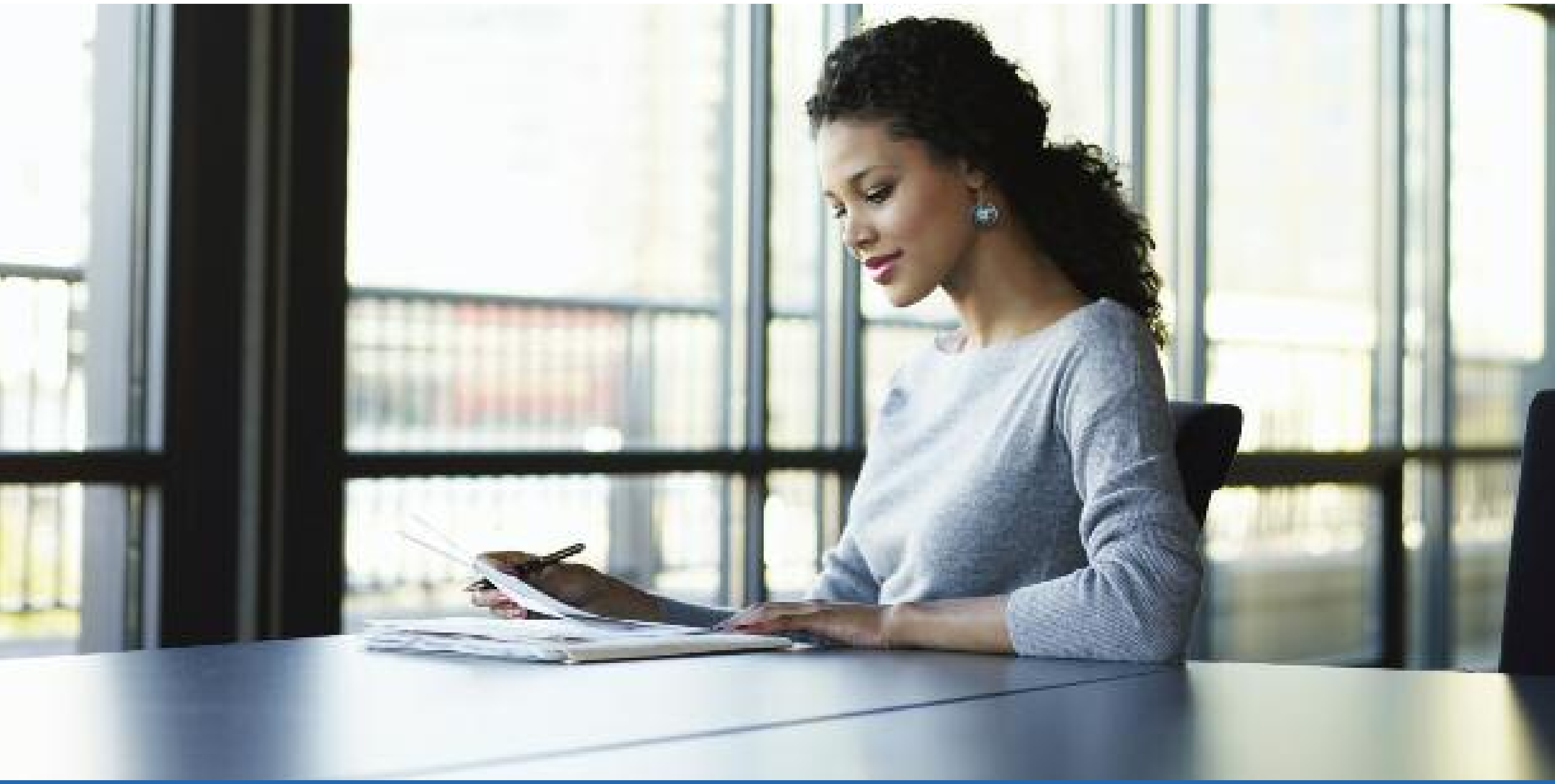
Understanding Leveraged Exchange-Traded Funds

An exploration of the associated risks & benefits



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Contents

3x Exchange-Traded Funds (ETFs) are leveraged funds that provide 300% leverage and the ability for investors to navigate changing markets with bull and bear flexibility.

Although Leveraged ETFs share some similarities with non-leveraged ETFs, there are two key concepts that impact the way they are managed and the way they perform:

- ***Leverage:*** *Each dollar invested provides $3 of exposure to the performance of the benchmark, which means 300% of the risk and volatility.*
- ***Daily*** *investment objectives: The funds seek to magnify the returns of their benchmarks on a daily basis; returns for longer periods are a product of the daily leveraged returns during the period.*

The educational material is designed to provide you with detailed information concerning the composition of these funds, as well as the potential risks associated with them.

Funds' Objectives

Each Bull ETF is designed to seek **daily** investment results, before fees and expenses, of 300% of the performance of its benchmark. **There is no guarantee that the funds will achieve their objective.**

Investor Suitability

These funds are intended for use only by sophisticated investors who: a) understand the risks associated with the use of leverage; b) understand the consequences of seeking daily leveraged investment results; and c) intend to actively monitor and manage their investments.

It is recommended that prospective investors seek the advice of an investment professional before making an investment in Leveraged ETFs.

These funds are <u>not</u> intended for use by conservative investors who:

a) cannot tolerate substantial losses in short periods of time;
b) are unfamiliar with the unique nature and performance characteristics of funds that seek leveraged daily investment results; and
c) are long-term investors who do not monitor their portfolios frequently.

The Power of Leverage

Leveraged ETFs offer high levels of magnification in the ETF marketplace today, which increases the level of volatility associated with a particular fund. For example, if the Russell 1000® Index increases by 1% in a single day, Daily Large Cap Bull 3x Shares is designed to return approximately 3% on that same day (minus fees and expenses). Conversely, if the same index is down 1% in a day, that same fund should decrease by approximately 3%.

Inside Leveraged ETFs

Composition and Exposure

To obtain the necessary exposure, the Leveraged ETF provider will invest all or a portion of their net assets in derivatives—typically swaps or futures. These derivatives are agreements that provide the ability to gain exposure to respective indexes and sectors without the need for full dollar-for-dollar investment. The Bull ETFs will generate between 80% and 100% of their requisite 300% exposure from equities and the remainder from derivatives. The Bear ETFs generate their entire -300% exposure through derivatives.

Strategy	Equities	Derivatives
Bull Funds	**80% - 100%**	**200% - 220%**
Bear Funds	**0%**	**300%**

Terms leveraged ETF investors should know:

Futures Contract

A contract, traded on a futures exchange, to buy or sell a standardized quantity of a specified commodity of standardized quality (e.g., a "basket" of corporate equities ["stock indices"]) at a certain date in the future, at a price (the futures price) determined by the market price at the time of the purchase or sale of the contract.

Swap

A derivative in which two counterparties agree to exchange one stream of cash flows for another stream. These streams are called the *legs* of the swap.

The cash flows are calculated over a notional principal amount, which is usually not exchanged between counterparties. Consequently, swaps can be used to create unfunded exposures to an underlying asset, since counterparties can earn the profit or loss from movements in price without having to post the notional amount in cash or collateral.

(Direxion uses swaps to obtain additional exposure [or inverse exposure] to the benchmark indexes that the funds track.)

Counterparty

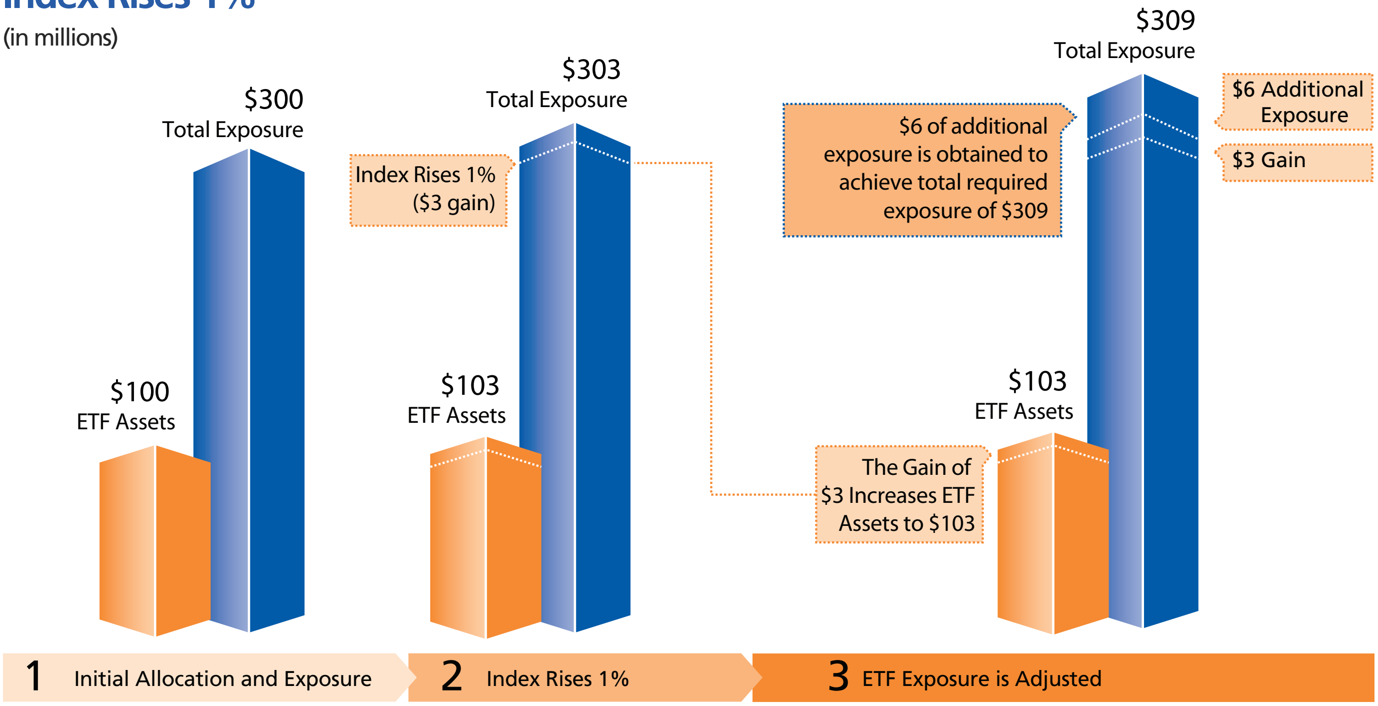
In financial service terms, counterparty can refer to brokers, investment banks, and other securities dealers that serve as the contracting party when completing "over-the-counter" securities transactions. The term is generally used in this context in relation to "counterparty risk," which is the risk of monetary loss a firm may be exposed to if the counterparty to an over-the-counter securities trade encounters difficulty meeting its obligations under the terms of the transaction.

Managing Exposure in Changing Markets

Each 3x Leveraged ETF seeks daily goals which are a multiple, 300% or -300%, of each fund's net assets. ***Daily*** market fluctuations cause net asset levels to rise or fall, which results in portfolio adjustments to help ensure that exposure levels for the following day are set at the correct multiple. Rebalancing exposure daily by buying or selling swaps to ensure that each fund tracks as closely as possible to 300% or –300% of the benchmark's daily performance.

Hypothetical Example: **Index Rises 1%**

(in millions)



1. Initial Allocation and Exposure:

If a 3x ETF has $100 million in net assets, $300 million of net exposure to the fund's underlying index must be maintained.

2. Index Rises 1%

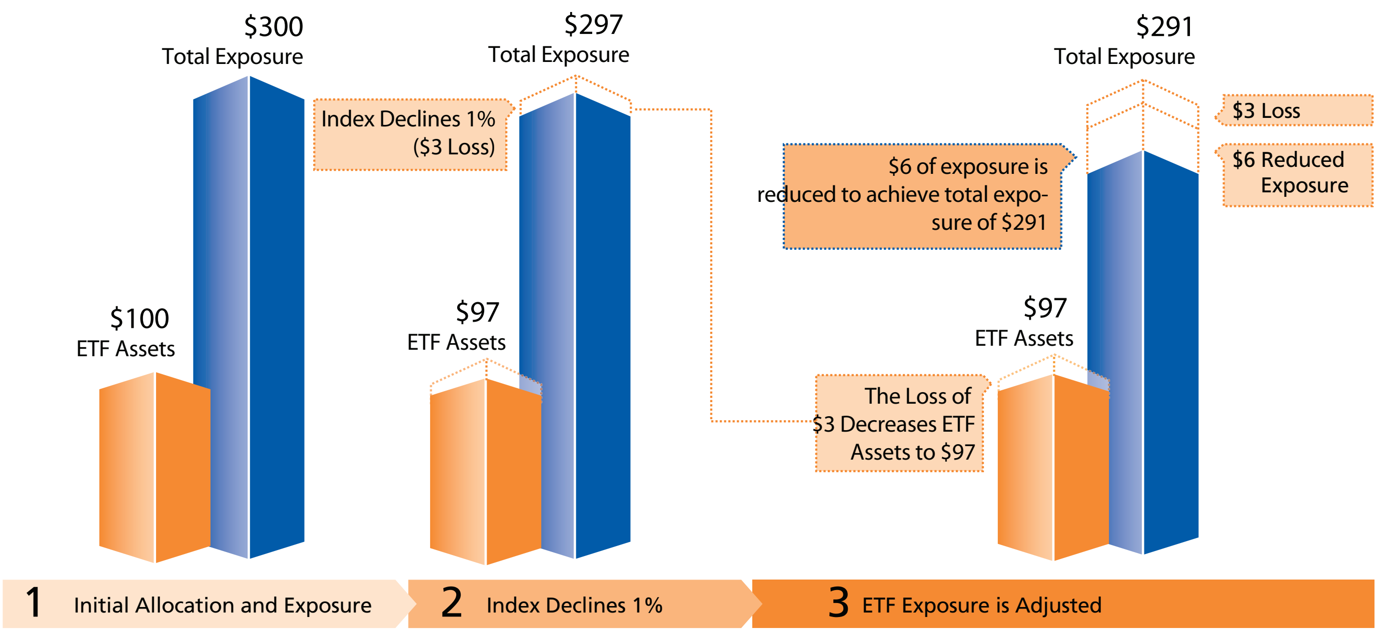
If the index increases by 1% in a trading day, the gross exposure would rise to $303 million and net assets would rise to $103 million, resulting in a $3 million gain.

3. ETF Exposure Adjusted

Since gross exposure must always equal 300% of net assets ($103 million in net assets x 300% = $309 million) at the beginning of each trading day, $6 million of exposure must be added to the portfolio.

Hypothetical Example:
Index Declines 1%

(in millions)



1. Initial Allocation and Exposure:
If a 3x ETF has $100 million in net assets, $300 million of net exposure to the fund's underlying index must be maintained.

2. Index Declines 1%
If the index decreases by 1% in a trading day, the gross exposure would decline to $297 million and net assets would decline to $97 million, resulting in a $3 million loss.

3. ETF Exposure Adjusted
Since 300% of $97 million equals $291 in exposure, the current exposure must be reduced by $6 million from $297 million to $291.

A Closer Look at Some of the Risks

The Impact of Seeking Daily Betas on Long-Term Performance

Daily rebalancing has important implications for the performance of the funds for periods longer than a day. First, and most importantly, the performance of the fund for periods longer than a day will not be the fund's beta (3x) multiplied by the return of the target index. Second, daily rebalancing will have positive implications for longer-term performance in certain markets and negative implications in other markets.

Q: If the benchmark index for a Bull ETF advances 5% in a month, should the Bull ETF be expected to gain 15%?

A: No. The performance of the fund over longer periods of time will be the product of the daily returns during the period and may be very different from its daily target multiplied by three. This will, in some cases, be to the advantage of the shareholder—other times, it will be to their disadvantage.

A term leveraged ETF investors should know:

Beta

A measure of the systematic variability of a security or a portfolio in relation to a target index. A beta of more than 1.00 indicates that the security or portfolio would have higher volatility than the index; a beta of less than 1.00 indicates lower volatility.

(3x Leveraged ETFs are sometimes referred to as 3-beta ETFs. This is because their daily objective is to overperform or underperform their benchmark index by 300%.)

Let's consider the following three different market scenarios:

In trending markets with low volatility, the performance for periods longer than a day may exceed the return of the index, multiplied by the beta of the portfolio, as demonstrated in the first two scenarios below.

Market Rises Steadily

In a steadily rising market, the fund's gains may be larger than expected. In this first example, the ETF gained 89.85%, more than the 75% gain expected, given the 25% index gain and the fund's beta of 3.

Day	Index Value	Index Daily Return	Index Cumulative Return	Index Cumulative Return 3x	3x Fund Daily Expected Return	Fund NAV	Actual Cumulative Fund Return*
	100					$20.00	
1	105	5.00%	5.00%	15.00%	15.00%	$23.00	15.00%
2	110	4.76%	10.00%	30.00%	14.28%	$26.28	31.40%
3	115	4.55%	15.00%	45.00%	13.65%	$29.86	49.30%
4	120	4.35%	20.00%	60.00%	13.05%	$33.75	68.75%
5	125	4.17%	25.00%	75.00%	12.51%	$37.97	89.85%

Market Declines Steadily

In a steadily declining market, the fund's loss may be less than expected. In this next example, the ETF declined 60%, less than the 75% loss expected, taking into consideration the 25% index loss and the fund's beta of 3.

Day	Index Value	Index Daily Return	Index Cumulative Return	Index Cumulative Return 3x	3x Fund Daily Expected Return	Fund NAV	Actual Cumulative Fund Return*
	100					$20.00	
1	95	-5.00%	-5.00%	-15.00%	-15.00%	$17.00	-15.00%
2	90	-5.26%	-10.00%	-30.00%	-15.78%	$14.32	-28.40%
3	85	-5.56%	-15.00%	-45.00%	-16.68%	$11.94	-40.30%
4	80	-5.88%	-20.00%	-60.00%	-17.64%	$9.84	-50.80%
5	75	-6.25%	-25.00%	-75.00%	-18.75%	$8.00	-60.00%

In volatile markets, the pursuit of daily investment targets will have a negative impact on the ETF's performance for periods longer than a single day, as illustrated in this final example.

Market is Flat, Yet Volatile

In this last example, the index is flat for the six-day period, but the fund lost 4.50%, despite achieving its daily target.

Day	Index Value	Index Daily Return	Index Cumulative Return	Index Cumulative Return 3x	3x Fund Daily Expected Return	Fund NAV	Actual Cumulative Fund Return*
	100					$20.00	
1	95	-5.00%	-5.00%	-15.00%	-15.00%	$17.00	-15.00%
2	100	5.26%	0.00%	0.00%	15.78%	$19.68	-1.60%
3	105	5.00%	5.00%	15.00%	15.00%	$22.63	13.15%
4	100	-4.76%	0.00%	0.00%	-14.28%	$19.40	-3.00%
5	95	-5.00%	-5.00%	-15.00%	-15.00%	$16.49	-17.55%
6	100	5.26%	0.00%	0.00%	15.78%	$19.09	-4.50%

*These numbers do not reflect daily operating expenses and financing charges, are hypothetical in nature, and are not representative of actual leveraged ETF returns.

Essentially, leveraged ETFs are likely to underperform in volatile markets as a result of the need for constant, substantial portfolio adjustments. **Users of leveraged ETFs are encouraged to monitor the changing exposure provided by their investment and modify share holdings as they deem necessary.**

Market Price Variance Risk

Leveraged ETFs are bought and sold in the secondary market on the NYSE ARCA exchange. The market prices of the shares will fluctuate in response to changes in NAV and supply and demand for the shares. It is not possible to accurately predict whether the shares will trade above, below, or at their NAV.

On occasion, ETFs may trade at larger-than-expected premiums due to a lack of supply of outstanding shares available in the markets. The result could be that an investor may buy shares at a price that is somewhat inflated above the total market value of the underlying holdings of the fund. However, as more shares are introduced into the secondary market, supply and demand ordinarily return to relative balance. The result typically would be a natural decrease in the size of the premiums.

Counterparty Risk

Leveraged ETF providers may invest in financial instruments involving counterparties for the purpose of attempting to gain added exposure to the benchmark indexes. Counterparty risk is the risk of monetary loss a firm may be exposed to if the counterparty encounters difficulty meeting its obligations under the terms of the transaction.

To minimize counterparty risk, leveraged ETF providers may primarily diversifying their portfolio of relationships for swap and futures contracts across multiple brokers. Leveraged ETF providers will regularly monitor the balance sheets of all counterparties and will suspend or terminate relationships with any organization that shows material signs of insolvency.

Terms leveraged ETF investors should know:

NYSE ARCA

Previously known as **ArcaEx**, an abbreviation of **Archipelago Exchange**, NYSE ARCA is a securities exchange on which both stocks and options are traded. It is owned by NYSE Euronext, which merged (as NYSE Group) with Archipelago Holdings in a reverse merger on 2/27/2007.

Secondary Market

The financial market for trading of securities that have already been issued in an initial private or public offering. New ETF shares are created in the primary market in large lots called **creation units** by financial professionals called **Authorized Participants**. Once these shares are created, they become available for purchase to all investors in the secondary market.

Summary

Leveraged ETFs are powerful investment vehicles for investors who are looking to gain magnified exposure to the markets. This brochure has provided a detailed explanation as to how these funds operate, as well as a description of certain risks that must be understood before investment is made. It is also important to remember that, particularly **in volatile markets, these funds must be watched closely to ensure that one's exposure levels are in line with their desired objectives**.

Frequently Asked Questions

Q The target benchmark index for a 3x Leveraged ETF in which I invested advanced 5% last month. So why, then, didn't the fund return 15% for the month?

A Daily leveraged ETFs' investment objective to seek investment results of 300% (or -300%), before fees and expenses, of the price performance of its benchmark index, is a *daily* objective, and does not necessarily apply to longer periods of time. As outlined in the section entitled "The Impact of Seeking Daily Betas on Long-Term Performance" (on page 6), the actual longer-term performance may be close to the daily targets—but depending on certain market movements and due to the portfolio adjustments required to pursue the daily investment targets set by the fund, performance over time may vary. This will, in some cases, be to the advantage of the shareholder; other times, it will be to their disadvantage.

In markets predominantly trending in one direction with low volatility, the performance for periods longer than a day may exceed the return of the index, multiplied by the target beta of the portfolio. However, in volatile markets, the pursuit of daily investment targets will typically have a negative impact on performance for periods longer than a single day.

Q The target benchmark index for a 3x Leveraged ETF in which I invested was up 3% yesterday, but if I compare the fund's closing price from two days ago to yesterday's close, I only see a gain of approximately 7.5%. Shouldn't this return be closer to 9%?

A Ordinarily, yes. But when we see this type of daily performance discrepancy, it is commonly due to the fund trading at an abnormally large price premium (as compared to the fund's NAV) at the time of the market close. This is usually caused by a higher demand for shares than are currently available in the market. That is, there are more interested buyers than there are sellers of shares in the market at that time. The result is a temporary inflation of the market price for the fund. This means that those investors who bought shares at this premium paid more than the actual net asset value per share, or more than the actual value of the underlying holdings per share in the fund. The disadvantage of buying at a premium is that the investor will essentially be "selling" a portion of the fund's return to the buyer. This is a reason for the difference in the expected daily returns that can sometimes be seen.

The good news is that this situation is typically resolved relatively quickly. Historically, we've often seen that, as new shares are introduced to the market, supply and demand come back into relative balance and the price premiums ordinarily decline.

ETF shares trade on the open (or secondary) market throughout the day on securities exchanges (i.e.: the NYSC ARCA). *ETF providers do not have any control over how they trade—whether at a premium or discount.* As mentioned earlier, at times when supply is lower than demand, the shares can trade at significant premiums. It is recommended that when investors are considering a trade in any ETF, they check with their investment professional to see if the shares are trading at excessively large premiums or discounts, and consider the impact of this on their investment.

Q What happens if the value of the index that a 3x Leveraged ETF is tracking moves more than 33% in one day?

A Each 3x Leveraged ETF seeks daily exposure to its target index equal to 300% of its net assets. Consequently, a fund could theoretically lose an amount greater than its net assets in the event of a daily movement of its target index in excess of 33% in a direction adverse to the fund (meaning a decline in the value of the target index of a Bull Fund and a gain in the value of the target index for a Bear Fund). It is unlikely that this type of market activity would occur in a single day, given the trading curb rules that are in place on most exchanges, but in the event that it does, the Leveraged ETF provider reserves the right to be responsive to index movements up to, but not beyond, a certain point. For example, if a Bull Fund's target index gained 25%, the Fund would be expected to gain 75%. However, if the target index gained 30%, the Fund's portfolio might not respond to the index gains which result in the difference between the 25% daily movement from 25% to 30%—meaning the Fund's return would be capped for the day at 75%.

This precaution is in place to mitigate some risk of the investment interests of shareholders. **It is important to understand that an investor in Leveraged ETFs cannot lose an amount greater than their initial investment.**

Q Are Leveraged ETFs appropriate for buy and hold investing?

A **No, this is not recommended.** Leveraged ETFs ***seek daily investment results.*** Investors who choose to hold a fund for periods longer than one day should recognize that their holding period is not in line with the fund's objective and such investors should regularly monitor and adjust their position to harness the daily objectives of the funds for their longer holding period.

An investor should consider the investment objectives, risks, charges, and expenses of Direxion Shares carefully before investing. The prospectus contains this and other information about Direxion Shares. To obtain a prospectus, please visit www.direxionshares.com. The prospectus should be read carefully before investing.

Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted. Returns for performance for one year and under are cumulative, not annualized. Short-term performance, in particular, is not a good indication of the fund's future performance, and an investment should not be made based solely on returns. For additional information, see each fund's prospectus.

Investing in index funds may be more volatile than investing in broadly diversified funds. The use of leverage by a 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.

The risks associated with each fund are detailed in the prospectus. These include adverse market condition risk, adviser's investment strategy risk, aggressive investment techniques risk, concentration risk, counterparty risk, credit and lower-quality debt securities risk, equity securities risk, currency exchange risk, daily correlation risk, daily rebalancing and market volatility risk, depository receipt risk, foreign and emerging markets securities risk, sector securities risk, interest rate risk, inverse correlation risk, leverage risk, market risk, non-diversification risk, shorting risk, small- and mid-cap company risk, tracking error risk, and special risks of exchange-traded funds.

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