Quarterly
Newsletter
& Investment Review

Issue 26 | Combined news & investment review from Heritage | Quarter 2 2004

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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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A difficult environment

Markets have struggled to make any progress so far this year with the main cause for concern being developing signs of inflation and the resultant turn upwards in the interest rate cycle. Bonds have been hit particularly hard, suffering their worst quarter for over 20 years.

Fortunately, most Heritage clients have heeded the warnings that we raised in recent quarterly reviews and have switched some or all of their portfolios from the Enhanced Bond Funds into the Absolute Return and Managed Portfolio Funds, which have had a solid first half-year despite the difficult environment.

Private equity investment - adding some spice

Regular readers of our quarterly newsletter will be familiar with our generally conservative investment style and overall focus on capital preservation and enhancement. However, without taking any risk it is impossible to generate returns above those obtainable from basic cash deposits and therefore, where appropriate, we are not averse to taking on risk if we think that we will be adequately rewarded. An example of this is our limited exposure within the Heritage Managed Portfolio Fund to investments in unquoted companies or private equity as it is otherwise known.

The private equity market itself can be sub-divided into various sub sectors such as early stage venture capital, expansion or growth capital and management buy-outs or buy-ins of more mature businesses.

A common feature is strong management teams whose interests are closely aligned with the capital providers through having a meaningful equity stake. In addition, with ever increasing regulation and scrutiny of publicly listed companies many of the best management teams prefer to build a business away from the public arena.

The value of such companies can grow in a number of ways. New opportunities and markets can be developed, other complimentary businesses can be acquired or a simple established business can be bought at a favourable price with cash flows then used to reduce debt and increase equity value.

The historical returns from private equity are excellent when compared to other asset classes as evidenced by the returns of the listed investment trusts specialising in this sector. Over the past 10 years their average returns have comfortably beaten all 30 other investment trust sectors including for example UK equity growth, global equities, bonds and high income etc.

Our investment is through a combination of holdings in suitable private equity investment trusts and direct investment in unquoted companies. The investment trusts, which are themselves quoted on the stock exchange, provide exposure and diversification whilst also maintaining our liquidity and flexibility. The direct holdings allow us to take advantage of specific opportunities that we come across and to take a more active approach to realising value through supporting the development of the company.

Heritage Capital Management Limited

Review for the quarter ended 30 June 2004

Market Commentary

Any doubts as to the strength of the global economic recovery in the first few months of the year have subsequently dissipated as the US in particular has enjoyed a robust recovery as evidenced by the improvement in the employment figures and other economic indicators. However, this has given rise to a new worry for financial markets – rising interest rates in response to inflationary fears.

This has created a headwind for bonds and equities to struggle against and returns for global investors in the first half of the year have generally been disappointing. Furthermore, it is also a concern that the recent period of ultra low rates has encouraged huge amounts of cheap money to be borrowed to finance the purchase of higher yielding assets such as longer duration and low quality bonds, property and emerging markets securities.

The resultant asset price inflation and increased leverage has raised the level of risk within the financial markets and a measure of caution may be advisable whilst the extent and impact of higher interest rates becomes clearer.

United Kingdom

Although the FTSE 100 index outperformed the other major international indices in the second quarter, at 4464 it remains below the level at which it started the year.

A bid for the company that everyone seems to have a view on, Marks & Spencer, helped to put some life in the market but this has been offset by concerns over the level of corporate pension scheme deficits and the recent re-emergence of profit warnings by high profile companies such as Sainsbury's.

There were a further two quarter point base rate rises during the quarter. Rates have now already risen by a full percentage point from the low of 3.5% last summer to 4.5% today and indications from the Bank of England's Monetary Policy Committee are that further increases will follow until the desired slow down in consumer borrowing, spending and the housing market are achieved.

United States

The US market has continued to trade in a fairly narrow range and was marginally up over the quarter. Corporate results so far this year have generally been encouraging and ahead of expectations but opposing this positive force has been the fear of rising interest rates. Confirmation that the interest rate cycle has turned came on the last day of June when the Federal Reserve increased rates for the first time since they fell to just 1.0% a year ago.

Having suffered a minor collapse in the first few months of the year, the US Dollar has recovered some of the lost ground and appears to have stabilised, although further weakness is a distinct possibility given the continuing trade and budget deficit problems.

Europe

European bourses have generally traded in line with the US and UK markets so far this year.

However, Europe continues to lag behind the recovery currently being experienced by the other major global economies and the European Central Bank has not yet needed to raise Euro interest rates.

Japan

Despite falling by over 10% in the space of a couple of weeks at one point during the quarter, the Nikkei index has subsequently recovered and is currently comfortably the best performing market for the year-to-date with an 11% rise.

The upturn continues to feed through to all areas of the economy and there are reasonable grounds for optimism and belief that Japan is finally emerging from the deflation and structural issues that have plagued it for over a decade.

Emerging markets

Following their impressive gains over the previous 12 months, emerging markets suffered a setback this quarter. In China, fears of a possible hard landing as policymakers try to engineer a slowdown to the overheated economy highlight the cyclical nature and risks in emerging economies, although for a global investor such markets still offer some of the best opportunities for long term growth.

Investment Statistics - 30/6/2004

Equity Markets	Q2 2004	2004 ytd	2003	2002	2001	2000
Global - MSCI World ($)	0.01%	2.34%	30.61%	-21.47%	-17.29%	-14.05%
UK - FTSE 100	1.79%	-0.29	13.62%	-24.48%	-16.15%	-10.21%
US - S&P 500	1.46%	2.60%	26.38%	-23.37%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	1.01%	2.14%	11.38%	-33.51%	-18.64%	-3.82%
Japan - Nikkei 225	1.22%	11.07%	24.45%	-18.63%	-23.52%	-27.19%

Other	UK	US	Europe	Japan
PE Ratio	17	20	18	20
Dividend Yield	3.2%	1.9%	2.0%	0.9%
Interest rates - base	4.5%	1.25%	2.0%	0.0%
Bond Yields - govt. 10 year	5.09%	4.60%	4.31%	1.78%
Exchange rates (vs GBP)	-	1.8135	1.4905	197.88
Exchange rates (vs USD)	1.8135	-	1.2167	109.11
Gold ($ per ozs)		$395		

Source : Financial Times

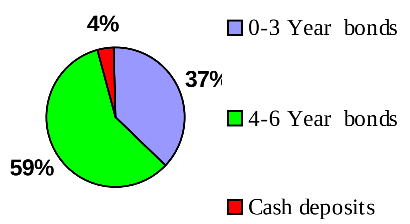
Heritage Investment Fund Limited

Review for the quarter ended 30 June 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 30 June 2004	£141.49	US$124.41	£122.76	US$118.50	£108.78	MSCI £ Index
Return for quarter (net)	-2.04%	-2.77%	1.31%	-0.24%	0.21%	1.35%
Return for year to date (net)	+0.63%	-1.43%	2.99%	1.52%	2.02%	0.86%
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	3.3%	3.0%	0.8%	1.4%	4.2%	8.9%
Size of Fund (millions)	£5.8	US$2.4	£30.1	US$11.8	£12.7	

Enhanced Bond Funds

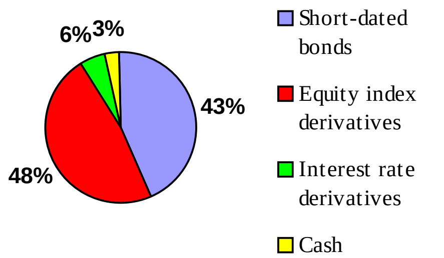


The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The Sterling and US Dollar bond portfolios currently yield 6.2% and 4.0% per annum gross to maturity, and have average durations of 1.8 and 2.3 years respectively, having been shortened from 3 years at the beginning of the quarter.

Bonds experienced their worst quarter in 20 years as yields rose significantly across the curve on confirmation of strong economic growth and expectations of rising interest rates and inflation. US Dollar and Sterling bond yields rose by around 1.0% and 0.4% during the quarter, causing 5 year bonds to fall by approximately 4% and 2% respectively.

Both Enhanced Bond Funds experienced one of their worst quarters, producing disappointing negative returns but, nevertheless, did not fall by as much as the market and are now showing attractive yields to maturity going forward.

Absolute Return Funds

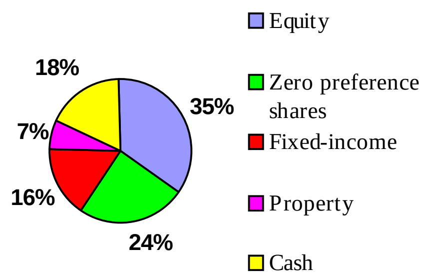


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross exposure of these derivatives positions is limited to the total funds under management. 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 continued to adopt a cautious approach in our derivatives positions 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 put on a number of modest directional trades in equity indices, US Treasuries, the Euro and gold during the quarter, which produced mixed results.

Both Absolute Return Funds produced returns below expectations for the quarter, restrained by weakness in bond prices, especially in the case of the US Dollar Fund.

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 fairly dull quarter, only managing to return 0.21%. For the year-to-date the Fund has gained 2.02% compared to the 0.86% rise in the MSCI £ World Index.

Overall it was a difficult quarter for our equity holdings as our favoured sectors and markets, suffered a correction following their strong gains over the previous 12 months.

Bonds had a very poor quarter as interest rate expectations continued to rise although our zero dividend preference shares held up well despite the combination of rising rates and flat equity markets.

With the major indices generally finding it difficult to make further progress we continue to concentrate on finding good individual investments which can outperform in the long-term and maintain reasonable levels of cash to take advantage of any opportunities that may arise later this year.

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

The outlook for short-term interest rates

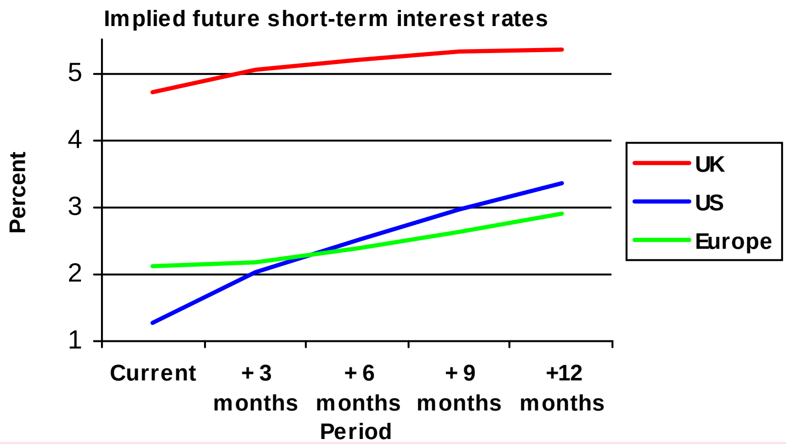
It is widely accepted that the bottom of the interest rate cycle in the major Western economies has now passed and that future moves in interest rates in the UK, US and Europe will be upwards. The economic recovery appears to be reasonably well established, although perhaps a little tentative in Europe, and the continuing escalation in property values and the expansion of credit have raised concerns over an increase in future inflation rates.

In the UK, we have already experienced four interest rate increases totalling 1.00% since November 2003, taking the base rate from 3.50% to 4.50% per annum. The US has just had its first increase in interest rates in 4 years, with the Federal funds rate being increased by 0.25% from 1.00% from 1.25% per annum. In the European Union, where the economic recovery is still fragile, the short-term interest rate has remained at 2.00% per annum for the past year.

Although most commentators are generally agreed on the future upward direction of interest rates, the more important question for investors and borrowers is when and by how far are they expected to rise. One of the best ways in which to obtain a view on the timing and quantum of future interest rate moves is to look at the levels of short-term interest rate futures. These are futures contracts traded in significant volume on regulated derivatives exchanges and represent the consensus market view of the levels of future three month interest rates.

Based on the levels of interest rate futures contracts at the end of June, the implied UK base rate at the end of the year is expected to increase by a further 0.50% from 4.50% currently to 5.00%, and by a further 0.25% to 5.25% by June 2005. In the US, where economic activity is strongest and potential interest rate increases are off a low base, the anticipated interest rate increases are much more significant. US interest rates are expected to increase by another 1.25% from 1.25% to 2.50% by December 2004, and by a further 0.75% to 3.25% by June 2005. In Europe, however, where economic recovery is weakest, short-term interest rates are expected to increase by only 0.25% from 2.00% to 2.25% by the end of the year, and by a further 0.50% to 2.75% by the middle of next year.

Although short interest rate futures are traded out to maturities of three years into the future and more, the implied levels of future interest rates become less reliable as a forecast in excess of one year out. It must be appreciated that the above forecasts of expected short-term interest rates are implied from futures markets at this point in time and may well differ from the actual outcome.



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

	Suggested asset allocation: Enhanced Bond Fund	Absolute Return Fund	Managed Portfolio Fund	Target returns £	Target returns US $	Last 12 months Actual return £	Actual return US$	Average volatility
Model portfolios:								
Cautious	33%	67%		6.0%	3.8%	4.6%	1.9%	1.3%
Balanced	19%	50%	31%	8.0%	5.9%	5.9%	7.5%	1.5%
Growth		40%	60%	10.0%	8.0%	7.4%	12.8%	2.7%
Benchmarks:								
3 month interest rate						4.0%	1.0%	0.1%
10 Year government bonds (total return)						-2.4%	-4.0%	3.1%
MSCI World Equity Index						10.6%	21.6%	8.1%

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