

Sector by Sector

Rydex Sector Rotation Fund is built on the premise that industries that have performed well in the past will continue to perform well in the future. The management uses two measures of momentum - a 3-month and a 12-month look back on the industry performance. The fund ranks all of the 62 industries in its universe and is buying the top 10% in either measure of momentum.

Q: What is the investment philosophy of the fund?

A: The Sector Rotation Fund is a disciplined quantitative momentum based approach to industry investing. The fund is built on the premise that industries that have performed well in the past will continue to perform well in the future. There's been a lot of academic work done on both single stock and industry level momentum. We're trying to capture this phenomenon. Single stock momentum is already used as a factor in many active and quantitative portfolios industry wide. To our knowledge this is the only publicly available fund that focuses on industry momentum.

Q: Which are the sectors where the fund is over/under weighted?

A: Currently the fund's largest position is in financials sector flowed by heavy concentrations in industrials, utilities, and consumer staples. We also have smaller exposures to materials and technology. It is important to keep in mind that the fund can benefit from not only

what we do own, but also form the sectors that the fund avoids. Right now the fund is avoiding the energy, consumer discretionary, telecommunications, and health care sectors.

Q: Who are the investors who should be taking advantage of your strategy?

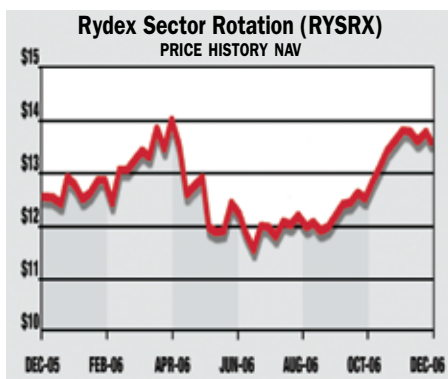
A: The typical investor in this fund is looking for low correlation equity exposure. Our investors want the opportunity to out-perform the broad market. Typically the fund has about a 70% correlation to the S&P 500 so it has some diversifying properties and can benefit many investors' portfolio. Depending on the investor's risk-reward preferences, the fund usually is given a 20% to 40% portfolio allocation.

Q: Would you place the fund within a particular style box?

A: As we rotate in and out of industries, the fund's characteristics will change over time. When we are buying industries that tend to be constructed of many large-cap names, the style characteris-



ADRIAN BACHMAN joined Rydex in 1997 and was involved in research efforts designed to enhance existing and develop new quantitatively driven investment strategies/techniques. As a portfolio manager Adrian oversees the Rydex Sector Rotation, Financial Services, Banking, Internet, Leisure, Retailing, Europe, and Japan funds. Prior to joining Rydex, Adrian worked as a financial advisor for the Rockville, Maryland based Capital Management, Inc. Adrian holds a bachelor's degree in finance and international business from the University of Maryland. Adrian has been quoted in publications such as Barron's, Buyside Magazine, Chicago Tribune, Dow Jones News Wires, Forbes, Investment-News, Reuters, TheStreet.com, and USA Today where he has discussed the Rydex Sector Rotation fund and other sector fund related topics.



tics can change and the portfolio can look very much like a large-cap fund. On the other hand, there can be periods where we buy industries that are mostly made up of mid or even some small-cap names so our average weighted capitalization of the fund will drop at that point. Even though the style characteristics of the fund can fluctuate to some degree, on a size basis, the fund will never really move into the small-cap arena because we're always trying to represent the industries as best as possible. We're always going to own some of the large and mid-cap names but it can definitely fluctuate between large and mid-cap. The fund's style exposures can change significantly between value and growth depending on the time period. Early in 2005 based on the fund holdings, the fund would have most likely been considered a mid-cap value fund. Towards

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the end of 2005, we looked much more like a large-cap growth fund and now the fund's looking more like a mid-cap blend fund.

Q: How do you define the measure of momentum?

A: We use two measures of price momentum independently. We use a, short-term measure, a three-month look back on the industry performance and a, long-term, 12-month measure of momentum. This provides a weight of evidence approach. If either short or long-term momentum is strong we will buy that industry, but if both measures are confirming strong momentum we will buy a double weight in that industry. For the portfolio we buy the top 10% of industries based on their relative ranks in either measure of momentum. This means that when the rankings for both measures of momentum are very similar in our universe of 62 industries we may own as few as six industries. If the rankings are completely discrete, we'll own as many as 12 industries.

Q: Discuss your sales process and sales discipline - what signals do you follow and what leads you to sell a sector?

A: This is a very important issue and one that many investors overlook. For a lot of momentum investors it's easy to pick up on what the hot industry is. It was easy to tell in the late '90s when Internets were doing extremely well. The problem is when to sell out. A lot of people hold their winners too long, or continue to hold their losers too long praying for a rebound. The Sector Rotation fund follows both a disciplined buy and

sell strategy. When we see an industry falling out of the top 20% of all industries, we get out relatively quickly. This accomplishes two objectives. First, when an industry has fallen an entire decile it is demonstrating a clear degradation in the industry's relative strength. Secondly, this rule helps to curb our turnover within the fund. Rotational strategies by nature are fairly high turnover strategies, so we try to implement the strategy in a way that's powerful enough to capture the benefits of momentum investing while causing minimal turnover to the portfolio.

Q: Recently ETF's have become very popular. Do you use or leverage them as part of the investment management process?

A: At Rydex, we have 17 sector funds and a lot of advisors use them to do sector rotations similar to what a lot of investors do with ETF's. One of the reasons that we created the Sector Rotation Fund is that a lot of advisors were looking for a way to rotate between sectors with a disciplined quantitative approach. They wanted to take bets without having to spend the time to examine the sectors, do research on what sector they should be in, or spend time reviewing current economic conditions. A main driver for assets into the fund is the investor that wants to take sector bets but doesn't want to spend the time managing the rotation process themselves.

Q: How does your strategy take into account inflection points in stock prices? Recently Exxon traded up from \$57 to \$70 and

now it is down to \$65. If you were to look at last 3 - 4 months data, it could have been painful to pursue Exxon.

A: The fund focuses on industry returns so single stock volatility is smoothed to some degree, but attempting to pick up on inflection points is partially why we incorporate two momentum singles. The two signals work together. The 3-month signal tends to quickly pick up on industry regime shifts while the 12-month measure confirms long term industry momentum. If you were to just use the 12-month measure, it would take a longer time before you pick up on the fact that an industry has experienced strong relative strength. If momentum changes and starts to sell off, it would also take a while before you remove that industry from your portfolio. When we use two measures together, we're diversifying our allocation - 50% of the portfolio is based on short-term momentum and the other 50% in the more long-term.


Q: Can you describe your research process?

A: As it's a quantitative-based fund, we don't do fundamental research on the industries that we're buying but we do calculate all of the returns of the industries, look at the individual holdings and at the style characteristics on computer based systems. We're picking the industries solely on their returns over the last three months and 12 months. Once we pick those industries, we're not currently employing a quantitative strategy for picking stocks within that industry. We're just trying to represent that industry as best we can.

Q: What are the most important elements of your portfolio construction?

A: We start by ranking all US equities by market capitalization and limit ourselves to the top 2,500 companies. After we screen on size, we eliminate names that are illiquid. With high turnover strategies, it's fairly important that you're using a liquid universe of stocks. Our screening process leaves us with roughly 2,000 names that we use to sort into industries. We define the industries in our universe based on the S&P Global Industry Classification Standards (GICS). The industries that we buy are typically represented by buying 15 to 20 names using a modified cap weighted approach. There are a few industries that have less than that and in those cases we will buy all the names in that industry. For example, one of the industries that we own, tobacco, only holds seven companies so we'll buy all those companies.

Q: What kind of risks do you perceive? How do you monitor and mitigate them?

A: Sector rotation is a moderate to high-risk strategy, but that is exactly what our investors are looking for. Since the portfolio can be concentrated in a hand full of industries, from time to time you can see a fairly high active risk to the S&P 500. Many people are looking for a fund that is willing to take bets on specific sectors so there can be some fairly large differences in sector weightings between our fund and most broad market indexes. Currently, we're not holding four of the larger sectors within the S&P 500. 

Rydex Sector Rotation

Symbol	RYSRX (H CLASS)
Website	www.rydexfunds.com
Address	Rydex Investments 9601 Blackwell Road, Suite 500 Rockville, MD 20850
Tel. No.	800-820-0888
Inception	3/22/2002

PORTFOLIO

Total Net Assets*	\$319.8
Avg Mkt Cap (\$ Weighted)*	\$12,300
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	262%

INVESTMENT INFORMATION

New Investment	Open
Standard Direct	\$25,000
IRA Direct	\$25,000

RISK (AGAINST S&P 500 INDEX - 3 YEARS)

Beta	138.45
R-Squared	61.23
Ann Std Deviation	3.89
Sharpe Ratio	0.03

RETURNS VS. S&P 500

	RYSRX	Index
1 Year (Cum.)	11.30%	15.79%
3 Year (Ann.)	11.90%	10.44%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.66%

PORTFOLIO MANAGER

Adrian Bachman	3/22/2002
Michael Byrum	3/22/2002

*millions

Data through: 12/31/06

Source: Company Documents; Lipper

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