Quarterly Newsletter & Investment Review

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Heritage Capital Management Limited

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 good quarter all round

The second quarter of 2003 was a good one for investors with equities leading the way by staging a sharp recovery from their pre Iraqi War lows. It was also a good quarter for bonds as interest rates continued to fall and even commodities, gold and oil all appreciated. The Heritage Funds also all managed to produce positive returns with the Managed Portfolio Fund having a particularly good quarter with a gain of 11.5%.

Such a combination of positive returns across the board for all asset classes is pretty unusual. In particular the equity and bond market rallies appear to be contradictory, with equities rising on the prospects of an economic recovery whilst the strength of the bond market is due to falling yields on the assumption that the economy will remain weak. Clearly both views cannot be correct and the likelihood is that this happy state of affairs with both markets rising will not be sustainable for much longer. For cautious, long-term investors the sensible approach therefore remains to have a portfolio diversified across the major asset classes.

Another milestone for the Heritage Funds

During the quarter the Heritage Investment Fund reached a significant milestone when the total amount invested in the Fund passed the £50 million mark.

The past three years have been very difficult for markets generally with the MSCI World Index falling by approximately 35% during this period. Against this background the Fund, which consists of the Enhanced Bond Funds, Diversified Hedge Funds and the Managed Portfolio Fund, has managed to buck the general trend by steadily growing from a total of £30 million three years ago, to the current total of just over £50m.

The source of this progress can be attributed to a combination of new subscriptions and good investment returns.

New subscriptions have come from both existing and new clients. For existing clients our funds have proved a popular alternative to having a separately managed portfolio consisting of numerous individual equity and bond holdings, and the proportion of Heritage's funds under management held within our own Funds has recently increased to over 50% for the first time. New investors have also been attracted by the combination of performance, simplicity and below average charges which our fund range offers in contrast to many other funds which have shrunk due to the impact of falling markets and redemptions by disillusioned investors.

The steady performance derives from our conservative investment approach and our disciplined investment processes, which are designed to produce consistent positive returns in the Bond and Hedge Funds and long term capital growth at a lower risk than pure equity alternatives in the Managed Portfolio Fund.

As ever it is difficult to predict exactly what will happen to the markets going forward, but clients will hopefully be re-assured that the Heritage approach has demonstrated its ability to continue to produce steady progress and growth during what has been a very turbulent few years.

Market Commentary

Global equity markets had their best quarter since the height of the last bull market three years ago. In addition to the double digit percentage gains achieved across the major equity markets as shown in the table below, every single one of the 50 country markets which make up the MSCI equity indices rose for the first time since they were introduced in 1987.

Such a comprehensively positive performance might reasonably be expected to be accompanied by a fundamental improvement in the global economy and its prospects. However, in the real world recent economic data and company results have not been that positive and any economic recovery remains very fragile. The rise in equity prices therefore probably has more to do with an increased appetite for riskier investments, such as equities, following the reasonably benign outcome to the Iraqi War, coupled with the liquidity injected into the financial markets by central banks as they cut interest rates in an attempt to counter the threat of deflation.

The danger for the second half of 2003 is that equity markets have already recovered further and faster than can be reasonably justified by the underlying fundamentals. For this reason we remain cautious about the sustainablity of the current equity market rally and await further hard evidence of a genuine recovery in the global economy and corporate profits before heralding the start of a new bull market.

United Kingdom

The FTSE 100 index managed to break back above the 4,000 mark ending the quarter up 11.6% at 4,031. The performance of mid and small caps was even more impressive, boosted by an increase in take-over activity.

UK base rates remained at 3.75% and are now significantly higher than rates in the US and Eurozone, although there is a distinct possibility that rates will need to fall to counter the effect of tax increases coupled with a slowing housing market and record levels of consumer debt.

The UK government again deferred any decision on possible entry to the Euro when it announced that only one of the five economic tests for convergence had been passed.

United States

The rally in US markets has been led by the technology stocks, with the Nasdaq index now up by over 20% for the year-to-date compared to a rise of 10.8% for the wider market as represented by the S&P 500 index.

The Federal Reserve seems determined to boost the sluggish US economy and avoid the threat of deflation. Since 2000 it has cut interest rates on 13 occasions taking them from 6.5% to their current level of just 1%, and US Dollar bond yields have fallen to their lowest levels for 45 years. There have been some signs that the combination of lower interest rates, tax cuts and a weaker Dollar will help a recovery in corporate profits this year but as the Fed Chairman, Alan Greenspan, recently commented "the economy has yet to exhibit sustainable growth".

Europe

Europe was the best performing major regional market during the second quarter with a gain of just over 16%, but this was off a lower base and it has only just managed to creep into positive territory for the year-to-date.

The Euro has continued to recover and against the US Dollar it has appreciated from 0.82 at its low point in 2001 to its recent high of 1.19 which is back to where it started its life three and a half years ago. However, this currency strength probably has more to do with current Dollar weakness rather than enthusiasm for the Euro itself and as far as Europe's industry and exporters are concerned the currency strength will be a drag on corporate profits.

Japan

The Japanese market also recovered strongly from the 20 year lows which it reached in the first quarter. However, this recent recovery has mainly been fuelled by foreign buyers and the danger is that it will reverse later this year as domestic investors continue to sell stocks and the attention returns to the underlying fundamentals which remain as weak as ever.

Emerging markets

Selective emerging markets continue to offer some diversification away from the sluggish major economies. In particular, Asia could provide attractive investment opportunities with the triple merits of above average economic growth rates, a favourable demographic profile and attractive valuations.

Investment Statistics - 30 / 06 / 03

Equity Markets	**Q2 2003**	**2003 ytd**	**2002**	**2001**	**2000**
Global - FTSE World ($)	16.59%	9.99%	-20.60%	-16.20%	-14.05%
UK - FTSE 100	11.57%	2.30%	-24.48%	-16.15%	-10.21%
US - S&P 500	14.90%	10.76%	-23.37%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	16.13%	0.73%	-33.51%	-18.64%	-3.82%
Japan - Nikkei 225	13.93%	5.88%	-18.63	-23.52%	-27.19%

Other	**UK**	**US**	**Europe**	**Japan**
PE Ratio	17	32	16	42
Dividend Yield	3.5%	1.9%	2.5%	1.1%
Interest rates - base	3.75%	1.00%	2.00%	0.00%
Interest rates - 10 year	4.18%	3.57%	3.80%	0.81%
Exchange rates (vs GBP)	-	1.6502	1.4327	198.10
Exchange rates (vs USD)	1.6502	-	1.1484	120.10
Gold ($ per ozs)		$ 347.70		

Source : Financial Times

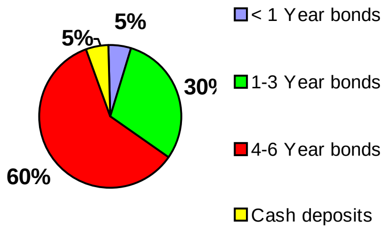
Heritage Capital Management Limited

Review for the quarter ended 30 June 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 30 June 2003	£140.11	US$126.94	£115.39	US$114.04	£100.65	MSCI Index
Return for quarter (net)	1.10%	1.00%	2.40%	2.21%	11.50%	11.53%
Return for year to date	2.13%	1.44%	2.33%	1.26%	9.59%	7.27%
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)	£24.4	US$10.0	£11.9	US$4.3	£6.1	

Enhanced Bond Funds

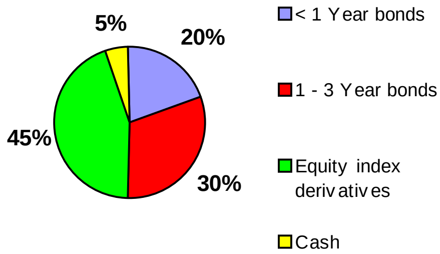


The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds, with not more than 5% allocated to any one issuer. The Sterling and US Dollar bond portfolios currently yield 4.4% and 2.1% per annum gross to maturity, and both have average durations of 2.8 years.

Both Sterling and US Dollar 5 to 10 year bond yields fell by approximately 25 basis points during the quarter on concerns about deflation and anticipated further interest rate cuts. With the economic outlook and equity markets recovering, bond prices look vulnerable to a possible correction. We continue to partially hedge the interest rate exposure of the longer duration bonds, but not as tightly in order to enhance returns, which could lead to increased short-term price volatility.

Both Enhanced Bond Funds produced positive returns for the quarter, with their year-to-date returns running ahead of cash deposit rates, particularly in the case of the US Dollar denominated Fund.

Diversified Hedge Funds

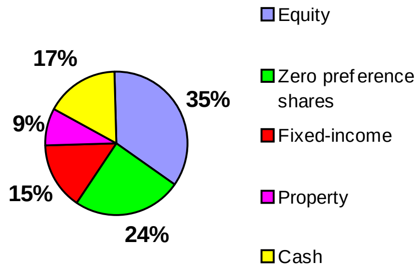


The Diversified Hedge Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross exposure of these derivatives positions is limited to the total funds under management. 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.

In view of the difficulty of forecasting market movements within the limited and specific time frames dictated by our option expiries, we have been focusing on generating returns from non-directional equity index positions involving premium capture. We employ tight stop loss policies to contain losses on positions that move against us. We did not hold any interest rate or currency positions at the quarter-end in view of their low implied volatility.

Both Diversified Hedge Funds generated pleasing positive returns for the quarter ahead of their benchmarks, but are still running behind their target returns for the year to date.

Managed Portfolio Fund



The Managed Portfolio Fund had an exceptionally good quarter, gaining 11.5% and it is now up 9.6% for the year-to-date. Although the Fund has a lower risk profile than pure equity alternatives due to its sizeable holdings of cash and bonds, it has nevertheless managed to outperform the MSCI World Index, which is up 7.3%, for the year-to-date.

The strong market rally and our overweight position in small caps helped our equity holdings, and our Far Eastern positions have begun to recover from the recent SARs related setback.

Our zero dividend preference shares, which are listed fixed interest securities backed by equity portfolios, benefited from the combination of rising equity markets, which improved asset cover, and falling bond yields.

During the first half of the year we reduced the large cash weighting which we started the year with by investing in companies and zeros which we considered good value. However, having now experienced a sharp recovery we are currently returning the portfolio to a more defensive positioning.

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

The use of derivatives in managing our mutual funds

We use both futures and options (collectively referred to as derivatives as they derive their value from underlying assets) in managing the investments of both our Enhanced Bond and Diversified Hedge Funds. Our more traditional long-only Managed Portfolio Fund does not employ any derivatives in its investment strategies.

A futures contract is an agreement to buy or sell an asset at a certain time in the future for a certain price. Options, on the other hand, give the holder the right to buy (ie a call option) or sell (ie a put option) an asset by a certain date for a certain price. A futures contract imposes an obligation on the holder and costs nothing aside from dealing costs, whereas the holder must pay an up-front premium for an options contact which gives the right, but not the obligation, to buy or sell an asset. We only deal in financial, and not commodity, derivatives for our mutual funds which are quoted on recognised derivatives exchanges, where the contracts are highly liquid, the pricing is transparent and there is no counterparty risk.

Our Enhanced Bond Funds utilise both futures and options for hedging purposes only and not for speculation. When the yield curve is positive-sloping, we may hold longer duration bonds in these Funds to earn higher yields on these bonds than those obtainable on short-dated bonds. The prices of such longer-duration bonds are more sensitive to changes in interest rates and, where we wish to protect the capital values of these investments against a rise in bond yields, we may either sell bond futures or buy put options on bond futures. Sometimes, we may sell out-of-the money call options to reduce the net premium payable on the put option hedge. Where these Funds hold bonds denominated in a currency other than the reporting currency of the Fund, we use forward currency contracts arranged with our custodian bank to hedge the currency exposure of these bonds, rather than using currency futures where transaction costs are higher.

Our Diversified Hedge Funds, on the other hand, use options (and less frequently futures) to establish positions in equity index, bond and currency futures, in order to generate returns for the Funds. Despite the fact that derivative instruments can provide significant leverage, we strictly limit the gross exposure under these contracts to the funds under management in each Fund, to ensure than any losses are not magnified. This does, understandably, limit the gains that can be made from successful trades. Stop loss levels are also determined when each derivatives position is entered into in order to limit the downside from any unexpected losses. We tend to favour non-directional derivatives positions which have a higher probability of success. This could, for example, involve the simultaneous purchase of both call and put options when market volatility is historically low and a market move either up or down is expected. From time to time, we may also establish modest directional trading positions, which have a lower probability of success, but which can boost returns if successful. At its simplest, this could involve purchasing a call option to establish a bullish position and, perhaps, selling another call option further out-of-the-money to reduce the overall cost of the position.

The above explanation of the use of derivatives in our mutual funds is by no means exhaustive, but seeks to provide investors with some limited understanding of how derivatives are employed in our investment strategies and to provide the reassurance that we use derivatives responsibly in the management of our mutual funds.

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

	Suggested asset allocation: Enhanced Bond Fund	Diversified Hedge Fund	Managed Portfolio Fund	Target returns £	Target returns US $	Last 12 months Actual return £	Actual return US$	Average volatility
Model portfolios:								
Defensive	100%			4.0%	2.0%	5.4%	4.3%	0.9%
Cautious	33%	67%		6.0%	4.0%	6.3%	4.6%	1.5%
Balanced	19%	50%	31%	8.0%	6.0%	7.1%	5.9%	3.6%
Growth		40%	60%	10.0%	8.0%	7.8%	7.0%	6.4%
Benchmarks:								
3 month interest rate						3.7%	1.3%	0.0%
MSCI World Equity Index						-10.2%	-2.8%	24.7%

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