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ABSOLUTE FOCUS FUND

A Ponzi Scheme to make Mr Madoff Proud

Almost exactly a year on from the last wobble, a run of disappointing economic data from around the world has caused investors to fret again about authenticity of the recovery. Policymakers and politicians have been quick to attribute the slowdown to one-off and temporary factors, chief amongst them March's earthquake and tsunami in Japan. This assurance appeared to work in May, limiting the fall in the local currency FT World Share Index to just 1.3%. However, further evidence that economic growth is faltering and that house prices in the US have resumed their decline has caused share prices to tumble again in June and many stock market indices are now down for the year. A sense of déjà vu is understandable. Last year the US Federal Reserve rode to the rescue with its announcement of QE2, the flood of manufactured liquidity turning a loss of 7% in the FT World Share Index at the end of June into a gain more than 10% by the end of the year. However, with QE2 set to end at the end of this month and the Federal Reserve talking down the prospects of QE3 (at least for now), there is no guarantee of a similar bail-out.

The US Treasury bond market has, in any case, become a giant Ponzi scheme. Whilst other governments, notably in the UK, seek to address the excesses of past decade or more and impose fiscal discipline, the Obama administration continues to spend. It has only been able to do this because the dollar remains the world's reserve currency, the notion of the US government defaulting on its debts is virtually unthinkable and, most importantly, because the Federal Reserve has been printing money to buy US\$600bn of Treasury bonds. Indeed, the Federal Reserve recently surpassed China as the biggest investor in US debt. Of course, Mr Madoff's Ponzi scheme was exposed when the flow of money from investors reversed. Despite the political horse-trading about the US debt ceiling and the threat of technical default, the US Treasury bond market isn't going to collapse like Mr Madoff's scheme. However, bond yields could rise sharply when the Federal Reserve ceases to be the main buyer of Treasury bonds and the US economy is currently in no state to absorb higher borrowing costs.

The modest decline in the FT World Share Index in May flatters to deceive. In fact, there were violent reversals to recent trends in industry sector performance with commodity and financial stocks suffering steep falls whilst long-neglected shares in defensive sectors such as pharmaceuticals and food returned to favour. As a consequence, the main indices of hedge fund performance were

down by almost as much as stock markets in May. Of course, and with the benefit of hindsight, it is easy to say that managers should have been positioned for such a change and, indeed, it is consistent with our long-held view that the cocktail of quantitative easing and negligible interest rates was creating a bubble in cyclical and speculative shares. The problem with bubbles, however, is that it is very hard to know when they will burst and, as we have seen within Absolute Focus Fund, any manager who has been persevering with the perfectly sensible but contrarian stance of being long of quality, defensive shares and short of cyclical companies has endured miserable returns over the last two years.

At underlying fund level, we made money in 9 out of 18 investments which is no mean achievement in the circumstances. Lyon Street was (again) our most profitable investment with a gain of 3.6%. Both USLS6 and USLS2 lost money on their long investments but made much bigger gains on their shorts. Artemis has been a disappointing investment so far this year but, as we wrote in January's Monthly Report, we expect this to be one of the more volatile investments within Absolute Focus's portfolio in terms of monthly returns. In 2010 EELS4 was up by more than 30%. However, we have decided to redeem from USLS8 after May's loss took the cumulative peak-to-trough loss since May last year to 12%, which breaches our stop-loss limit. It's vital to have strong risk management controls when making investments which are blatantly contrarian to consensus and sentiment. USLS8's manager was, in our judgement, guilty of intellectual stubbornness in persevering for so long and in such size in his investments in US house-building stocks.

Following our fund research trip to Asia last month and after completing our final due diligence checks, we made an investment in JELS3 on 1st June. This is exactly the kind of fund we like to invest in. The fund itself is small (currently only about US\$20m in size) although its manager can draw on the resources and infrastructure of the much bigger JELS3 group, it has an excellent track record (+16% in 2008, +11% in 2009, +12% in 2010, +12% YTD in 2011) and it has never been marketed. We have been investing in hedge funds for almost 20 years but we still get a 'buzz' when we find a fund like this.

Charles Hovenden & Andrew Wheeler
21st June 2011

Results

Share Class	NAV	May 2011		Year-to-date	
		Fund (%)	FT World (%)*	Fund (%)	FT World (%)*
Class A - US\$	US\$123.13	(0.23)	(2.09)	+1.12	+6.89
Class B - £	£124.61	(0.19)	(0.79)	+1.28	+1.66

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

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Biggest 5 Holdings as at 31st May 2011

Name of Fund	Size %	Strategy	May (%)	Year-to-date (%)
USLS6	7.2	US Equity Long/Short	+3.6	+21.0
JELS2	6.9	Japanese Equity Long/Short	+0.4	+3.3
USLS2	6.8	US Equity Long/Short	+3.0	+4.4
EELS1	6.8	European Equity Long/Short	+0.5	+1.1
USLS9	6.3	US Equity Long/Short	(1.9)	+0.6

Best 3 Funds in May

Name of Fund (size)	Strategy	April %	YTD%
USLS6 (7.2%)	US Equity L/S	+3.6	+21.0
USLS2 (6.8%)	US Equity L/S	+3.0	+4.4
EELS2 (6.3%)	European Eq L/S	+1.4	+1.5

Worst 3 Funds in May

Name of Fund (size)	Strategy	April %	YTD%
EELS4 (6.0%)	European Eq L/S	(3.4)	(5.5)
USLS8 (3.0%)	US Equity L/S	(3.3)	(5.7)
USLS9 (6.3%)	US Equity L/S	(1.9)	+0.6

Full Track Record & Summary Statistics (Class B - £)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Year
2005									0.98	(0.05)	0.77	1.83	3.57
2006	2.13	(0.19)	0.94	0.99	0.25	(0.99)	(1.61)	0.88	0.32	(0.36)	0.30	1.86	4.55
2007	0.23	1.12	1.08	0.59	1.72	1.17	0.17	(0.11)	0.66	2.59	(0.87)	0.70	9.39
2008	(0.65)	0.76	(0.51)	0.54	0.57	0.93	0.27	0.19	(0.72)	(1.01)	1.12	0.24	1.72
2009	0.60	0.15	(0.69)	(0.99)	1.48	0.02	(1.18)	0.05	0.57	(0.12)	(0.15)	0.72	0.43
2010	0.00	0.03	0.47	0.28	(0.83)	(1.35)	0.68	(0.09)	0.75	0.59	0.66	0.49	1.67
2011	0.64	1.03	(0.05)	(0.15)	(0.19)								1.28
Annual Rate of Return	3.90		Sharpe Ratio (@ 3% risk free)		0.31		Biggest Monthly Loss		(1.61)				
Standard Deviation	2.86		Correlation FT World Index (Local)		0.27		Biggest Peak-to-Trough Drawdown		(2.58)				

Source: Absolute Fund Managers LLP

General Information

Description: Equity-focused fund of hedge funds
Firm AuM: US\$89.6m/£54.4m
No. of Holdings: 18
Share Classes: US\$, £ and Euro
Basic Fee: 0.50% p.a.
Incentive Fee: 15% of profits
High Water Mark: Yes
Dealing: Monthly (with 35 days notice for redemptions)
Min. Investment: US\$100,000
Fund Domicile: Cayman Islands
Listing: Irish Stock Exchange

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