Quarterly
Newsletter & Investment Review

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Heritage Capital Management Limited is an independent, specialist investment management company based in London and regulated by the Financial Services Authority, providing a wide range of investment services to individuals, trusts and companies.

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A difficult start to the year

It was a poor first quarter for most investors with all the major markets falling below their opening levels. However, what made things even more difficult was the huge volatility. Equity markets first plunged in response to the initial uncertainty over when and if a war with Iraq would happen, only to then rally powerfully around the actual start of hostilities. Subsequent movements reflect the continual re-assessment by the markets of the possible outcomes in response to news from the war. Bonds movements have been a mirror image to equities and similar volatility has also been experienced by the currency, oil and gold markets making trading and investing very tricky.

Against this background, the Heritage funds held up reasonably well, but were unable to make any real progress.

A guaranteed advantage

Regular readers of our investment reviews will know that we are very skeptical of investment products which offer performance guarantees. These guarantees invariably come at a high price and careful inspection of the small print often reveals significant risks not highlighted in the headline 'guarantee'. Our view is that any investment other than cash carries some level of risk and that it is much better to have investments where you can fully understand the risks and see how they are being managed.

However, although investment performance cannot be guaranteed, investors can make sure that their portfolio is structured and managed in such a way so as to ensure that they have an advantage over the alternatives. For example, there are many reasons why for the vast majority of investors the use of investment funds is preferable to having an individually managed portfolio.
The benefits of the fund structure include ;
- continuous day to day management of the portfolio by a professional expert
- investment decisions are taken purely on the basis of the investment merits rather than being hampered by tax concerns
- the fund is able to deal at more favourable rates and will be able to access investments not available to individuals on the same terms
- a significant reduction in the record keeping, administration and calculations required for an individual portfolio.

Also, if the fund is a non-distributing ("roll-up") fund like the Heritage Investment Funds, then all income, expenses and gains are retained and administered within the fund itself which will further simplify the accounting and administration as well as offering additional tax planning opportunities.

Of course, managing clients' investments through a fund also has advantages for financial advisors and investment managers, so in theory everyone should be happy with this solution. However, the problem for the average retail investor is that the industry has developed in such a way that the above benefits come at a high cost. Most funds charge an initial fee on amounts invested of 3% to 5% and the annual management fee is typically 1.5%. A large portion of these charges is usually used to cover the payment of commissions to the advisor and the fund manager's marketing costs. The impact of this charging structure can, not surprisingly, have a serious impact on an investor's returns. We are pleased to say that Heritage clients do not pay any initial charges and that the annual management fee for the Heritage Investment Funds is just 1% per annum. The result of this is that, before we even consider the impact of investment performance, investors in our funds have a considerable "guaranteed" advantage over most other alternatives.

Heritage Capital Management Limited

Review for the quarter ended 31 March 2003

Market Commentary

The global equity bear market of the past three years has continued into 2003. In fact, as shown in the table below, every one of the major markets is now showing a negative return for each of the past three calendar years and for the current year-to-date.

The markets' current pre-occupation is with the war in Iraq. As it progresses, they continue to react to the daily news flow emanating from the battlefields. However, even on the assumption of a reasonably swift and successful outcome to the military campaign, there will remain a number of further uncertainties arising from the conflict which may present longer-term problems. Examples of these include; will there be an increased threat of terrorist attacks on Western targets, what will happen to oil supplies and prices, will the new political map of the Middle East be even more unstable than before, which "axis of evil" country will be the next target, will America's deteriorating relationship with France and Germany recover, and will the UN be a spent force?

It seems as though these so called "geopolitical" risks will therefore remain for some time to come. However, as we have previously commented, ultimately the strength and sustainability of an equity market recovery will depend on the extent to which the global economy and more particularly corporate profitability can recover.

United Kingdom

At its worst point during the quarter, the FTSE 100 index fell to 3,287, a level not seen since 1994. At this point the dividend yield on the market was higher than the yield available on cash and gilts, a situation which last occurred in 1959. However, helped by a one-week 17.5% pre-war rally, the FTSE finally ended the quarter at 3,613 – down 8.3%.

Both the UK markets and Sterling have recently been negatively impacted by the perceived increase in political risk associated with the deep divisions in the Labour Party caused by the Tony Blair's close alliance with George Bush. However, the underlying fundamentals look better than in mainland Europe, with a return to earnings growth this year coupled with lower corporate debt and an above average dividend yield providing some support.

UK base rates, unlike US and European rates which have been falling over the past year, had remained unchanged since November 2001. However, with signs of a slowdown in the housing boom and a general deterioration in consumer confidence, the MPC decided to cut base rates to 3.75% in February.

United States

Of the major markets, the US held up better than most in the first quarter with the S&P 500 index falling just 3.6% and the Nasdaq index, which appeared to be in almost terminal decline, actually managing to register a small gain.

Although all the focus currently appears to be on the war in Iraq there have been further significant developments domestically, most of them negative. Unemployment is rising and the consumer confidence index is at a 10 year low, company pension schemes are in aggregate deficit for the first time since 1993, yet more accounting frauds have been discovered and economic growth and company earnings remain depressed.

Despite the above problems, share price valuations are still on the high side - the current market PE is in the 20's and the dividend yield is below 2%, compared to a PE of 15 and a dividend yield of 3.75% back at the time of the previous Gulf War in 1991. When you also take into account America's huge current account deficit which is putting pressure on the US Dollar, there appears little cause for optimism at present.

Europe

Europe was again the weakest of all the major markets, down by 13.2% in the first quarter of 2003.

Germany continues to be the main cause for concern and the German DAX index has been particularly weak and volatile. At its low point during the quarter it was down 33.6% from the start of the year and down more than 70% from its all time high in March 2000. Although it is tempting to think a recovery in Germany must be due, the underlying fundamentals remain poor with an already weak economy struggling to overcome interest rates that are too high, a currency that is too strong, poor consumer confidence and high corporate debt.

Japan

In Japan the Nikkei has now fallen below 8,000 to a new 20 year low and the economy remains weak. Although, share prices might be low they are not cheap as the market PE ratio of over 30 demonstrates. There is some hope that having a new governor of the Bank of Japan will help produce some improvements but the radical changes required are unlikely to take place.

Emerging markets

In addition to the usual economic risks inherent in emerging economies, these markets have also recently suffered from additional new risks such as the deadly pneumonia virus sweeping much of Asia and the threat of a possible conflict in Korea. However, Asian markets have recently been rather less volatile than the major markets and also offer the prospects of domestic growth.

Investment Statistics - 31/03/03

Equity Markets	Q4 2003	2002	2001	2000
Global - FTSE World ($)	-5.66%	-20.60%	-16.20%	-14.05%
UK - FTSE 100	-8.30%	-24.48%	-16.15%	-10.21%
US - S&P 500	-3.60%	-23.37%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	-13.26%	-33.51%	-18.64%	-3.82%
Japan - Nikkei 225	-7.07%	-18.63%	-23.52%	-27.19%

Other	UK	US	Europe	Japan
Interest rates - base	3.75%	1.25%	2.50%	0.00%
Interest rates - 10 year	4.30%	3.82%	4.04%	0.69%
Exchange rates (vs GBP)	-	1.5807	1.4486	187.433
Exchange rates (vs USD)	1.5807	-	1.0912	118.455
Gold ($ per ozs)		$ 336.00		

Source : Financial Times

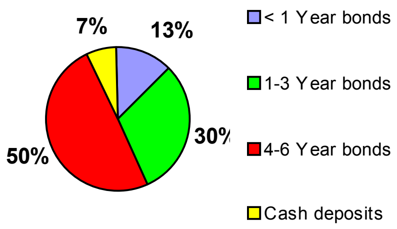
Heritage Investment Fund Limited

Performance for the quarter ended 31 March 2003

Performance

	Enhanced Bond Funds		Diversified Hedge Funds		Managed Portfolio Fund	
Risk profile	Low		Moderate		High / Moderate	
Minimum investment horizon	1 year +		3 years+		5 years+	
Target annual return	Bank deposits + 1%		Bank deposits + 4%		10%+	
Typical range of returns	2% - 5%		0% - 8%		-9% - +12%	
Price at 31 March 2003	£138.58	US$125.68	£112.69	US$111.57	£90.27	MSCI Index
Return for quarter (net)	1.01%	0.43%	-0.06%	-0.93%	-1.71%	-3.82%
Return for year to date	1.01%	0.43%	-0.06%	-0.93%	-1.71%	-3.82%
Year 2002 return (net)	5.19%	4.27%	7.95%	5.82%	-0.41%	-29.01%
Year 2001 return (net)	5.51%	5.11%	6.83%	5.38%	-7.19%	-15.11%
Year 2000 return (net)	9.59%	9.66%	6.53%	6.89%	-0.64% (1 mth)	- 7.11%
Annual volatility	0.9%	1.1%	2.0%	2.3%	8.1%	24.7%
Size of Fund (millions)	£25.5	US$10.0	£9.5	US$4.0	£5.4	

Enhanced Bond Funds

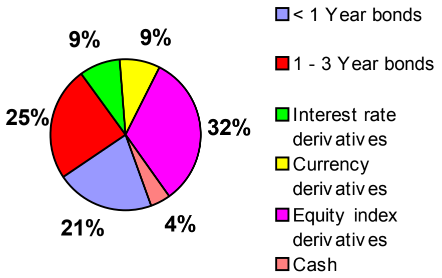


The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds, with not more than 5% allocated to any one issuer. The Sterling and US Dollar bond portfolios currently yield 4.5% and 2.6% per annum gross to maturity, and both have average net hedged durations of less than 1 year.

US Dollar bond yields, in particular, rose across the curve during the quarter as investors switched out of bonds into equities in anticipation of a decisive coalition victory in the Iraqi war. The consequent fall in bond values was tempered slightly by a general tightening of corporate credit spreads on the back of the equity market rally. Our continued hedging of the interest rate exposure of the longer duration bonds meant that we were isolated from the worst of the falls in bond values.

Both Enhanced Bond Funds produced positive returns for the quarter slightly ahead of cash deposit rates.

Diversified Hedge Funds

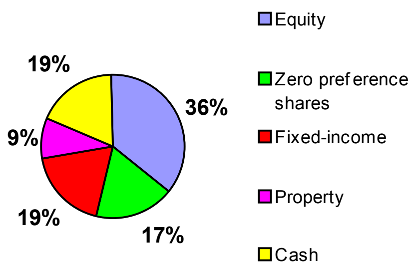


The Diversified Hedge Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross exposure of these derivatives positions is limited to the total funds under management. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment grade bonds to provide underlying income for the Funds.

The extreme market movements and trend reversals experienced this quarter, exacerbated by the geopolitical situation in the Gulf, made this a very challenging and difficult period for our derivatives strategies. We intentionally reduced our exposure in the weeks leading up to the onset of the war in Iraq, but the capped premium losses incurred on our modest unsuccessful directional positions exceeded the small gains made on our non-directional exposure.

Both Diversified Hedge Funds disappointingly failed to generate positive returns for the quarter in the light of the geopolitical uncertainty.

Managed Portfolio Fund



The Fund had a difficult quarter losing 1.7%. However, this compares to a fall of 3.8% for the MSCI (£) World Index and over the last 12 months the Fund is down less than 2%, whilst the World Index has lost over 30%.

Our equity holdings had a mixed quarter with many recent strong performers falling back whilst there was a recovery from several previous underperformers.

The zero dividend preference shares generally held up quite well, despite a small decline in asset cover due to falling equity markets, and now are on an attractive average yield to maturity of 14.1%, assuming markets do not fall further from current levels.

The bonds which we hold continue to provide a stabilising effect to the portfolio in what are very difficult times for equity based funds.

During the quarter we have gradually reduced the large cash weighting which we started the year with by investing in selected individual companies and zeros which we consider to offer good value.

The detailed composition of the Fund portfolios is available to investors upon request.

The effect on bond values of rising interest rates and the implications for Heritage's mutual funds

A very high proportion of the funds under management in our Heritage mutual funds is invested in fixed-income securities (commonly referred to as bonds). All of our five mutual funds hold bonds to varying degrees. Bonds are directly impacted by changes in interest rates and their values move inversely to the direction of interest rate changes. Interest rates in the UK, US and Europe have generally been on a declining trend since 1990 as inflation has fallen, but are now at historical lows. This has been a very favourable period for bond investors, particularly over the past three years of equity market falls. Whilst inflation presently appears benign, any improvement in the global economic outlook could lead to an increase in interest rates and a consequent fall in bond values. Bond yields, however, are based on expected future levels of interest rates and inflation, and generally anticipate changes in interest rates, as is already evident from the rise in bond yields this quarter.

The purpose of holding bonds varies between each type of mutual fund:

Our Enhanced Bond Funds generate their return from the interest earned on a well-diversified portfolio of high-quality bonds, supplemented to a limited extent by modest capital gains when interest rates are declining. It holds a proportion of longer duration bonds with maturities of between 4 and 6 years to earn higher rates of interest. As the values of longer-dated bonds are more sensitive to changes in interest rates, we currently are hedging the interest rate exposure of bonds with maturities between 4 and 6 years. The short maturities of less than 3 years are left unhedged as their values are less affected by interest rate movements and the costs of hedging do not make it beneficial.

Our Diversified Hedge Funds hold a spread of short-dated high quality bonds with a maximum maturity of up to 3 years to generate an underlying income for the Funds. Here, bonds are held as an alternative to cash deposits to generate a slightly higher return and to provide more flexibility and liquidity for the Funds. For the reasons set out above, the interest rate exposure on these bonds is not hedged.

Our Managed Portfolio Fund holds approximately half of its investments in bonds and zero-dividend preference shares. The purpose of these is to act as a counterbalance to movements in equity values and smooth returns, as returns on bonds and equities are generally negatively correlated and move inversely to each other. For this reason, the Fund will often hold a proportion in longer-dated bonds and does not hedge the interest rate exposure of these bonds. Zero-dividend preference shares, whilst differing from straight bonds in that they are purchased at a discount, do not pay interest and the repayment of their capital value at maturity is subject to them being at least covered by underlying equities, are similarly affected by movements in interest rates.

It will be apparent from the above that we are very conscious of the exposure of our mutual funds to bonds and actively manage the potential impact that changes in interest rates can have upon their values. The above comments do not, however, cover the credit risk which is also inherent in certain bonds. We avoid holding corporate and high-yield bonds in our Enhanced Bond and Diversified Hedge Fund because of this credit risk, and instead focus on government, supranational and financial bonds with the highest AAA and AA credit ratings.

The typical percentages invested in bonds by our range of mutual funds and the spread of maturities are as follows:

	Enhanced Bond Funds	**Diversified Hedge Funds**	**Managed Portfolio Fund**
% invested in bonds	93%	86%	19%
% invested in zero-dividened preference shares			17%
Range of maturities	0-6 years	0-3 years	0-6 years
Interest rate hedging	4-6 years	none	none

Model risk-adjusted asset allocations for Heritage's mutual funds:

	Suggested asset allocation					Last 12 months		
	Enhanced Bond Fund	Diversified Hedge Fund	Managed Portfolio Fund	Target returns £	Target returns US $	Actual return £	Actual return US$	Average volatility
Model portfolios:								
Defensive	100%			4.5%	2.3%	5.2%	3.8%	0.9%
Cautious	58%	42%		5.8%	3.5%	5.4%	3.6%	1.1%
Balanced	26%	53%	21%	7.3%	5.5%	4.0%	2.4%	2.2%
Growth		50%	50%	8.8%	7.6%	1.9%	0.8%	4.3%
Benchmarks:								
3 month interest rate						3.9%	1.5%	0.0%
MSCI World Equity Index						-33.0%	-25.6%	24.7%

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