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, pension funds, trusts and companies.

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Heritage

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A mixed bag for investment markets

For equities it has been a summer of two halves, with the initial weakness that pushed the major markets down sharply subsequently giving way to a good recovery. Bond markets have also experienced a turnaround, as fears that the interest rate cycle was taking a significant turn upwards have been replaced by concerns that the global economy may already be faltering.

We are pleased to report that all the Heritage Funds produced solid positive performances this quarter and further details can be found as usual on page 3.

Heritage's unique approach to investment

At Heritage, we have always been a little different when it comes to our approach to investment and never followed the herd! In the investment world, most of the large investment houses seem to take comfort from following each other, which can often be disastrous when things go wrong. We pride ourselves on being original thinkers, who operate entirely independently of the mainstream investment community.

WE DO NOT:
- operate a funds of funds, investing in other third party funds with a consequent additional layer of charges which reduces your investment return.
- levy any initial charges, which typically can be up to 5% of the amount invested.
- employ any quarter-end window-dressing by selling losing shares and buying the winners after the event.
- keep investors waiting for months when they redeem their investment.
- tell clients that we have done well when we have lost money because an index has gone down by even more.

WE DO:
- provide a personal service to investors, to whom we are always accessible.
- make our own investment decisions and invest directly in bonds, equities and derivatives.
- have continuity of management as the principals of our business take the investment decisions.
- ensure that the securities held by our mutual funds are readily realisable and traded on recognised markets.
- pay out fund redemptions within a few days of each month end in full, without question.
- focus on generating positive returns for clients whatever the overall markets are doing.
- have significant amounts of our own family funds invested in our mutual funds on a long-term basis, giving us a vested interest in our performance.

Our above disciplined approach to investment has led to a steady increase in our funds under management over the years, which is comprised of a limited number of high net-worth individuals and small pension funds with whom we have long-term relationships.

Market Commentary

Last quarter we reported that bond markets had suffered as the world economy appeared to be recovering strongly. Since then bonds have rallied due to signs that the global economic recovery may already be slowing down. One of the major contributing factors has been higher oil prices brought about by a combination of supply threats such as insurgency in Iraq and Nigeria, the Yukos affair, and severe hurricanes, as well as increased demand for oil, particularly from China.

Although the MSCI World Equity Index was down by 1.23% for the quarter, the strength of the recent late summer rally has taken many investors by surprise, as it appears at odds with the more downbeat expectations for economic recovery from the bond markets. Overall though markets have remained within a fairly narrow trading range this year, certainly compared to recent times when by this stage of the year a much clearer trend had usually emerged.

This overall lack of direction for markets has made it difficult for equity, bond and hedge fund managers alike to make significant gains so far this year.

United Kingdom

The FTSE 100 index continued its run of outperformance against the other major international indices with a 2.4% gain for the quarter.

UK corporate earnings have generally continued to recover well in 2004 and valuations now appear reasonable, although as ever it could be difficult for the UK stock market to continue to make significant further progress without the dominant US market leading the way.

A further interest rate rise during the quarter has taken sterling base rates to 4.75% and there are finally signs that the rate rises have started to take effect with the housing market and consumer spending beginning to slow. In fact predictions earlier this year that interest rates may need to rise beyond 5.5% now look overdone and rates may already be near their peak for this cycle.

United States

After initially falling sharply the US market recovered towards the end of the quarter but overall still lost 2.3%.

Several companies reported disappointing Q2 results accompanied by lacklustre outlook statements. This was most prevalent in the technology sector, although some stalwarts such as Coca-Cola and MacDonalds were not immune and the home loans giant Fannie Mae provided yet another accounting related shock.

The Federal Reserve resumed its series of 0.25% interest rate rises in August and September to the current level of 1.75%. However, it remains to be seen that its expectations - that the economy will recover to a stronger pace of growth following a "soft" spot earlier in the summer - will be borne out.

Europe

European markets had a good September and for the year-to-date Europe is now ahead of the other major international markets with a rise of 3.2%.

Financial stocks attracted most attention with Banco Santander's bid for Abbey being the first major cross-border banking deal for some time.

Euro interest rates have now been held at just 2.0% for over a year and there appears little reason for these to be raised in the near future as the European economy continues to be sluggish, with its largest constituent, Germany, being the main culprit.

Japan

Japanese equity markets had a very poor quarter with a 9% loss virtually wiping out the good progress made in the first half of the year.

Also, after rising sharply earlier this year in anticipation of the end of deflation and a recovering economy, Japanese bond yields fell back during the quarter as the earlier optimistic expectations were moderated.

Emerging markets

Emerging markets have generally recovered quite well over the summer months. Even Latin America is finally showing signs of attracting some interest from investors as their more insulated domestic markets have shown signs of recovery.

Investment Statistics - 30/9/2004

Equity Markets	Q3 2004	2004 ytd	2003	2002	2001	2000
Global - MSCI World ($)	-1.23%	1.08%	30.61%	-21.47%	-17.29%	-14.05%
UK - FTSE 100	2.39%	2.10%	13.62%	-24.48%	-16.15%	-10.21%
US - S&P 500	-2.30%	0.24%	26.38%	-23.37%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	1.04%	3.21%	11.38%	-33.51%	-18.64%	-3.82%
Japan - Nikkei 225	-8.73%	1.38%	24.45%	-18.63%	-23.52%	-27.19%

Other	UK	US	Europe	Japan
PE Ratio	14	20	15	22
Dividend Yield	3.1%	1.7%	2.1%	1.0%
Interest rates - base	4.75%	1.75%	2.0%	0.0%
Bond Yields - govt. 10 year	4.83%	4.14%	3.99%	1.45%
Exchange rates (vs GBP)	-	1.8096	1.4570	199.44
Exchange rates (vs USD)	1.8096	-	1.2420	110.22
Gold ($ per ozs)		$418		

Source : Financial Times

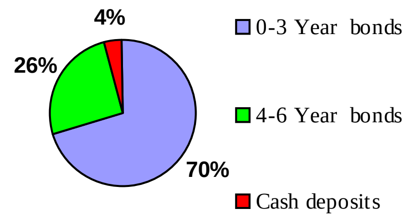
Heritage Investment Fund Limited

Review for the quarter ended 30 Sept 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+	
Typical range of returns	2% - 5%		0% - 8%		-9% - +12%	
Price at 30 September 2004	£144.19	US$126.16	£124.89	US$119.95	£111.84	MSCI £ Index
Return for quarter (net)	1.91%	1.41%	1.74%	1.22%	2.81%	1.02%
Return for year to date (net)	2.55%	-0.05%	4.77%	2.76%	4.89%	-0.16%
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	2.9%	2.8%	0.8%	1.3%	3.1%	7.0%
Size of Fund (millions)	£4.8	US$1.7	£33.6	US$13.1	£15.2	

Enhanced Bond Funds

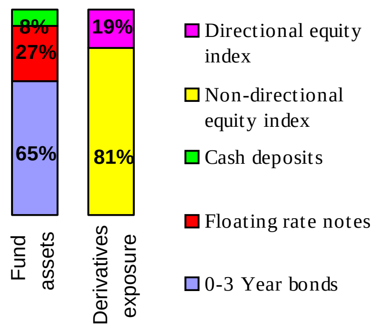


The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The Sterling and US Dollar bond portfolios currently yield 5.9% and 3.5% per annum gross to maturity, and have average durations of 1.7 and 2.1 years respectively.

During the quarter, both UK and US medium and longer-dated bond yields fell by between 30 and 50 basis points, resulting in rising bond values, based on signs of slowing economic growth and the realisation that short-term interest rates may not have much further to rise. Short-term interest rates increased by 25 and 50 basis points in the UK and US respectively over the quarter.

Both Enhanced Bond Funds produced above average positive returns for the quarter, but the year to date performance of the US Dollar Fund has been disappointing as 2 year yields have risen by almost 1% this year. Both Bond Funds are on attractive yields to maturity going forward.

Absolute Return Funds

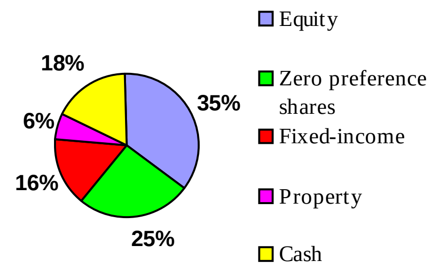


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross exposure of these derivatives positions is limited to the total funds under management. 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 continue to adopt a cautious approach to our derivatives positions by predominantly focusing on generating incremental returns from non-directional equity index positions. However, low market volatility has led to a fall in option premiums, making some strategies less attractive. Our directional positions in interest rates and equity indices during the quarter produced mixed results, with markets trends being difficult to forecast.

Both Absolute Return Funds produced positive returns for the quarter much in line with expectations, and continue to generate returns significantly in excess of cash deposits for the year to date.

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 gained 2.81% over the quarter compared to a fall of 1.02% for the MSCI £ World Index and for the year-to-date the Fund is up 4.89% compared to a small decline in the index.

Our equities had a good quarter overall, with gains from our property, utility and Far East holdings outweighing losses in our insurance stocks arising from the severe hurricane season.

Bonds also did well and our zero dividend preference shares benefited from the combination of falling bond yields and improved cover due to the rising UK equity market.

We continue to concentrate on finding good individual investments which offer potentially attractive returns over the long-term and maintain reasonable levels of cash to take advantage of any opportunities that may arise.

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

How the additional return in the Absolute Funds is generated

The core funds held by the Absolute Return Funds are invested in a mix of floating rate notes, short-dated bonds and cash deposits to generate an underlying income for the Funds slightly in excess of that available on cash deposits. Through a wholly-owned special purpose company and using approximately 10% of these funds as margin, the Funds then establish positions in the major international equity indices, interest rates and currencies using futures and options, to attempt to generate an incremental return. The total exposure under these derivatives positions does not exceed the total funds under management in the Absolute Return Funds, so consequently the additional return is limited as no leverage is employed.

Three different approaches are adopted with regard to the derivatives positions established:
- the core strategy is non-directional and is established to generate positive returns within certain limits, typically month by month. As the tolerance for error in this strategy is reasonably large, the returns generated are consequently modest.
- medium-term directional positions may also be established for periods of between 1 and 3 months to capture some of the anticipated trends in equity indices, interest rates or currencies. Losses can be incurred on these positions if the underlying securities do not move as expected.
- finally, short-term trading positions may be set up in an attempt to capture some of the daily and weekly moves in equity indices, interest rates or currencies. This is the most demanding and risky strategy and, consequently, the exposure under these positions is limited to around 10% and tight stops are employed to limit downside losses.

Although the historical monthly returns of the Absolute Return Funds are fairly stable and the occasional losses are modest, it must be appreciated that it is not possible to generate returns in excess of those available on cash deposits without exposure to some element of risk. We recognise and quantify this risk in our Funds, and take appropriate steps to reduce and limit any potential losses.

Finding value in company shares

A large part of the role of a fund manager involves researching and analysing companies. Through studying a company's business model, profitability and cash flow, management and strategy, assets and liabilities, and its future prospects, it is possible to make an assessment of the quality of the company.

However, this is only the starting point as good companies may sometimes be a very poor investment if the initial price paid is too high. For example, in 2000 the share price of Vodafone peaked at 400p and it was the largest holding in most UK equity funds. The shares subsequently fell to below a pound and today trade at just 130p. So what went wrong? Well the business has actually done very well – in fact it has doubled its earnings per share from 4.6p in 2000 to over 9p last year. The problem was that at 400p the PE ratio of over 80 was simply way too high.

The key to success is selectively investing in only those companies that can be bought at a discount to their intrinsic value. It is for this reason that the Heritage Managed Portfolio Fund ignores the make-up of the stock market indices in favour of identifying individual companies that can be bought at a price which is lower than our assessment of their underlying value.

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

	Suggested asset allocation					Last 12 months		
	Enhanced Bond Fund	Absolute Return Fund	Managed Portfolio Fund	Target returns £	Target returns US $	Actual return £	Actual return US$	Average volatility
Model portfolios:								
Cautious	33%	67%		6.0%	3.8%	5.6%	3.1%	1.3%
Balanced	19%	50%	31%	8.0%	5.9%	6.6%	7.8%	1.5%
Growth		40%	60%	10.0%	8.0%	7.7%	12.5%	2.7%
Benchmarks:								
3 month interest rate						4.4%	1.0%	0.2%
10 Year government bonds (total return)						2.6%	2.8%	1.6%
MSCI World Equity Index						5.6%	15.0%	7.0%

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