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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Equities and bonds in role reversal

The latest quarter was quite different to what investors have become used to in recent years. For once it was the turn of bonds to suffer from volatility and negative returns whilst equities had a quieter quarter with most major markets making limited further progress.

The Heritage Funds generally coped with this turnaround in fortunes quite well. The defensive positioning of the Enhanced Bond funds limited the impact of weaker bond markets, whilst the Diversified Hedge Funds made further gains and the equity based Managed Portfolio Fund continued its good run by extending its return for the year-to date to 12.5%, which despite its lower risk profile is ahead of the World Index.

Gross roll-up funds offer tax efficiency and flexibility

Most governments offer some form of tax incentives for investors and savers. For example in the UK we have the ISA (Individual Savings Account) and personal pensions.

The problem with both these savings vehicles is that they are limited and inflexible. The current annual ISA limit is just £7,000 and pension contributions are capped by a complex formula relating to an individual's salary. In addition once funds have been withdrawn from an ISA they cannot be re-invested and pensions are only available at retirement when they are both taxable and subject to complex rules such as the compulsory purchase of an annuity.

For anyone with an additional lump sum to invest the commonly used alternatives can also be problematical. An individual portfolio of equities and bonds will produce returns that are taxable and very burdensome to manage and administer. Other alternatives offering tax-efficiency such as the products of insurance companies sold by financial advisors are usually difficult to understand, expensive to buy and highly inflexible.

An offshore gross roll-up fund such as our own Heritage Funds could provide the answer.

A roll-up fund automatically retains income and capital gains within the fund without the deduction of tax. These returns produce an increase in the net asset value and price of the fund and subsequent re-investment enables returns to compound tax free within the fund itself. On an ongoing annual basis there is no need for the individual investor to account for or pay any tax.

When you do need to drawdown some of your investment you simply sell sufficient shares in the fund to raise the required amount. For example, if your original investment was £100,000 and three years later it is worth £120,000 you may decide to drawdown the £20,000 of growth. However, you do not pay tax on the full £20,000 but just on the 20% of it that represents growth, i.e. just £4,000 is taxable with the balance simply representing a return of capital. Assuming your tax rate is 20% the tax due is therefore £800, equivalent to just 4% of the £20,000 "income" which you have drawndown.

We therefore believe that investors looking for a simple way to invest an uncapped sum in a tax efficient vehicle which allows you access to your money whenever you want it would do well to consider an offshore gross-roll up fund.

Market Commentary

Following a very strong recovery in the previous quarter, global equity markets made further progress in the third quarter of 2003. Although the economic news and corporate earnings reported were on balance encouraging, share prices had already anticipated much of this in advance, therefore limiting the scope for further significant gains in reaction to the actual announcements.

The best performing sectors in this year's equity market rally have been the more economically sensitive areas such as technology and other cyclicals, whilst more defensive sectors such as pharmaceuticals and utilities have lagged behind.

The danger going forward is that this is not a typical cyclical recovery with the prospects of a return to above trend GDP growth and that we are instead in for a longer period of at best weak growth as the excesses of the "bubble" continue to be deflated.

United Kingdom

The FTSE 100 index gained a further 1.5% in the quarter and is now up by 3.8% for the year-to-date.

The UK equity market is likely to benefit less from a global recovery due to its relatively defensive nature. However, this defensiveness combined with reasonable valuations makes the UK an attractive market for more cautious equity investors.

UK base rates were reduced to 3.5% in July, as the indications at the time were that both the housing market and the economy generally were slowing down. However, more recent data has suggested that things remain fairly robust and current market expectations are now that further interest rate cuts are unlikely this year.

United States

The S&P 500 index managed to gain a further 2.2% during the quarter and is now up 13.2% for the year-to-date.

There are signs that the combined effects of stimulative monetary policy (interest rates are just 1%) and tax cuts are now helping the US economy to show signs of a recovery. Certainly the rebound in company earnings has generally been better than expected and corporate accounting has been improved following the huge "exceptional" write-offs taken in 2002.

However, it is not all good news for US equities. The economic recovery has not been accompanied by an increase in jobs and much of the earnings growth has been the result of cost cutting and a weaker US Dollar rather than top-line growth. Furthermore, valuations are still too high with technology stocks in particular once again trading on sky-high PE ratios.

Europe

European markets continued to recover strongly over the summer but recent falls now mean that Europe is the only major market with negative returns for the year-to-date.

Several European economies including its largest, Germany, are currently in recession. This has lead to a fierce debate within the Eurozone about whether countries with struggling economies such as France and Germany should be allowed to ignore the Stability Pact and run larger deficits in order to stimulate growth. Watching from the outside, the Swedish electorate recently took their chance to reject the Euro and current indications suggest that the UK would do likewise if and when it is given the chance.

Japan

Japan has so far this year been the best performing of the major equity markets helped by a 3rd quarter rise in the Nikkei index of 12.5%.

However, despite the current evidence of a cyclical upturn in economic performance, the longer-term structural problems and weak demographic position remain in place. Also, the recent rally has left valuations looking very demanding and there is therefore a real risk of yet another setback for the Japanese market.

Emerging markets

Emerging markets have more than matched developed markets in this year's rally. In particular Asian countries are benefiting from the current optimism surrounding China's huge growth prospects and Latin America is benefiting from improved stability following last year's political and economic crises.

Investment Statistics - 30/09/2003

Equity Markets	Q3 2003	2003 ytd	2002	2001	2000
Global - MSCI World ($)	4.43%	14.82%	-21.47%	-17.29%	-14.05%
UK - FTSE 100	1.49%	3.83%	-24.48%	-16.15%	-10.21%
US - S&P 500	2.20%	13.20%	-23.37%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	-0.91%	-0.18%	-33.51%	-18.64%	-3.82%
Japan - Nikkei 225	12.51%	19.12%	-18.63%	-23.52%	-27.19%

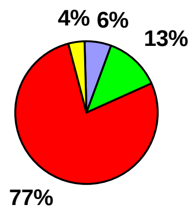
Other	UK	US	Europe	Japan
PE Ratio	16	20	17	40
Dividend Yield	3.5%	2.0%	2.4%	0.9%
Interest rates - base	3.50%	1.00%	2.00%	0.00%
Interest rates - govt. 10 year	4.61%	4.08%	4.00%	1.37%
Exchange rates (vs GBP)	-	1.6614	1.4266	185.60
Exchange rates (vs USD)	1.6614	-	1.1645	111.72
Gold ($ per ozs)		$385		

Source : Financial Times

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 September 2003	£139.78	US$125.61	£116.93	US$114.95	£103.35	MSCI £ Index
Return for quarter (net)	-0.24%	-1.05%	1.33%	0.80%	2.68%	3.72%
Return for year to date	1.89%	0.38%	3.70%	2.07%	12.53%	11.26%
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	2.2%	2.0%	1.6%	2.1%	7.2%	18.1%
Size of Fund (millions)	£18.0	US$4.2	£18.0	US$10.7	£8.2	

Enhanced Bond Funds

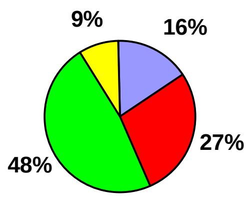


The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The Sterling and US Dollar bond portfolios currently yield 5.0% and 2.8% per annum gross to maturity, and have average durations of 2.9 and 3.3 years respectively.

Bond yields rose substantially during the quarter as investors sold bonds and invested in equities on positive signs of global economic recovery. This resulted in 5 and 10 year bond prices falling by approximately 2% and 3% respectively, with US Dollar bonds being particularly volatile during the period. Our partial hedge of the interest rate exposure of the longer duration bonds reduced the magnitude of our bond losses.

The poor quarter for bonds has resulted in the year to date returns for both Enhanced Bond Funds falling slightly behind those obtainable on cash deposits, although they remain positive.

Diversified Hedge Funds

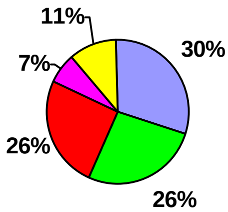


The Diversified Hedge Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross exposure of these derivatives positions is limited to the total funds under management. 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 performance of the Hedge Funds for the quarter was constrained by the weakness of bonds, which are held unhedged until maturity to generate income. Any fall in the capital value of these bonds can, therefore, be viewed as temporary. We continue to focus on generating incremental returns from non-directional equity index positions involving premium capture. However, equity market losses in the second half of September reduced our gains from this source.

Both Diversified Hedge Funds produced positive returns for the quarter, and their year to date returns, although behind target, are ahead of cash deposits.

Managed Portfolio Fund



The Managed Portfolio Fund gained 2.7% for the quarter, and it is now up 12.5% for the year-to-date. Although the Fund has a lower risk profile than pure equity funds, it has nevertheless so far this year outpaced the rise in the MSCI World Index.

The continuing market rally helped our equity holdings, and our overweight positions in small caps and Far Eastern markets have performed particularly well.

This quarter the Fund's bonds on the other hand have been impacted by the weakness in bond markets but we are comfortable maintaining these positions as they help control the Fund's overall risk profile.

Our zero dividend preference shares, which are listed fixed interest securities backed by equity portfolios, did reasonably well with the positive effect of improved cover compensating for the negative impact of rising bond yields.

Following the strong recovery in equity markets we are maintaining a reasonably high cash weighting to allow us to take advantage of any buying opportunities that may occur later this year.

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

A volatile quarter for bonds

This quarter proved to be the most volatile period for bonds in over 20 years. Following the end of the Iraqi war and based on signs of economic recovery, investors sold bonds aggressively and invested in equities. Ten year bond yields in the US rose from 3.5% to 4.5% during July and August, resulting in a fall in bond prices of 7.1%. UK ten year bond yields rose by less but, nevertheless, bond prices fell by 3.5% over the same period. From this oversold position, bond prices then recovered a portion of their losses in September as markets became concerned about the sustainability of the economic recovery.

Both our Sterling and US Dollar Enhanced Bond Funds hold a high proportion of US Dollar bonds as the US yield curve is steep, enabling the Funds to earn a higher return by holding longer maturities. In our Sterling Enhanced Bond Fund, the currency exposure of holding US Dollar bonds is hedged back into Sterling which, because of interest rate differentials, generates a further 2% return. With a spread of maturities of up to 6 years, the average yield-to-maturity (inclusive of the currency hedge) of our Sterling and US Dollar Enhanced Bond Funds is currently 5.0% and 2.8% respectively. These are attractive returns when compared with the UK base rate of 3.5% and the US Fed Funds rate of 1%.

Although the duration (ie the average term to maturity) of the Sterling and US Dollar Enhanced Bond Fund portfolios is only 2.9 and 3.3 years respectively, the values of the bond portfolios are affected by changes in bond yields such as those outlined above, although to a lesser degree. We do attempt to reduce the effect of these price changes by generating additional income from the sale of covered options and, in certain instances, by buying protective put options. These strategies helped to contain the losses on our Enhanced Bond Funds during the quarter. However, if the economic recovery does prove to be sustainable, bond yields will, in all probability, rise further, making it difficult for our Bond Funds to generate superior returns to cash deposits.

The importance of asset allocation

With the weakness in bonds and the rise of equities over the past quarter, it is perhaps appropriate to remind investors again of the importance of asset allocation in generating positive long-term returns. Asset allocation is the process of determining the proportion of funds that should be invested in cash, bonds, hedge funds and equities to generate an investor's expected return, commensurate with the amount of risk that an investor is prepared to accept. Various studies have shown that more than 90% of an investment portfolio's performance is derived from asset allocation.

With the information freely available today over the internet, investors are more well-informed about economic and market events, with the consequence that markets react faster and more extremely to news and rumours. For this reason, it is important for investors to have a balanced and diversified asset allocation strategy to achieve their long-term return objective and cushion them from severe moves in one particular asset class. One's asset allocation should be periodically reviewed in the light of changing economic and market conditions and personal circumstances, to ensure that it is still appropriate to meet one's long-term goals.

Every investor has a different return objective and attitude to risk, and his/her preferred asset allocation will be unique. In order to assist investors in understanding the potential risks and returns of various asset allocation strategies, we run four asset allocation models which use our own range of mutual funds. These risk-adjusted asset allocation models are shown at the foot of page 4 each quarter and show the expected net annual return, together with the actual net return and volatility (ie risk) over the past year. Obviously, the higher the return an investor seeks, the greater the risk exposure. With bond yields being historically low and the opportunities for generating future capital gains being limited, those investors presently 100% invested in our Enhanced Bond Funds should seriously consider allocating a proportion of their investment to our Diversified Hedge and/or Managed Portfolio Funds.

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 £	US $	Actual return £	US$	Average volatility
Model portfolios:								
Defensive	100%			4.0%	2.0%	3.3%	1.4%	2.2%
Cautious	33%	67%		6.0%	4.0%	4.9%	2.8%	1.3%
Balanced	19%	50%	31%	8.0%	6.0%	8.8%	7.3%	2.6%
Growth		40%	60%	10.0%	8.0%	12.6%	11.7%	4.5%
Benchmarks:								
3 month interest rate						3.6%	1.1%	0.0%
MSCI World Equity Index						17.1%	23.7%	18.1%

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