

# *Leveraged and Inverse ETFs:* Strategies for a Changing Economy

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# **Leveraged and Inverse ETFs: Strategies for a Changing Economy**

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# Agenda

- ETF growth fueled by their effectiveness for trading efficiency and fund management
- Leveraged and Inverse ETFs:  
Tools for tactical strategies
- Investment themes for changing markets

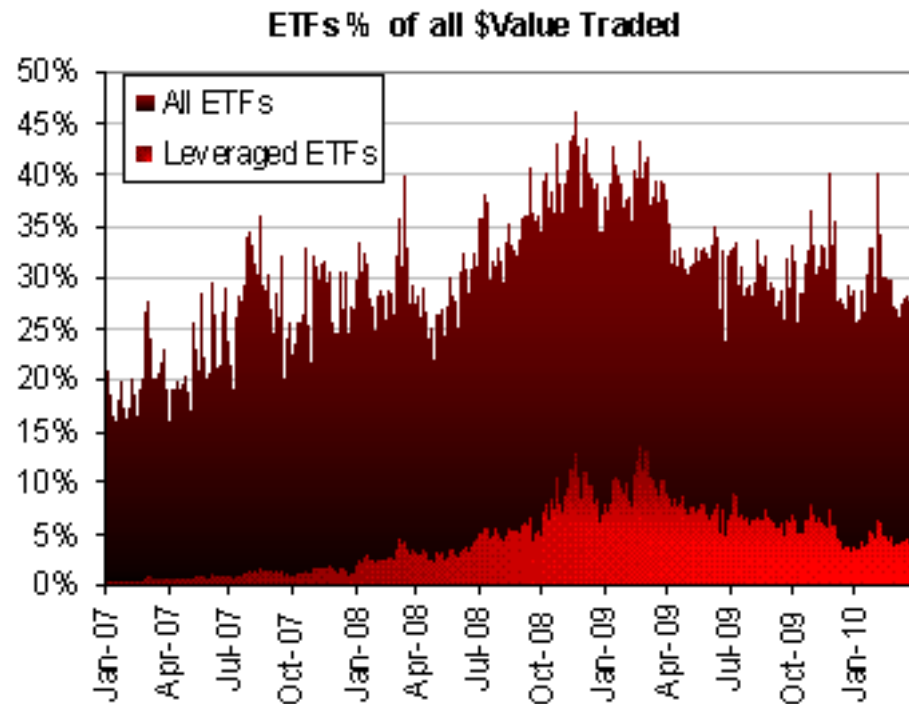
# Drivers of ETF growth in the current investment environment

## Objectives shared by institutional and individual investors

- Increased focus on asset classes and market segments rather than individual stocks
- Broader choice set of tradable indexes for expressing investment views, risk management, and cash equitization
- Recognition that portfolio strategies must be more opportunistic and adaptive to shifts in market risk
- More of an absolute return focus

# Liquidity features of ETFs are a key driver of asset growth

- Short-term trading tools
  - Approaching 30-40% of overall U.S. equity volumes<sup>1</sup>
- Heavy institutional use
  - Estimated that 40-50% of assets held by institutions, which also account for a much larger portion of trading activity<sup>2</sup>



Source: Credit Suisse: Portfolio Strategy, April 5, 2010

Source: <sup>1</sup> Bloomberg, March 2010

<sup>2</sup> 2009 Strategic Insight report

Past performance does not guarantee future results.

# Largest ETFs are valued for both investment and trading features

- The list includes widely used equity indexes but also gold, TIPS, and corporate debt
- A wide range of ratios of \$Assets to Daily \$Volume
- The average ratio of \$Asset/Volume across all ETFs has recently been approximately 10 days

Largest long-only ETFs			
Ticker	ETF Name	Assets (m)*	\$Assets/Daily Volume
SPY	SPDR S&P 500	\$77,824	4.0
GLD	streetTRACKS Gold	\$40,504	24.4
EFA	iShares MSCI EAFE	\$35,735	19.4
EEM	iShares MSCI Emerging Markets	\$35,099	4.9
VWO	Vanguard Emerging Markets	\$22,920	19.2
IVV	iShares S&P 500	\$22,782	56.0
QQQQ	PowerShares QQQ	\$20,917	2.2
TIP	iShares Barclays TIPS	\$20,128	170.0
VTI	Vanguard Total Stock Market	\$14,425	67.9
IWM	iShares Russell 2000	\$13,244	2.2

Source: Bloomberg, March 2010

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# ETF flows in 2009 varied with market themes and investors' risk appetite

Current interest in:

- Commodities (gold and natural gas) and emerging markets
  - Strong returns and diversification potential
- Fixed income (corporate, and inflation-hedged) inverse S&P 500 and financial sectors
  - Risk reduction, income, and tactical asset class views

Top ETF asset gainers in 2009			
Ticker	ETF Name	YTD Flows	\$Assets/ Daily Volume
GLD	streetTRACKS Gold Shares	\$11,095	27.9
VWO	Vanguard Emerging Markets	\$9,310	53.8
TIP	iShares Barclays TIPS	\$8,860	130.4
EEM	iShares MSCI Emerging Markets	\$5,791	13.3
UNG	United States Natural Gas	\$5,297	10.3
LQD	iShares iBoxx \$ Investment Grade	\$4,830	108.6
CSJ	iShares Barclays 1-3 Year Credit	\$3,937	77.2
FAZ	Direxion Daily Financial Bear 3x Shares	\$3,382	0.8
BND	Vanguard Total Bond	\$3,211	132.5
SDS	ProShares UltraShort S&P500	\$2,963	1.9

Source: Bloomberg, December 2009  
 Past performance does not guarantee future results.

## Q1 2010 ETF flows continue be tilted toward emerging markets and fixed income

- Continuation of flows into emerging market equities and fixed income funds
- New on list of top 10 flows in Q1 2010:
  - High yield bond ETFs (JNK) and VIX Futures ETN (VXX)
  - Equities: QQQQ, industrial sector (XLI), and dividend-tilted indexes (VIG)
- Off the list are gold, natural gas, corporate bond, and inverse financial sector and S&P 500 ETFs

Source: Bloomberg, December 2009

Past performance does not guarantee future results.

### Top ETF asset gainers in 2010

Ticker	ETF Name	YTD Flows	\$Assets/ Daily Volume
VWO	Vanguard Emerging Markets	\$2,903	19.2
SHV	iShares Barclays Short Treasury Bond	\$1,840	67.3
TIP	iShares Barclays TIPS	\$1,586	170.0
QQQQ	PowerShares QQQ	\$1,346	2.2
CSJ	iShares Barclays 1-3 Year Credit Bond	\$1,068	125.6
BND	Vanguard Total Bond Market	\$859	107.7
VXX	iPath S&P 500 VIX Short-Term Futures ETN	\$830	1.8
JNK	SPDR Barclays Capital High Yield	\$815	22.5
XLI	Industrial Select Sector SPDR	\$775	2.6
VIG	Vanguard Dividend Appreciation	\$771	62.9

# What lies ahead for the ETF industry ?

- As investors turn to a more absolute return approach, direct and indirect use (through hedge funds) of ETFs should benefit
- Innovation with products incorporating alphas, new risk factors, and trading strategies
- A continued focus on product and strategy education
  - Critical role for industry to educate ETF investors as they cover more asset classes, use derivatives in index construction and portfolio management, and have become more specialized



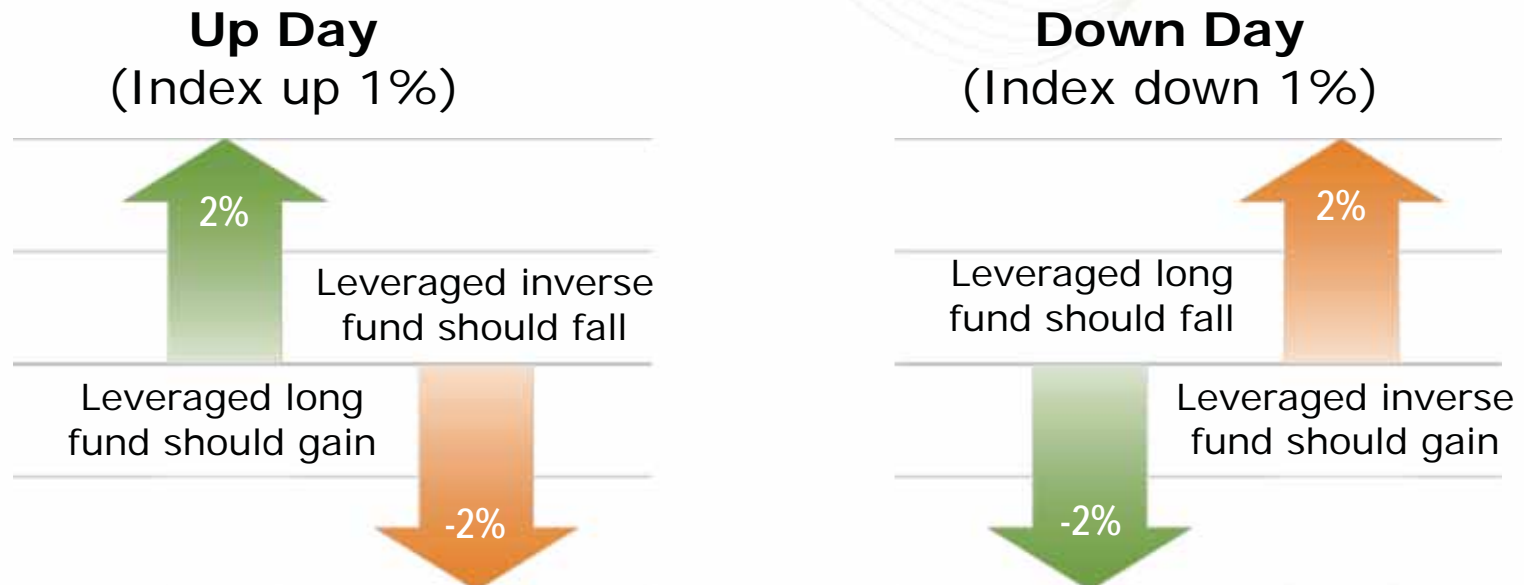
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## **Leveraged and inverse ETFs:**

Tools for tactical strategies

# What are leveraged & inverse ETFs?

## Example Using +2x and -2x ETFs



The ETFs seek a daily return that is a multiple of the return of the index (target). Due to compounding of daily returns, results over periods other than a day will likely differ in amount and possibly direction from the target return for the same period.

Before fees and expenses.  
There is no guarantee an ETF will meet its objective.

# Universal effects of compounding on investment returns

- Compounding affects all investments over time
  - Upward trending periods enhances returns
  - Downward trending periods reduces losses
  - Volatile periods may reduce returns and increase losses
- Positive and negative effects of compounding are magnified in leveraged and inverse funds

# Leveraged and inverse funds and ETFs: History and profile

- Leveraged and inverse mutual funds introduced in 1993
  - Grew to over 100 funds with \$10 billion in assets
  - ETFs introduced in 2006 in the U.S.
- Today more than 178 funds
  - Assets are now more than \$31 billion
  - Daily volume of more than \$16 billion per day

Largest Leveraged & Inverse ETFs			
Ticker	ETF Name	Assets (m)*	\$Assets/ Daily Volume
TBT	ProShares UltraShort 20+ Year Treasury	\$4,635	7.4
SDS	ProShares UltraShort S&P500	\$3,242	0.9
UYG	ProShares Ultra Financials	\$1,844	1.1
SSO	ProShares Ultra S&P500	\$1,499	0.8
SH	ProShares Short S&P500	\$1,489	6.6
FAZ	Direxion Daily Financial Bear 3x Shares	\$1,232	0.2
QID	ProShares UltraShort QQQ	\$919	0.6
FAS	Direxion Daily Financial Bull 3x Shares	\$889	0.3
QLD	ProShares Ultra QQQ	\$843	1.1
SRS	ProShares UltraShort Real Estate	\$587	0.4

Source: Bloomberg, December 2009  
Past performance does not guarantee future results.

## Why they're valued

- **Efficient tool for investors with a view of the market**
- **Can trade and follow like a stock**
- **Can't lose more than you invest**
- **Institutional pricing**
- **Transparent**
- **Liquid**

## How they're used

- **Tactical tools like other ETFs**
- **Component of overall portfolio strategy**
  - Target exposure with less cash
  - Overweight or underweight exposure
  - Help manage overall portfolio risk or seek to hedge specific risk exposures

# A reminder about risk

- Short ProShares are also subject to inverse correlation risk and short sale risk.
- UltraQQQ, ShortQQQ and UltraShort QQQ are also subject to technology risk.
- UltraDow30, ShortDow30 and UltraShort Dow30 also involve concentration risk.
- UltraMidCap400, ShortMidCap400 and UltraShort MidCap400 also involve mid-cap company investment risk.
- Shares of the ProSharesETFs may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from a Fund by Authorized Participants, in very large creation/redemption units.
- In addition to the normal risks associated with investing, narrowly-focused investments typically exhibit higher volatility and smaller companies typically exhibit higher volatility.
- The fees and expenses associated with ProShares are higher than traditional ETFs.
- International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations.
- For descriptions of these risks, please see the prospectus at [www.proshares.com](http://www.proshares.com).
- Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Securities focusing on a single country may be subject to higher volatility.
- Bonds will decrease in value as interest rates rise.
- The principal risks associated with ProShares include the following:
  - aggressive investment technique risk
  - correlation risk
  - counterparty risk
  - credit risk
  - early close/trading halt risk
  - equity risk
  - liquidity risk
  - market price variance risk
  - market risk
  - non-diversification risk
  - portfolio turnover risk
  - repurchase agreement risk
  - volatility risk

# A reminder about risk

- Some ProFunds employ leveraged investment techniques that magnify gains, losses and volatility
- Small-capitalization funds typically carry additional risks since smaller companies generally have a higher risk of failure.
- Some ProFunds invest internationally, which involves increased risk and volatility.
- UltraSector ProFunds invest in a single industry. Their shares do not represent a complete investment program. As non-diversified and single industry fund, the value of their shares may fluctuate more than shares invested in a broader range of industries and companies.
- All ProFunds permit active investment strategies that can decrease performance and increase expenses.
- The principal risks associated with ProFunds include the following:
  - aggressive investment technique risk
  - correlation risk
  - counterparty risk
  - credit risk
  - equity risk
  - leverage risk
  - liquidity risk
  - market price variance risk
  - market risk
  - non-diversification risk
  - repurchase agreement risk
  - volatility risk

# True Diversification is maintained by focusing on the R.I.G.H.T. Asset Allocation

## Portfolio Asset Classes

### Reserves

Cash Equivalents used to provide liquidity for trading and to help accommodate client withdrawals

### Income Securities

Loans to Governments and Businesses

### Growth Opportunities

Equity interests in businesses around the world

### Hard Assets

Security ownership of tangible assets such as precious metals, natural resources and real estate

### Tactical Investments

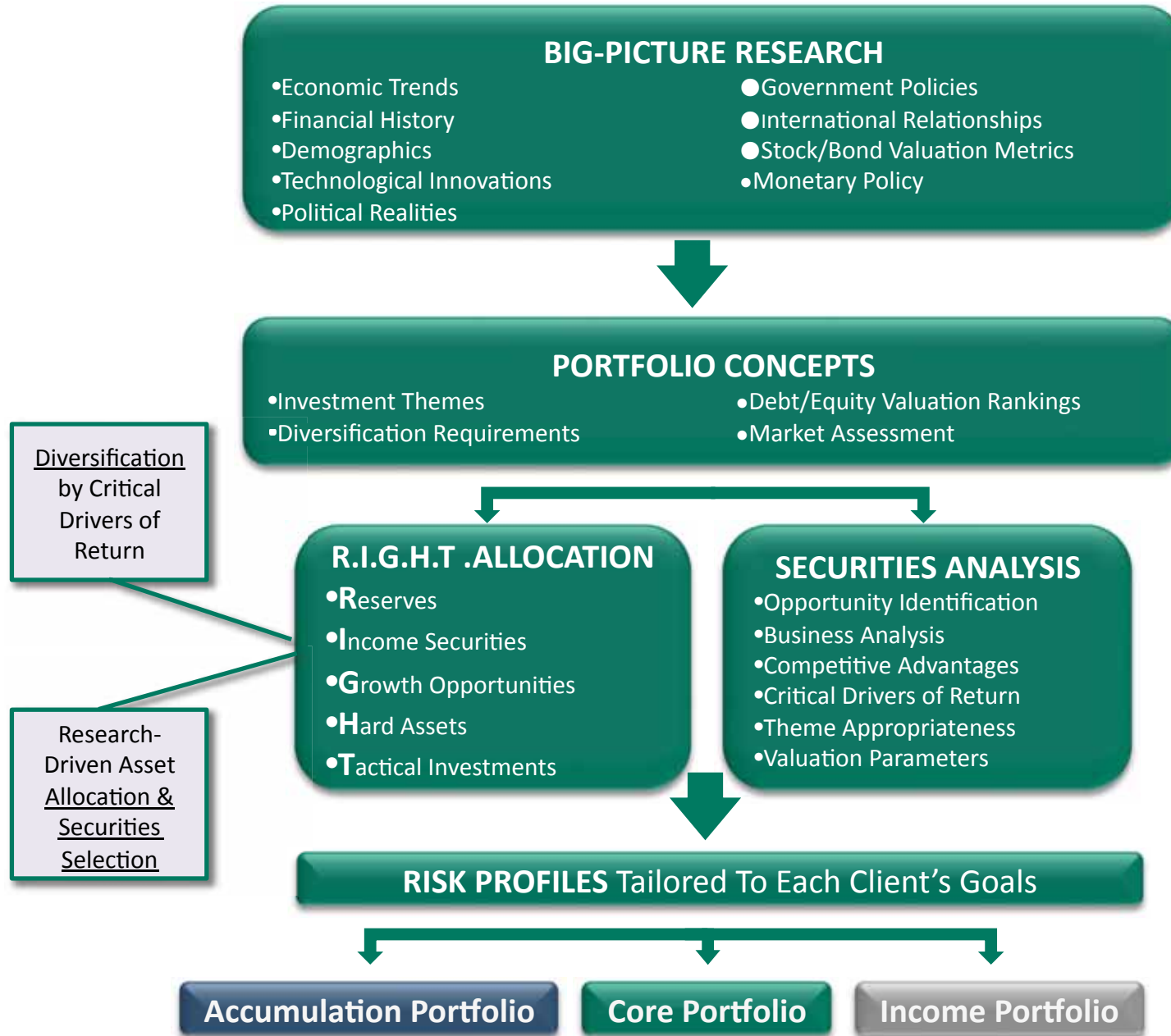
A variety of defensive and non-correlated investments



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# Q & A

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