MFM HATHAWAY FUND

INVESTMENT ADVISER'S REPORT

For the year ended 30th September 2006

We have pleasure in presenting the Investment Adviser's report on the MFM Hathaway Fund – an *equity and bond* unit trust – for the year ended 30th September 2006.

The overall gain of an *accumulation* unit in the fund over the twelve months under review was 7.3p (mid-price to mid-price), an increase of 10.1%. Since we launched the fund in November 2002, those units have grown from 50p to 79.655p, a rate of 12.3% compounded annually.

The gain in the year was made up of a capital gain of 7.3% and income received amounting to 2.8%; meanwhile, income unit holders saw an increase of 21% in the dividend yield over the year, reflecting enhancements in payouts from our investees and further investments in higher yielding securities (much of which occurred in the second half).

The following table reflects the progress over the long-term in more detail (see also the explanatory notes at the end).

Year	MFM Hathaway Fund	Benchmark (30% gilts, 70% equities)	FTSE All Share Index (equities)	FTSE All Stocks Index (gilts)
2002/3	+13.1%	+ 6.7%	+ 8.2%	+ 3.3%
2003/4	+ 9.8%	+ 9.8%	+12.1%	+ 4.4%
2004/5	+16.4%	+19.7%	+24.7%	+ 8.2%
2005/6	+10.1%	+10.7%	+13.7%	+ 4.0%
Cumulative	+59.3%	+55.2%	+72.2%	+21.4%

The table records that the fund remains ahead of our "benchmark", which is a simple amalgam of the two indices beside it, reflecting approximately our asset allocation in the first years of the fund's life (although, since our unit trust held an average of about 40% in gilts and cash during the year in review (and is currently at 50%), the benchmark in fact overstates what our performance might have been in the last year or so).

Had we adjusted our benchmark to reflect the recent actual asset allocation of 40% or so in government bonds and cash, it would have returned c.9.8% for the last year (i.e. rather than 10.7%), so we performed in fact slightly ahead of the underlying indices. We do not however propose to change our benchmark.

Meanwhile, the actual business growth of the companies driving the advance in the stockmarket, again generally lagged the rise in their shares (the opposite of the case when we reported to you a few years ago), confirming the continuing speculative nature of those price increases; partly for that reason, our levels of cash and short-dated bonds remain high as we demand an ever greater standard of safety from our overall portfolio.

We said in our annual report last September, that the real test faced by an investor, is to outperform a falling market, and that is why we hold a *margin of safety* in readiness for such conditions, whenever they may occur. With this in mind, our caution grows at the same rate as the average investor's desire for risk and we do not lose sight of the fact that the stockmarket moves money from the active to the patient.

In our maiden annual report in November 2003, we commented that we had been able to find real value in (principally) equity securities that year; by the time of the interim report, in March this year, we were lamenting that undervalued securities were thin on the ground and that remains the case.

Investors are not despondently selling as we go to press (and therefore not uncovering buying opportunities for us), nor are they particularly enthusiastically buying either, although purchasers are outweighing sellers; as we said a year ago, our *value investing* philosophy leads us to be ever more sceptical as the equity market rises.

However, against this background, strong performance in the first half of the year led to a fair *absolute* return for the year and we maintained our position ahead of the average *equity and bond* investor since we started.

In summary on performance, our growing list of investors has continued to receive (depending, in the short term, on when they joined us), a reward commensurate with the level of risk they have run would indicate, which is our long-stated goal; however, we are not complacent and look almost constantly at how we can add value to the fund.

Equally, the dominance of capital growth so far on the portfolio led us to comment at the half-way stage that we were seeking opportunities to increase the fund income; that task has been and continues to be a challenge, but there are currently rather more opportunities for deploying capital to address that objective, than to finding long-term value (we see the equity part of our portfolio as only mildly attractive, since prices are fairly full). We are therefore gratified to see the healthy increase in dividends to income unit holders recorded above.

As ever, we would ask unitholders to keep their expectations within reasonable parameters and, whilst we may have (modestly) exceeded them so far, we do not necessarily expect this always to be the case; we also said, in our first annual report three years ago, that rising interest rates would help investors in framing their expectations. We were early in making that comment then, but the application by the main central banks of the remedy to the glut of money in circulation, is now more pressing.

Our level of liquidity reflects our cautious stance in relation to equities in the face of these conditions, where valuations – both generally and of our favourite companies – appear at least full when viewed against the prospect of rising interest rates, the (largely unnoticed) great volatility in financial markets and the twin spectres of accelerating inflation and choppier economic waters.

The level of cash, however, remains slightly higher than we would like, following the receipt of takeover proceeds in respect of *British Airports Authority* and *British Oxygen* where we have yet to find suitable opportunities to redeploy the capital. Although successful investments in the short term, those holdings may take some time to replace.

We are therefore defensively looking at protecting our unit holders' capital in the face of the dominance of risk over reward, until we return to conditions such as those which prevailed when we started our fund and we were able to buy shares in wonderful businesses at cheap prices; in the meantime, our judgement is that 30% - 40% liquidity is about right. This makes our fund, by any measure, low risk, but we do not see this constraining returns in the long-term; patience remains our main steer.

We look forward to reporting our interim performance in the spring, while unitholders wishing to read more about our *value investing* philosophy or to note the current fund prices for *income* or *accumulation* units, can view our web-site at www.hathawayinvestment.com.

We should close by thanking Marlborough who, as managers and registrars, did a first-class job on the housekeeping and Barlow Andrews who do an impeccable job on the audit; both provide us with a standard to follow as investment advisers.

Graham Englefield
Robert Bogle
Graham Shaw

31.10.06

Notes

1. Statistical source: the index figures we quote in the table above are derived from the Financial Times newspaper (and all are calculated on a mid-to-mid price basis, with net income reinvested); the MFM Hathaway Fund, equally, shows performance based on the mid-price of *accumulation* units, so that all figures in the table are on the same footing. Movements in the price of an *accumulation* unit, provide a complete record of performance, since accrued income is included alongside capital performance.

2. "Equities" means company shares and the FTSE All Share Index (what we generally mean by "the stockmarket") records the experience of a commitment to almost all quoted companies; "Gilts" means UK government bonds, while the FTSE All Stocks Index is an average of all those in issue.

3. The cumulative figures in the last line of the table very accurately show the *total return* from 25.11.02 to 30.09.06; the apparent discrepancy from an aggregation of annual statistics, is explained by rounding each year.