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GEARED INVESTING

An introduction to leveraged and inverse funds

GEARED FUNDS have generated a great deal of interest in recent years. Also known as **LEVERAGED AND INVERSE FUNDS**, these investments have attracted a growing number of investors looking for tools to manage their portfolios in today's markets.



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The concepts behind leveraged and inverse investing are hardly new. For centuries, investors have used leverage to increase their buying power and inverse strategies to profit or to protect a portfolio during declines. The more recent availability of leveraged and inverse mutual funds and exchange traded funds (ETFs), also known as “geared” funds, has provided more ways for investors to access these strategies.

Geared investing is *not* for everyone. Each vehicle for geared investing is a specialized tool, useful for a variety of specialized strategies—but each also has special risks. Geared funds are generally riskier than funds without leveraged or inverse exposure. Before investing, you should fully understand the risks and benefits of the investment—including the amount of attention you will need to devote to monitoring your position, which may be as frequently as daily.

This overview covers basic information and is not intended to be comprehensive. If, after you review it, you think geared funds may have a place in your portfolio, you can learn more about compounding and its effect on performance over time, and about leverage and other risks by reading a fund prospectus. For a prospectus and other information, visit proshares.com or profunds.com or consult your financial adviser.

BASICS OF **LEVERAGED** INVESTING

In the financial world, *leverage* means the use of borrowed capital to increase potential return. Investors commonly use leverage to increase their buying power.

FOR EXAMPLE, an investor who believes a stock will go up can buy more of it using a margin account, a common way for investors to borrow. Like any borrower, the investor generally pays interest and may incur other costs, but hopes increased profit from having more exposure to the stock will more than offset those costs.

Another investor might decide to buy a leveraged investment to get a certain level of exposure to a specific segment of the market for less cash. The investor may then use the money he would have invested to further diversify his portfolio or for cash reserves.

Investors can choose to pursue a variety of sophisticated strategies using leverage. But, with magnified exposure, increased upside potential can also mean increased downside potential. Investors should understand and accept the potential risks and costs before using leverage.

HOW INVESTORS GET LEVERAGE

Traditionally, investors have obtained leverage in a variety of ways, each with its own advantages and disadvantages. Common choices have included margin, call options, and futures.

» **MARGIN:** When a brokerage firm lends an investor the cash to purchase securities, it is called buying “on margin.” With the borrowed capital, the investor can buy more. The investor typically pays interest and is asked to keep a certain level of assets in the brokerage account.

» **BUYING CALL OPTIONS:** Options give an investor the option to buy an asset at an agreed-upon price during a certain time period. “Buying a call”—purchasing the option to buy the asset—is one way to use options to get leverage. For the price of the call contract, an investor can control more shares than investing directly in the stock. With this leverage, the investor could earn a larger percentage profit if the stock rises. If it falls, a call buyer could lose the amount paid for the contract.

» **BUYING FUTURES:** Futures contracts obligate the investor to buy or sell an asset in the future at a price level set now. As with buying calls, an investor buying futures may control a larger position than he could by buying the asset itself with the same amount of money. With this magnified exposure, the investor could earn a larger percentage profit if the asset’s value increases. However, the investor may be required to maintain a certain account balance, and losses could be more than the amount invested.

For a comparison, see page 5.

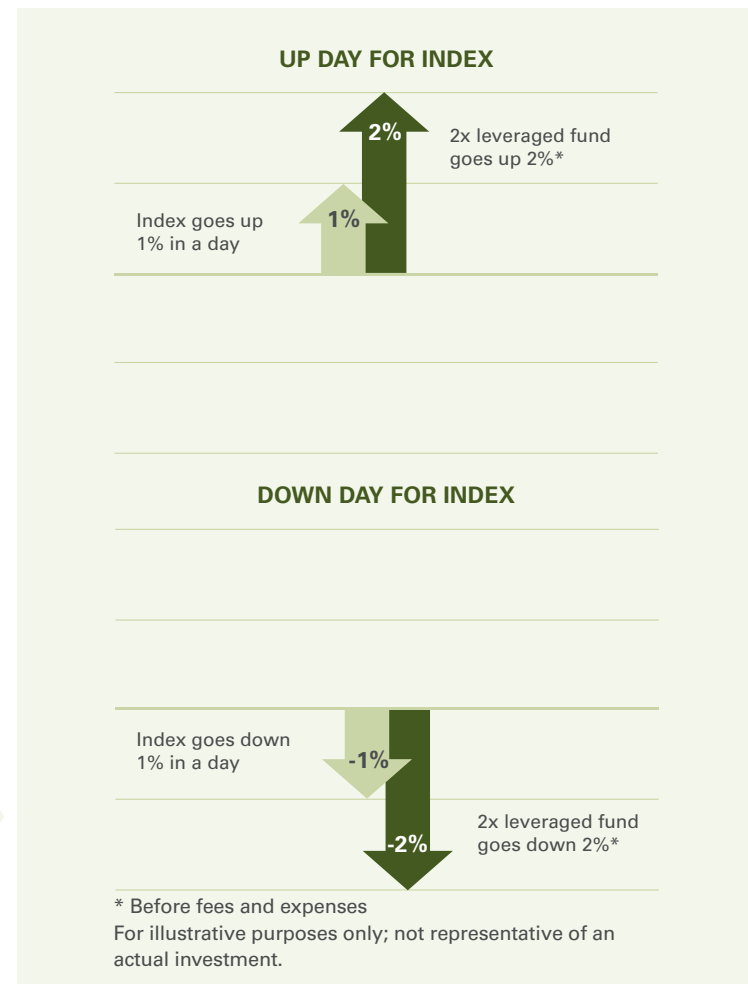
LEVERAGED FUNDS

The more recent availability of a type of geared investment, leveraged funds, has provided another way to get leverage. Available as both ETFs and mutual funds, leveraged funds provide magnified exposure to a market index or other benchmark.

The funds track benchmarks ranging from broad selections of stocks, like the S&P 500®, to narrow sectors of the market, like biotech. Leveraged funds are available covering U.S. and foreign stock markets, bonds, commodities, and currencies.

Leveraged funds have been available as mutual funds since 1993 and ETFs since 2006. Like other leveraged investments, fund gains and losses are magnified. Investors can't lose more than they invest in the fund. Unlike buying on margin or buying call options or futures, leveraged funds generally seek to provide their leverage target—for example, 2x the index return—for one day. *(See page 10 for more on one-day returns.)*

Many leveraged funds are designed to provide double the one-day return of a benchmark, before fees and expenses. So a 2x leveraged fund should go up about 2% on a day when its benchmark goes up 1%. And, it should go down about 2% when the benchmark goes down 1%.



COMPARING

COMMON WAYS TO GET **MAGNIFIED EXPOSURE**

	BUY ON MARGIN	BUY CALL OPTIONS	BUY FUTURES	LEVERAGED FUNDS
Possible to lose more than invested?	Yes	No	Yes	No
Can offer high—more than 3x—leverage?	Yes	Yes	Yes	No
Can provide magnified exposure to an individual stock or security?	Yes	Yes	Yes	No
Available without a margin, option, or futures account?	No	No	No	Yes
May require investors to add to account to maintain margin levels?	Yes	No	Yes	No

See page 12 for important information.

BASICS OF **INVERSE** INVESTING

Most investors are aware that markets move in two directions. And some want to protect against the downside—or take advantage of it. They can do this with inverse investing.

FOR EXAMPLE, an investor who believes a stock he wants to continue to hold will fall could try to hedge against its decline by buying an investment designed to move in the opposite direction. A gain in the inverse investment may help counterbalance a loss in the stock. Another investor who doesn't own the stock may "short" it to try to profit from a potential decline. In either case, however, if the stock rises, the inverse investment is likely to decline.

Like leverage, inverse investing can be used in a wide range of sophisticated strategies. Before taking an inverse position, investors should weigh the cost of the inverse investment and how their portfolios will be affected if the stock or other securities shorted go up.

HOW INVESTORS GET INVERSE EXPOSURE

Some of the traditional ways investors have sought inverse exposure include short selling, put options, and futures.

» **SHORT SELLING:** “Shorting” is a transaction that reverses the order of a financial trade—a stock or other asset is sold before it’s bought. Typically, the investor borrows shares, immediately sells them, and later buys them back to return to the lender. If the price has fallen in that time, the investor profits from the difference, less the borrowing costs and any dividends the investor may have paid. If the price rises, the investor pays more for the shares and loses money. Short selling usually requires a margin account, and an investor needs to maintain a certain level of assets in the account.

» **BUY PUT OPTIONS:** A common way to get inverse exposure using options is to buy “puts.” Put contract owners have the option to sell an asset at an agreed-upon price during a specified time period. Like an investor who sells short, they hope to profit from a decline in the value of the asset. The inverse exposure to the asset is often leveraged, that is, magnified. For put buyers, the amount at risk if the asset’s price rises is the amount paid for the contract.

» **SELLING FUTURES:** Selling a futures contract obligates the investor to sell an asset in the future at a price level set now. Investors looking for inverse exposure might sell futures contracts hoping to benefit if the asset’s value goes down. These positions are typically leveraged. If the value of the asset rises, it is possible to lose more than the amount invested. The investor typically is required to keep a certain amount in the account.

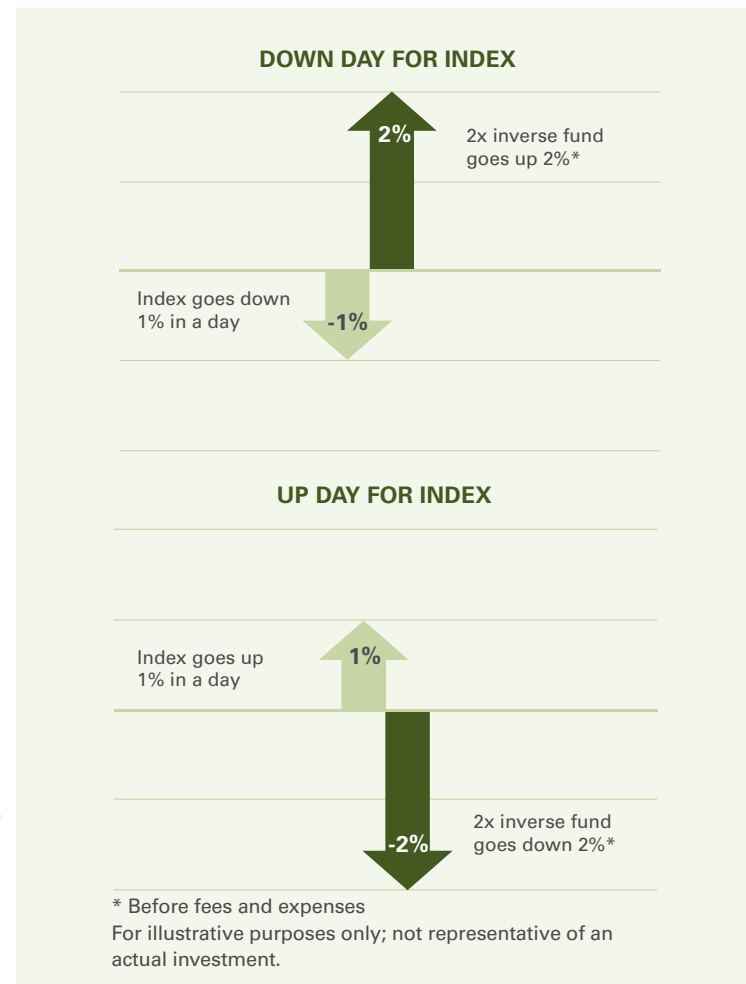
For a comparison, see page 9.

INVERSE FUNDS

Inverse ETFs and mutual funds are designed to provide “short” exposure by moving in the opposite direction of indexes or other benchmarks. Inverse funds are available covering U.S. and foreign stock markets, bonds, commodities, and currencies, on both broad market indexes and narrow market segments.

Inverse funds have been available as mutual funds since 1994 and as ETFs since 2006. Inverse funds and other inverse investments share many similar risks. However, with funds, losses are limited to the amount invested. And, unlike the other inverse investments described, inverse funds generally seek to provide their target return—for example, -1x or -2x the index return—for one day. (See page 10 for more on one-day returns.)

Inverse funds seek the inverse—or a multiple of the inverse—of the one-day return of a benchmark, before fees and expenses. So a -2x inverse fund should go up about 2% on a day when its benchmark falls 1%. And it should go down about 2% if the benchmark rises by 1%.



COMPARING

COMMON WAYS TO GET **INVERSE EXPOSURE**

	SHORT SELLING	BUY PUT OPTIONS	SELL FUTURES	INVERSE FUNDS
Possible to lose more than invested?	Yes	No	Yes	No
Can offer high—more than 3x—leverage?	Yes	Yes	Yes	No
Can provide short exposure to an individual stock or security?	Yes	Yes	Yes	No
Available without a margin, option, or futures account?	No	No	No	Yes
May require investors to add to account to maintain margin levels?	Yes	No	Yes	No

See page 12 for important information.

ONE-DAY PERFORMANCE VS. PERFORMANCE OVER TIME

The goal of a typical geared fund is to return the multiple of an index—say 2x—for one day. Every geared fund investor should understand that for any other time period, the return from a geared fund is likely to be more or less than that multiple of the index return. This means an investor in a 2x fund may get more or less than double the index return. The difference can be significant, depending on the path the index performance takes during the period.

THIS HAPPENS, in large part, because of the compounding of returns over periods greater than one day. Compounding is the math that affects returns of *all* investments. Most people understand compounding in a savings account—after an interest payment is added to the account, the next interest payment is calculated on the higher balance.

Compounding can have both positive and negative effects. As shown in the example on the next page, compounding tends to improve returns in upward or downward trending periods and hurt returns in times of volatility. These effects are greater for geared funds.

FOR GEARED FUNDS, COMPOUNDING IS MAGNIFIED



For leveraged and inverse funds, the positive and negative effects of compounding are magnified. In the example, you'll note that during the upward trend, the gain for the 2x fund is *more* than two times the compounded index return. In the volatile period the return is *less* than two times the compounded index return. In short, an investor could gain or lose more money faster in a geared fund.



Investors looking to maintain a specific multiple of index performance over time with a geared fund must actively monitor their positions and may consider rebalancing—that is, increasing or decreasing their investment—to maintain their exposure level. Because the investor is buying and selling, rebalancing may have costs and tax consequences.



Why do most geared funds aim to track index returns for just one day? So investors can start with the target multiple of index performance no matter what day they invest. For example, to provide 2x exposure for investors buying each day, a fund's holdings are readjusted to 2x exposure to the index each day. Otherwise, as the index moves and the geared fund magnifies that performance, the fund's exposure to the index is likely to be smaller or larger than 2x. If a geared fund's objective was to track returns for a month, its exposure would be adjusted only once a month, so those investing after the first day would likely not get 2x exposure.

COMPOUNDING CAN HELP OR HURT RETURNS

In upward and downward trending periods the 2x fund returns more than two times the index. In the volatile period the 2x fund returns less than two times the index.

	INDEX RETURN	2x FUND RETURN
UPWARD TREND  		
Day 1 Return	+10%	+20%
Day 2 Return	+10%	+20%
Compounded 2-Day Return	+21%	+44%

	INDEX RETURN	2x FUND RETURN
DOWNWARD TREND  		
Day 1 Return	-10%	-20%
Day 2 Return	-10%	-20%
Compounded 2-Day Return	-19%	-36%

	INDEX RETURN	2x FUND RETURN
VOLATILE PERIOD  		
Day 1 Return	+10%	+20%
Day 2 Return	-10%	-20%
Compounded 2-Day Return	-1%	-4%

This example shows extreme hypothetical index movement to illustrate the point. Actual index movements can be very different, and returns would be lower after fees, expenses, and taxes.

GEARED FUNDS **ARE NOT** FOR EVERY INVESTOR

If you are considering investing in geared funds, please be sure you understand that:

- » There are advantages, disadvantages, and risks with any geared investment. *(See pages 2–9.)*
- » Geared funds typically seek a multiple of the return of a benchmark for a single day only. *(See pages 4, 8, 10–11.)*
- » Investment results over time can be significantly more or less than the multiple times the benchmark return. *(See pages 10–11.)*
- » Geared fund positions should be actively monitored. Some investors may want to rebalance on a regular basis to maintain consistent exposure. *(See page 11.)*
- » There are many ways to use geared funds in combination with other investments, but geared funds should not be a large portion of most investors' portfolios.
- » You should do your homework and read the prospectus before investing in any fund.

ABOUT PROFUNDS GROUP

ProFunds Group was founded in 1997. Today, with over 100 ProFunds mutual funds and over 100 ProShares ETFs, ProFunds Group is the world's leader in geared funds. ProFunds Group also offers other specialized ETFs and mutual funds, allowing investors to execute sophisticated investment strategies.

To learn more about us and our growing family of investments, please visit profunds.com and proshares.com.

Each Ultra and Short ProShares ETF and leveraged or inverse ProFund seeks a return that is a multiple or inverse multiple (e.g.,-2x) of the return of an index or other benchmark (target) **for a single day**. Due to the compounding of daily returns, Ultra and Short ProShares' and leveraged or inverse ProFunds' returns over periods other than one day will likely differ in amount and possibly direction from the target return for the same period. Investors should monitor their holdings consistent with their strategies, as frequently as daily. For more on correlation, leverage and other risks, please read the ProShares or ProFunds prospectus.

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Carefully consider the investment objectives, risks, charges and expenses of ProShares and ProFunds before investing. This and other information can be found in their summary and full prospectuses. Read them carefully before investing. For a ProShares ETF prospectus, visit proshares.com or obtain one from your financial adviser or broker/dealer representative. For a ProFunds mutual fund prospectus, visit profunds.com.

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ProFunds Group is the world's leader in geared funds according to Lipper, based on a worldwide analysis of all of the known providers of leveraged and inverse funds. The analysis covered ETFs, ETNs, and mutual funds by the number of funds and assets (as of 6/30/2010).

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