	-60.00%	-17.64%	\$9.84	-50.80%
75	-6.25%	-25.00%	-75.00%	-18.75%	\$8.00	-60.00%
Return Difference:						15.00%

Perhaps surprisingly, the fund's loss for a period may be less than the product of (a) the index move and (b) the fund's stated multiple or beta if the benchmark moves in a direction unfavorable to the fund (meaning down for a Bull Fund and up for a Bear Fund) but does so in a linear trend. This is so because the fund's assets decline in response to index moves unfavorable to the fund and, as a consequence, market exposure declines, which mutes the impact of subsequent unfavorable index movements.

Scenario 2: Market is Volatile

In markets in which there are no clear trends, the impact of daily rebalancing is harmful to performance over time. In essence, the fund follows a momentum strategy which responds to gains by increasing exposure and responds to losses by decreasing exposure. This is not helpful in a market which lacks direction. A gain leads to increased exposure in advance of a loss, which then leads to decreased exposure in advance of a gain, and so on. Seeking leveraged daily returns in such a market may negatively impact performance. At the end of the period, the fund has a loss when it might be expected to have provided no return whatsoever. The loss is a consequence of the application of the daily beta leveraged model to a period of significant volatility.

Index Value	Index Daily Return	Index Total Return	Index Total Return X 3.0	3.0 Beta Fund Daily Return	Fund NAV	Total Fund Return
100					\$20.00	
95	-5.00%	-5.00%	-15.00%	-15.00%	\$17.00	-15.00%
100	5.26%	0.00%	0.00%	15.78%	\$19.68	-1.60%
105	5.00%	5.00%	15.00%	15.00%	\$22.63	13.15%
100	-4.76%	0.00%	0.00%	-14.28%	\$19.40	-3.00%
95	-5.00%	-5.00%	-15.00%	-15.00%	\$16.49	-17.55%
100	5.26%	0.00%	0.00%	15.78%	\$19.09	-4.50%
Return Difference:						-4.50%

Decisions on how to modify a portfolio in response to gains or losses in

leveraged ETFs are of significant importance. Direxion Shares are powerful investment vehicles for investors who are looking to gain magnified exposure to the markets. We strongly urge investors to continuously monitor their positions to determine if market activity has caused them to become over or underexposed to the given index in which they are invested. In order to remain aligned to the desired exposure, overexposed investors should consider taking some money off the table, and underexposed investors should consider additional investments. This strategy is especially important in volatile markets, these funds must be watched closely to ensure that the portfolio's exposure levels are in line with their desired objectives.

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