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.

Contacts

Roy Glew
E-mail : roy@heritage-capital.co.uk
Roy is a director of Heritage Capital Management Limited and is responsible for advising the Heritage Enhanced Bond Funds and Absolute Return Funds as well as providing other investment management services.

Graeme Olsen
E-mail : graeme@heritage-capital.co.uk
Graeme is a director of Heritage Capital Management Limited and is responsible for client portfolios and advising the Heritage Managed Portfolio Fund.

Heritage

www. heritage-capital.co.uk
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
40 Broadway, London, SW1H OBT

The momentum slows

The net result for markets in the first quarter of 2004 was fairly flat as the momentum from last year's rally subsequently gave way to profit taking and the impact of the Madrid bombings.

We are pleased to report that we have made a solid start to the year with all the Heritage Funds producing positive returns.

The Heritage investment approach – from theory to practice

We consider it important that our existing and potential clients understand our approach to managing investments, which is why in previous newsletters we have attempted to describe our investment style and the target returns that we seek to achieve.

In summary, we are generally conservative as we feel that the management of wealth and the trust placed in us demands this. Our clients' investments often represent a substantial portion of a family's accumulated capital and may be regarded as pension or trust moneys which we seek to preserve and enhance.

But apart from the theory, in practical terms what does this mean and what results has it produced?

The last few years have been testing times for investment managers with rising geo-political uncertainty, the bursting of a speculative bubble and a severe bear market followed by a strong rebound last year and historically low interest rates to contend with. Against this background, since 1st January 2000 the progress of the Heritage Funds has been as follows;

The **Enhanced Bond Funds**, which are low risk bond funds that aim to beat the return on cash deposits by a small margin, are up by 28.0% for the Sterling Fund and 22.9% for the US Dollar Fund, which represents compound annual returns of 6.0% pa and 5.5% pa respectively.

The **Absolute Return Funds**, which seek to produce consistent positive returns a few percent above risk free cash returns by taking positions in interest rate, equity and currency derivatives and using hedging techniques, have gained 32.0% (Sterling Fund) and 25.7% (US Dollar Fund) which represents compound annual returns of 6.8% pa and 5.5% pa respectively.

The **Managed Portfolio Fund**, which aims to benefit from the long-term capital growth potential of equities whilst also seeking to reduce the risks associated with stock-market investment, is up by 8.8% since its inception on 1/12/00 compared to a fall of 32.4% for the MSCI £ World Index over the same period.

Of course past performance is not a guarantee of future returns, but we believe that a tried and tested, conservative investment approach which continues to be consistently and soundly applied by a stable management team will produce satisfactory results over the long term.

Heritage Capital Management Limited

Review for the quarter ended 31 March 2004

Market Commentary

Following last year's roller-coaster ride when markets plunged in the first quarter leading up to the war in Iraq, followed by a sharp recovery over the following nine months, this year has started with a fairly flat quarter.

Generally the corporate reporting season went well with profits recovering quite strongly from the previous year's downturn. However, the market had anticipated this in last year's rally and although the positive momentum carried the markets higher by the end of February they were already starting to show signs of weakness before the bombings in Madrid. As the wider consequences of the terrorists' actions, such as the influencing of an election result and the possibility of an extension to other allied countries were digested, the markets fell more sharply.

Although markets have now regained their poise, there are signs that the leading economic indicators may have already peaked, which raises questions about the sustainability and strength of the recovery. Although this has been beneficial to bond investors, with confidence dented and increasing political risk, it is unlikely that stock market investors will see a repeat of the high returns that they enjoyed last year.

United Kingdom

The FTSE 100 lost 2.0% in the first quarter with the index being impacted in January by large regulatory driven sales by a major life assurer and by the general fall in global markets in March.

Despite widespread concerns the UK budget turned out to be a bit of a non-event, although fears remain that the Chancellor's high spending and borrowing will ultimately result in the need for higher taxes.

There was a further quarter point base rate rise to 4.0% in February. With the housing market continuing to strengthen and consumer spending buoyant it appears most likely that further rate rises will now be required as the Monetary Policy Committee attempts to avoid an ultimate hard landing.

United States

The US market ended the quarter marginally in positive territory after recovering sharply in the final week. With the presidential election later this year, investors are becoming increasingly preoccupied with politics as well as the usual economic concerns.

In January valuations in the more speculative parts of the US market were becoming overextended, and there has subsequently been some profit taking and signs of rotation into the more defensive stocks.

The US Dollar has staged a minor recovery in the past month, although with the structural problems remaining unresolved further significant falls later this year should not be ruled out.

Europe

Not surprisingly the bombings in Spain hit Europe the hardest with the market falling nearly 7% in mid March, although this was offset by the early gains and late rally which overall resulted in a small gain of 1.1% for the full quarter.

Unlike the UK where interest rate rises are likely, the expectation in Europe is that rates will need to be cut further to stimulate the sluggish economy. However, corporate earnings are at least currently recovering at a much faster rate than the economy (GDP) making PE ratio valuations more attractive.

Japan

Japan was the best performing major market in the first quarter with the Nikkei index gaining 9.7%.

The upturn is beginning to feed through to all areas of the economy and investor sentiment is correspondingly improving. However, Japan has seen numerous false dawns in the past decade and caution is still warranted.

Emerging markets

Emerging markets generally held up fairly well this quarter. Although the gains over the past year have been impressive, in many areas the valuations and fundamentals still appear more favourable than in the major markets and although a correction is likely this may produce good buying opportunities for long term investors.

Investment Statistics - 31/3/2004

Equity Markets	Q1 2004	2003	2002	2001	2000
Global - MSCI World ($)	2.33%	30.61%	-21.47%	-17.29%	-14.05%
UK - FTSE 100	-2.04%	13.62%	-24.48%	-16.15%	-10.21%
US - S&P 500	1.13%	26.38%	-23.37%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	1.12%	11.38%	-33.51%	-18.64%	-3.82%
Japan - Nikkei 225	9.73%	24.45%	-18.63%	-23.52%	-27.19%

Other	UK	US	Europe	Japan
PE Ratio	16	20	18	43
Dividend Yield	3.3%	1.6%	2.4%	0.8%
Interest rates - base	4.0%	1.0%	2.0%	0.0%
Bond Yields - govt. 10 year	4.74%	3.86%	3.92%	1.44%
Exchange rates (vs GBP)	-	1.8378	1.4955	191.20
Exchange rates (vs USD)	1.8378	-	1.2289	104.04
Gold ($ per ozs)		$425.5		

Source : Financial Times

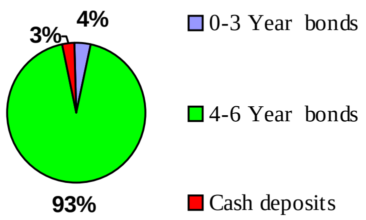
Heritage Investment Fund Limited

Review for the quarter ended 31 March 2004

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 March 2004	£144.44	US$127.96	£121.17	US$118.78	£108.55	MSCI £ Index
Return for quarter (net)	2.73%	1.38%	1.65%	1.76%	1.80%	-0.48%
Return for year to date (net)	2.73%	1.38%	1.65%	1.76%	1.80%	-0.48%
Year 2003 return (net)	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)	£8.8	US$2.5	£27.8	US$11.9	£11.9	

Enhanced Bond Funds

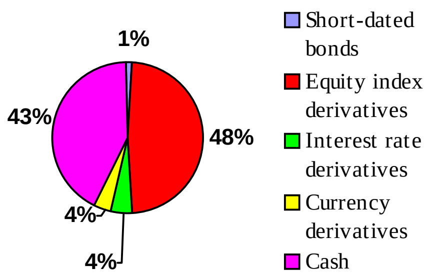


The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The Sterling and US Dollar bond portfolios currently yield 6.2% and 3.1% per annum gross to maturity inclusive of currency hedging, and have average durations of 3.4 and 3.2 years respectively.

US Dollar bonds rallied strongly during the quarter as yields fell by about 35 basis points across the curve, based on a benign outlook for US interest rates and inflation. Corporate bond credit spreads widened slightly over the quarter on equity market nervousness. It is expected that future returns for the Enhanced Bond Funds may be more volatile as we have discontinued our strategy of partially hedging the interest rate exposure of the longer duration bonds.

Both Enhanced Bond Funds produced strong positive returns for the quarter, well ahead of expectations.

Absolute Return Funds

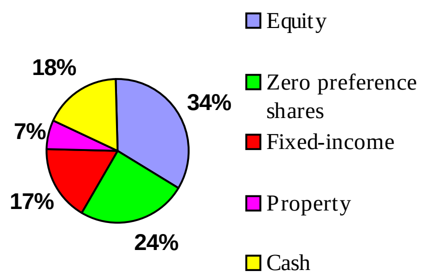


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross exposure of these derivatives positions is limited to the total funds under management.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

We have adopted a cautious approach to the new investment year by focusing on generating incremental returns from non-directional equity index positions involving premium capture. However, market volatility remains at historically low levels, which has led to a fall in option premiums. We also benefited from modest directional positions in US Treasuries, the Euro and Gold.

Both Absolute Return Funds produced positive returns for the quarter much in line with expectations and well in excess of cash deposits.

Managed Portfolio Fund



The Managed Portfolio Fund seeks to generate long-term capital growth at a lower risk than that associated with pure equity market investment. The Fund had a reasonable first quarter, gaining 1.8% compared to a fall of 0.5% in the MSCI £ World Index.

Our focus on finding value in smaller and mid caps shares has continued to pay off and it was a good quarter for our direct equity holdings with several rising by more than 5%.

Within our fixed income holdings the investment grade bonds performed steadily whilst there were mixed results from our convertibles.

The very strong run which our zero dividend preference shares have been enjoying finally ended as the market fell in March, although overall they did still make a good positive contribution for the quarter.

The strong run-up in equity markets currently shows some signs of running out of steam and we maintain reasonable levels of cash to take advantage of any set backs.

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

Investing in property

Residential property investors have continued to enjoy a boom which has now lasted for over a decade. Encouraged by the seemingly unstoppable rise in house prices and the perceived unattractiveness of the alternatives, with cash and bonds currently yielding historically low returns and the ending of the equity bull market, an ever increasing number of people have been attracted to the buy-to-let market.

However, the rise in house prices has forced rental yields below that of mortgage rates. At these levels buyers need to rely on property prices continuing to rise and for interest rates to remain low in order to make a decent return, particularly if the purchase is partly funded by a mortgage as is normal practice.

Any falls in value could severely impact the net equity invested due to the **effects of gearing** and any interest rate rises would make the cost of finance significantly higher than the rental income. Given that most people will already have a significant exposure to the property market via their own home the risks become even higher.

In addition to the risks involved there are also **significant costs** to take account of. General ongoing maintenance and periodical major refurbishments usually end up being higher than budgeted. In addition there can be significant costs and problems associated with letting property including agents fees, void periods and troublesome tenants. Transaction fees are also high in the property market with estate agents, surveyors and solicitors fees to be paid as well as stamp duty.

Another problem with property is that it is a large **illiquid** investment which cannot be readily sold nor adequately diversified.

However, we do still think that exposure to **commercial property**, which can be achieved via a well diversified and tax efficient fund, is a useful addition to the traditional asset mix of cash, bonds and equities.

Typical yields for office, industrial or retail properties are still fairly attractive at around 7%. This means that returns are primarily from the **stable income stream** from long-term leases, rather than from the more unpredictable changes in capital values. Also, unlike bonds there is the potential for the income to rise in future years as most rent reviews are upwards. This growing income should also help to drive capital values higher over time.

For clients who are determined to make a significant investment in property we would be happy to discuss suitable commercial property funds as an alternative to residential buy-to-let.

Our **Heritage Managed Portfolio Fund** allocates approximately 10% to commercial property, which we consider to be sufficient exposure for most investors.

Revised investment parameters for Heritage Enhanced Bond Funds

The investment objective of the Enhanced Bond Funds is to generate an annual return of approximately 1% in excess of that obtainable on bank deposits. To position the Enhanced Bond Funds to achieve this objective, they hold a laddered portfolio of high investment-grade bonds with maturities ranging up to approximately 6 years. These bonds are purchased on a yield-to-redemption and are typically held until they mature, locking in this return over the life of the bond. However, during the period that the bonds are held, their capital values will fluctuate as interest rates vary, with longer-dated bonds being more sensitive to changes in yields.

Up to now, it has been our policy to hedge the interest rate exposure of the longer duration bonds held by the Enhanced Bond Funds, in order to reduce the volatility of their monthly returns. This hedging can be beneficial when bond yields rise and the capital values of bonds fall, but it can also restrain returns if the timing of putting on the hedge is not right and yields fall back. For this reason, during the quarter we decided to discontinue the interest rate hedge and to hold bonds unhedged until maturity. This approach may result in the monthly returns of the Enhanced Bond Funds being more volatile than previously and more closely correlated to those of other short-duration bond 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 £	Target returns US $	Actual return £	Actual return US$	Average volatility
Model portfolios:								
Defensive	100%			4.5%	2.0%	4.2%	1.8%	2.3%
Cautious	57%	43%		6.0%	3.3%	5.7%	3.8%	1.1%
Balanced	23%	50%	27%	8.0%	5.9%	10.2%	9.1%	2.2%
Growth		33%	67%	10.0%	9.0%	16.0%	15.7%	4.9%
Benchmarks:								
3 month interest rate						3.7%	1.0%	0.1%
10 Year government bonds (total return)						1.1%	3.5%	3.0%
MSCI World Equity Index						21.7%	41.5%	9.7%

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Heritage Capital Management Limited
40 Broadway, London SW1H 0BT
Tel: +44 (0) 20 7799 2110 Fax: +44 (0) 20 7222 1599
General Email: info@heritage-capital.co.uk
Website www.heritage-capital.co.uk