

Building on the Past

Essential Portfolio TheorySM: The Next Generation of Investing

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Essential Portfolio Theory was used as the basis for creating the Rydex Essential Portfolios. The Essential Portfolios seek to integrate many, but not necessarily all of the central tenets of Essential Portfolio Theory to achieve their investment objectives.

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Important Risk Information



The various products and investment strategies referenced throughout this presentation may not be suitable for all investors. Potential risks include, but are not limited to, the following:

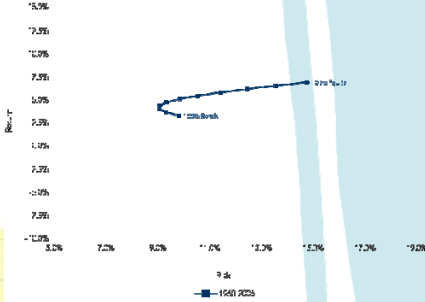
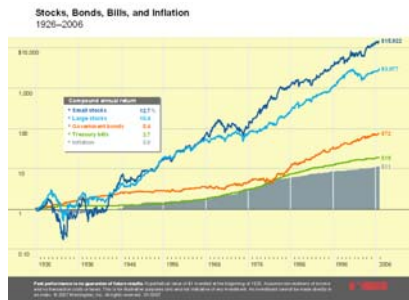
- **Absolute return** strategies are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his/her investment. Hedge-fund-like strategies may utilize speculative investment strategies, such as leverage, derivatives and short sales of securities, which involve significant risk.
- A **bond** fund's market value will change in response to interest rate changes and market conditions, among other factors. In general, bond prices rise when interest rates fall and vice versa. Moreover, while securities with longer maturities tend to produce higher yields, the prices of longer maturity securities are also subject to greater fluctuations as a result of changes in interest rates. Bond funds are not guaranteed by the U.S. government.
- An investment in **commodities** may be subject to greater volatility than investments in traditional securities. The value of commodities and commodity-linked derivative investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Under certain market conditions, it may be difficult or impossible to liquidate a commodities position. In addition, the high degree of leverage often used in commodities investing will magnify any gains or losses on an investment. Managed commodity accounts may also be subject to substantial charges for management and advisory fees.
- The value of investments in foreign **currencies** can change when foreign currencies strengthen or weaken relative to the U.S. dollar. Currency rates in foreign countries may fluctuate significantly over short periods of time for a number of reasons, including changes in interest rate and the imposition of currency controls or other political developments in the U.S. or abroad.
- **Diversification** neither assures a profit nor protects against loss in a declining market.
- Investing in **exchange traded funds** (ETFs) involves risks similar to those of stocks, including the possible loss of the principal amount invested. Although ETF shares are sold on an exchange, there can be no assurance that an active trading market for the shares will develop or be maintained. In addition, shares of ETFs are bought and sold through a broker and may only be redeemed from Authorized Participants via Creation Units. As a result, the selling shareholder may have to pay brokerage commissions in connection with the sale.

Important Risk Information

- The use of **futures or options** will expose an investor to additional risks that the investor would not be subject to if the investor invested directly in the securities underlying those futures or options.
- **Hedge funds** are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his/her investment. There is no secondary market for the interest in hedge funds, and none is expected to develop. There may be restrictions on transferring interests in the funds. Hedge funds may use speculative investment strategies, such as leverage, derivatives and short sales of securities, which involve significant risk.
- There are special risk considerations involved with **international investing**, including fluctuating exchange rates, government regulations and differences in liquidity that may affect such an investment.
- **Inverse** strategies or funds involve certain risks, which may include increased volatility due to the possible use of short sales of securities or derivatives, such as futures and options.
- The strategies referenced within this paper will expose potential investors to market risks and potential loss of capital. **The referenced strategies and asset allocation examples are for illustrative purposes only.** Strategies and/or allocation percentages should change based on an individual's risk tolerance, investment objectives and investing time horizon. There is no assurance that the investment strategies referenced in this paper will achieve their objectives or perform consistently with the examples contained in the paper. No investment product or strategy can eliminate risk or guarantee investment returns.
- 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 any gains or losses on those investments.
- Investing in **sector funds** (*i.e.*, a real estate sector fund) is more volatile than investing in broadly diversified funds, as there is a greater risk due to the concentration of the fund's holdings in issuers of the same or similar offerings.
- **Short selling** involves increased risks and costs. You risk paying more for a security than you received from its sale.
- **For more details regarding the risk of any referenced product or strategy, please consult with your financial advisor.**

The Callan Periodic Table of Investment Returns
Annual Returns for Key Indices (1997-2006)

Index	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
S&P 500	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%
Large Cap	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%
Small Cap	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%
Mid Cap	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%
International	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%
Bond	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%
High Yield	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%
Commodity	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%
Inflation	11.9%	-1.1%	11.9%	11.9%	-11.9%	-11.9%	11.9%	11.9%	11.9%	11.9%



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In setting investing expectations over the years, advisors have had several tools at their fingertips that have been used extensively. It's safe to say that most advisors are familiar with these three images--the Callan Chart, the Efficient Frontier and the Morningstar Chart. This presentation explains what they are and examines whether or not the concepts they project can be extended, enhanced and updated—and if so, what is potentially a more modern way to view them? We call this new view “Essential Portfolio Theory.”

- The only thing that's important is time in the market
- Combining equities and fixed income may help you better control risk and reward
- Diversification across style boxes may lower volatility and enhance returns

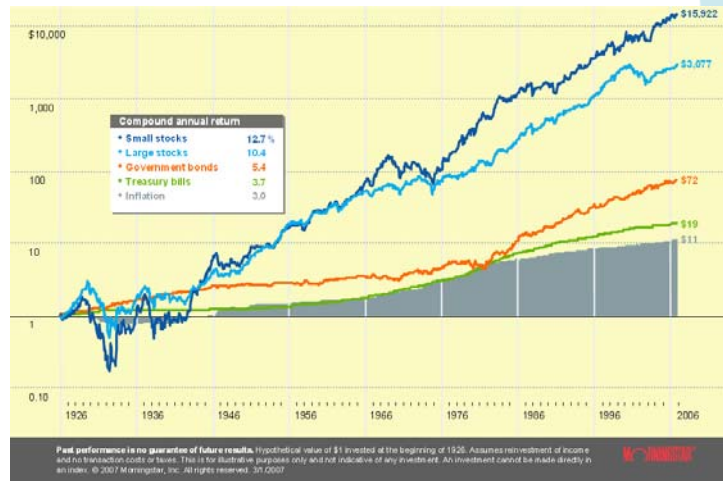
There are three common investment sentiments that are widely believed today.

Belief number one is the only thing that's important is time in the market. There is a popular cliché “it's not the timing of the market, but the time in the market,” which speaks to the belief that a buy-and-hold strategy is the best way to ensure good returns.

Belief number two is that the combination of equities and fixed income may help you better control risk and reward. Again, investors often are invested primarily in stocks, bonds, or cash—or some combination of the three.

Finally, the presentation will discuss the breaking of equity asset classes down into style boxes. When this happened, there were a few more equity asset classes to diversify into. Many investors found that large-cap growth didn't necessarily correlate with small-cap value and concluded that they might do a better job of controlling risk and reward by simply accounting for investment styles. This presentation will explore a potentially more modern approach to this as well.

Stocks, Bonds, Bills and Inflation 1926-2006

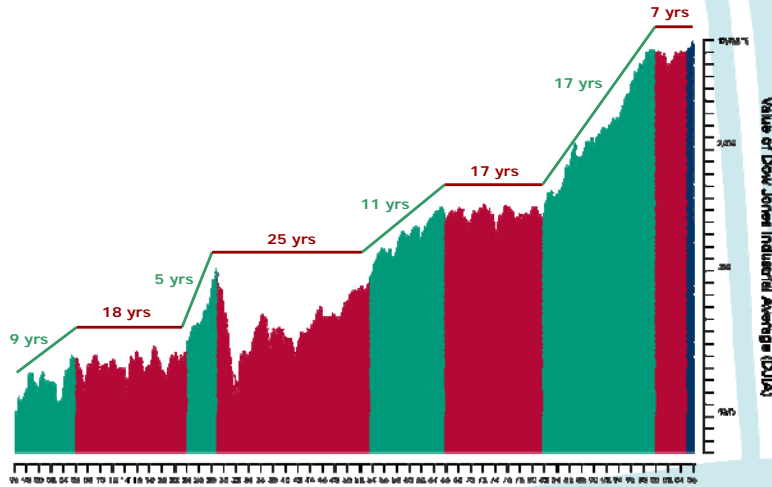


Images source: Morningstar © 2007. Used with permission. Performance displayed represents past performance, which is no guarantee of future results. The above chart represents the hypothetical value of \$1 invested at the beginning of 1926. Assumes reinvestment of income and no transaction costs or taxes. Graphics are for illustrative purposes only and are not representative of any particular index, fund or investment. An investment cannot be made directly in an index. © 2007 Morningstar, Inc. All rights reserved. 3/1/2007

What does it mean when we talk about time in the market? One of the most widely used images—the Morningstar Chart (shown above)—provides a good explanation. As illustrated by the line-graph, it gives us good reason to stay in the market. It's an impressive mountain chart that rises from the bottom left to the top right. If you “bought and held” over this period you did very well.

This chart also highlights another point of interest. 1982 marked the beginning of probably one of the world's greatest bull markets. And this is commonly believed to be the start of the whole “buy-and-hold” era.

Where do you think we're headed?



Data source: dowjones.com. ©2007. Performance displayed represents past performance, which is no guarantee of future results. This is for illustrative purposes only. The index is unmanaged and not available for direct investment. Returns do not reflect any management fees, transaction costs or expenses.

The Morningstar chart gives us a very nice picture to support a buy-and-hold strategy, but what might a different view show us? This is a chart of the Dow Jones Industrial Average from 1896 through 2006. Just like the Morningstar chart, it's an impressive mountain chart and it goes from the bottom left to the top right. If an investor bought and held over that period he or she did very well.

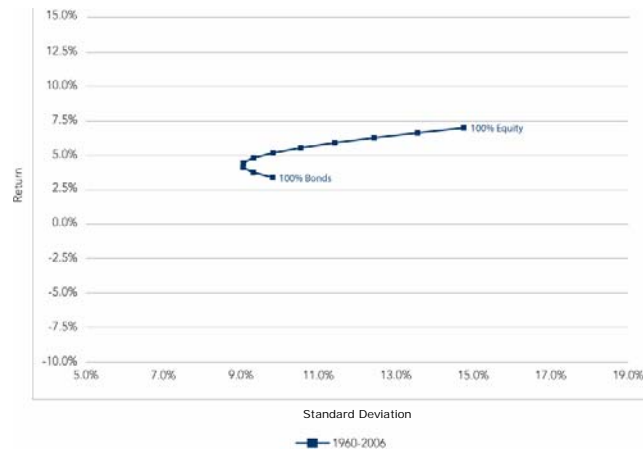
The Dow Jones Chart depicts secular bull and bear cycles for this time period. A secular bull market is defined as an upwards trending market and occurs when each successive high point is higher than the previous one. On the contrary, a secular bear market, or downward trending market, occurs when a trend does not rise above the previous high.

And while it is important to look at a longer history of the markets, a closer look at shorter time intervals, as we have illustrated here, reveals that the Dow moves in secular cycles. Here we see that over the last 110 years, the average cycle lasted about 14 years, and coming off a 17-year-strong bull market that ended in 2000, do we really expect it to just keep heading higher?

We now know that the last 7 years have yielded generally flat—or sideways—returns. While it is very difficult, if not impossible, to predict precisely when these cycles will occur, it is crucial to be aware of the current market cycle that we're in. So, where do you think we're headed?

The Efficient Frontier Revisited

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Source data used to create the chart: Calculated by Rydex Investments using information from Bloomberg © 2007. Standard deviation (risk) is a statistical measure of the historical volatility of an investment, usually computed using 36 monthly returns. More generally, a measure of the extent to which numbers are spread around their average. The higher the number, the more volatility is to be expected. **Performance displayed represents past performance, which is no guarantee of future results.** This example is for illustrative purposes only. The following depicts the efficient frontier of equity and bond portfolios illustrated in 10% increments. Equity returns are based on the S&P 500® Index, which includes the reinvestment of dividends and is adjusted for inflation. Bond returns include the reinvestment of dividends and are based on the Lehman Brothers Aggregate Bond Index, also adjusted for inflation. The S&P 500 and the Lehman Brothers Aggregate Bond Index are unmanaged and not available for direct investment.

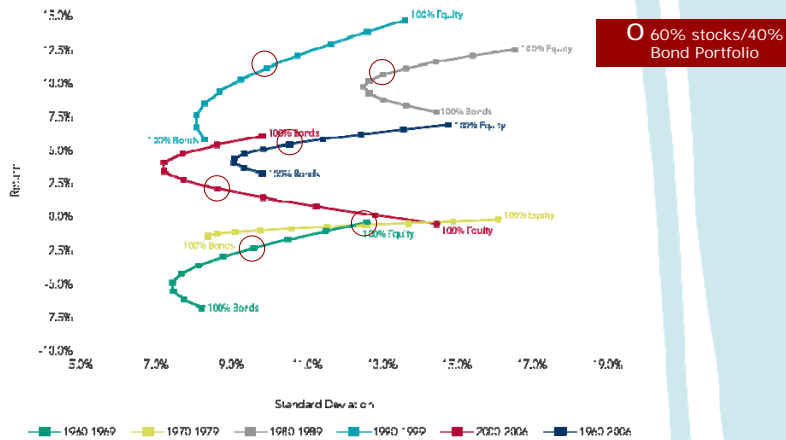
Here's another image that many advisors are familiar with—the Efficient Frontier. The Efficient Frontier represents portfolios that are considered the most efficient—that is, have the greatest potential return for a given level of risk. Portfolios near the bottom left of the chart have relatively low risk and returns. Those near the upper right offer higher returns, but at a higher risk.

The classic Efficient Frontier is shaped like a fishhook. begins at the left end of the curve with a 100% bond portfolio. Equities are added in 10% increments until you reach the upper right end of the curve, which represents a 100% equities portfolio. This “fishhook” plot line lays out the optimal mix of bonds and equities for each risk level.

Taking a look at the “average” curve here, which consists of 46 years of data, provides a nice robust starting point to work from. The historical average image certainly supports the common belief that combining equities and fixed income may help you better control risk and reward.

But who has 46 years to invest? Most of us probably have a 5, 10 or 20 year timeframe.

The Inefficient Frontier?



Source data used to create the chart: Calculated by Rydex Investments using data from Bloomberg.com, 2007. Standard deviation (risk) is a statistical measure of the historical volatility of an investment, usually computed using 36 monthly returns. More generally, a measure of the extent to which numbers are spread around their average. The higher the number, the more volatility is to be expected. Performance displayed represents past performance, which is no guarantee of future results. This example is for illustrative purposes only. The following depicts the efficient frontier of equity and bond portfolios illustrated in 10% increments. Equity returns are based on the S&P 500® Index, which includes the reinvestment of dividends and is adjusted for inflation. Bond returns include the reinvestment of dividends and are based on the Lehman Brothers Aggregate Bond Index, also adjusted for inflation. The S&P 500 and the Lehman Brothers Aggregate Bond Index are unmanaged and not available for direct investment.

So, what happens when we look at the change/movement in the Efficient Frontier on a decade-by-decade basis?

While the historical average (represented in blue) shows the typical fishhook shape that represents the traditional efficient frontier image, a closer look by decade reveals that the efficient frontier appears to take on different shapes and sizes—more importantly, it shifts and moves with time, depending on market conditions.

Investors expect their returns to go up as they take on more risk. However, the risk/return ratio, like the efficient frontier itself, changes along with market cycles. In a strong market such as in the 1990s (represented by the teal line) you may be handsomely rewarded for taking on more risk. But in a weak market such as in the 1970s (represented by the lime line), you may only reap minimal returns when taking on more risk.

So is the efficient frontier truly efficient in its current form?

Callan Periodic Table of Investment Returns

Annual Returns for Key Indices (1987-2006) —Ranked in order of performance (Best to Worst)

1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
MSCI EAFE	Russell 2000 Value	S&P 500 Growth	LB Agg	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	MSCI EAFE	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Value	LB Agg	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	MSCI EAFE
24.64%	29.47%	6.40%	8.96%	51.19%	29.14%	7.78%	23.77%	23.87%	23.87%	26.52%	42.16%	43.09%	22.83%	14.02%	48.54%	22.25%	33.54%	23.48%	23.48%
S&P 500 Index	MSCI EAFE	S&P 500 Index	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	S&P 500 Index	Russell 2000 Value
6.50%	28.26%	31.89%	6.20%	18.41%	23.77%	8.13%	27.88%	22.96%	23.88%	28.24%	28.38%	28.24%	11.83%	8.43%	-11.43%	20.25%	5.82%	23.48%	23.48%
S&P 500 Index	Russell 2000 Value	Russell 2000 Value	S&P 500 Index	S&P 500 Index	S&P 500 Index	Russell 2000 Value	S&P 500 Index	S&P 500 Index	Russell 2000 Value	MSCI EAFE	MSCI EAFE	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	Russell 2000 Value	MSCI EAFE	Russell 2000 Value	Russell 2000 Value
6.20%	25.52%	21.67%	-4.11%	41.70%	10.52%	18.88%	1.32%	38.89%	21.78%	20.00%	26.86%	6.08%	2.49%	-15.84%	38.59%	15.71%	4.71%	18.37%	18.37%
S&P 500 Index	S&P 500 Index	Russell 2000 Value	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	Russell 2000 Value	S&P 500 Index	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	S&P 500 Index	Russell 2000 Value	Russell 2000 Value
3.88%	21.67%	20.17%	-8.85%	38.37%	7.77%	18.61%	31.04%	29.98%	21.27%	29.98%	14.89%	21.28%	-3.02%	-8.23%	-20.48%	38.59%	15.71%	4.71%	18.37%
LB Agg	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	S&P 500 Index	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	LB Agg	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value
20.37%	16.26%	-17.41%	30.47%	7.62%	13.37%	-1.54%	16.42%	16.49%	22.38%	8.70%	21.04%	-9.11%	-11.71%	-20.85%	31.79%	14.21%	4.55%	15.79%	15.79%
Russell 2000 Value	S&P 500 Index	LB Agg	Russell 2000 Value	S&P 500 Index	LB Agg	S&P 500 Index	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	S&P 500 Index	S&P 500 Index	S&P 500 Index	Russell 2000 Value
-7.11%	16.91%	18.33%	15.48%	22.98%	7.60%	16.98%	-1.82%	28.73%	12.88%	1.23%	12.73%	-14.17%	-11.60%	-22.10%	-26.60%	15.88%	4.19%	4.34%	4.34%
Russell 2000 Growth	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	LB Agg	S&P 500 Index	LB Agg	S&P 500 Index	Russell 2000 Value	MSCI EAFE	LB Agg	Russell 2000 Value	LB Agg	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index
-8.80%	11.95%	12.43%	21.77%	17.00%	9.79%	-2.43%	18.46%	6.09%	9.64%	2.00%	2.00%	22.08%	-12.73%	-23.85%	25.88%	6.13%	4.00%	11.01%	11.01%
Russell 2000 Growth	LB Agg	MSCI EAFE	MSCI EAFE	MSCI EAFE	MSCI EAFE	S&P 500 Growth	LB Agg	MSCI EAFE	LB Agg	MSCI EAFE	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	Russell 2000 Growth	LB Agg	LB Agg	LB Agg	LB Agg
-10.48%	7.89%	10.53%	-23.45%	12.14%	-12.18%	1.88%	-3.92%	11.21%	3.94%	1.78%	-8.45%	-1.49%	-2.43%	-21.44%	-30.26%	4.19%	4.34%	2.43%	4.33%

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This image is another that has been widely used by financial advisors. It is a trusted image called the Callan Chart. It is a tool that shows the case for diversification across investment style (growth vs. value), capitalization (large vs. small), and equity markets U.S. vs. international is strong. The asset classes, which are represented by market indices, are ranked from best to worst over a 20-year timeframe. The Callan Chart helps to illustrate that “winners rotate” and that the potentially best approach to investing is to be well diversified across all asset classes to “hedge away volatility.”

Consider this example. The yellow boxes represent the Russell 2000 Value Index, which have been randomly selected, from 1987 through 2006. As you can see, in 1987, this category performed at -7.11%. The following year it shot up to 29.47%. The following year it decreased in performance, leaving it down near the bottom. By 1992 it was up at the top again. It is easy to see then, how an investment style rotates throughout the years.

Reality: Diversifying Across Correlated Asset Classes Creates Relative Returns



The Callan Periodic Table of Investment Returns
Annual Returns for Key Indices (1987-2006)—Ranked in order of performance (Best to Worst)

1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value
94.6%	29.4%	36.4%	9.9%	51.9%	25.1%	40.8%	7.7%	38.1%	23.8%	36.5%	42.1%	43.9%	22.8%	14.0%	12.2%	48.5%	22.5%	22.5%	21.4%
S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth
8.5%	11.8%	5.2%	48.4%	18.4%	13.7%	3.1%	17.5%	21.9%	31.3%	25.5%	34.2%	34.2%	11.8%	8.4%	-11.4%	47.2%	20.2%	19.0%	21.4%
NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value	NASDAQ Value
9.2%	25.2%	28.1%	-3.1%	41.7%	19.5%	18.8%	1.9%	36.9%	22.0%	31.7%	40.6%	40.6%	6.0%	2.4%	-21.0%	48.0%	18.3%	4.9%	20.8%
S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div
3.6%	21.8%	16.1%	-8.5%	38.3%	7.7%	18.5%	-0.6%	31.0%	21.3%	25.0%	31.7%	31.7%	14.8%	21.8%	-3.6%	-2.2%	15.7%	4.7%	18.5%
Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth
2.7%	18.2%	17.4%	30.1%	7.8%	18.3%	-1.5%	28.4%	18.4%	22.8%	8.7%	21.0%	-9.1%	-11.7%	-20.8%	31.7%	16.2%	4.6%	19.7%	19.7%
Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value
-7.1%	16.8%	14.3%	-19.4%	7.4%	10.0%	-1.8%	25.7%	11.2%	19.6%	1.2%	12.7%	-10.7%	-11.8%	-20.1%	-28.6%	19.9%	4.1%	13.3%	13.3%
S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div	S&P 500 Div
-8.8%	11.5%	12.4%	-21.7%	18.0%	5.0%	8.7%	-2.4%	18.6%	11.2%	12.7%	-2.5%	-8.2%	-22.8%	-12.7%	-23.5%	25.6%	8.1%	4.0%	11.0%
Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth
-16.8%	7.8%	10.0%	-10.0%	10.5%	-9.0%	1.8%	-9.0%	11.3%	9.0%	1.7%	-4.5%	-1.6%	-22.4%	-21.0%	4.1%	4.8%	3.4%	4.5%	4.5%

Source: ©2007 Callan Associates, Inc. Reprinted with permission from Callan Associates, Inc., 2007. www.callan.com. Performance displayed represents past performance, which is no guarantee of future results. This example is for illustrative purposes only. Referenced indices are not available for direct investment.

Yet when you come to a year like 2002, does the Callan Chart really help? Seven of the eight asset classes had negative returns.

The problem depicted here is that when diversifying into correlating asset classes—or asset classes that move in tandem with one another—investors may be unknowingly subjecting their portfolios to undue risk, especially during down market environments.

Based on this example and its current form, is this chart a tool that is still current for uncertain markets? Or can it be updated and viewed differently?

- Essential Portfolio Theory (EPT) is an investment strategy that presents a more dynamic approach to investing
- It is a complement to and an extension of Markowitz's Nobel-Prize winning work in Modern Portfolio Theory (MPT)
- The goal of EPT is to lay out a framework for improving investor performance based on concepts that historically have proven effective for many leading institutional investors

12

Essential Portfolio Theory is an extension of Modern Portfolio Theory—a concept based on many of the investing tools I just highlighted. MPT—an investment framework developed by Harry Markowitz in 1952 and later awarded the Nobel Prize in 1990—has helped investors understand the importance of diversifying a portfolio in an attempt to control risk and increase reward. The theory states that by combining asset class such as stocks and bonds in various proportions within a portfolio, an investor could determine which allocation produced the greatest potential return for the least amount of acceptable risk. The central value of MPT is how it elegantly presents the benefits of diversification.

But the world's financial markets have experienced a revolution over the past 50 years. There are now literally tens of thousands of investment choices, from stocks to bonds to mutual funds and ETFs to limited partnerships and direct investments. There has also been an explosion of alternative financial instruments. We believe that investors need to approach this world of opportunity in a disciplined way, with a full understanding of each product's benefits and risks within a framework that takes into account all of the factors that influence *today's* financial markets.

That's why Rydex Investments hired, and paid Professor John Mulvey of Princeton University as a consultant to research a new investment strategy and write a whitepaper on his findings -- one that presents a more dynamic approach to investing—called Essential Portfolio Theory. Essential Portfolio Theory proposes an extension of diversification to include innovative and widely available strategies that can help individual investors attempt to improve performance, control risk and customize market exposure.

Our vision for EPT is to extend upon classic investment theory with respect to modern financial instruments, improvements in information and trading systems and enhanced risk-management techniques.

- **Options**—Rights (but not obligations) to buy or sell a given amount of a security, at a specific price for a specific period of time. The use of options will expose an investor to additional risks that the investor would not be subject to if the investor invested directly in the securities underlying those options.
- **Equity Futures**—Standardized, transferable, exchange-traded contracts that require delivery of stocks, or stock indices, at a specified price, on a specified future date. Unlike options, futures contracts oblige the purchaser to buy the securities specified by the terms of the contract. The use of futures will expose an investor to additional risks that the investor would not be subject to if the investor invested directly in the securities underlying those futures.
- **Managed Futures**—Futures can be managed in an account, like a mutual fund, except that the positions used to manage the portfolio include government securities, futures contracts and options on futures contracts. The use of futures will expose an investor to additional risks that the investor would not be subject to if the investor invested directly in the securities underlying those futures.
- **Commodities**—Tangible substances, such as oil, food, grains and metals, generally traded through futures contracts. Commodities generally perform counter-cyclically to stocks and bonds and, when added to a portfolio, can act as a hedge against inflation. An investment in commodities may be subject to greater volatility than investments in traditional securities. Under certain market conditions, it may be difficult or impossible to liquidate a commodities position.
- **Real Estate**—Investments in real property are considered hard assets that have been shown to have little correlation to traditional stock and bond markets. Investing in sector funds (i.e., a real estate sector fund) is more volatile than investing in broadly diversified funds, as there is a greater risk due to the concentration of the funds' holdings in issuers of the same or similar offerings.
- **Leverage**—Investment products that borrow funds to purchase securities, indices or other assets; returns are enhanced when the investment returns are greater than borrowing costs. The more an investor invests in leveraged instruments, the more the leverage will magnify any gains or losses on those investments.
- **Inverse investing**—Strategies that attempt to address a market downturn with an investment that seeks returns opposite a specified index. Inverse strategies or funds involve certain risks, which may include increased volatility due to the possible use of short sales of securities or derivatives, such as futures and options.
- **Currency**—investing in currencies can be an effective hedge against the broader stock and bond markets since currency movement tends to have a weak correlation to both of those asset classes. The value of investments in foreign currencies can change when foreign currencies strengthen or weaken relative to the U.S. dollar. Currency rates in foreign countries may fluctuate significantly over short periods of time for a number of reasons.
- **Absolute Return**—In absolute return investing, risk is often defined as loss of capital, not as underperforming a benchmark. Absolute return, or "hedge fund-like," strategies seek an attractive positive return with preservation of capital usually being a primary objective. Absolute return strategies are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his/her investment.

- 1. Take advantage of “true” diversification**
2. Use leverage with diversification to achieve a targeted risk/return objective
- 3. Offset the constraints of long-only portfolios**
- 4. Move away from cap weighting**
5. Incorporate current and forward-looking data
6. Implement multifactor strategies
- 7. Employ rules-based rebalancing**

14

Diversification neither assures a profit nor protects against loss.

There are seven tenets of EPT. These seven tenets of the EPT model are efforts to recognize that standard ways to diversify may be sub-optimal in today's markets and to provide an actionable framework moving forward. This presentation focuses on true diversification, offsetting the constraints of long-only portfolios, moving away from cap weighting and employing rules-based rebalancing.

EPT Tenet #1

Take Advantage of "True" Diversification

Diversification neither assures a profit nor protects against loss.

Callan Periodic Table of Investment Returns

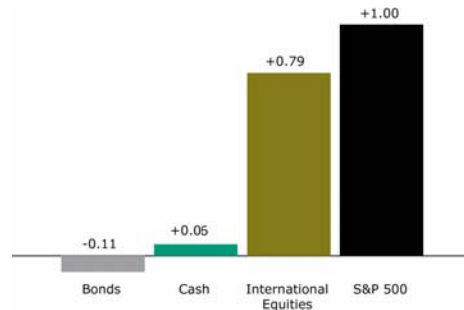
Annual Returns for Key Indices (1987-2006) —Ranked in order of performance (Best to Worst)

1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	7 of 8 had negative returns			
MSCI EAFE	Russell 2000 Value	S&P 500 Growth	LB Agg	Russell 2000 Growth	Russell 2000 Value	MSCI EAFE	MSCI EAFE	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	S&P 500 Growth	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Value	LB Agg	Russell 2000 Value	MSCI EAFE	S&P 500 Value	Russell 2000 Value
24.64%	23.47%	36.40%	8.96%	51.19%	29.14%	32.57%	7.78%	38.12%	23.87%	36.52%	42.16%	43.09%	22.83%	14.02%	10.28%	48.54%	22.25%	13.54%	26.34%
S&P 500 Growth	MSCI EAFE	S&P 500 Index	S&P 500 Growth	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Value	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	LB Agg	LB Agg	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	S&P 500 Value	Russell 2000 Value
8.50%	28.28%	31.89%	0.20%	46.04%	18.41%	23.77%	3.13%	27.88%	22.96%	33.38%	28.38%	28.24%	11.63%	8.43%	-11.43%	7.25%	20.25%	5.82%	23.48%
S&P 500 Index	Russell 2000 Value	S&P 500 Index	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	S&P 500 Index	S&P 500 Index	Russell 2000 Value	MSCI EAFE	MSCI EAFE	S&P 500 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	S&P 500 Index	S&P 500 Index
3.20%	25.52%	28.12%	-1.11%	41.70%	10.52%	18.88%	1.32%	38.89%	22.00%	20.00%	26.96%	6.08%	2.49%	-15.84%	-20.48%	15.23%	4.91%	20.81%	18.37%
S&P 500 Value	S&P 500 Value	Russell 2000 Growth	S&P 500 Value	S&P 500 Growth	Russell 2000 Growth	S&P 500 Value	S&P 500 Value	Russell 2000 Growth	Russell 2000 Value	S&P 500 Value	S&P 500 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	S&P 500 Value	Russell 2000 Value	Russell 2000 Value
3.88%	21.67%	20.17%	-8.85%	38.37%	7.77%	18.61%	-0.64%	31.04%	21.37%	29.58%	1.489%	21.28%	-3.02%	-9.23%	-20.48%	-3.59%	15.71%	4.71%	18.37%
LB Agg	Russell 2000 Growth	Russell 2000 Growth	Russell 2000 Growth	S&P 500 Index	S&P 500 Index	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	LB Agg	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	S&P 500 Index
2.75%	20.37%	16.26%	-17.41%	30.47%	7.62%	13.37%	-1.54%	28.43%	16.49%	22.36%	8.70%	21.04%	-9.11%	-11.21%	-20.85%	-2.79%	14.21%	4.55%	15.79%
Russell 2000 Value	S&P 500 Index	LB Agg	Russell 2000 Value	S&P 500 Value	LB Agg	S&P 500 Index	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	S&P 500 Value	MSCI EAFE	S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value	Russell 2000 Value	Russell 2000 Value
-7.11%	16.47%	18.32%	-15.44%	22.95%	7.40%	16.98%	-1.82%	25.73%	11.28%	12.85%	1.23%	12.73%	-14.17%	-11.80%	-22.10%	6.60%	15.88%	4.19%	13.38%
Russell 2000 Value	S&P 500 Growth	Russell 2000 Value	Russell 2000 Value	LB Agg	S&P 500 Value	LB Agg	Russell 2000 Value	LB Agg	MSCI EAFE	LB Agg	Russell 2000 Value	LB Agg	S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value
-8.80%	11.95%	12.43%	-21.77%	16.00%	5.00%	9.79%	-2.43%	18.46%	6.00%	9.64%	-2.55%	-0.82%	-22.08%	-12.73%	-23.59%	25.88%	6.13%	4.00%	11.01%
Russell 2000 Growth	LB Agg	MSCI EAFE	MSCI EAFE	MSCI EAFE	S&P 500 Growth	LB Agg	MSCI EAFE	LB Agg	MSCI EAFE	LB Agg	Russell 2000 Value	Russell 2000 Value	Russell 2000 Value	MSCI EAFE	Russell 2000 Growth	LB Agg	LB Agg	LB Agg	LB Agg
-10.48%	7.93%	10.53%	-23.45%	12.14%	-12.18%	1.68%	-3.92%	11.21%	3.94%	1.78%	-8.45%	-1.49%	-22.43%	-21.44%	0.26%	4.19%	4.34%	2.43%	4.33%

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Revisiting this image. Is the Callan Chart a tool that is still current for today's uncertain markets? Or can it be updated and viewed differently?

Historical Correlation of Various Asset Classes vs. S&P 500
January 1997-December 2006



Correlation is a statistical measure of how two variables move in relation to each other. This measure ranges from -1 to +1, where -1 indicates perfect negative correlation and +1 indicates perfect positive correlation.

Data source: All correlations are measured vs. the S&P 500® Index Total Return. This is for illustrative purposes only and is not indicative of any investment. You cannot invest directly into an index. Data source: Calculated by Rydex Investments using information from Bloomberg.com 2007.
International Equities: MSCI EAFE Morgan Stanley Capital International Index. **Bonds:** Lehman Brothers Aggregate Bond Index. **Cash:** Bloomberg 1 Month CD Index. **Performance displayed represents past performance, which is no guarantee of future results.**

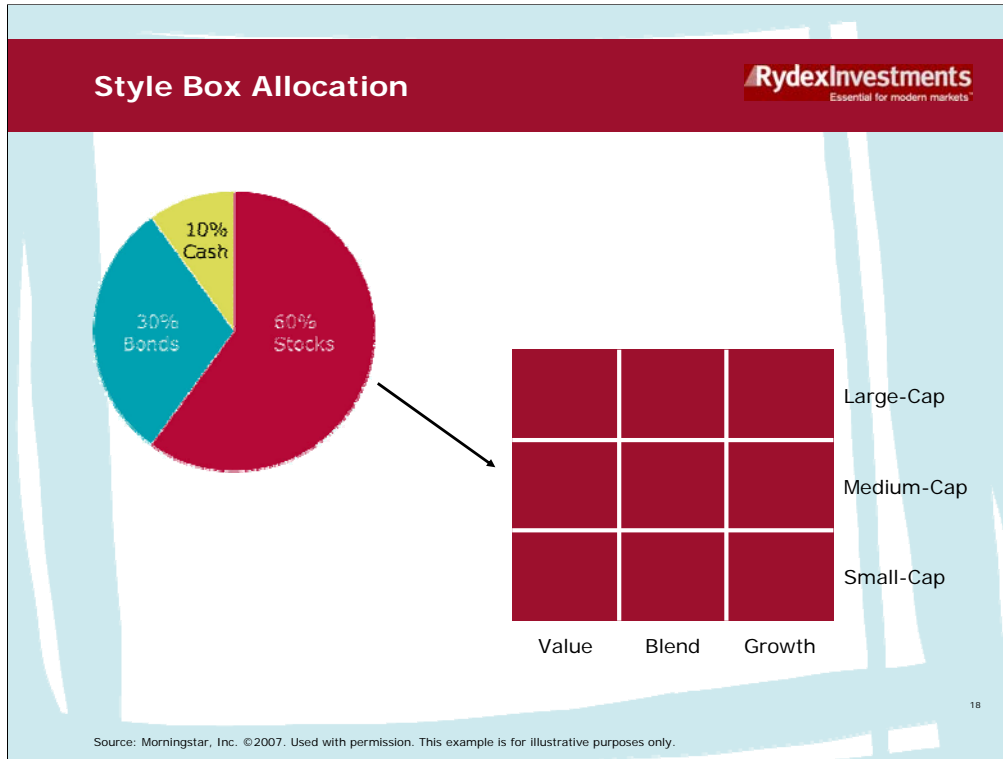
17

As mentioned earlier, the Callan Chart builds a case for the need to diversify your portfolio. But to truly understand diversification, it's important to understand correlation and what it means to investors.

Asset class correlation is the degree to which assets move together. A positive correlation of 1.0 means that asset classes move in exactly the same direction—when one goes up, so does the other. A correlation of -1.0 means that asset classes move in exactly the opposite direction—when one goes up, the other goes down. And a correlation of 0.0 means the asset classes appear to have no direct relationship at all.

If investing in asset classes that perform similarly—especially in downward-moving markets—investors could unknowingly subject their portfolios to unnecessary risk.

That said, the asset classes that make up the Callan Chart are all rooted in just four areas: domestic equities, international equities, bonds and cash. If you look at these asset classes, as portrayed by the chart above, you can see that although some have lower correlations than others – all, with the exception of bonds—have a positive correlation to each other.



About nine years ago, Morningstar started breaking down the equity asset classes into style boxes, allowing investors to allocate across investment styles and market capitalizations. When styles and market caps are placed together, they form what is commonly referred to as a style box matrix, as shown here.

But what is an investment style? Growth and value are the most common styles we've heard of—but understanding the difference is important.

Growth—attempts to invest in companies that have rates of earning growth greater than the “norm.”

Value—attempts to invest in companies deemed to be good stocks at great prices

Blend—attempts to combine both growth and value styles

And what does market capitalization mean? It is a potential measure of a company's worth and is calculated by multiplying the number of shares outstanding by the price per share.

Large-cap typically includes those companies with market capitalization, or worth, exceeding \$5 billion. Mid-cap typically includes those companies with market capitalization between \$1 billion and \$5 billion. Finally, small-cap typically includes those with market capitalization between \$250 million and \$1 billion.

It's been common practice to use the style box as a starting point in building a proper equity allocation to create a diversified, or more balanced, portfolio in order to help reduce volatility and potentially produce more consistent returns.

Does Traditional Diversification Work?

Monthly Correlations Large vs. Small—Growth vs. Value

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Monthly Correlations of Equity Style Boxes to S&P 500 January 1997-December 2006

	Value	Blend	Growth
Large	.94	1	.96
Medium	.82	.86	.85
Small	.70	.72	.72

Performance displayed represents past performance, which is no guarantee of future results. Source data used to create the chart: Calculated by Rydex Investments using information and data from Bloomberg.com, 2007. The following are the indices that were used to determine the monthly correlations shown: S&P 500® Index, S&P Large-Cap Growth Index, S&P Large-Cap Value Index, S&P Mid-Cap Growth Index, S&P Mid-Cap Value Index, S&P Small-Cap Growth Index and S&P Small-Cap Value Index. The aforementioned indices are not available for direct investment. This example is for illustrative purposes only and is not indicative of any investment. Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

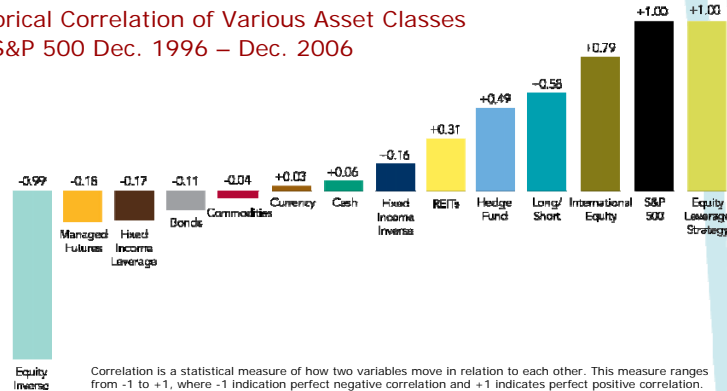
19

This image shows the monthly correlation of equity style boxes to the S&P 500. As depicted here, they are generally very correlated. And as a result, investors may not get the benefits of diversification in style boxes either.

Achieve True Diversification

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Historical Correlation of Various Asset Classes vs. S&P 500 Dec. 1996 – Dec. 2006



See appendix for detailed benchmark information. Data source: Calculated by Rydex Investments using information from Bloomberg.com, 2007. All correlations are measured vs. the S&P 500® Index Total Return. The index returns do not include any management fees, transaction costs or expenses. This is for illustrative purposes only and is not indicative of any investment. You cannot invest directly into an index. Performance displayed represents past performance, which is no guarantee of future results. This information is subject to change at any time, based on market and other conditions and should not be construed as a recommendation of any specific security. There are special risk considerations associated with each of the strategies mentioned and they are not suitable for all investors. None of the strategies can guarantee a return in a declining market. Additionally, an investor could lose all or a substantial amount of their investment. For more information about these strategies and their risks, consult your financial advisor.

One of the key takeaways of Essential Portfolio Theory is to expand upon this traditional asset allocation menu to enhance diversification.

As shown here, a broader asset allocation menu—both positively and negatively correlated to the market—may allow more possibilities to lower your risk and increase reward potential. Here asset classes such as hedge funds, commodities, managed futures and inverse strategies have been added.

For example, commodities generally perform counter-cyclically to stocks and bonds and, when added to a portfolio, can act as a hedge against inflation. Contrary to how the media portrays hedging strategies as inherently risky, a properly hedged portfolio seeks to reduce risk by decreasing the volatility of a long-only portfolio.

By complementing a core, buy-and-hold strategy with some specialized investments, investors may have the potential to better diversify and take advantage of changing market conditions.

Alternative Asset Classes May Offer Broader Diversification



Callan Chart

2000	2001	2002	2003	2004	2005	2006
Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth
10.80%	19.24%	-11.43%	47.25%	29.25%	13.73%	4.77%
MSCI EAFE	MSCI EAFE	MSCI EAFE	MSCI EAFE	MSCI EAFE	MSCI EAFE	MSCI EAFE
10.80%	19.24%	-11.43%	47.25%	29.25%	13.73%	4.77%
S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value	S&P 500 Value
6.98%	2.49%	-9.22%	14.81%	4.55%	12.72%	13.35%
Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth
11.09%	12.19%	20.80%	10.86%	4.15%	11.61%	8.20%
S&P 500 Growth	S&P 500 Value	S&P 500 Growth	S&P 500 Value	S&P 500 Growth	S&P 500 Value	S&P 500 Growth
22.86%	-13.73%	-25.59%	25.68%	8.15%	4.86%	11.61%
Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth
-22.42%	-20.25%	5.18%	5.21%	2.12%	8.20%	8.20%

1 of 8 had positive returns

Rydex Modern Markets Scorecard

2000	2001	2002	2003	2004	2005	2006
Commodities	REITs	Commodities	Equity Leverage	REITs	Commodities	REITs
49.74%	15.53%	32.07%	42.02%	30.41%	25.55%	34.02%
REITs	Equity Inverse	REITs	International Equity	International Equity	REITs	Commodities
25.89%	15.32%	26.77%	29.17%	20.70%	17.29%	17.29%
Fixed Income Leverage	Bonds	Fixed Income Leverage	REITs	Commodities	REITs	Commodities
23.07%	8.44%	19.51%	38.47%	17.29%	17.29%	17.29%
Managed Futures	Currency	Bonds	S&P 500	Equity Leverage	Equity Leverage	Equity Leverage
18.30%	8.58%	10.20%	38.48%	18.21%	18.21%	18.21%
Equity Inverse	Fixed Income Leverage	REITs	Commodities	Managed Futures	Fixed Income Leverage	Long/Short
11.92%	5.81%	5.24%	20.77%	13.93%	5.82%	17.70%
Bonds	Hedge Funds	REITs	Long/Short	Long/Short	REITs	Hedge Funds
11.62%	4.42%	1.15%	17.27%	11.54%	8.29%	1.81%
Currency	Cash	REITs	Hedge Funds	S&P 500	Hedge Funds	Fixed Income Leverage
7.85%	3.64%	1.04%	15.44%	10.88%	7.61%	8.97%
Cash	Managed Futures	Cash	Managed Futures	Fixed Income Leverage	Managed Futures	Managed Futures
6.55%	3.30%	1.84%	4.54%	0.82%	7.55%	5.75%
Hedge Funds	Long/Short	Long/Short	Bonds	Hedge Funds	S&P 500	Cash
4.61%	3.69%	1.69%	4.10%	4.14%	4.91%	3.16%
Long/Short	Fixed Income Leverage	Currency	Cash	Bonds	Equity Leverage	Bonds
2.98%	2.66%	-12.76%	1.14%	4.34%	4.14%	4.37%
S&P 500	S&P 500	Fixed Income Leverage	Fixed Income Leverage	Cash	Cash	Fixed Income Leverage
6.31%	11.69%	-14.00%	0.22%	1.50%	3.44%	-3.35%
Fixed Income Inverse	International Equity	International Equity	Fixed Income Inverse	Equity Inverse	Bonds	Equity Inverse
13.65%	13.65%	20.17%	14.64%	-4.65%	2.43%	3.21%
International Equity	International Equity	S&P 500	Currency	Equity Inverse	Equity Inverse	Currency
12.94%	27.23%	22.10%	-14.44%	-4.98%	0.96%	8.25%
Equity Leverage	Equity Leverage	Equity Inverse	Fixed Income Inverse	Fixed Income Inverse	Commodities	Commodities
-18.17%	-31.87%	-20.94%	7.74%	4.06%	-15.09%	-15.09%

8 of 14 had positive returns

Scorecard (Modern Markets Scorecard): Calculated by Rydex Distributors, Inc. using data from bloomberg.com, 2007. Callan Chart. © 2007 Callan Associates Inc. Reprinted with permission from Callan Associates Inc. 2007 www.callan.com. See appendix for indices used to determine the returns. **Performance displayed represents past performance, which is no guarantee of future results.** The information provided here is intended to be general in nature and should not be construed as investment advice from Rydex Investments and its affiliates. This is for illustrative purposes only and is not indicative of any investment. You cannot invest directly into an index. The index returns do not include any management fees, transaction costs or expenses. The S&P 500 inception date is 1/1/2004. Performance data prior to this is pro-forma, has been prepared with the benefit of hindsight and is therefore hypothetical. The pro-forma indicator methodology varies slightly from the current indicator methodology, with changes made to accommodate market changes. Please note that hypothetical performance results have many inherent limitations and there may be differences between pro-forma and actual indicator performance results. Investors should be particularly wary of placing undue reliance on these hypothetical performance results. **There are special risk considerations associated with each of the strategies mentioned and they are not suitable for all investors.** None of the strategies can guarantee a return in a declining market. Additionally, an investor could lose all or a substantial amount of their investment. For more information about these strategies and their risks, consult your financial advisor.

What if the Callan Chart was expanded to include those new positively and negatively correlated asset classes that I just mentioned? This is what Rydex calls the “Modern Markets Scorecard.” By adding specialized asset classes and strategies, we get a much more robust view of the yearly winners and losers.

And when re-examining 2002, when seven of the eight asset classes on the Callan Chart had negative returns, we now see that eight of the 14 on the Rydex Modern Markets Scorecard had positive returns. The addition of these investments into portfolios could make a real difference in meeting financial goals on time and on target. Which portfolio would you have wanted to be invested in during this period?

EPT Tenet #3

Offset the Constraints of Long-Only
Portfolios

What Is A Long-Only Portfolio?

- Based on the belief that all markets will go up over time
- Prohibits short selling—or investment results that move in the opposite direction of an index

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What is a long-only portfolio? Many investors today position their portfolios solely for an up-trending market. Such portfolios are called “long” portfolios and typically hold securities that go up when the market goes up and down when the market goes down. Conversely, “short” portfolios seek to profit from a declining market or a fall in a specific security. Using a long-only approach means that there is little opportunity to take advantage of market declines. This limitation may actually lead to increased risk and volatility.

Potential Constraints of Long-Only Portfolios

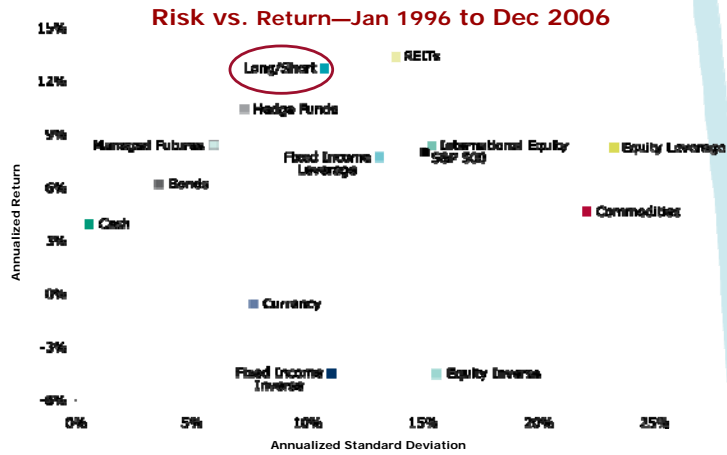
- Can only make money in a rising market
- Creates relative return environment
- Rarely able to hedge downside risks
- Cash is only option when anticipating a downward move

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It is important to note some of the constraints associated with a long-only portfolio.

Long/Short Hedge Fund Strategy 1996-2006

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Data calculated by Rydex Distributors, Inc. using data provided by Bloomberg ©2007. The following are the indices that were used to determine the return and risk figures for the portfolios shown: S&P 500®, 100% of the daily inverse S&P 500® (equity inverse), S&P 500® leveraged 150% daily (equity leverage), 100% of the daily inverse of the U.S. Government Long Bond price (fixed income inverse), U.S. Government Long Bond leveraged 120% daily (fixed income leverage), Lehman Brothers Aggregate Bond Index (bonds), Bloomberg 1 Month CD Index (cash), NAREIT (National Association of Real Estate Investment Trusts) Index (REITs), Goldman Sachs Commodity Index (commodities), MSCI EAFE Index (international equity), Tremont Long/Short Equity Index (long/short), S&P 500® Diversified Trends Indicator (managed futures) and the US Dollar Index® (currency). The aforementioned indices and indicator are not available for direct investment. The S&P DTI inception date is 1/1/2004. Performance data prior to this is pro-forma, has been prepared with the benefit of hindsight and is therefore hypothetical. The pro-forma indicator methodology varies slightly from the current indicator methodology, with changes made to accommodate market changes. Please note that hypothetical performance results have many inherent limitations and there may be differences between pro-forma and actual indicator performance results. Investors should be particularly wary of placing undue reliance on these hypothetical performance results. Performance displayed represents past performance, which is no guarantee of future results.

To dig a little deeper, Rydex took a closer look at the Equity Long/Short Index (this index is a sub-set of the Tremont Hedge Fund Index). This index is made up of hedge fund managers who go both long and short equity at the same time. Looking at returns data from 1997-2006 and comparing those to other asset classes, it is easy to see the potential benefit of a long/short strategy.

The Long/Short strategy has higher returns than the other asset classes—except for REITs, and, based on this historical data, lower standard deviation than all the other asset classes with the exception of the overall hedge fund index, t-bonds, cash, managed futures and the currency index.

Until recently, there was no way for an individual investor to implement a long/short strategy effectively—but the advent of long/short mutual funds has made this possible.



**Move Away from Cap
Weighting**

COMPARISON OF EQUAL WEIGHTING VS. CAP WEIGHTING

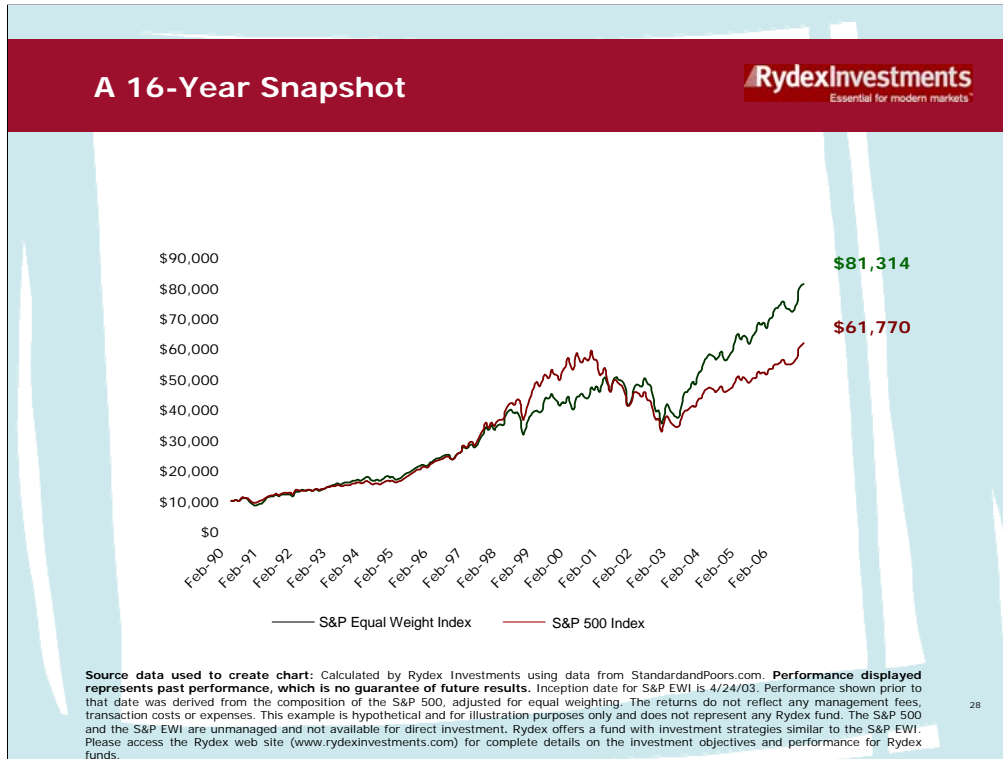
Equal Weight Index (Ex. S&P Equal Weight Index)	Cap Weight Index (Ex. S&P 500 Index)
Equally weighted	Capitalization weighted
Results in relatively higher exposure to value stocks	Results in style bias toward whichever style is in favor
Quarterly rebalance	No rebalance
More smaller stock exposure	Large-cap bias
Avoids domination by a few stocks	Largest few stocks dominate

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The most common benchmarks used by investors today, such as the S&P 500 Index, are market-cap weighted. This means that the representation of stocks included is typically based on the total market value of the shares outstanding. And the result is that a handful of relatively large companies can have a disproportionate effect on the movements in the index and therefore on the investment decisions made by portfolio managers who try to match or beat the index.

One solution to the problem is an equal-weighted strategy. In an equal weighted index, for example, each component company is assigned the same weight. In the S&P Equal Weight Index, each company has a 0.2% weighting that is regularly rebalanced to maintain that percentage.

Here we compare an equal weight index to a cap weighted index.



Comparing the cap-weighted S&P 500 to the Equal Weighted S&P 500 (S&P EWI) over a 16 year time frame gives us a clear picture. First, let me point out that the S&P EWI did not go “live” until April of 2003—so all data prior is “pro-forma” or hypothetical. Placing \$10,000 into each index and tracking the performance for 16 years—we see the difference. As this graph shows, a \$10,000 investment grew to approximately \$81,000 when invested in the S&P EWI compared to almost \$62,000 invested in the cap-weighted S&P 500.

Please keep in mind that during bull markets where large caps outperform—as occurred during the mid 1990s—the cap weighted index will outperform the equal weight index. Also please be aware that investing in small companies may involve a greater risk of loss and more abrupt fluctuations in market price than investments in larger companies.



**Rules-Based
Rebalancing**

Calendar-driven:

- Portfolio rebalancing is determined strictly by the calendar
- Can occur quarterly or annually

Rules- or risk-based:

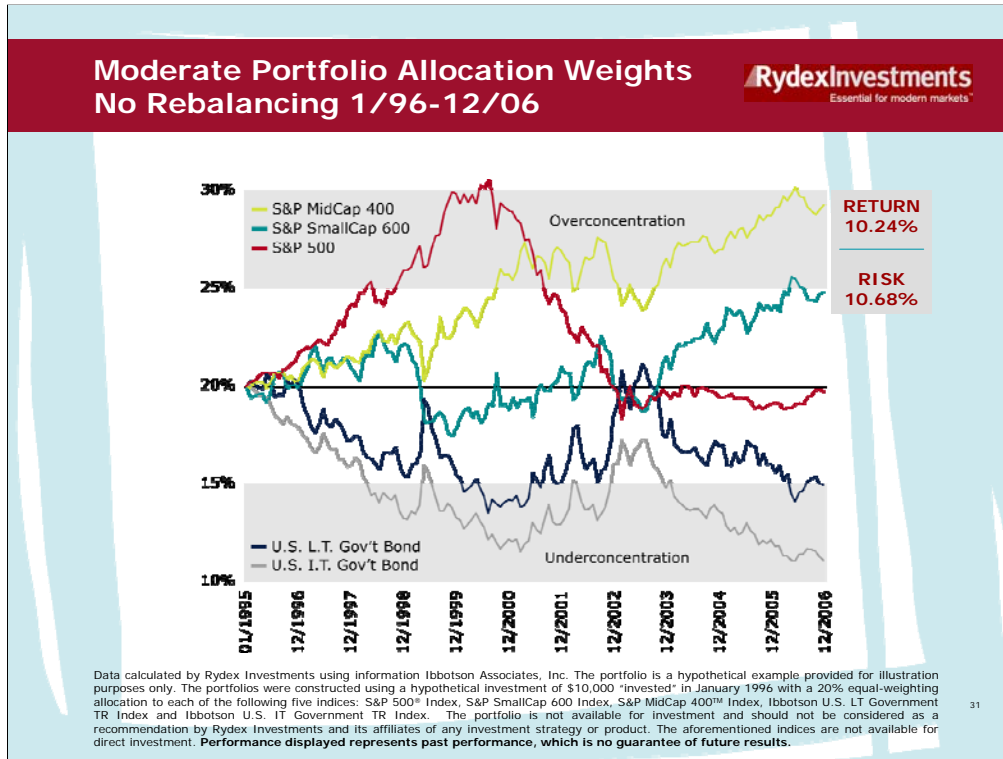
- Employing trigger points (when portfolio allocations have drifted too far) in order to rebalance the portfolio

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Many of us, understand the importance of maintaining asset allocation targets by periodically rebalancing a portfolio. And why do we do this? Because when better-performing asset classes become too heavily weighted in a portfolio, it adds to the risk of the portfolio. Selling the winners and adding to the losers is the simplest way to understand rebalancing.

Most investors rebalance on a calendar-basis. And while any rebalancing is better than none, the problem with calendar-driven methods is that they miss significant events that occur in between quarterly or annual rebalances.

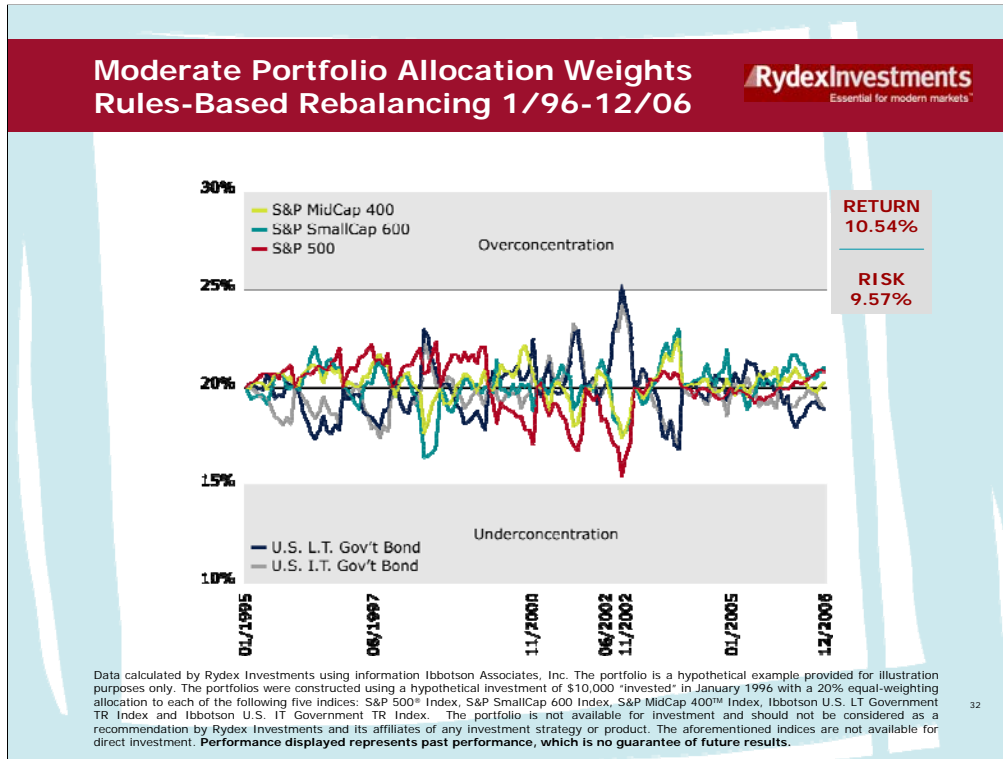
Instead, investors may want to consider employing certain triggers in order to rebalance the portfolio. This is called rules- or risk-based rebalancing.



Rules or “risk” based rebalancing seeks to avoid overconcentration by putting in place parameters that are based on portfolio weightings rather than a pre-set rigid calendar based schedule. This approach seeks to help a portfolio avoid the over-concentration risks that can occur in a volatile market between January- based rebalancing.

This image shows what can happen to a portfolio that has never been rebalanced. It takes a hypothetical equity portfolio comprised of 20% of each of the following: S&P 500, S&P MidCap, S&P SmallCap, U.S. Long Term Government Bonds and U.S. Intermediate Term Government Bonds and U.S. Intermediate-Term Government Bonds. At the outset, everything is equally weighted—but over time we can see how the over and underperformers severely skew the weight of the portfolio. As you can also see these over- and under-concentrations occur between Januarys, so waiting to rebalance could leave the portfolio open to undue risks. And, while any rebalancing is better than none, the problem with calendar-driven methods is that they may miss significant economic events that occur in between quarterly or annual rebalances.

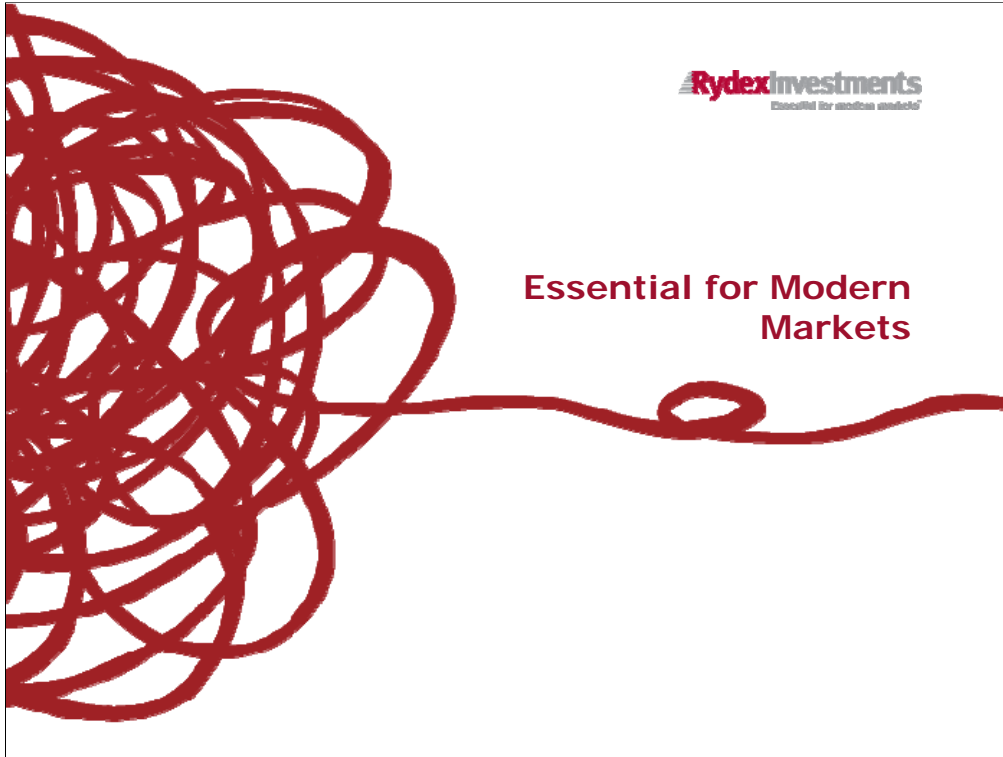
Over the period January 1996 to December 2006, had you done nothing to the portfolio—had you simply bought and held—the return for this portfolio would have been 10.24% with a standard deviation of 10.68%.



Investors may wish to consider employing certain triggers in order to rebalance the portfolio, such as flagging trading zone when a specific asset falls outside of its target range (+/- 5%, for example).

Here we see an equity portfolio weighted 20% in each of the styles we mentioned before. Now we implement a weighting rule. Any time a particular style moves 5% in either direction (25% or 15% weightings), we rebalance the entire portfolio. As you can see, this approach does a nice job of helping the portfolio avoid over- and under-weightings. Furthermore, over the same period, this method yielded a slightly higher return of 10.54% than no rebalancing, but at a substantially lower level of risk 9.37% standard deviation.

EPT takes the rebalancing concept further and puts forth the premise that rules-based rebalancing can potentially offer more benefits than a calendar-based approach. Rules- or risk-based rebalancing can potentially offer more benefits than a calendar-based approach. It seeks to avoid overconcentration by putting in place parameters that are based on portfolio weightings rather than a preset, rigid, calendar-based schedule. This approach seeks to help a portfolio avoid the overconcentration risks that can occur in a volatile market between January-based rebalancings.



At one time, a buy-and-hold strategy composed of traditional asset classes made sense. However, today's market environment is quite different, and yesterday's approaches may no longer be appropriate. Essential Portfolio Theory lays the groundwork for building a modern portfolio for today's modern markets.

Institutional Investors Use Alternative Investment Strategies



10-year annualized returns (as of 6/2006):

Harvard ³ :	15.2%
Yale ⁴ :	17.2%

Past performance is no guarantee of future results. 1. Source: "Financial Report to the Board of Overseers of Harvard College," FY 2005-2006. Harvard's total exceeds 100% because of leverage. 2. Source: "The Yale Endowment 2006." Figures are target allocations as of June 2006; actual portfolio composition varies with market conditions. 3. Source: "Harvard Endowment Posts Solid Positive Return," *Harvard Gazette Archives*, 6/2006. 4. Source: "Endowment Skyrockets," *Yale Daily News*, 6/2006. This information is subject to change at any time, based on market and other conditions and should not be construed as a recommendation of any specific security or strategy. The above referenced report is created and maintained by independent, third parties that are not affiliated with Rydex Investments or any of its affiliates. Accordingly, Rydex Investments and its affiliates expressly disclaim any responsibility for the content and the accuracy of the information presented, or the quality of the products and services provided therein. Although Rydex Investments believes the information from these organizations is reliable, it cannot, and does not, guarantee or warrant the completeness or suitability of this information for any purpose.

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It is important to note that prominent institutional investors, such as Ivy League Endowments and pension funds have used a full range of asset types and investment techniques in an attempt to reduce risk and capture more consistent returns in all types of market conditions. For example, the Yale Endowment has averaged an annual net investment returns over 17% for the last 10 years. Most of this success may be attributed to their disciplined and diversified asset allocation policies, active management results and strong capital market returns.

As shown, the most striking aspect of Yale's allocation is that they target only 12% of their assets to be invested in domestic equities and 4% in fixed income. They also target 15% invested in international. It is also important to note that approximately 15% of Yale's portfolio is targeted in non-traditional assets including, absolute return strategies and real assets such as commodities, real estate and inflation-indexed bonds.

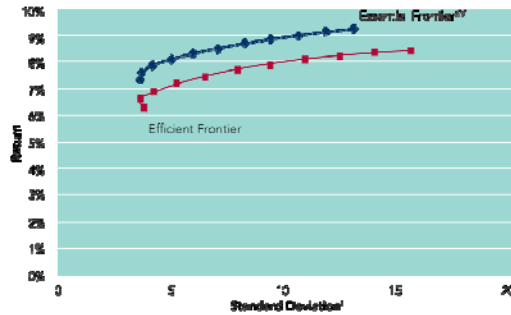
Note: Private equity can be defined as securities of companies that are not listed on a public exchange.

Essential FrontierSM vs. Efficient Frontier (1997-2006)

RydexInvestments
Essential for modern markets

Adding 20% alternative assets to an equity/bond portfolio

(The Essential FrontierSM adds 4% NAREIT Index, 4% GSCI, 4% Tremont HFI, 4% Tremont L/S Equity Index and 4% S&P DTI)



Performance displayed represents past performance, which is no guarantee of future results. Source: Calculated by Rydex Investments using information and data from Bloomberg.com. The portfolios are hypothetical examples provided for illustration purposes only. No assumptions should be made that similar asset allocations will be profitable, suitable or perform as indicated above. Allocations and their percentages should change based on an individual investor's needs. The indices and indicators used to determine the return and risk figures for the portfolios shown were: S&P 500[®] Index, Lehman Brothers Aggregate Bond Index, NAREIT (National Association of Real Estate Investment Trusts) Index, Goldman Sachs Commodity Index, Tremont Hedge Fund Index, Tremont Long/Short Equity Index and S&P DTI. The S&P DTI inception date is 1/1/2004. Performance data prior to this is pro-forma, has been prepared with the benefit of hindsight and is therefore hypothetical. The pro-forma indicator methodology varies slightly from the current indicator methodology, with changes made to accommodate market changes. Please note that hypothetical performance results have many inherent limitations and there may be differences between pro-forma and actual indicator performance results. Investors should be particularly wary of placing undue reliance on these hypothetical performance results. Indices and indicators are not available for direct investment. See appendix for detailed index and indicator information. Essential FrontierSM is a service mark of Rydex Investments and is protected by copyright.

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This shows the effect of adding a 20% allocation of alternative assets and strategies to the traditional Efficient from 1997-2006.

At Rydex, we call this the Essential Frontier. The 20% alternative allocation proxy is comprised of the following: 4% NAREIT Index, 4% GSCI, 4% Tremont HFI, 4% Tremont L/S Equity Index and 4% to the S&P DTI.

The Essential Frontier line shows how the new allocations affected the Efficient Frontier by moving it upward and leftward, resulting in higher returns and lower standard deviation at every data point. The potential result is a more diversified portfolio that can help even out the ups and downs of the equity and fixed-income markets.

Appendix

Bonds	Lehman Brothers Aggregate Bond Index
Cash	Bloomberg 1 Month CD Index
Commodities*	Goldman Sachs Commodity Index®
Currency	U.S. Dollar Index
Equity Inverse*	100% of daily inverse of the S&P 500®
Equity Leverage*	S&P 500 leveraged 150% daily
Fixed Income Inverse*	100% of the daily inverse of the U.S. Government Long Bond price
Fixed Income Leverage*	U.S. Government Long Bond leveraged 120% daily
Hedge Funds	Tremont Hedge Fund Index
International Equity	MSCI EAFE Index
Long/Short	Tremont Long Short Equity Fund Index
Managed Futures*	S&P Diversified Trend Indicator
REITs	NAREIT (National Association of Real Estate Investment Trusts)®
S&P 500	S&P 500 Index

About Rydex

Rydex Investments continues to drive change in the financial industry by introducing investment products and services that challenge conventional thinking, empower investors and provide essential new options for uncertain market conditions. Rydex manages \$15 billion in assets via more than 80 mutual funds and exchange traded products.

*Rydex offers funds with investment strategies similar to these referenced asset classes. However, performance for the referenced index or indicator is not that of any Rydex fund.

Please call 800.820.0888 or visit www.rydexinvestments.com for a prospectus. Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. The fund's prospectus contains this and other information about the fund. Please read the prospectus carefully before you invest or send money.

Rydex Distributors, Inc., an affiliate of Rydex Investments, is the distributor of Rydex funds.

The referenced indices are not available for direct investment. The S&P DTI inception date is 1/1/2004. Performance data prior to this is pro-forma, has been prepared with the benefit of hindsight and is therefore hypothetical. The pro-forma indicator methodology varies slightly from the current indicator methodology, with changes made to accommodate market changes. Please note that hypothetical performance results have many inherent limitations and there may be differences between pro-forma and actual indicator performance results. Investors should be particularly wary of placing undue reliance on these hypothetical performance results.

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Appendix: Index Definitions

- **Standard & Poor's Diversified Trends Indicator (S&P DTI)** is a long/short investment methodology that can benefit from trends (in either direction) in the global futures markets. It is comprised of 14 sectors from around the world, with 50% allocated to financial futures and 50% allocated to commodity futures.
- **Credit Suisse First Boston/Tremont Advisors Hedge Fund Index** is the industry's first asset-weighted benchmark of hedge fund performance.
- **Goldman Sachs Commodity Index (GSCI)**, a composite index of commodity sector returns, representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets.
- **Lehman Brothers Aggregate Bond Index:** An unmanaged index composed of securities from the Lehman Brothers Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization.
- **Bloomberg 1 Month CD Index:** A Certificate of Deposit is a debt instrument issued by a bank that will pay interest periodically or at maturity and principal when it reaches maturity. These CD rates are a proxy of the CD Market. The proxy is taken from a bid side tick of the time of deposit. This is when the majority of money is traded in Money Market.
- **MSCI Europe, Australasia and Far East Index (EAFE):** An unmanaged market capitalization-weighted equity index comprising 20 of the 48 countries in the MSCI universe and representing the developed world outside of North America. Each MSCI country index is created separately, then aggregated, without change, into regional MSCI indices. EAFE performance data is calculated in U.S. dollars and in local currency.
- **NAREIT Index (National Association of Real Estate Investment Trusts)** is an unmanaged index that reflects performance of all publicly traded equity REITs listed on the New York Stock Exchange, American Stock Exchange and the Nasdaq National Market System.
- **S&P 500® Index:** An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.
- **Tremont Long/Short Equity Fund Index:** Long/short equity managers seek to profit from investing on both the long and short sides of equity markets. Managers have the ability to shift from value to growth, from small to medium to large capitalization stocks, and from net long to net short. In addition to equities, long/short managers can trade equity futures and options as well as equity related securities and debt. Manager focus may be global, regional or sector specific, such as technology, healthcare or financials. Managers tend to build portfolios that are more concentrated than traditional long-only equity funds.
- **The U.S. Dollar Index** indicates the general international value of the U.S. Dollar. The USDX does this by averaging the exchange rates between the U.S. dollar and six major world currencies: euro, yen, British pound, Canadian dollar, Swedish krona, and Swiss franc.