

Share Class (Principal series)	NAV	January 2008			2008 Year to Date		
		Fund (%)	Cash (%)*	FT World†	Fund (%)	Cash (%)*	FT World†
Class A – US\$	US\$136.36	(0.55)	+0.42	(7.81)	(0.55)	+0.42	(7.81)
Class B - £	£146.88	(0.58)	+0.52	(7.68)	(0.58)	+0.52	(7.68)
Class C - €	€132.74	(0.70)	+0.40	(8.96)	(0.70)	+0.40	(8.96)

\*Citigroup 3-Month Eurodeposits – Source: Citigroup

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

### Staying Cautious

Going against the consensus and being contrarian has often been a highly successful investment strategy but is psychologically difficult to do. Who, for example, was bearish about financial markets in the early summer of last year when private equity funds were announcing ever larger takeover deals and investors seemed to have an inexhaustible appetite for corporate loans? Similarly, who was bullish at the beginning of 2003 when investors were still reeling from the spate of huge corporate bankruptcies and the FT World Share Index had plummeted by 48% in the preceding two and half years? There are no doubt those who believe that the recent falls in equity markets over the last few months are overdone and represent a buying opportunity because Central Banks will cut interest rates aggressively to stave off recession and boost liquidity, just as they did between 2000 and 2002. However, we remain unreservedly cautious in our investment outlook and strategy and fear that additional losses are in store for long-only and long-biased investors. In contrast, our truly hedged approach makes us optimistic about the opportunities and prospects for the Absolute Fund.

It may not be as glamorous as investing in equities but investors in corporate bond markets are widely regarded as better-informed and wiser. Although equity markets have rallied in response to interest rate cuts, spreads on corporate bonds (the difference between corporate and government bond yields) have continued to widen and this signifies that investors in bonds believe that more trouble lies ahead. Although banks and other investors have so far confessed to losses of approximately US\$120bn on structured, sub-prime mortgage investments, actual losses on such investments are expected to reach US\$400bn so we expect the drip-feed of disclosures to continue. Yet even this staggering sum could prove to be too low because the US housing market continues to deteriorate and many more mortgagors are likely to default as the ‘teaser’ rates on their loans expire. Of equal if not greater concern, weakening economies are likely to spread the contagion to other kinds of consumer debt such as credit card and car loans, to commercial property loans and to the corporate loans which have mushroomed in the private equity boom. The outlook for credit markets therefore remains bleak and high levels of investor leverage will only exacerbate the pain and losses which are yet to come. The meltdown will, of course, create fantastic bargains in both performing and distressed corporate debt but this is an opportunity for 2009 and 2010. For the time being, the Absolute Fund will remain ‘net short’ in its exposure to credit.

We are very pleased with the defensive changes we made to the Absolute Fund portfolio at the beginning of the year but, with the benefit of hindsight, we wish we had been even bolder. Further changes in the next few months will continue to emphasise our cautious outlook and we are focusing especially on equity long/short funds in the US and Europe whose managers have proven short-selling skills. Our pipeline of candidate funds in various stages of due diligence is busy and exciting and we are therefore confident that the Absolute Fund can continue to deliver attractive returns whatever the future holds.

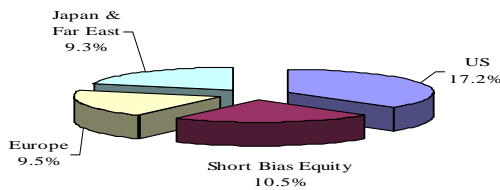
As always, we welcome your questions, comments and suggestions.

### Best 3 Funds in January

### Worst 3 Funds in January

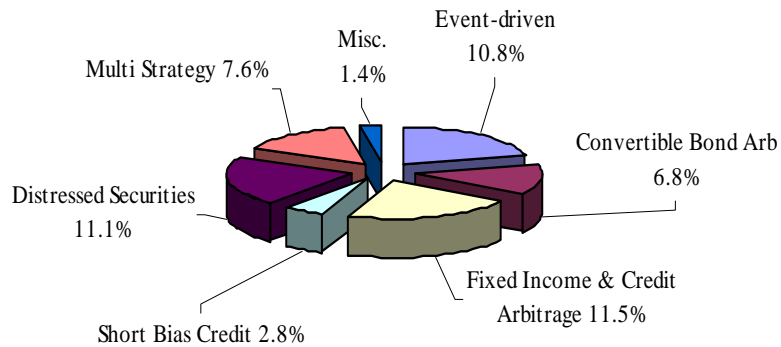
Name of Fund (Size)	Strategy	Jan	YTD	Name of Fund (Size)	Strategy	Jan	YTD
USELS(2.7%)	US Equity L/S	+8.0	+8.0	AEELS1 (1.4%)	Asian Equity L/S	(8.8)	( 8.8)
SBE1 (1.5%)	Short-bias Equity	+7.5	+7.5	ED1 (1.3%)	Event-driven	(7.6)	( 7.6)
SBE2(3.1%)	Short-bias Equity	+6.7	+6.7	USELS2 (1.4%)	US Equity L/S	(7.3)	(7.3)

**Equity Long/ Short (46.6%)**



Source: Absolute Fund Management

**Arbitrage & Other (51.9%)**



In denial since the sub-prime mortgage debacle began to unfold last summer, equity markets finally cracked in January as investors faced up to the certainty that the crisis would not be contained within esoteric corners of the credit markets, but will have a real and damaging impact on economies and corporate profits. The local currency FT World Share Index (down 8.5%) and the UK's FTSE 100 Index (down 9.1%) suffered their biggest falls since September 2002 and January 2003 respectively and many emerging equity markets fell by much more. It could have been even worse. At their low points for the month, the World and FTSE indices were each down by more than 12% before US Federal Reserve Chairman Bernanke intervened with the steepest interest rate cuts we can remember, prompting a fragile recovery in share prices.

We have mixed feelings about the performance of the Absolute Fund in January. On one hand, to be down only fractionally in such circumstances is reasonable achievement, especially when the HFR Fund of Hedge Funds Index, which is representative of peer group performance, was down by almost 3%. On the other hand, however, we have said many times before that we are not in the business of relative performance and so any month in which we lose money for investors is a disappointment to us. In mitigation, the sell-off was so severe and indiscriminate that prices of almost all financial assets became highly correlated, so depriving many of our managers of the opportunity to generate 'alpha', i.e. profit from stock-picking. Indeed, almost the only way to have made money in January was to have been significantly 'net short' in aggregate market exposure and a directional gamble such as this is not consistent with the Absolute Fund's investment strategy. Since its peak in October, the FT World Share Index has tumbled by 13%. Over the same period, the £ share class of the Absolute Fund has risen by 1%. This is admittedly a modest return over the last four months but it is a profit nonetheless and only increases the margin by which the Absolute Fund has outperformed stock markets (as well as bonds and cash) since the start of our track record in 1999.

Predictably, the short-bias and other defensive components of the Absolute Fund prospered in January and the addition at year-end of SBE2, another short equity fund, was certainly timely. Pride of place, however, belongs to USELS1, a San Francisco-based US equity long/short fund in which net market exposure remained close to zero throughout January. All three offenders in the Worst 3 Funds list were half-sized units of investment, commensurate with our assessment of a higher risk tariff, so their impact on overall performance was diluted. Despite this, we have concluded that the balance of risk and potential reward offered by ED1 and USELS2 is not acceptable and we are redeeming from both funds. A conference call with the managers of Hong Kong-based AELS1 in the next few days will decide that fund's fate.

**Charles Hovenden and Andrew Wheeler**

**22<sup>nd</sup> February 2008**



## 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
2008	(0.58)												(0.58)
<b>Annual Rate of Return</b>			7.66	<b>Sharpe Ratio (@ 5% risk free)</b>				1.12	<b>Biggest Monthly Loss</b>				(0.90)
<b>Standard Deviation</b>			2.38	<b>Correlation FT World Index (Local)</b>				0.39	<b>Biggest Peak-to-Trough Drawdown</b>				(2.02)

\* 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

**Size of Fund:** US\$103.5m

**No. of Holdings:** 40

**Share Classes:** US\$, £, €

**Basic Fee:** 1%

**Incentive Fee:** 15% of gains between 6% & 24% p.a.

**High Water Mark:** Yes

**Dealing:** Monthly (with 35 days notice for redemptions)

**Min. Investment:** US\$50,000

**Fund Domicile:** Cayman Islands

**Listing:** Channel Islands Stock Exchange (CISX)

**Investment Manager:** Absolute Fund Management Ltd.

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### Price Information

	<b>Bloomberg</b>	<b>SEDOL</b>	<b>ISIN</b>
<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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[www.absolutefund.co.uk](http://www.absolutefund.co.uk)

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