CAZENOVE
CAPITAL MANAGEMENT

Cazenove Absolute Return Fund Company

Cazenove UK Absolute Target Fund

Short report for the year ended 30 September 2010

Cazenove Absolute Return Fund Company

Cazenove Absolute Return Fund Company ("CARFCo" or "the Company") is an umbrella company comprising two sub-funds which have their own investment objectives and policies. Its investment and borrowing powers and restrictions are prescribed by the Financial Services Authority's ("FSA") Collective Investment Schemes Sourcebook ("COLL") and the Open-Ended Investment Companies Regulations 2001 (as amended) ("the OEIC Regulations").

This report relates to the Cazenove UK Absolute Target Fund ("the Fund") only.

Cazenove UK Absolute Target Fund

Authorised Corporate Director's ("ACD's") investment report

Investment objective and policy

The objective of the Cazenove UK Absolute Target Fund is to achieve absolute returns through targeted investment strategies independent of United Kingdom market conditions or indices.

The ACD will seek to achieve its investment objective by investing predominantly in companies incorporated in the United Kingdom or in companies which derive a significant proportion of their revenues or profits from this country or which are primarily operating in this jurisdiction. Investments will be made predominantly in the equities of large or mid-sized companies and other equity related transferable securities, such as preferred shares, debentures, warrants (not exceeding 5 per cent of the total assets of the Fund) and convertible securities or in derivatives thereof. This does not, however, preclude investment in a limited way in smaller companies. As the Fund has an absolute return objective it will not be managed against any index.

Whilst the Fund will mainly invest in equities, it may also invest in debt securities (such as bonds and notes of any maturity which are transferable securities), where this is deemed appropriate in the market conditions prevailing at that time. Any such securities will be rated investment grade by Moody's or S&P, or if not rated, deemed by the investment manager to have at least an equivalent rating and will be issued by the United Kingdom government or companies incorporated in the United Kingdom or in companies which derive a predominant proportion of their revenues or profits from this country or which are principally operating in that jurisdiction. The Fund may also invest in short-term securities which are rated investment grade (such as certificates of deposit, bankers' acceptances and commercial paper) for temporary defensive purposes.

The Fund will seek to achieve its investment objective and policy through the use of various investment strategies including the use of derivatives to obtain long and synthetic short positions principally through contracts for differences. The Fund may also use forward foreign exchange transactions, interest rate and government bond futures, and other exchange traded and off exchange traded derivative contracts for the purposes of efficient portfolio management and/or meeting the investment objectives of the Fund. Such derivative contracts have the potential to significantly increase the Fund's risk profile.

The ACD employs a risk management process that seeks to control the volatility of Fund returns.

The Fund may at any time have substantial holdings in ancillary liquid assets.

Performance

Over the year from 1 October 2009 to 30 September 2010 the Cazenove UK Absolute Target Fund fell by 8.3%, disappointingly reversing last year's gains. The FTSE All-Share Index, for comparison only, rose by 12.5%. Although the Fund's beta and correlation to the market remain low at 0.1x and 0.28x respectively, the Fund's relative volatility picked up with an absolute volatility of 7% compared with the market volatility of 17%.

Market review

The year under review continued the trends witnessed in 2009 with risk assets performing particularly strongly. In an equity market context that meant cyclical sectors outperforming (technology hardware +75%, paper +66%, electronics +60%, engineering +55%, chemicals +54% and autos +50%) whilst defensive sectors were more muted (life insurance +3%, electricity +4%, telecoms +4%, food producers +5%, food retail, pharmaceuticals and healthcare all up by 8%). Financial sectors which normally track the market direction performed poorly with banks falling 5%, held back by continuing capital and regulatory concerns as well as a more subdued outlook for top line growth.

When risk assets are in favour large capitalisation companies tend to underperform and the year under review was no exception with the FTSE 100 producing a return of 8.1% almost half of the FTSE 250's 15.2% return. BP's disaster in the Gulf of Mexico was responsible for 2% off the FTSE 100.

What drove the continued outperformance of cyclicals? The end of 2009 and first half of 2010 saw global growth stage a classic inventory led V shaped recovery and this fed through to strong upgrades for most industrial companies around the world. Having attacked cost bases in 2008 in fear of a sustained recession, the operational gearing of cyclical companies kicked in as the revenue line stabilised and recovered leading to strong profit growth. We asked the rhetorical question in our last annual report 'what happens when the stimulus stops and reverses' believing this would be a question for investors in 2010. Our concerns were demonstrably too early but it still remains a key question as policy is starting to be tightened in various areas of the world (interest rate increases in the East in response to rising inflation and tax increases/spending cuts in the West as some governments try to contain burgeoning deficits). Our argument has centred around a belief that consumer demand would not be strong enough to sustain the recovery in the face of rising tax rates/interest rates/inflation which were all going to constrain disposable income and that the global economy would suffer a double dip. The fact that the Federal Reserve, two years on from the crisis period, is still thinking about embarking on another round of quantitative easing should tell all of us that this remains a highly uncertain and dangerous time. Competitive devaluations are unlikely to work in our mind without risking protectionism and attempts at inflating away debts – if successful – will exacerbate the huge wealth divide which has grown substantially (East and West) over the last decade, risking huge social conflict. To square the circle the Western economies need wage growth but with unemployment remaining stubbornly high, wage growth is likely to continue to lag inflation, leading to a subdued demand picture.

Portfolio activity

We have run with an average 25% cash net long since January last year but reduced the cash net long in September to mid-teens net long, which because the beta of our long book is materially lower than that of our short book has left us beta net short of the market. We feel the market, particularly for risk assets, has run too far and with directors selling five times more than they are buying and with investor positioning broadly long risk, we hope our structure of long defensive assets and short cyclical assets will start delivering positive returns. The price earnings ratio ("p/e") of our long book at 11x is appreciably lower than the p/e of our short book at 16x and we very much doubt that cyclical shares will be able to repeat the degree of earnings upgrades they have had in 2010. Costs are rising and if demand dips, forecasts for next year will prove to be too high. We are obviously aware that the Federal Reserve still wants to keep its foot on the monetary accelerator and there is a risk that the current market trends continue but it is our view that further bursts in commodity inflation (particularly oil) are likely to be very demand deflationary. Investors only need to look at share prices of commodity stocks in 2008 to see how quickly profits can turn to dust when price momentum fades.

In terms of attribution for the year under review our long book added 12.7% to net asset value and our short book detracted 20.0%. The performance of our short book continued to be very disappointing. We wrote last time that we were reluctant to short defensive shares which we feel offer compelling long-term value but being short almost exclusively cyclical shares has been very damaging to performance. Two of our short positions were bid for during the year, Dimension Data and Tomkins which cost the Fund over 3%. Shorts in mining shares continue to be costly with our net positioning in mining impacting the net asset value by 3.7% and shorts in technology and chemical shares costing 2% and 1.4% respectively. On the positive side our position in Melrose, our key cyclical long, added 2.4% as they produced three profit upgrades through the year and Babcock International bid for VT added 0.8%. A short in Barratt Developments added 0.7% as the recovery in the housing market came to a halt.

Outlook

Whilst we do not dispute the possibility of a continuing Gadarene rush into cyclical assets as the Federal Reserve continues to print money, Chinese tightening could have a more important impact on the direction of risk assets particularly commodity related shares. We expect growth rates to be appreciably slower in 2011 than 2010 and continue to expect a reversal in market leadership. Liquidity driven booms nearly always end in tears and the continuing imbalances in the global economy leaves markets looking as exposed as they were in 2007 and 2008. Zero per cent interest rates are luring investors to take risks and the fact that the monetary authorities have not raised interest rates in the West from their emergency levels reached in 2008 (which they should have) suggests the economic edifice remains very precarious. If the authorities are too scared of the implications of 1-2% interest rates, this recovery is built on sand.

Fund facts

	Accounting date	Distribution payment date
Interim	31 March	31 May
Final	30 September	30 November

Performance record

	30.09.10 p	30.09.09 p	Share price % change*	Total return % change* (net of tax)
P1 GBP Accumulation	99.54	108.61	(8.35)	(8.35)
P2 GBP Accumulation	100.54	109.17	(7.91)	(7.91)

	30.09.10 ¢	30.09.09 ¢	Share price % change*	Total return % change* (net of tax)
P1 Euro Accumulation	95.46	105.06	(9.14)	(9.14)
P2 Euro Accumulation	95.12	103.90	(8.45)	(8.45)

* % change reflects net income reinvested.

Fund performance summary

Calendar year	Lowest price	Highest price	Distribution per share
2010*			
P1 GBP Accumulation	99.27p	107.47p	0.0466p
P1 Euro Accumulation***	95.32¢	103.51¢	0.0000¢
P2 GBP Accumulation	100.19p	108.32p	0.5529p
P2 Euro Accumulation	94.90¢	102.79¢	0.5370¢
2009			
P1 GBP Accumulation***	95.57p	109.08p	0.0000p
P1 Euro Accumulation***	92.60¢	105.51¢	0.0000¢
P2 GBP Accumulation***	95.52p	109.64p	0.0000p
P2 Euro Accumulation***	91.48¢	104.35¢	0.0000¢
2008**			
P1 GBP Accumulation	97.96p	106.38p	0.4127p
P1 Euro Accumulation***	100.00¢	103.10¢	0.0000¢
P2 GBP Accumulation	98.06p	106.57p	0.4711p
P2 Euro Accumulation***	98.31¢	101.69¢	0.0000¢

* To 30 September 2010.

** P1 GBP and P2 GBP Accumulation shares were first issued on 18 July 2008 at a price of 100p. P1 Euro and P2 Euro Accumulation shares were first issued on 17 November 2008 at a price of 100¢.

*** The share class did not pay a distribution during the year.

Total expense ratio

A total expense ratio ("TER") is shown which takes into account the management fee and all other operating expenses over the year and is expressed as a percentage of average daily assets over the same period (annualised).

	Excluding performance fee %	Including performance fee %
30 September 2010*		
P1 GBP Accumulation	1.40	1.40
P1 Euro Accumulation	1.62	1.62
P2 GBP Accumulation	0.90	0.90
P2 Euro Accumulation	0.91	0.91
30 September 2009		
P1 GBP Accumulation	1.43	3.21
P1 Euro Accumulation	2.05	3.36
P2 GBP Accumulation	0.93	2.95
P2 Euro Accumulation	0.98	3.17

* No performance fee was taken during the year.

Net asset value record

	Net asset value per share	
	30.09.10 p	30.09.09 p
P1 GBP Accumulation	99.84	108.84
P1 Euro Accumulation	82.16	95.63
P2 GBP Accumulation	100.85	109.40
P2 Euro Accumulation	81.85	94.71
	30.09.10	**30.09.09**
Total net asset value	£280,986,356	£357,297,139

Portfolio structure

Net position and leverage	Percentage of net assets	
	30.09.10 %	30.09.09 %
Long exposure	84.73	82.05
Short exposure	(71.43)	(55.54)
Net long exposure	13.30	26.51
Gross investment	156.16	137.59

Five largest long positions

As at 30.09.10	Percentage of net asset %
Babcock International	6.99
Melrose	5.74
GlaxoSmithKline	4.47
RSA Insurance	4.01
Howden Joinery	3.56

As at 30.09.09	Percentage of net assets %
Legal & General	3.87
Melrose	3.70
GlaxoSmithKline	3.58
RSA Insurance	3.07
Babcock International	2.86

Ten largest net sector positions (five net long, five net short)

As at 30.09.10	Long %	Short %	Gross %	Net %
	Percentage of net assets			
Media	8.04	-	8.04	8.04
Pharmaceuticals & Biotechnology	6.87	-	6.87	6.87
Tobacco	4.40	-	4.40	4.40
Nonlife Insurance	4.01	-	4.01	4.01
Food & Drug Retailers	4.52	(1.09)	5.61	3.43
Banks	-	(2.17)	2.17	(2.17)
Software & Computer Services	-	(2.32)	2.32	(2.32)
Chemicals	1.40	(4.50)	5.90	(3.10)
Beverages	-	(3.91)	3.91	(3.91)
Mining	-	(12.46)	12.46	(12.46)

As at 30.09.09	Long %	Short %	Gross %	Net %
	Percentage of net assets			
Life Insurance	8.15	(1.90)	10.05	6.25
Pharmaceuticals & Biotechnology	5.72	-	5.72	5.72
Travel & Leisure	8.96	(3.29)	12.25	5.67
Aerospace & Defence	4.05	-	4.05	4.05
Electricity	4.12	(0.36)	4.48	3.76
Beverages	0.69	(2.07)	2.76	(1.38)
General Industrials	0.82	(2.35)	3.17	(1.53)
Software & Computer Services	1.47	(3.38)	4.85	(1.91)
Chemicals	0.43	(3.03)	3.46	(2.60)
Mining	1.76	(9.52)	11.28	(7.76)

Risk factors

Equities

Funds investing in equities tend to be more volatile than funds investing in bonds, but also offer greater potential for growth. The value of the underlying investments in equity funds may fluctuate quite dramatically in response to activities and results of individual companies, as well as in connection with general market and economic conditions. The Cazenove UK Absolute Target Fund will invest primarily in equities or derivatives thereof.

Derivative instruments

The Fund may trade certain derivative instruments for hedging and for investment purposes, in both exchange-traded and over-the-counter ("OTC") markets. Such instruments may include forward foreign exchange contracts, futures, options, swaps, contracts for differences and repurchase and reverse repurchase agreements. The use of derivative and forward transactions for investment purposes involves special risks which may:

- significantly raise the risk profile of the Fund;
- increase the volatility of the Fund when taking additional market or securities exposure;
- depend on the ability of the ACD to predict movements in the prices of securities;
- place some reliance on the imperfect correlation between instruments and the underlying securities; and
- involve investing in instruments not traded on exchanges and not standardised, which in turn may involve negotiations on transactions on an individual basis.

The following generic risks are particularly relevant in terms of the use of derivatives and forward transactions in the Fund:

Position (market) risk: There is also a possibility that ongoing derivative transactions will be terminated unexpectedly as a result of events outside the control of the ACD, for instance, bankruptcy, supervening illegality or a change in the tax or accounting laws relative to those transactions at the time the agreement was originated. In accordance with standard industry practice, it is the Company's policy to net exposures against its counterparties.

Liquidity risk: Derivatives traded OTC may not be standardised and thus may involve negotiations on each contract on and individual basis. This may result in OTC contracts being less liquid than exchange traded derivatives.

Correlation risk: Derivatives do not always perfectly or even highly correlate or track the value of the securities, rates or indices they are designed to track. Consequently, the use of derivative techniques may not always be an effective means of, and sometimes could be counter-productive to, the Fund's investment objective. An adverse price movement in a derivative position may require cash payments of variation margin that might in turn require, if there is insufficient cash available in the portfolio, the sale of a Fund's investments under disadvantageous conditions.

Legal risk: There are legal risks involved in using derivatives which may result in loss due to the unexpected application of a law or regulation or because contracts are not legally enforceable or documented correctly.

Leveraged risk: Since many derivatives have a leverage component, adverse changes in the value or level of the underlying asset, rate or index can result in a loss substantially greater than the amount invested in the derivative itself. Certain derivatives have the potential for unlimited loss regardless of the size of the initial investment. If there is a default by the other party to any such transaction, there will be contractual remedies; however, exercising such contractual rights may involve delays or costs which could result in the value of the total assets of the related portfolio being less than if the transaction had not been entered.

Liabilities of the Company

Each Fund, under normal circumstances, is treated as a separate entity, with its own assets and liabilities. However, the Funds are not "ring-fenced" and, if the assets of any Fund are insufficient to meet the liabilities attributable to it, the excess liabilities may have to be met out of the assets of the other Funds. Shareholders are not liable for the debts of the Company. Shareholders are not liable to make any further payment to the Company after they have paid the purchase price of the shares.

The long version of this report is available on written request to the Marketing Department, Cazenove Investment Fund Management, 12 Moorgate, London, EC2R 6DA.

AUTHORISED CORPORATE DIRECTOR

Cazenove Investment Fund Management Limited

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The ACD is authorised and regulated by the Financial Services Authority

For more information

Please telephone the Business Development Department at Cazenove Investment Fund Management Limited, on 020 3479 1000, or access the website at **www.cazenovecapital.com**

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