

The Sri Lanka Fund

Annual Report

2007

Managed by Guardian Fund Management Limited, Colombo, Sri Lanka

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We, as the Managers to the Fund, have pleasure in reporting to unit-holders on the Fund's results for the year ended 31 December 2007.

REVIEW OF THE ECONOMY AND MARKET

Economy

The Sri Lankan economy has expanded at a slower rate of 6.8% for 2007, compared to a growth rate of 7.4% recorded in 2006. The economy has proved to be resilient and it is noteworthy to mention that Sri Lanka has moved on to a higher growth path above 6% per annum from the historical average of around 4%-5%.

The service sector made the highest contribution of 62% to overall growth whilst the Industry and Agriculture sectors contributed 32% and 6% respectively. The service sector accounts for 60% of GDP and grew 7.1% in 2007 compared to 7.7% in 2006. The slow down was evident due to contraction in the hotels & restaurants and import & domestic trade sub-categories. The services sector performance was boosted by export trading, port related services, banking and telecommunications. The Industry sector accounting for 28% of GDP included the high performing construction and power generation sub-sectors, but recorded an overall slow down to 7.6% in 2007 from 8.1% in 2006. The Agricultural sector which

accounts for 12% of GDP continued to under perform the other sectors and had moderate growth of 3.3% due to low volume growth despite the rise in commodity prices.

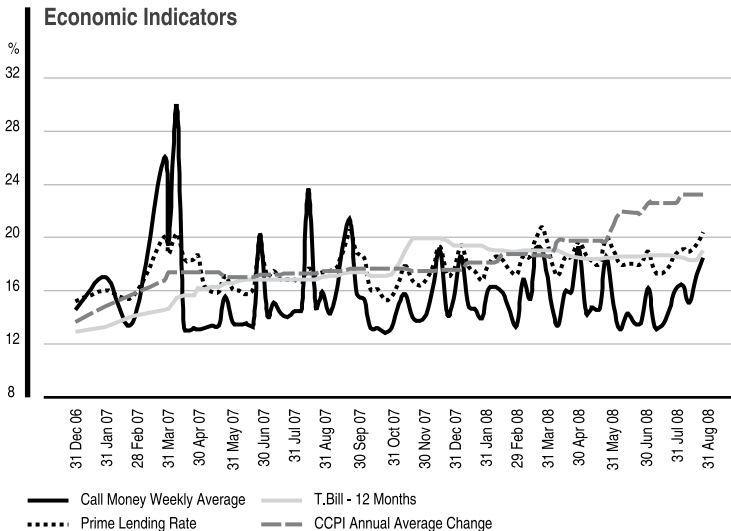
For the year 2007, exports grew by 12.5% amounting to US\$ 7,740 Million and imports grew by 10.2% amounting to US\$ 11,301 Million. This resulted in a trade deficit of US\$ 3,561 Million. Due to private remittances of US\$ 2,213 Million, the overall balance of payments remained in surplus. The savings investment gap, as a per cent of GDP, improved during 2007. However, the domestic savings investment gap of 10%, highlights the important role played by foreign capital and inflow of worker remittance in filling the required gap in investments in order to achieve desired economic growth levels. Remittances have become a strong foundation for the Sri Lankan economy, sustaining both its external position, as well as infusing greater spending power to the domestic economy.

Inflation became the greatest threat during the year. The Colombo Consumer Price Index (CCPI) measure of inflation increased 380 basis points to 17.5% end December 2007 from 13.7% end December 2006. Hence both individuals and corporates

faced spiralling cost increases thereby hitting bottom line profits. Increase in international oil prices, removal of fuel subsidies and sharp rise in other commodity prices in international markets led to upward adjustment in domestic prices contributing to domestic inflation; while inflationary financing to bridge budget deficits further added to the pressure.

The currency appreciated marginally by 0.9% during 2007, and interest rates moved up to 18%-20% levels during the year from lows of 13%-15%. Despite these hikes in interest rates, real interest rates remained negative or low, due to the unprecedented rates of inflation that

prevailed. To ease the pressure on rising interest rates capital account liberalisation measures were announced to encourage foreign investors to buy up to 10% of Government bonds with a maturity over 1 year. Also the Government issued dollar denominated bonds in the international markets to ease the pressure further. With the opening up of short-term Treasury Bill investments to foreign investors, we would expect interest rates to stabilise in the short term, although the currency would be more exposed to fluctuations as capital movements take place. Further, exchange control restrictions for migrating persons were lifted allowing US\$ 150,000 to be taken from the country.



The country's per capita income rose to US\$ 1,617 in 2007. This performance was achieved in a challenging environment amidst heightened security concerns in the North of the country and rising petroleum and commodity prices in the international markets. The higher growth in exports and a steady increase in worker remittances mitigated the impact of higher prices on imports. The balance of payments recorded a surplus of US\$ 531 Million, which raised the country's external reserves to a higher level and greater stability in the exchange rates. The country received the highest ever foreign direct investment (FDI) of US\$ 734 Million during the year which mitigated deficit financing along with foreign debt borrowings.

The security concerns in the country escalated in both 2007 and 2008. The clearing of the Eastern Province has enabled development activity in the area to commence, while local government elections were also recently concluded, installing a civil administration in the area.

Stock Market

During the year, the equity market posted negative returns after 6 years of continued growth, with the All Share Price Index down 6.7% and Milanka Price Index down 11.3%. The stock market started on a positive note beginning

of year with the ASPI & MPI reaching an all time high of 3016.4 and 4214.8 respectively in February, but thereafter downward trend set in and at the end of the year the All Share Price Index closed at 2540.9 and Milanka Price Index at 3291.9 which was down 15.8% and 21.9% respectively from the all time high.

The market capitalisation of the Colombo Stock Exchange decreased from Rs. 834.8 Billion to Rs. 820.7 Billion during the year. The market P/E from 14.0 times has come down to 11.6 times during the year, thus making Colombo one of the cheapest markets in the South Asian region on P/E multiples. With India trading at a P/E multiple of 26.9 times and Bangladesh 23.5 times as at 31 December 2007; the CSE offers more upside potential for overseas investors seeking South Asian Exposures.

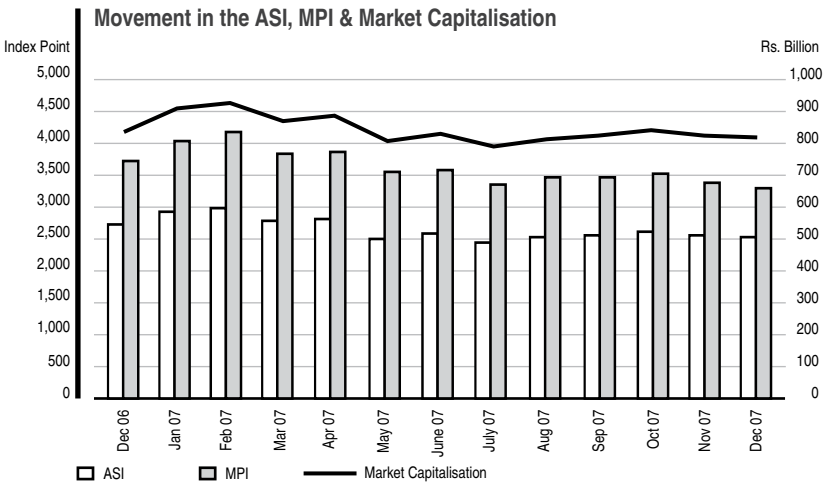
The sectors that performed during the year were the Plantation sector which recorded the largest annual gain of 68.7%, Construction and Engineering sector 56.6% and Healthcare sector by 17.2%. The market rally in the plantation stocks were mainly due to high rubber prices and greater demand for high/low grown teas. The Telecommunication sector which has been the impetus of growth in the past slowed down due to stiff competition and profit

margins have got affected. The sector which accounts for 29% of the market capitalisation has under-performed (-15.8%) the ASPI. The Healthcare sector was active and up 17.5% during the year given acquisitions and consolidation in the sector.

The rise in interest rates during the second half of 2007, put a dampener to the Colombo Stock Exchange due to most investors shifting from equity to fixed income investments, prompting a sell off in the market. Given the high cost of financing due to rising interest rates, margin facilities to clients were curtailed and portfolios were shed in keeping with stringent rules of the

regulators. Hence, turnover volumes at the CSE dwindled.

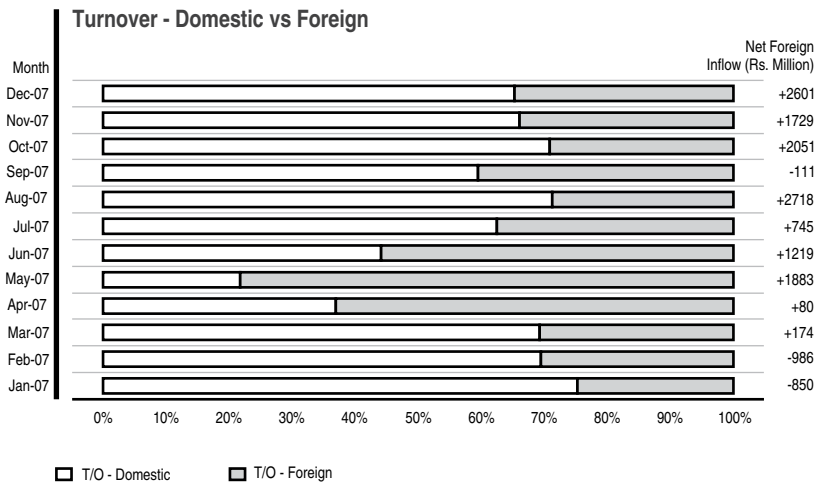
As would be expected in a market downturn, acquisitions by strategic investors replaced the more active trading environment that is created by conventional institutional and retail investors in a growth phase. These deals kept the market alive during a period of relative stagnation, and offered investors on the sidelines an opportunity for quick gains. A sum of Rs. 44.6 Billion (approximately US\$ 446 Million) was raised through the stock market through Initial Public Offerings and Rights Issues during the year. Dividend yield of the market marginally improved to 2.5% from 2.2% recorded in year 2006.

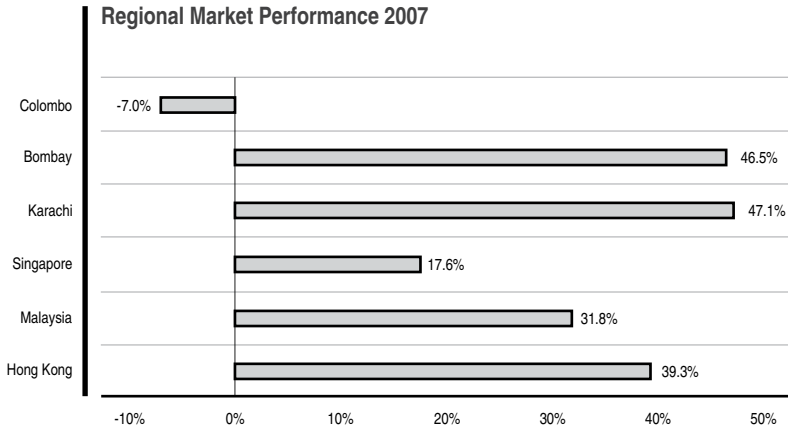


Local investors continued their dominance at the Colombo Bourse with local participation being in the region of 60%-69% during the year. Foreign interest on selected high quality blue-chips continued, adding a further boost to the market, with attention being focused on the conglomerates, telecom and banking sectors. Foreigners remained net purchasers in 2007 with net foreign inflows of Rs. 8.7 Billion. However, the CSE remains relatively shielded from the upheavals in foreign markets since it is less exposed to conventional foreign funds that respond to short-term market movements.

In comparison to regional markets the Colombo Bourse has posted negative returns in comparison to other regional markets in 2007.

The global economy has recorded a 3.6% growth in year 2007 from 3.9% recorded in year 2006, a marginal decline. The global economy has been in turmoil with the US sub-prime crisis, credit melt down and high commodity prices. However, the equity markets in Asia have been shielded as highlighted above, in 2007 although these positions have now drastically reversed.



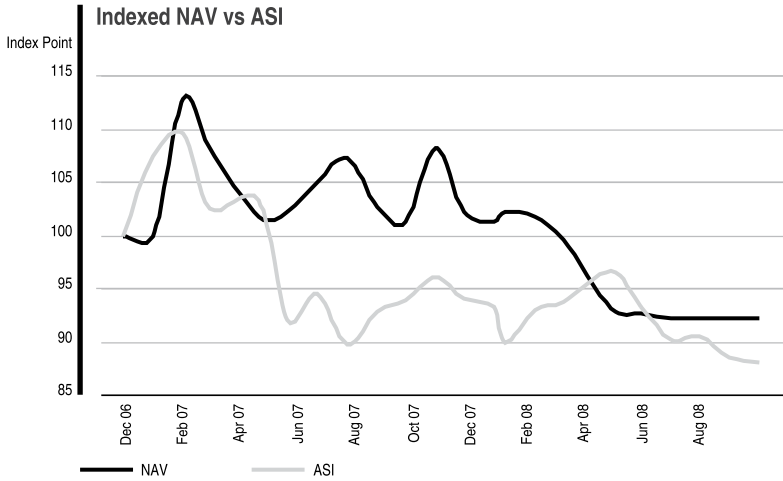
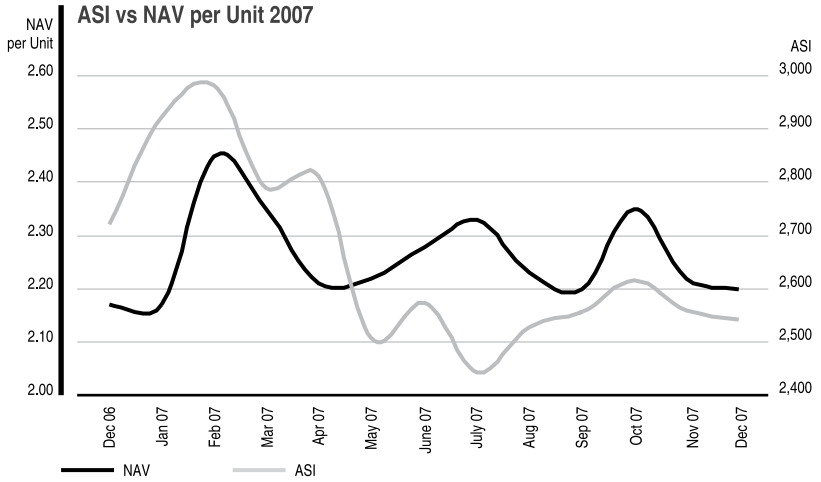


Unfortunately, the worsening of the country situation saw the market drop almost 12.3% in the first seven months of 2007. Investor participation has since subsided to marginal levels, although serious investors continue to see this as an opportunity to accumulate fundamentally strong stocks on the Colombo Bourse which yet offer excellent value. Another reason for the withdrawal of retail activity is the high interest rate regime which now prevails, offering an opportunity for small investors to improve yields in the short term. During the year a new Companies Act was passed by Parliament and this is expected to further facilitate commerce and improve the governance and transparency of companies. New rules

on corporate governance for listed companies are also expected to come on stream shortly.

PERFORMANCE OF THE FUND

The total value of The Sri Lanka Fund inclusive of cash & cash equivalents amounted to US\$ 976,982 as at 31 December 2007 down from US\$ 1,111,847 as at 31 December 2006, a decline of 12%. The net asset value per unit too saw a marginal increase of 1.38% from US\$ 2.17 in end 2006 to US\$ 2.20 in end of 2007. The performance in the local currency - Rupee has been a depreciation of 0.73% for the calendar year with a negative market growth of 6.7% for the year.



Redemptions during the year under review totalled US\$ 228,997, whilst the figure recorded last year was US\$ 76,380. Inflows of funds via creation of units amounted to US\$ 97,559 during the year. The fund recorded a net outflow of US\$ 131,438 for the period of review.

Total participating shares in issue as at end of December 2007 was 444,058.

Also exposure to John Keells Holding and Distilleries Company of Sri Lanka Limited, both being a proxy to the Sri Lankan economy was divested during the period of review. The fund for the first time invested in a Government Bond given the attractive rates prevalent taking into consideration the return to commensurate the risk.

Key Investments of the Portfolio as at 31 December 2007	Value of the Holding US\$	% of Net Assets
The Laxey Investment Trust	912,036	91.6
John Keells Holdings	47,816	4.8
Distilleries Company of Sri Lanka	61,229	6.2
Sri Lanka Telecom	37,107	3.7
Asian Hotels & Properties	18,619	1.9
Dialog Telekom	14,414	1.4

One of our key investments, The Laxey Investment Trust has shown an improvement in performance over the last year, with its listed price moving in US\$ equivalent from 1.35 to 1.51. We continued to hold this investment, in the absence of a ready market for its shares and would attempt to divest this investment in the course of 2008 to bring in more liquidity to the Fund.

As far as our investments in the Colombo Bourse are concerned, we were on the selling side by divesting our holdings in the two telecommunication companies Dialog & Sri Lanka Telecom.

Future Outlook

We expect the CSE to be very much event driven in the coming year with the pursuit of strategic holdings in identified companies by interested parties, implementation of new regulations governing the banking and insurance sectors, anticipated new listings in the market and the entry into new business segments by the top companies. Such interest will drive investor interest in selected stocks. However, the general sentiment towards equity is likely to be negative due to other investment opportunities posing better returns in the current context.

Corporate earnings will weaken as margins in most industries tighten as a result of cost push inflation, higher cost of funding and slower growth in consumer demand. In the absence of a positive outlook either in the country situation or the economy, it is likely that the capital market in general terms would remain relatively quiet during the current year.

Conventional foreign portfolio investments to emerging markets like the Colombo Bourse is likely to be curtailed given turmoil in overseas financial markets with the US sub-prime

mortgage crisis, curtailment of credit and deteriorating economic fundamentals, spreading to other markets as well. Nevertheless, we expect investors with a greater risk appetite to look at our valuations favourably. Additionally, foreign investors would now have a choice between fixed income instruments (both Treasury Bills and Bonds) and equity; as well as factor in a possible currency depreciation when making their investment decision. Colombo proved more resilient to the financial crisis and during the first 10 months of 2008 the CSE's performance against regional markets are highlighted below:

Index	Market	Performance for 2008 (Jan. to 15 Oct.)
All Share Index	Colombo	-20.21%
Dow Jones Industrial	New York	-35.33%
FTSE 100	London	-36.82%
Hang Seng	Hong Kong	-42.48%
Nikkei 225	Tokyo	-37.63%
ST Times	Singapore	-40.86%
Sensex	Bombay	-46.72%

Global inflationary pressures with the rise of crude oil per barrel above US\$ 120 and rising commodity prices attributing to cost push inflationary pressures is likely to drive inflation globally, and have an impact on market sentiments and corporate earnings. Write down of banking sector assets and curtailment of credit in the US is likely to drive the US economy to a recession; but the general anticipation is that Asian economies driven by the consumption expenditure boom will sustain themselves. Despite the global turmoil, the impact on the Colombo Bourse is likely to be minimal as our market is mainly locally driven; and Colombo is also likely to look more towards Asia to gather inflows to its equity market.

In the backdrop of high interest rates and an inflationary environment, retail investors are likely to stay out of the market and switch to high yielding fixed income investments. Institutional investors will selectively stock pick based more on strategic deals than on fundamentals. This would add colour to the market with interest by both foreign and local investors on a bottom up basis of stock picking. Thus growth sector stocks and asset rich under exploited companies will be targeted for acquisition by long-term investors.

Foreign investors with an understanding of the local market dynamics have

continued to hold their positions in the Colombo Bourse. We foresee the re-entry of foreign investors on a selective basis on under valued blue-chips yielding good dividend. Similarly, the Sri Lanka Fund too will look to build positions in good companies when opportunities arise. Our outlook being that of a medium to long-term oriented growth fund, we are likely to select stocks in the high growth sectors of the economy that have strong business models, are well managed and score high on transparency and governance. We will also aggressively look to switch between asset classes to maximise returns to shareholders.

Furthermore, with a view to enhancing the visibility and presence of The Sri Lanka Fund to global investors, we are actively exploring the setting up of new marketing channels for this Fund.

To ease the pressure on rising interest rates capital account liberalisation measures were announced to encourage foreign investors to buy up to 10% of Government Bonds with a maturity over 1 year. Also the Government issued Dollar denominated bonds in the international markets to ease the pressure further.

Update on 2008

The stock market started on a positive note at the beginning of the financial year. However, the downward trend set

in following the global crisis and the All Share Index declined 28% as at end October. The market capitalisation of the Colombo Stock Exchange decreased from Rs. 820.7 Billion to Rs. 594.3 Billion during the year. The market P/E from 11.6 times has come down to 6.6 times during the period of review.

A market rally was seen in plantation stocks given record high rubber prices, and plantations with high exposure to Rubber sector were very much sought after. The Telecommunication sector has been the impetus of growth in the past; however, given stiff competition profit margins have got affected and performance has declined. The sector accounts for 29% of the market capitalisation which under-performed the ASI during the current year. The largest transaction ever recorded on the CSE amounting to Rs. 32 Billion was witnessed on 1st of April, Sri Lanka Telecom, with the sale of a strategic stake held by NTT of Japan to Global Telecom Holdings of Netherlands (GTH) a related company of the Maxis Group in Malaysia. One off strategic deals have propped market turnover with the movement of a strategic stake in Hayleys and the purchase of a controlling stake in AMW Motor

Company. Total foreign inflow for the calendar year 2008 to end September is Rs. 14,520 Million.

The hype was short lived with the market heading south thereafter, due to heightened security threats and deteriorating economic fundamentals.

Despite the considerable loss of value we do not see a major cause for concern as the key listed companies of the Colombo Stock Exchange have the potential to record enhanced corporate performances, given the diversity of their business exposures to the growth sectors of the Sri Lankan, and increasingly, the regional economies such as Maldives and India.

We are of the view that the Colombo Bourse will continue to offer value to investors in the medium to long term, despite temporary drawbacks and will look to accumulate stocks in identified sectors like banking, retail, healthcare and infrastructure when opportunities arise. The possibility of investing in Government securities will also be explored, given the high yields presently available, since foreign investors are now permitted to invest in fixed income instruments such as Treasury Bonds/Bills.

The Directors hereby submit their annual report together with the audited financial statements of The Sri Lanka Fund (the Fund) for the year ended 31 December 2007.

THE COMPANY

The Company is an open-ended investment company, incorporated as an exempt company in the Cayman Islands with limited liability. The Sri Lanka Fund was launched via a prospectus and currently the Fund represents the class A shares of the Company. The articles of the Company permits the creation of new classes of shares to accommodate subordinated funds, though no such subordinated funds have been created as at 31 December 2007.

The Fund's investment objective is to achieve long-term capital growth by investing in a diversified portfolio of equity securities including convertible bonds and warrants listed on the Colombo Stock Exchange and those issued outside Sri Lanka by any Corporation organised in and under the laws of Sri Lanka and which has its shares listed on the Colombo Stock Exchange and equity securities issued

by listed investment companies and funds, wherever established, which invest primarily in equity issued by Sri Lankan companies listed on the Colombo Stock Exchange.

RESULTS AND DIVIDENDS

The results of the Fund for the year ended 31 December 2007 are set out on pages 15 to 31 of the Annual Report. The Directors do not recommend the payment of a dividend for the year ended 31 December 2007.

SHARE CAPITAL

The details of changes in the issued share capital including subscriptions and redemptions of shares for cash during the year are set out in the statement of changes in ownership equity and Note 3 to the financial statements.

DIRECTORS

The Directors during the year and up to the date of this report were:

- Don Chandima Rajakaruna
Gunawardena
- Palehenalage Chandana Priyankara
Tissera
- Adrian John Reginald Collins

DIRECTORS' AND OTHER INTERESTS

Don Chandima Rajakaruna Gunawardena and Palehenalage Chandana Priyankara Tissera are Directors of Guardian Fund Management Limited, the Investment Manager of the Fund and Carsons Management Services (Private) Limited the Fund's Administrator.

Apart from the above, as at 31 December 2007, none of the Directors had any interest in the share capital of the Company or any interest in any material contracts or contracts for the provision of services during the year significant to the business of the Company.

All Directors are entitled to an annual fee. However, Don Chandima Rajakaruna Gunawardena and Palehenalage Chandana Priyankara Tissera have waived their Directors' fee for the year.

AUDITORS

KPMG, retire and being eligible, offer themselves for reappointment.

A resolution for the reappointment of KPMG as Auditors of the Company is to be proposed at the forthcoming Annual General Meeting.

By order of the Board

Director

23 September 2008

Report of the Independent Auditors



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INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the accompanying financial statements of The Sri Lanka Fund ('the Fund'), which comprise the balance sheet as at 31 December 2007, and the income statement, statement of changes in net assets attributable to holders of participating shares and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Fund as at 31 December 2007, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

23 September 2008

Income Statement

For the year ended 31 December

	Note	2007 US\$	2006 US\$
Income			
Bank interest income		678	359
Dividend income		4,469	5,350
Realised gain/(loss) on sale of investments		136,557	(9,992)
(Loss)/gain on remeasurement of investments		(54,963)	261,609
Foreign exchange losses on investments		(7,760)	(65,021)
Other income		–	2,439
Net investment income		78,981	194,744
Expenses			
Investment Manager's fee	6	(16,510)	(14,811)
Custodian's fee	6	(20,000)	(20,000)
Administrator's fee	6	(2,062)	(2,087)
Legal & professional fees		(7,679)	(10,155)
Auditors' remuneration		(10,750)	(9,500)
Directors' remuneration	6	(5,000)	(5,000)
Sundry expenses		(6,171)	(11,809)
Operating expenses		(68,172)	(73,362)
Change in net assets attributable to holders of participating shares resulting from operations		10,809	121,382

The accompanying notes form an integral part of these financial statements.

Balance Sheet

<i>As at 31 December</i>	Note	2007 US\$	2006 US\$
Assets			
Cash & cash equivalents		1,045	2,146
Equity investments	2, 7	1,091,223	1,180,200
Total assets		1,092,268	1,182,346
Liabilities			
Accruals & other payables		(95,089)	(64,538)
Total liabilities (excluding net assets attributable to holders of participating shares)		(95,089)	(64,538)
Net assets attributable to holders of participating shares		997,179	1,117,808
Represented By:			
Net assets attributable to holders of participating shares	3,4	997,179	1,117,808
		997,179	1,117,808
Net asset value per share, based on 444,058 (2006 - 502,366) shares outstanding	3,4	2.25	2.23

The accompanying notes form an integral part of these financial statements.

The financial statements were approved and authorised for issue by the Board of Directors and are signed on their behalf.

(Sgd.)
D. C. R. Gunawardena
Director

(Sgd.)
P. C. P. Tissera
Director

23 September 2008

Cash Flow Statement

For the year ended 31 December

	2007 US\$	2006 US\$
Operating Activities		
Dividend received	4,469	5,350
Interest received	678	359
Operating expenses paid	(37,621)	(77,049)
Cash flows from operating activities	(32,474)	(71,340)
Investing Activities		
Proceeds on sale of investments	235,372	143,187
Payments for purchase of investments	(72,561)	(91,071)
Cash flows from investing activities	162,811	52,116
Financing Activities		
Payment for redemption of participating shares	(228,997)	(76,380)
Proceeds from issue of participating shares	97,559	97,561
Cash flows from financing activities	(131,438)	21,181
Net increase/(decrease) in cash & cash equivalents	(1,101)	1,957
Cash & cash equivalents as at 1 January	2,146	189
Cash & cash equivalents as at 31 December	1,045	2,146

The accompanying notes form an integral part of these financial statements.

Statement of Changes in Net Assets Attributable to Holders of Participating Shares

For the year ended 31 December

	2007 US\$	2006 US\$
Balance as at 1 January	1,117,808	975,245
Change in net assets attributable to holders of participating shares resulting from operations for the year	10,809	121,382
Redemption of participating shares during the year	(228,997)	(76,380)
Issue of participating shares during the year	97,559	97,561
Balance as at 31 December	997,179	1,117,808

The accompanying notes form an integral part of these financial statements.

1. SIGNIFICANT ACCOUNTING POLICIES

The Sri Lanka Fund ('the Fund') is an open-ended investment fund incorporated as an exempt company under the Companies Law (Revised) of the Cayman Islands on 21 October 1993 and registered under the Mutual Funds Law on the 26 July 1994.

The objective of the Fund is to provide shareholders with above average returns over the medium to long-term through both capital growth and income. The Fund aims to deliver this objective mainly by investing in highly diversified portfolios of equity securities including convertible bonds and warrants listed on the Colombo Stock Exchange and those issued outside Sri Lanka by any corporation organised in and under the laws of Sri Lanka and which has its shares listed on the Colombo Stock Exchange, and equity securities issued by listed investment companies and funds, wherever established, which invest primarily in equity issued by Sri Lankan companies listed on the Colombo Stock Exchange. In doing so, it applies techniques more fully defined in the Fund's Offering Memorandum.

The investment activities of the Fund are managed by Guardian Fund Management Limited ('the Investment Manager') and the administration of the Fund is delegated to Carsons Management Services (Private) Limited ('the Administrator'). The registered office of the Fund is located at P.O. Box 309, Uglund House, Grand Cayman KY1-1104, Cayman Islands.

(a) Statement of Compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) and interpretations adopted by the International Accounting Standards Board (IASB).

(b) Basis of Preparation

The financial statements are presented in United States Dollars and not the local currency of the Cayman Islands reflecting the fact the shares of the Fund are issued and redeemed in United States Dollars. They are prepared on a fair value basis for the financial assets and financial liabilities at fair value through profit or loss. Other financial assets and liabilities are stated at amortised cost or redemption amount (redeemable shares).

The preparation of the financial statements in conformity with IFRSs requires management to make judgments, estimates and assumptions that affect the applications of policies and the reported amounts of the assets and liabilities, income and expense. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgments about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revision to accounting estimates are recognised in the period in which the estimates is revised if the revision affect only that period, or in the period of the revision and the future period if the revision affect both current and future periods.

The accounting policies have been applied consistently by the Fund and are consistent with those used in the prior year.

(c) Foreign Currencies Translation

Transactions in foreign currencies are translated at the foreign currency exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated to United State Dollars at the foreign currency closing exchange rate ruling at the Balance Sheet date. Foreign currency exchange differences arising on translation and realised gains and losses on disposal or settlement of monetary assets and liabilities are recognised in the Income Statement. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated to United States Dollars at the foreign currency exchange rates ruling at the dates that the values were determined. Foreign currency exchange differences relating to investments at fair value though profit or loss are presented separately.

(d) Financial Instruments

(i) Classification

The Fund designates all its equity investments into the financial assets at the fair value through profit or loss category.

Financial instruments are designated at fair value through profit or loss upon initial recognition. These include equity securities listed on the Colombo Stock Exchange and those issued outside Sri Lanka by any corporation organised in and under the laws of Sri Lanka and which has its shares listed on the Colombo Stock Exchange, and equity securities issued by listed investment companies and funds, wherever established, which invest primarily in equity issued by Sri Lankan companies listed on the Colombo Stock Exchange.

Financial liabilities that are not at fair value through profit or loss include accounts payable and financial liabilities arising on redeemable shares.

(ii) Recognition

The Fund recognises financial assets and financial liabilities on the date it becomes a party to the contractual provisions of the instruments.

A regular way purchase of financial assets is recognised using trade accounting. From this date any gains and losses arising from changes in fair value of the financial assets or financial liabilities are recorded.

(iii) Measurement

Financial instruments are measured initially at fair value (transaction price) plus, in case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Transaction costs on financial assets and financial liabilities at the fair value through profit or loss are expensed immediately, while on other financial instruments they are amortised.

Subsequent to the initial recognition, all instruments classified at the fair value through profit or loss, are measured at the fair value with changes in their fair value recognised in the Income Statement.

Financial liabilities, other than those at fair value through profit or loss, are measured at amortised cost using the effective interest rate. Financial liabilities arising from the redeemable shares issued by the Fund are carried at the redemption amount representing the investor's right to a residual interest in the Fund's assets.

(iv) Fair Value Measurement Principles

The fair value of financial instruments is based on their quoted market prices at the Balance Sheet date without any deduction for estimate future selling cost. Financial assets are priced at the current bid prices.

If a quoted market prices is not available on a recognised stock exchange or from a broker/dealer for non-exchange traded financial instruments, the fair value of the instrument is estimated using valuation techniques, including use of recent arm's length market transaction, reference to the current fair value of another instrument which is substantially the same, discounted cash flow techniques that provides a reliable estimate of prices obtained in actual market transactions.

(v) Impairment

Financial assets that are stated at cost or amortised cost are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such indication exists, an impairment loss is recognised in the Income Statement as the difference between the assets carrying amount and the present value of estimated future cash flows discounted at the financial assets original effective interest rate.

If in a subsequent period the amount of impairment loss recognised on a financial asset carried at amortised cost decreases and the decrease can be linked objectively to an event occurring after the write down, the write down is reversed through the Income Statement.

(vi) Derecognition

The Fund derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire or it transfers the financial asset and the transfer qualifies for derecognition in accordance with IAS 39.

The Fund uses weighted average method to determine realised gains and losses on derecognition.

A financial liability is derecognised when the obligation specified in the contract is discharged, cancelled or expired.

(vii) Specific Instruments

Cash & Cash Equivalents

Cash comprises current deposits with banks. Cash equivalents are short-term highly liquid investments that are readily convertible to known amount of cash, are subject to an insignificant risk of changes in value, and are held for the purpose of meeting short-term cash commitments rather than for investments or other purposes.

(e) Interest Income

Interest income and expenses is recognised in the Income Statement as it accrues, using the original effective interest rate of the instruments calculated at the acquisition or origination date.

(f) Dividend Income

Dividend income relating to exchange-traded equity investments is recognised in the Income Statement on the ex-dividend date.

In some cases, the Fund may receive or choose to receive dividends in the form of additional shares than cash. In such cases the Fund recognises the dividend income for the amount of the cash dividend alternative with the corresponding debit treated as an additional investment.

(g) Expenses

All expenses, including management fee and custodian fees, are recognised in the Income Statement on an accrual basis.

Included in sundry expenses are registers fees paid by the Fund, safe custody and bank charges and printing and advertising.

(h) Foreign Exchange Gains and Losses

Foreign exchange gains and losses on financial assets and financial liabilities at fair value through profit or loss are recognised together with other changes in the fair value.

(i) Taxation

Under the current system of taxation in Cayman Islands the Fund is exempt from paying taxes on income, profits or capital gains. The Fund has received an undertaking from Governor in Cabinet of the Cayman Islands authorities exempting it from income tax for a period of 20 years.

Dividend and interest income received by the Fund may be subject to withholding tax imposed in the country of origin.

(j) Participating Shares

All participating shares issued by the Fund provide the investors with the right to require redemption for cash at the value proportionate to the investor's share in the Fund's net assets at the redemption date. In accordance with IAS 32 such instruments give rise to a financial liability for a present value of redemption amount.

2. INVESTMENTS*For the year ended 31 December*

	2007 US\$	2006 US\$
Cost:		
Balance at the beginning of the year	1,586,856	1,713,985
Additions during the year	72,561	91,071
Disposals during the year	(106,575)	(218,200)
Balance at the end of the year	1,552,842	1,586,856
Unrealised depreciation in value	(461,619)	(406,656)
Fair value (Note 7)	1,091,223	1,180,200

3. SHARE CAPITAL

	2007		2006	
	Number of Shares	Amount US\$	Number of Shares	Amount US\$
Authorised				
Founder shares of US\$ 1 each	100	100	100	100
Participating shares of US\$ 0.01 each	89,990,000	899,900	89,990,000	899,900
	89,990,100	900,000	89,990,100	900,000
Issued and fully paid				
Founder shares of US\$ 1 each	100	100	100	100
Participating shares of US\$ 0.01 each				
Balance at the beginning of the year	502,366	5,024	492,554	4,925
Issued during the year	41,692	417	53,312	534
Redeemed during the year	(100,000)	(1,000)	(43,500)	(435)
Balance at the end of the year	444,058	4,441	502,366	5,024
Total		4,541		5,124

Founder Shares

Founder shares confer upon the holders thereof rights in a winding up or repayment of capital in accordance with the Articles of Association of the Fund but confer no other rights to participate in the profits or assets of the Fund. The holder of a founder share has no right to receive notice of or to attend and vote as a shareholder of the Fund at any General Meeting of the Fund. The issued founder shares are held by the Investment Manager.

Participating Shares

Participating shares may be redeemed on the first and third Tuesday of the month or such other dates as the Board of Directors shall from time to time determine (Valuation Day) at Net Asset Value per Share based on mid-market prices. The shareholder must request such redemption at least 14 days prior to the last business day of each month or such other day as the Directors may determine.

Participating shares have the right to receive notice of or to attend and vote as a shareholder of the Fund at any General Meeting of the Fund. Participating shares confer upon the holders of their right of a winding up or repayment of capital in accordance with the Articles of Association of the Fund. They also have the right to share in all profits or assets of the Fund in excess of the value of the issued share capital of the founder shares. The Fund does not have any externally imposed capital requirements.

4. NET ASSET VALUE PER ORDINARY SHARE

The calculation of Net Asset Value per participating share is based on the Net Asset Value attributable to participating shareholders of US\$ 995,887 (2006 - US\$ 1,117,808) and on the total number of 444,058 (2006 - 502,366) participating shares in issue at the Balance Sheet date.

5. FINANCIAL INSTRUMENTS AND ASSOCIATED RISKS

Financial assets of the Fund include cash and marketable securities. Financial liabilities include accruals and other payables.

(a) Market Risk

The Fund's investment activities expose it to various types of market risk, which are associated with the markets in which it invests, to the extent of the amount invested in equity securities. The Fund invests in securities listed on the Colombo Stock Exchange and those issued outside Sri Lanka by any corporation organised in and under the laws of Sri Lanka, and equity securities issued by listed investment companies and funds, wherever established, which invest primarily in equity issued by Sri Lankan companies listed on the Colombo Stock Exchange, which may experience greater volatility than those of Western companies.

(b) Foreign Exchange Risk

The Fund is exposed to foreign exchange risk from its investments and receivables and payables denominated in currencies other than United States Dollars, to the extent of the amount invested for investments, receivables and payables.

The Fund's total net exposure to fluctuations in foreign currency exchange rates at the Balance Sheet date was as follows:

All amounts are stated in US\$

	Fair Value 2007	Fair Value 2006
ASSETS		
Investments		
Sri Lankan Rupee	179,187	365,251
Sterling Pound	912,036	814,949
	1,091,223	1,180,200
Cash & cash Equivalents		
Hong Kong Dollar	13	553
Sterling Pound	85	30
Sri Lankan Rupee	1	-
	99	583

(c) Interest Rate Risk

The majority of the Fund's financial assets are non-interest bearing. Interest bearing financial assets mainly bank deposits mature or reprice in the short term, no longer than twelve months. As a result, the Fund is not subject to significant interest rate fluctuations.

(d) Credit Risk

Financial assets which potentially expose the Fund to credit risk consist principally of marketable securities and cash balances. Investments in Sri Lanka expose the Fund to risk of illiquidity and volatility. The extent of the Fund's exposure to risk in respect of these financial assets approximates to their carrying value as recorded in the Fund's balance sheet. The Fund limits its exposure to credit risk by transacting the majority of its securities and contractual commitment activity with broker dealers, banks and regulated exchanges with high credit ratings that the Fund considers to be well established.

(e) Fair Values of Financial Instruments

Investment securities are carried at market values unless the directors have determined that a discount is required to arrive at fair value. The Fund's other assets and liabilities include cash & cash equivalents and amounts due on open transactions which normally settle within a few days and other receivables which are realised or settled within a short period of time. The carrying values of these other assets and liabilities approximate their fair values.

(f) Price Risk

The Fund's investment portfolio exposes it to the Price Risk, which is associated with the relevant markets in which the Fund has made its investments. The Fund is in possession of investments which are listed in the Colombo Stock Exchange as well as the London Stock Exchange, from which, based on the market value available for each security, the respective investments are being reflected at fair value. Thus the fluctuation in the fair value in the securities reflected in the Fund's Investment portfolio are caused by factors affecting similar securities traded in each market, such as interest rates, exchange rates, taxation, inflation etc.

(g) Liquidity Risk

The financial position of the Fund reflects its ability to meet its accrued expenses and accounts payable due to the availability of the investments made by the Fund in listed securities which are readily realisable since they are being traded in active markets.

(h) Sensitivity Analysis

Based on Exchange Rate

Since the Fund's investments were not made in domestic currency the returns on the investment depends on the fluctuation of the exchange rate at the time they are traded in the market. As at 31 December 2007, if the US\$ appreciates by 5%, in relation to the LKR, then the fair value of the portfolio would decline by US\$ 8,959 (2006 - US\$ 18,263). Equal change in the opposite direction would have increased the fair value of the portfolio by the same amount. Similarly as at 31 December 2007, if the US\$ depreciates by 5% in relation to the GBP, the fair value of the portfolio would decline by US\$ 45,602 (2006 - US\$ 40,747). Equal change in the opposite direction would have increased the fair value of the portfolio by the same amount.

6. RELATED PARTIES

Investment Manager

The Fund appointed Guardian Fund Management Limited ('GFML'), an investment management company incorporated in Sri Lanka, to implement the investment strategy. Under the Investment Management Agreement, the Investment Manager receives a management fee equivalent to 1.5% per annum of the Net Asset Value of the Fund, a fee of 0.5% of the redemption price of each share redeemed, and a performance fee of 20% of any increase in Net Asset Value per share of the Fund in excess of the increase in the US\$ value performance of the Colombo Stock Exchange's All Share Price Index during the year. No performance fee was payable for the year ended 31 December 2007 (2006 - US\$ Nil). Total Investment Manager's Fee for the year ended 31 December 2007 was US\$ 16,510 (2006 - US\$ 14,811).

Administrator

Carsons Management Services (Private) Limited ('CMSL'), the present administrator, and a fellow affiliate of GFML, receives an administrative fee of 0.2% per annum of the average weekly Net Asset Value of the Fund until the termination of its administration agreement with the Fund. Total Administrator's Fee paid to CMSL during the year was US\$ 2,062 (2006 - US\$ 2,087).

Custodian

The custodian is HSBC International Trustee Limited, which received a fee of 0.15% per annum of the Net Asset Value of the Fund, subject to a minimum annual fee of US\$ 6,000 (2006 - US\$ 6,000). In addition, the Custodian was entitled to an annual administration fee of US\$ 14,000 (2006 - US\$ 14,000).

Directors' Fee

The Directors' fee is disclosed in the Income Statement.

Messrs Don Chandima Rajakaruna Gunawardena and Palehenalage Chandana Tissera, Directors of the Fund are Directors of the GFML and CMSL.

7. INVESTMENT PORTFOLIO

As at 31 December

	2007			2006		
	Holdings (No. of Shares)	Fair Value US\$	% of Net Assets	Holdings (No. of Shares)	Fair Value US\$	% of Net Assets
Listed Investments						
Blue Diamond Jewellery Worldwide Limited	90	2	-	90	3	-
Distilleries Company of Sri Lanka	66,200	61,229	6.15	69,100	57,915	5.18
Asian Hotels and Properties Limited	50,900	18,619	1.87	50,900	24,107	2.16
John Keells Holdings Limited	40,911	47,816	4.80	127,571	231,021	20.67
Dialog Telecom Limited	79,300	14,414	1.45	79,300	19,516	1.75
Sri Lanka Telecom Limited	128,000	37,107	3.73	128,000	32,689	2.92
Laxey Investment Trust PLC	603,569	912,036	91.62	603,569	814,949	69.05
		<u>1,091,223</u>	<u>109.62</u>		<u>1,180,200</u>	<u>106.16</u>
Unlisted Investments						
Ceyexxe Limited	1,000,000	-	-	1,000,000	-	-
		<u>-</u>	<u>-</u>		<u>-</u>	<u>-</u>
		<u>1,091,223</u>	<u>109.62</u>		<u>1,180,200</u>	<u>106.16</u>

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Investment Manager

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Administrator

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