

Share Class (Principal series)	NAV	December 2007			2007 Year to Date		
		Fund (%)	Cash (%)*	FT World†	Fund (%)	Cash (%)*	FT World†
Class A – US\$	US\$137.12	(0.03)	+0.43	(1.30)	+7.38	+5.44	+11.32
Class B - £	£147.74	+0.09	+0.53	+1.95	+7.95	+5.87	+9.45
Class C - €	€133.68	(0.10)	+0.40	(0.91)	+6.08	+4.20	+0.40

\*Citigroup 3-Month Eurodeposits – Source: Citigroup

†Index in the currency of the respective share class – Source: FT/Bloomberg

### Making money in falling markets

We have the comfort, but certainly not the complacency, of knowing that the Absolute Fund strategy made money for investors each year in 2000, 2001 and 2002 when the FT World Share Index suffered a peak-to-trough decline of 48%, a drop from which many investors' portfolios have still to recover. Not surprisingly, we are determined and confident that we can repeat this feat if 2008 is set to be a year of negative returns from stock markets. The euphoria and invincibility which characterised investor sentiment in the first half of last year has been replaced with gloom, and with good cause. As we wrote in October's report, the economic fallout from the reckless investments and lending made by major banks between 2003 and 2007 has the potential to rival the US Savings & Loans crisis of the 1980s and the Japanese banking crisis of the 1990s. Numerically, there is plenty of scope for Central Banks to cut interest rates to stave off recession. US interest rates, for example, have so far been cut from 5.25% to 4.25% but fell as low as 1% in 2002. At the same time, UK interest rates, which are currently at 5.5%, dropped to 3.5%. However, the economic need to cut interest rates aggressively is opposed by evidence of rising inflation. Central bankers are caught between a rock and a hard place and face tough decisions in the months ahead.

Against this background, it is tempting to move the Absolute Fund to an outright short bias. However, this is not how we made money for investors between 2000 and 2002 and it is not what we intend to do now. Returns from investments can simplistically be split into two components. The first comes from the movement of the market as a whole, as is captured by passive, index-tracking funds. The second, referred to as 'alpha', is the marginal return from the skill of a manager in actively picking stocks (or bonds) which outperform or under-perform the broad market. Good stock-pickers should be able to generate alpha in either rising or falling markets. The investment strategy of the Absolute Fund has always been to minimise the impact of the former and rely on the latter as the principal source of performance. Twenty years of investment experience has taught us that trying to time market peaks and troughs is a mug's game and, by combining long-bias and short-bias funds within the Absolute Fund, we have the luxury of being agnostic about market trends. Having said that, the changes we made to the Absolute Fund's portfolio at year-end did undoubtedly cause any residual market sensitivity within the Absolute Fund to decline even further and this has been helpful in January's turbulent markets.

For the reasons explained in October's monthly report, we redeemed from DS1, easily our most successful fund in 2007, at year-end. DS1 made a big contribution to the Absolute Fund's return last year and the question obviously arises how we will replace it. The answer is that we are determined to make fewer mistakes in our other fund selections. As well as FI1 (-32% in 2007), we lost money in a further twelve funds which collectively offset a large part of DS1's gain. Having purged the Absolute Fund portfolio of almost all of these laggards and replaced them with new funds, we have high conviction in the current composition of the Absolute Fund and in its potential to deliver attractive returns in 2008.

### Best 3 Funds in December

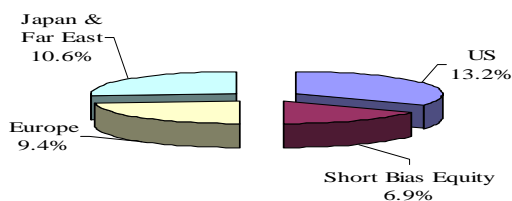
Name of Fund (Size)	Strategy	Nov	YTD
DS1 (3.5%)	Distressed Securities	+5.4	+118.3
ED1 (2.5%)	Event-driven	+4.5	(6.1)
FI1 (2.8%)	Fixed Income	+2.3	+10.0

### Worst 3 Funds in December

Name of Fund (Size)	Strategy	Nov	YTD
JELS2 (1.3%)	Japanese Equity L/S	(4.4)	(3.8)
FI2 (1.9%)	Fixed Income	(3.0)	(32.3)
JELS3 (1.3%)	Japanese Equity L/S	(2.8)	(9.3)

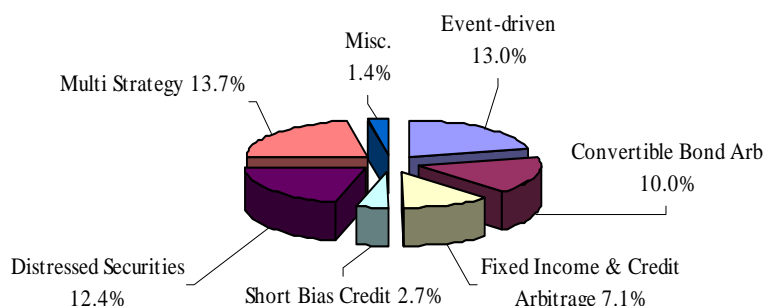
## Asset Allocation by Strategy (as at 31<sup>st</sup> December 2007)

### Equity Long/ Short (40.0%)



Source: Absolute Fund Management

### Arbitrage & Other (60.4%)



Battered and bruised from the mauling in November, many investors opted to see out 2007 from the sidelines. Although most markets drifted slightly lower in December, the flat performance of the Absolute Fund can be attributed mainly to the lack of events or other opportunities which our managers could exploit. Having got the Fund's rolling twelve-month return to more than 10% at the end of October, we are obviously disappointed not to have finished the year with a double-digit gain. Having said that, the Absolute Fund was still profitable for investors in the final quarter of 2007 when equity and corporate markets stumbled and returns for the whole year exceeded those from cash, bonds and stocks in local currency terms.

In such a featureless month, it is no surprise that contributions to performance from the various sub-strategies were clustered in a tight range. The most profitable was Distressed Securities where our four funds, representing 12.2% of the Absolute Fund's portfolio, delivered an aggregate gain of 28bps (0.28%). The other profitable sub-strategies were Event-driven, Short-bias Equity and Short-bias Credit. At the other end of the return spectrum, our five Japanese managers and one Asian manager, representing 10.7% of the portfolio, collectively lost 12bps. For the whole of 2007, our eclectic roster of Distressed Securities managers accounted for 40% of the Absolute Fund's performance, a stunning contribution considering that the default rate of corporate bankruptcies was at an all-time low. Although eclipsed by the exceptional Harbinger fund, the other four Distressed Securities funds we owned during the year posted just two losing months between them and delivered annual returns averaging just over 12%. Despite a 12% decline in the main TOPIX index and even bigger falls for the smaller company indices, Japanese Long/Short Equity also contributed usefully to the Absolute Fund's performance in 2007, proving that the very best managers don't need rising markets to invest profitably.

It was perhaps predictable that DS1 would top the Best 3 Funds list once again in December. For the whole year, DS1 was up by 118%, an extraordinary achievement for a fund which grew in size from US\$4.8bn to more than US\$15bn last year. ED1's gain in December was too little and too late to cause us to withdraw our redemption request which was effective at year-end. The sale is also consistent with our decision to reduce exposure to Event-driven managers who typically maintain a long bias and are hence a source of directional market risk within the Absolute Fund. On the losing side, JELS2's loss was testament to the exceptionally difficult trading conditions in the Japanese stock market in the final months of last year, although this was perhaps exacerbated by the manager's contrarian stance. An indirect casualty of the credit crunch, municipal bond arbitrage fund FI1 featured in the Worst 3 funds list for the fourth time in five months. The complex hedging used by FI1 was sound in theory but turned out to be ineffective in practice. We have learned a painful lesson.

As always, we welcome your questions, comments and suggestions

Charles Hovenden and Andrew Wheeler

21<sup>st</sup> January 2008

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**ABSOLUTE**  
FUND MANAGEMENT

## Manager's Track Record & Summary Statistics (for Class B £ shares)

Source: Absolute Fund Management

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
1999	0.83	1.07	0.96	2.60	1.43	0.74	1.61	0.37	0.81	0.70	2.46	0.57	15.05
2000	1.36	3.21	1.87	(0.03)	1.01	1.63	0.98	0.80	0.83	0.17	(0.28)	0.58	12.77
2001	0.87	0.41	0.36	0.38	0.62	(0.32)	(0.10)	0.68	(0.19)	(0.11)	0.35	0.73	3.72*
2002	0.73	0.15	0.95	0.77	0.56	(0.36)	(0.59)	(0.05)	(0.90)	(0.23)	0.36	1.07	2.57
2003	0.84	0.44	0.20	0.64	0.74	0.72	0.56	0.94	0.92	1.57	0.24	1.04	9.21
2004	1.13	0.42	1.09	0.73	(0.50)	0.99	0.20	0.34	0.69	0.45	1.35	1.12	8.29
2005	0.39	0.92	0.50	(0.30)	(0.35)	0.57	1.02	0.73	1.15	(0.18)	0.72	1.63	6.99
2006	1.09	0.02	1.00	0.61	(0.28)	(0.24)	(0.54)	0.44	(0.18)	0.41	0.89	1.12	4.33
2007	0.86	0.93	0.78	0.67	1.42	0.60	0.42	(0.54)	0.94	2.00	(0.47)	0.09	7.95
<b>Annual Rate of Return</b>			<b>7.81</b>	<b>Sharpe Ratio (@ 5% risk free)</b>				<b>1.19</b>	<b>Biggest Monthly Loss</b>				<b>(0.90)</b>
<b>Standard Deviation</b>			<b>2.36</b>	<b>Correlation FT World Index (Local)</b>				<b>0.37</b>	<b>Biggest Peak-to-Trough Drawdown</b>				<b>(2.02)</b>

\* The Manager's Record above consists of actual performance data for the sterling share class of The Absolute Fund from 1st October 2001 onwards. For January 1999 to October 2001 returns have been taken from the Manager's prior and verifiable track record in US dollars (restated to reflect the fee scale of the Absolute Fund). The differential in performance between the US dollar and sterling share classes of the Absolute Fund is a consequence of the differential between US dollar and sterling interest rates. US dollar and sterling interest rates were broadly similar between January 1999 and October 2001 and Absolute Fund Management Limited believes that returns in sterling in the first period would therefore have been broadly the same as in US dollars.

### General Information

<b>Size of Fund:</b>	US\$104.4 m	<b>Investment Manager:</b>	Absolute Fund Management Ltd. Marquis House 67/68 Jermyn Street London SW1Y 6NY Telephone: +44 (0) 20 7925 8078 Website: www.absolutefund.co.uk
<b>No. of Holdings:</b>	42	<b>Administrator:</b>	Northern Trust International Fund Administration Services (Ireland) Ltd. George's Court 54 -62 Townsend Street Dublin 2 Telephone: +353 1 670 0660
<b>Share Classes:</b>	US\$, £, €	<b>Contact:</b>	<b>Andrew Wheeler</b>
<b>Basic Fee:</b>	1%		
<b>Incentive Fee:</b>	15% of gains between 6% & 24% p.a.		
<b>High Water Mark:</b>	Yes		
<b>Dealing:</b>	Monthly (with 35 days notice for redemptions)		
<b>Min. Investment:</b>	US\$50,000		
<b>Fund Domicile:</b>	Cayman Islands		
<b>Listing:</b>	Channel Islands Stock Exchange (CISX)		

### Price Information

**Contact: Terry Fernandes**

	Bloomberg	SEDOL	ISIN
<b>Class A (US\$)</b>	ABSFNDA KY <Equity>	3093568	KYG0060S1241
<b>Class B (£)</b>	ABSFNDB KY <Equity>	3093591	KYG0060S1324
<b>Class C (€)</b>	ABSFNDC KY <Equity>	3093610	KYG0060S1407

### Risk Warning

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