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# Direxion/Wilshire Dynamic Asset Allocation Models

## Asset Management Tools Designed to Enhance Investment Flexibility

### Executive Summary

*At Direxion Funds, our goal is to consistently help investment advisors construct more optimized portfolios. Our primary role is to complement investment advisors’ core investment strategies, not to replace them. We believe opportunities exist in all market conditions and we seek to provide flexible, focused investment options to capitalize on that potential.*

Direxion Funds has teamed with Wilshire Funds Management, the global investment management business unit of Wilshire Associates Incorporated, a highly respected leader in global investment consulting and services, to offer advisors and their clients asset allocation models that can help them achieve their long-term investment objectives while allowing them to respond to the ever-changing short-term market environments.

Direxion Funds’ relationship with Wilshire® has enabled us to create highly diversified, flexible asset allocation models by incorporating certain institutional techniques and a tactical overlay\* into Wilshire’s Strategic Asset Allocation (SAA) Models.

### About Direxion Funds...

Since our founding in 1997, Direxion Funds has developed investment solutions that help sophisticated advisors and investors execute dynamic, active investment strategies.

Our family of leveraged index mutual funds brings a distinctive combination of leverage points, seeking 125% to 250% of the daily investment performance, before fees and expenses, of a wide range of well-known broad indexes and targeted sectors—both on the long side (Bull Funds) and on the short side (Bear Funds).

#### Direxion Funds

Fund Sponsor

Leveraged Index Fund Innovator

#### Wilshire Funds Management

Strategic Asset Allocation

Fund Analysis, Management and Optimization

### Direxion/Wilshire Dynamic Asset Allocation Portfolios

Efficiently manage assets to improve diversification and seek higher risk-adjusted returns

Adjust to market conditions through tactical overlays to core strategies

\* This term is defined in the Glossary section on page 7 . 1

## This paper will discuss:

- *Modern Portfolio Theory\**, which underscores the importance of diversification in any effective investment strategy;
- *How the addition of the Direxion funds to the traditional Wilshire models has the potential to create effective asset allocation models;*
- *The tactical aspects of the Direxion/Wilshire models; and*
- *How the Direxion/Wilshire models can help to improve diversification by “creating” additional capital for use in other sophisticated investment strategies.*

## Modern Portfolio Theory & Asset Allocation

Research has shown that more than 90% of the volatility in a portfolio’s return is attributable to the asset allocation decision over time. Investing in multiple asset classes increases the investor’s opportunity for a positive outcome, because different asset classes do not tend to move in unison. According to Modern Portfolio Theory, an investor may be able to maximize risk-adjusted returns\* by combining low-correlation\*, risky assets—allowing the investor to harness the benefits of diversification to attempt to maximize return for a given level of risk. To create a portfolio, asset classes are evaluated on three metrics:

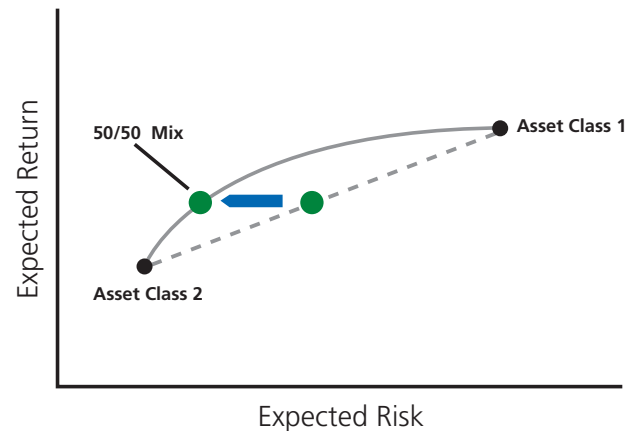
- expected return\*;
- standard deviation of return\*; and
- correlation with other asset classes.

With estimates of how these three metrics apply for each asset class, an investor can begin to analyze the risk and return characteristics of various combinations of asset classes. Rational investors seek to maximize return per unit of risk and Modern Portfolio Theory helps to identify the asset allocation with the highest expected return for each level of risk. This set of investment allocations spanning the risk spectrum is known as the Efficient Frontier\*.

The following graph illustrates the Efficient Frontier using two asset classes with expected risk represented by the horizontal axis and expected return represented by the vertical axis.

A portfolio which shows the lowest risk level for a given level of return is deemed to be “efficient” and a series of such efficient portfolios can be plotted to form an Efficient Frontier, which illustrates the expected trade-off faced by investors. The Wilshire Traditional Model Portfolios are constructed to help investors maximize the benefits of Modern Portfolio Theory and the Efficient Frontier.

## Efficient Frontier



Wilshire Funds Management uses mathematical and statistical investment processes to allocate assets, select managers, and construct portfolios and funds in ways that seek to outperform their specific benchmarks.

# How the Direxion Funds Can Amplify the Benefits of the Efficient Frontier

## The Direxion/Wilshire Asset Allocation Models

In applying Modern Portfolio Theory, we recognize that the introduction of leverage to a portfolio can offer potential return opportunities superior to those on the traditional Efficient Frontier.

Wilshire has found that the addition of Direxion's leveraged funds to Wilshire's Traditional Asset Allocation Models allows for improved diversification because the Direxion Funds generate beta\* in excess of allocated assets. Stated differently, the capital freed up as a result of using the Direxion funds can be employed to:

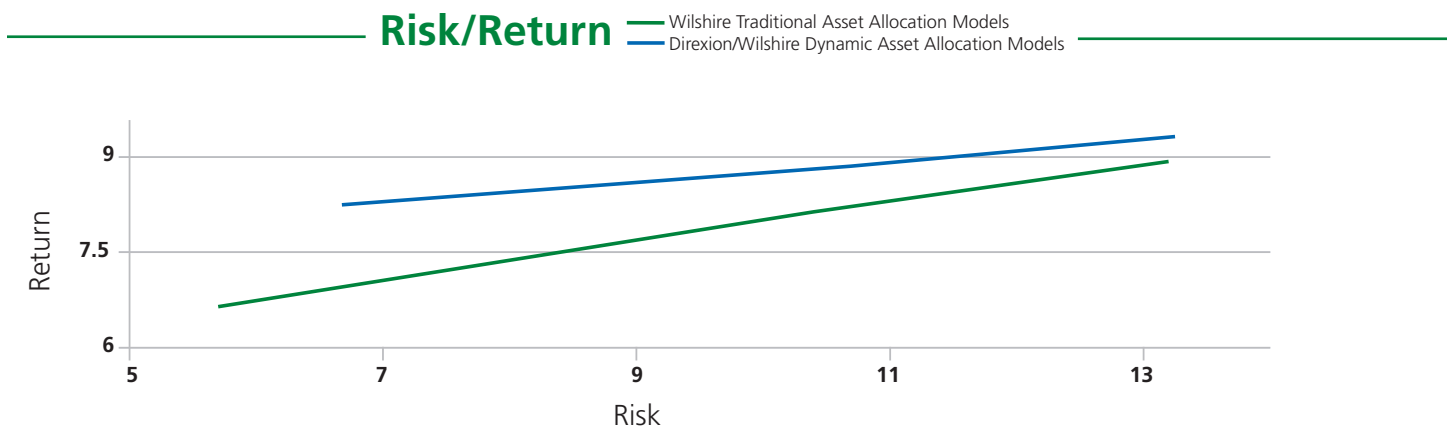
- permit higher allocations to asset classes already in the traditional portfolio which have low correlations to equities and fixed income securities; and
- allocate capital to asset classes that were not previously represented.

This approach is one that has increasingly found favor with institutional investors. The augmented diversification has led to improvements in risk-adjusted returns—essentially

extending, changing, and improving the Efficient Frontier by moving it higher on the return axis, without a commensurate increase in risk, as is shown graphically below. This higher position on the graph indicates that for each given level of risk, there is a higher expected return.

The graph compares the expected returns and expected risk of the current Wilshire Traditional Asset Allocation Models (green line) and the Direxion/Wilshire Dynamic Asset Allocation Models (blue line), which incorporate the Direxion funds. Each line represents a continuum of the respective portfolios, each with differing equity/fixed income ratios ranging from 40/60 to 100/0. Wilshire found that allocations that included Direxion funds offer a better return/risk ratio than the baseline models.

This is a notable finding with substantial implications for investment managers. The improvement in the Efficient Frontier is caused, as noted above, by **improved diversification** enabled by capital "created" by the use of leveraged funds.



*Wilshire found that allocations that include Direxion funds can offer a better expected return/risk ratio than the baseline models.*

### About Wilshire Associates...

Wilshire Associates is a leading global investment consulting and services firm with an expertise in both the creation of asset allocation models and their implementation. Wilshire was among the first to produce investment management tools for such diverse applications as creating index funds, optimizing portfolios, developing dedicated and immunized bond portfolios, and measuring performance.

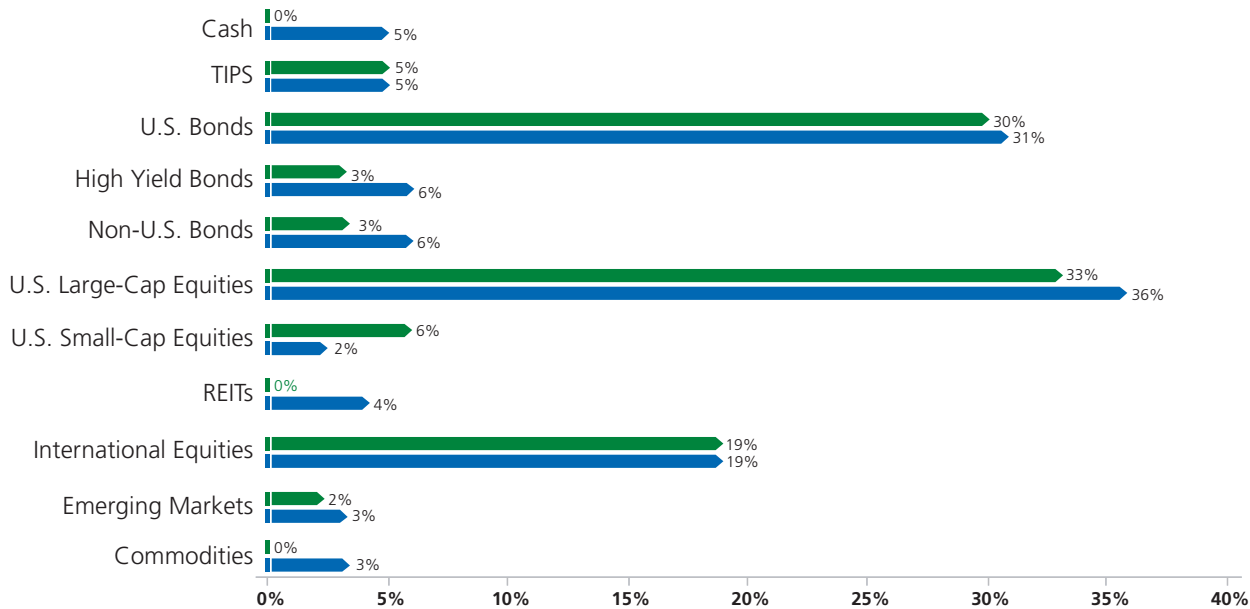
Wilshire works with some of the largest institutional investors and financial intermediaries, providing comprehensive investment consulting to assist them in making informed decisions on both traditional portfolio construction, as well as in innovations like performance fees and style mapping in equity management. In addition, Wilshire uses its experience, investment judgment and powerful analytics to develop structured investment products in the public and private equity markets. Today, Wilshire serves over 600 organizations in more than 20 countries, representing assets exceeding \$12.5 trillion.

With respect to improved diversification, the table below compares, for a “modestly conservative” investor, the current Wilshire Traditional Asset Allocation, with Wilshire’s allocation using certain Direxion funds (i.e., the Direxion/Wilshire Dynamic Asset Allocation Models).

The Direxion/Wilshire portfolios are more diversified, as is clearly seen in higher allocations to a variety of categories—including, most notably, commodities and REITs (real estate investment trusts).

## Asset Allocation Models

■ Wilshire Traditional Asset Allocation Model  
 ■ Direxion/Wilshire Dynamic Asset Allocation Model



### Seeking Alpha Through Tactical Tilts

As noted earlier, research has shown that more than 90% of the volatility in a portfolio’s return is attributable to the portfolio’s asset allocation decision over time. Use of Direxion funds to achieve efficient beta and increased diversification allows for alpha\* opportunities while keeping the investor’s risk level constant. In essence, “head room” is generated in the risk budget. The remaining risk budget can be spent through over- or underweighting specific asset classes, or by spending the risk on active manager selection. The Direxion/Wilshire models may be implemented using indexed investment options, active managers or a combination of the two. The models’ metrics reflect passive index investments, and use of active managers may provide additional risk and return not anticipated by the models.

Rather than seek alpha through security selection or through the recommendation of active managers alone, the Direxion/Wilshire models spend their risk budget through the use of tactical over- and underweightings or “tilts” to asset classes and sub-classes in an attempt to generate excess return. Instead of using constant asset allocation targets, these tactical models evaluate asset class allocations on a monthly basis in an effort to generate downside protection and enhance risk-adjusted return.

The Direxion/Wilshire Dynamic Asset Allocation Models attempt to provide investors with a long-term market approach that incorporates as much protection as possible from short-term market risk.

4 \* This term is defined in the Glossary section on page 7.

# The Wilshire Methodology

Wilshire maintains its own set of asset class forecasts, derived from proprietary analytic tools and universes. By comparing internal forecasts with those of Wilshire’s Strategic Asset Allocation portfolio, Wilshire is able to identify asset classes that it believes are over- and under-valued. These represent opportunities that can be exploited through disciplined tactical asset allocation strategies.

## How tactical tilts work

The process of developing the “tilts” begins with a bimodal “pairing” of asset classes or sub-classes. Pairings begin with broad asset classes, such as equity and fixed income or U.S. and non-U.S. equity. These pairings can also include additional granularity, such as large-cap versus small-cap equity, or investment- versus non-investment-grade bonds.

Wilshire provides monthly recommended tilts in the following key areas:

- (1) Equity versus Fixed Income;
- (2) Large versus Small; and
- (3) Domestic versus International.

Once the desired pairings have been selected, the performance of these asset classes is analyzed by creating an exponentially smoothed return measure\*, with a heavier emphasis placed on most recent periods. This allows for a comparison of the asset class’s relative performance against its long-term average. Then, by identifying the performance spread between pairs, opportunities to over- or underweight

certain asset classes are isolated. Once the proposed tilts are determined, they are evaluated and approved by Wilshire Funds Management’s Investment Committee.

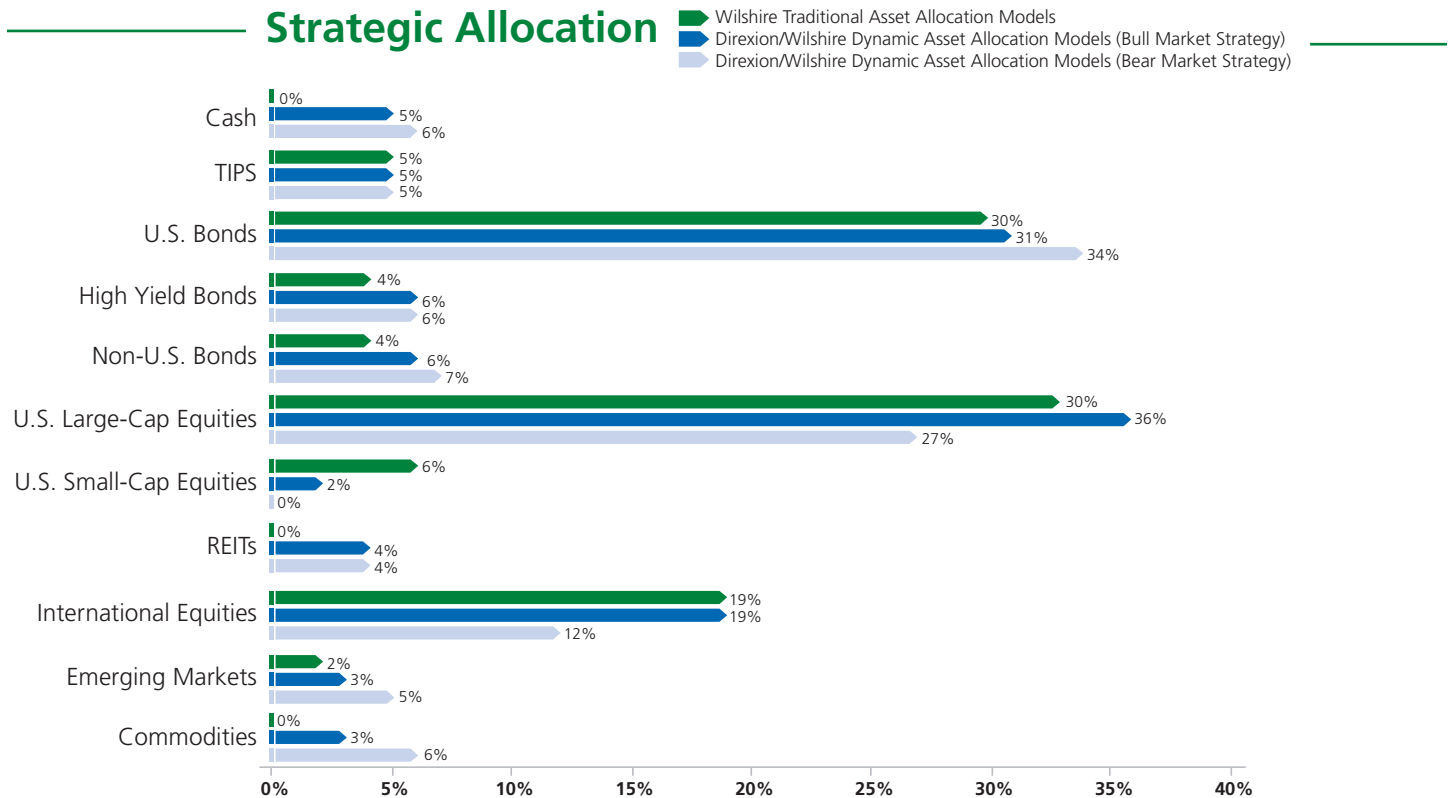
## How tactical tilts can benefit investors

- This approach provides two key benefits to the investor:
1. The exponential smoothing promotes making tilts only toward those asset classes for which the portfolio manager has strong conviction as a short-term performance opportunity.
  2. The use of the Investment Committee provides a qualitative oversight to the process.

The table below adds a hypothetical “Bear” Market allocation to the previous table and thus provides a comparison between a typical Wilshire model, a Direxion/Wilshire Bull markets allocation and a Direxion/Wilshire Bear markets allocation.

Please note that, although the allocations have changed—with higher allocations to fixed income and lower allocations to equities—the model remains fundamentally strategic in nature.

In light of the requirement for liquidity, changes in the models will typically be implemented by changes in allocations to the Direxion funds, which offer daily liquidity. Changes in the Direxion allocations may be reflected as smaller allocations to Bull funds or initial or higher allocations to Bear Funds.



\* This term is defined in the Glossary section on page 7. **5**

## Implementing the Direxion Models

As noted earlier, the metrics of the Direxion models reflect the assumption that users will implement the non-Direxion allocations using passive index funds. However, the use of

active managers can add alpha to a portfolio and users are encouraged to implement the non-Direxion managers using funds or managers that they believe can generate alpha. Such active funds or managers should be evaluated in the context of the asset allocation slots that they occupy in the models.

### Summary

Direxion and Wilshire have created and implemented a unique series of asset allocation models. Each one incorporates methods and techniques formerly used more exclusively by the largest institutions. These portfolios leverage Wilshire's advanced portfolio construction methods and their ability to keenly identify portfolio risks.

#### The results? The Direxion/Wilshire models are designed to:

- manage assets efficiently in order to help maximize risk-adjusted returns;
- improve diversification; and
- adjust to current market conditions through tactical overlays.

#### Direxion brings to the team an innovative set of leveraged index funds that offers:

- magnification to achieve beta efficiently;
- multi-directional investing to provide diversification and hedging opportunities; and
- daily liquidity to facilitate tactical applications seamlessly.

By combining Direxion's funds with Wilshire's experience and advanced analytics, these two organizations now offer a simplified approach to sophisticated portfolio management.



## Glossary of Terms Used in This Paper

**Alpha** – The difference in return above or below the return of a target index.

**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 a higher volatility than the index; a beta of less than 1.00 indicates a lower volatility.

**Correlation** – A measure of how closely the price actions of two investments correspond to each other in direction. A correlation of 1.00 indicates that when one goes up (or down), the other does the same thing at the same time. A correlation of -1.00 indicates that they always move in exactly the opposite direction. A correlation of zero indicates that the directional changes are totally independent of each other.

**Efficient Frontier** – A line created from the risk-reward graph, comprised of optimal portfolios. Optimal portfolios should lie on the Efficient Frontier Curve. The optimal portfolios plotted along the curve have the highest expected return possible for the given amount of risk.

**Expected Return** – The weighted average of a probability distribution of possible returns, calculated using the formula:

$$E(R) = \sum_{i=1}^n P_i \times R_i$$

As the formula denotes, each expected outcome is multiplied by the probability of such outcome; and having considered all expected outcomes (i.e., total probability of all outcomes is 1.00), the products of such multiplication are added up to result in the Expected Return. Although this is what you expect the return to be, there is no guarantee that it will be the actual return.

**Exponentially Smoothed Return Measure** – A measure of returns calculated based on past outcomes. However, if the belief is that the most recent observation is the most important (least stale indication of possible future outcome), then it gets the most weight; the next most recent observation gets a lower weight, and so on. For example, last year's return may have a weight of 0.5, the previous year, half of that (0.25), the previous year 0.125, etc.

**Modern Portfolio Theory** – A theory which proposes that rational investors diversify their portfolios to optimize or maximize their risk-adjusted returns, emphasizing that risk is an inherent necessity while seeking higher rewards. These optimal portfolios lie on the "Efficient Frontier."

**Risk-Adjusted Returns** – A concept that refines an investment's return by measuring how much risk is involved in producing that return, which is generally expressed as a number or rating. Risk-adjusted returns can be calculated for individual securities, funds or portfolios.

**Standard Deviation of Return** – A measure of dispersion of a data set from its mean. It is a measure of the risk and volatility of an investment. The higher the standard deviation, the higher the risk and volatility. Inversely, a volatile stock—that is, one which fluctuates a great deal from its average—would have a higher standard deviation than a not-so-volatile stock.

**Tactical Overlay** – Strategic asset allocation defines the broad guidelines for a portfolio designed to be held for a specified length of time (e.g., five years). A tactical overlay defines short-term, generally relatively minor, variations, in an attempt to enhance returns or hedge risk by taking advantage of market pricing anomalies or strong market sectors. As an analogy, one may decide to drive from Boston to Miami, and plan the highways to take (strategic plan). The tactical overlay includes variations on this routing (detours to avoid congestion [hedging]; detours to stop briefly at a historic village [enhancement] as a reaction to developments along the way).

## **Direxionfunds**

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*Wilshire Funds Management uses mathematical and statistical investment processes to allocate assets, select managers and construct portfolios and funds in ways that seek to outperform their specific benchmarks. Past performance is no guarantee of future results. Each model and asset class entails risk. There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown.*

*Wilshire is a registered service mark of Wilshire Associates Incorporated of Santa Monica, California.*

*There is no affiliation between Wilshire Funds Management and Rafferty Capital Markets, LLC.*

*The model portfolios described in this paper are hypothetical in nature. The actual characteristics and performance of a portfolio based on these models will vary.*

*All data used for explanatory purposes in this paper is as of December 31, 2007, except for the Bear Market Strategy, which uses January 31, 2008 data for comparative purposes.*

*An investor should consider the investment objectives, risks, charges, and expenses of the Direxion funds carefully before investing. The prospectus contains this and other information about Direxion funds. To obtain a prospectus, please contact Direxion Funds at 800.851.0511.*

*The prospectus should be read carefully before investing. Investing in index funds may be more volatile than investing in broadly diversified funds. The use of leverage by a mutual 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.*

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