Quarterly
# Newsletter & Investment Review

Issue 24 | Combined news & investment review from Heritage | Quarter 4 2003

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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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Heritage

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## The recovery continues

Investors will remember 2003 as the year in which the markets finally managed to turn around and stage a decent recovery.

In the final quarter all the major equity markets continued to respond positively to the improving economic backdrop, although bonds on the other hand had a much tougher time as deflationary fears have subsided.

Overall it was another good year for Heritage with our Enhanced Bond Funds holding up well despite the weak bond markets and the Absolute Return and Managed Portfolio Funds providing good returns.

## Target Returns for 2004

The major Western economies have all experienced record low interest rates during this past year and the expectation is that interest rates may start to rise around the middle of 2004, should it become clear that the global economic recovery is well advanced and sustainable. However, the fact that inflation presently shows no signs of escalating, may well restrain the size and frequency of any rate increases. This period of relatively stable, low interest rates has led to more modest returns from bonds and absolute return strategies, but has stimulated the recovery in equity markets.

Rising interest rates are, however, unfavourable for bonds, whose prices move inversely to the direction of interest rates. Although we do partially hedge the interest rate exposure of the longer-dated bonds held by our Enhanced Bond Funds, they are still vulnerable to any significant upward moves in interest rates. Should interest rates rise during 2004, it is possible that the Enhanced Bond Funds may not attain their target net return of approximately 1% over short-term bank deposit rates in the coming year.

Our Absolute Return Funds should be positioned to continue to generate consistent positive net returns over the coming year well in excess of bank deposit rates. These funds target a margin of 4% over short-term bank deposit rates, which translates to net target returns of approximately 7.5% and 5% for Sterling and US Dollars respectively. However, strong equity market reversals as seen in the first quarter of 2003, and the low market volatility of the past 6 months, are less than ideal conditions for our investment strategies.

Our Managed Portfolio Fund targets the long-run average annual return delivered by equities of approximately 10%, but with substantially lower volatility. However, with equity markets having recovered by over 30% since the end of the first quarter of 2003, it is anticipated that equity returns may be in the more modest single digit range for 2004.

Investors will appreciate that the above target returns are indicative only and that there is no guarantee that they will be achieved over the coming year. As you will be aware, past performance is no guarantee of future performance and the value of investments can fall as well as rise.

## Market Commentary

After three consecutive years in which all the major equity markets have fallen, 2003 at last provided some respite for investors. The year did not begin promisingly as markets worried about the war in Iraq and the weak global economy but after a poor first quarter the markets mounted a strong recovery over the course of the rest of the year rounding off with an excellent final quarter.

This year's rally has rewarded the riskiest sections of the market best with small companies outperforming blue chips, cyclical and technology companies outperforming defensives and emerging markets generally outperforming the major indices. Given that these areas had fallen the furthest in the bear market it is perhaps not surprising that they should recover more strongly once the global economy and corporate profits began to demonstrate that they were mounting a decent recovery.

For now this positive momentum looks set to continue into 2004. However, as always there are still considerable risks attached to equity investment. With the large gains made in 2003 the market has already priced in much of the good news and it could suffer a sizeable setback should the global economic recovery begin to falter at some point in the year ahead.

### United Kingdom

The FTSE 100 index gained a further 9.4% in the final quarter. This made a creditable full year return of 13.6%, although the UK market's defensive qualities meant that it has lagged behind the other major markets during the recovery phase.

The UK's Labour government increasingly appears to be returning to its traditional tax and spend roots and there continues to be a worrying fall in public sector productivity.

The quarter point interest rate cut in the previous quarter was reversed in November and with the housing market remaining stubbornly strong, expectations are that further interest rate rises are possible in 2004.

### United States

The US was the strongest of the major markets in 2003 with the S&P 500 gaining 11.6% in the final quarter to finish up by 26.4% for the year as a whole.The performance has been driven by a strong recovery in the conomy and in corporate profits helped by tax cuts, low interest rates and a weak dollar. However, some areas of the market look to have overheated. The technology heavy Nasdaq index was up 50% in 2003 and valuations have become reminiscent of the late 1990's bubble era in parts of the market.

Investors have finally started to focus on the structural problems of running huge budget and current account deficits and the US dollar has fallen significantly against all the other major currencies in recent months. These so called twin deficits could top a massive $1 trillion in 2004, equivalent to 10% of GDP and dollar weakness could become a continuing theme in 2004.

### Europe

Europe was the only major market still in negative territory at the previous quarter end but a strong final quarter pushed the market up to a decent double-digit gain at the year end.

Newsflow has improved markedly in recent months and GDP growth forecasts for the region are currently being revised upwards. However, the strength of the euro is becoming a problem for the regions exporters and Europeans were recently reminded that they are not immune to the major corporate scandals that we have seen in America, as demonstrated by the collapse of the major Italian company, Parmalat.

### Japan

Although Japan managed only a fairly modest 4.5% gain this quarter the 24.5% rise for the full year was fairly impressive.

Japan is currently enjoying a reasonable cyclical upturn and despite its own severe structural problems it still has a number of world class exporters that will benefit from a global recovery, particularly in the higher growth economies of its Far Eastern neighbours.

### Emerging markets

Emerging markets have generally had an excellent year with Brazil, Thailand and Argentina all producing returns of over 100% for sterling based investors. With GDP growth in the Asia/Pacific region again forecast to top 5% the outperformance versus the major markets could continue.

## Investment Statistics - 31/12/2003

| Equity Markets | Q4 2003 | 2003 | 2002 | 2001 | 2000 |
|---|---|---|---|---|---|
| Global - MSCI World ($) | 13.75% | 30.61% | -21.47% | -17.29% | -14.05% |
| UK - FTSE 100 | 9.42% | 13.62% | -24.48% | -16.15% | -10.21% |
| US - S&P 500 | 11.64% | 26.38% | -23.37% | -13.04% | -9.31% |
| Europe - FTSE Eurotop 100 | 11.59% | 11.38% | -33.51% | -18.64% | -3.82% |
| Japan - Nikkei 225 | 4.48% | 24.45% | -18.63% | -23.52% | -27.19% |

| Other | UK | US | Europe | Japan |
|---|---|---|---|---|
| PE Ratio | 16 | 23 | 17 | 38 |
| Dividend Yield | 3.4% | 1.6% | 2.5% | 1.0% |
| Interest rates - base | 3.75% | 1.00% | 2.00% | 0.00% |
| Bond Yields - govt. 10 year | 4.77% | 4.26% | 4.30% | 1.36% |
| Exchange rates ( vs GBP ) | - | 1.7901 | 1.4192 | 191.85 |
| Exchange rates ( vs USD ) | 1.7901 | - | 1.2613 | 107.17 |
| Gold ( $ per ozs ) | | $417 | | |

*Source : Financial Times*

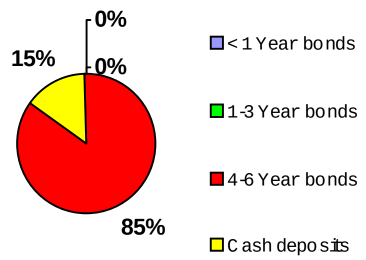
# Heritage Investment Fund Limited

*Review for the quarter ended 31 December 2003*

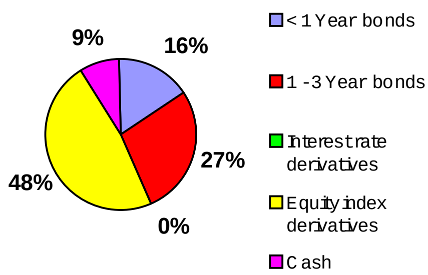
## Performance

| | Enhanced Bond Funds | | Absolute Return 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 December 2003 | £140.60 | US$126.22 | £119.20 | US$116.73 | £106.63 | MSCI £ Index |
| Return for quarter (net) | 0.59% | 0.49% | 1.94% | 1.55% | 3.17% | 5.74% |
| Return for year | 2.49% | 0.86% | 5.71% | 3.65% | 16.10% | 17.64% |
| 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% | 1.8% | 1.4% | 1.9% | 7.2% | 15.9% |
| Size of Fund (millions) | £9.0 | US$2.8 | £26.9 | US$11.2 | £9.8 | |

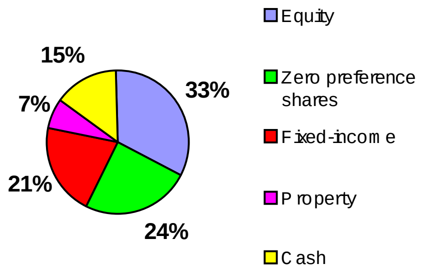
### Enhanced Bond Funds




### Absolute Return Funds




### Managed Portfolio Fund




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 6.3% and 3.2% per annum gross to maturity inclusive of currency hedging, and have average durations of 3.5 and 3.6 years respectively.

Bond yields rose by between 0.5% and 0.9% during the year as positive economic statistics supported the view that a global recovery is underway and funds flowed from bonds into equities. This resulted in 5 year US Dollar bond prices falling by approximately 3.5% over the year. Our partial hedge of the interest rate exposure of the longer duration bonds reduced the magnitude of our bond losses.

The Enhanced Bond Funds produced modest positive returns for the quarter, and ended up returning much the same as cash deposits in the respective currencies for the year.

The Absolute Return 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 annual performance of the Absolute Return Funds was constrained by the weakness of bonds, which are held unhedged until maturity to generate income. After a flat first quarter plagued by weak equity markets, we focused on generating incremental returns mainly from non-directional equity index positions involving premium capture, but low market volatility has led to a fall in option premiums.

Both Absolute Return Funds produced positive returns for the quarter much in line with expectations, and their annual returns, although behind target, are well ahead of cash deposits.

The Managed Portfolio Fund seeks to generate long-term capital growth at a lower risk than that associated with pure equity market investments. The Fund gained 3.2% for the quarter to give a total return for the year of 16.1%, only marginally behind the MSCI World Index.

Our equity holdings were helped by the rally in global stockmarkets, with our overweight positions in small cap stocks and Far Eastern markets making a good contribution this year.

Our fixed interest securities consist of a combination of investment grade bonds as well as some convertibles, preference shares and higher yield bonds in order to enhance returns.

The zero dividend preference shares have continued to do well, boosted by rising equity markets which have increased their cover, as well as improved sentiment towards the zeros market generally.

We continue to maintain a reasonable level of liquidity to allow us to take advantage of any buying opportunities that may follow the very strong rally that we have enjoyed this year.

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

## Heritage Investment Fund to migrate to Guernsey and the Diversified Hedge Funds to be renamed as the Absolute Return Funds

Although Heritage Capital Management in London acts as the investment advisor to Heritage Investment Fund, the administration of Heritage Investment Fund is performed by Heritage Fiduciaries Limited in Guernsey, under licence from the Guernsey Financial Services Commission. The investment assets held by Heritage Investment Fund, in the form of cash and various securities, are also retained in Guernsey by MeesPierson Reads (a subsidiary of the Fortis Group), who act as bankers and custodian. PricewaterhouseCoopers in Guernsey are the auditors of Heritage Investment Fund.

With such strong ties to Guernsey, it will come as no surprise to investors that Heritage Investment Fund is to migrate from the British Virgin Islands to Guernsey, where it will be registered as a Guernsey mutual company and be regulated as a Class B Collective Investment Scheme under the Protection of Investors Laws by the Guernsey Financial Services Commission.

Together with the above change, it was thought appropriate to rename the Diversified Hedge Funds as the Absolute Return Funds, to more correctly reflect their investment objectives and strategies. These Funds now no longer invest in third party hedge funds, but are managed entirely by Heritage and aim to generate consistent positive returns irrespective of market direction by taking positions in equity indicies, interest rates and currencies using derivative instruments.

## Zero Dividend Preference Shares

The Heritage Managed Portfolio Fund continues to invest in zero dividend preference shares. As this sector was tarnished by a number of poorly structured split capital investment trusts which collapsed during the bear market, we thought it would be a good idea to explain a bit about what zeros are and our approach to investing in them.

Zeros are the highest-ranking share class of split capital investment trusts. As the name implies, they pay no dividends but rather provide a fixed capital return on a pre-determined redemption date. They can therefore be considered as a special type of fixed interest security backed by an investment portfolio. The security of the redemption proceeds is dependent on the underlying investment trust portfolio – as opposed to for example a corporate bond which depends upon the fortunes of a single company.

It is therefore vital to assess the balance sheet of the investment trust in detail including an analysis of the quality of the underlying portfolio and any gearing in the form of bank debt.

A measure of the safety of the return is given by the "cover". For example, if a zero has cover of 1.0 it means that there are currently sufficient net assets in the fund's portfolio to repay the final redemption proceeds. A zero with cover of 1.5 would be considerably safer as the portfolio could fall significantly and the zero holders would still be paid in full, whilst a zero with cover of less than 1.0 would be riskier and would need some growth in the underlying portfolio in order to achieve full repayment.

The risk of zeros can also be further reduced by investing in a spread of different zeros. For example, we have constructed a portfolio of zeros within the Heritage Managed Portfolio Fund which currently has an overall redemption yield of over 8% with an average cover of over 1.5.

Also, because zeros are listed on the London Stock Exchange there is a liquid market for them and they can be traded and actively managed to take advantage of opportunities and pricing anomalies that may arise.

We believe that for those investors capable of analysing them correctly, zeros can provide attractive risk adjusted returns and we will therefore continue to use them within the Heritage Managed Portfolio Fund.

**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% | | | 4.0% | 2.0% | 2.5% | 0.9% | 2.2% |
| Cautious | 43% | 57% | | 6.0% | 3.7% | 4.3% | 2.5% | 1.1% |
| Balanced | 13% | 50% | 37% | 8.0% | 6.5% | 9.2% | 8.0% | 3.2% |
| Growth | | 25% | 75% | 9.4% | 8.8% | 13.5% | 13.0% | 5.6% |
| Benchmarks: | | | | | | | | |
| 3 month interest rate | | | | | | 3.7% | 1.1% | 0.1% |
| 10 Year government bonds (total return) | | | | | | 1.3% | 0.2% | 3.0% |
| MSCI World Equity Index | | | | | | 17.6% | 30.8% | 15.9% |

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