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Understanding Inverse or Leveraged Exchange Traded Funds

Inverse or Leveraged Exchange Traded Funds (ETFs) are complex investment products that carry risks that are not suited for conservative investing. Capital Synergy Partners, Inc. has created this **Guide to Understanding Inverse and Leveraged Exchange Traded Funds** to assist investors in understanding the features of these products. *Since each ETF is different, you should carefully review the corresponding prospectus for more detailed information about that fund.*

What is a Leveraged ETF?

Leveraged ETFs are ETFs that employ financial derivatives and debt to try to achieve a multiple (for example two or three times) of the return or inverse return of a stated index or bench mark over the course of a single day.

Are Leveraged ETFs risky investments?

The use of leverage typically increases risk for an investor. The more leverage is used (e.g., 150% versus 100%), the greater the potential magnification of gains or losses on those investments. Unlike utilizing margin or shorting securities in your own account, however, you cannot lose more than your original investment.

What is an Inverse ETF?

An inverse ETF is an ETF designed to track, on a daily basis, the inverse of its benchmark. Inverse ETFs utilize short selling, derivatives trading, and other leveraged investment techniques, such as futures trading to achieve their objectives.

In attempting to provide performance opposite to its benchmark over short investing horizons, and excluding the impact of fees and other costs, an inverse ETF attempts to provide a result similar to short selling the stocks in the benchmark index. For example, an inverse S&P 500 ETF seeks a daily percentage movement opposite that of the S&P 500. If the S&P 500 index rises by 1%, the inverse ETF is designed to fall by 1%; and if the S&P falls by 1%, the inverse ETF is designed to rise by 1%. Because it is assumed that their value will rise in a declining market environment, inverse ETFs are of interest to some investors during bear markets.

Are Inverse ETFs a risky investment?

Purchasing an Inverse ETF is not the same as holding short positions in securities that make up the underlying index or benchmark. That is, if one enters into a simple short position on one day, and after some number of days the price of the underlying security has changed in value by X%, then one's payoff is -X%, regardless of what has happened in the meantime. However, the performance of an inverse ETF, being the compound of daily returns, will likely differ in comparison with the simple short position.

Inverse ETFs carry liquidity risks and are speculative investments. Inverse ETFs are not designed to be used as long-term investment vehicles. Due to rebalancing methods, and compounding, extended holding periods beyond one day can lead to results that vary from just an inverse of the index or benchmark the investment tracks over the same time frame. In addition, gains or losses can be magnified in volatile markets. Inverse ETFs are not suited for long-term investment strategies. These funds tend to carry higher fees, due to active management, that can also affect performance.

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<u>Why are Inverse and Leveraged ETFs susceptible to market volatility?</u>
Most Inverse or Leveraged ETFs get their leverage by using derivatives. The prices of derivative contracts do not necessarily move in tandem with the underlying securities. As a result, Inverse or Leveraged ETFs can have volatile price movements and race ahead or fall behind their stated index over long and short periods. Costs of borrowing to implement leverage as well as any efforts to insure counterparty risk are borne by the fund, creating a potential drag on returns.

Example: If a target index is up 10% for a month, will a Leveraged ETF that utilizes a 3 times leverage have a 30% gain?"
Probably not, leveraged ETFs seek to amplify investment results, before fees and expenses, of the price performance of its benchmark index, based on a daily objective. Indeed, long-term performance (when held beyond a day) will almost certainly vary, depending on market movements and portfolio adjustments required to pursue the daily investment targets set by the Leveraged ETF. For example, it is not unheard of for two Leveraged ETFs - with completely opposite strategies (one with a bullish strategy, the other with a bearish one) - to BOTH show sizeable declines. Remember, most Leveraged ETFs (as are most Inverse ETFs) are considered short- term trading vehicles. Holding a Leveraged ETF for a period longer than one day may create returns that differ - sometimes greatly - from the stated multiple of the benchmark index.

<u>Are Inverse and Leverage ETFs for short-term or long-term investing?</u>
Inverse and Leveraged ETFs are designed to be used for relatively short-term investing as part of a market timing strategy and do not appear appropriate for the buy-and-hold or conservative investor.

Inverse and Leveraged ETFs are generally most suitable for sophisticated investors who understand leverage and are willing to assume the risk of magnified potential losses. Given the risk/ return trade-offs, these types of ETFs may not be appropriate for long-term investors who typically subscribe to “buy and hold” investment strategies. Suitability may also depend on the degree to which the Inverse or Leveraged ETF represents a proportion an individual’s investment portfolio. Investors must take special care to make sure they understand the investment theory around owning these instruments, and due to the volatile nature of the investments, watch them closely

Should you have any questions concerning our ETF policy, you may submit a written request for additional information to our Customer Service Department located at 4400 MacArthur Blvd, Suite 230, Newport Beach, CA 92660.