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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2004 finishes on a high note

Equity markets finally came to life with a strong rally in the final months of 2004 following a lacklustre performance over the first three-quarters of the year.

All the Heritage Funds produced solid positive performances this quarter, resulting in another good outcome for the full year. We are also pleased to report that our two largest funds, the Heritage Sterling Absolute Return Fund and the Heritage Managed Portfolio Fund, were the best performers with returns of 7.2% and 10.9% respectively.

Target returns for 2005

The question for 2005 is, as for last year, how much further interest rates have to rise and what effect this will have on long-term bond yields and equity markets. The futures markets are forecasting that UK short-term interest rates have peaked and will remain largely unchanged this year, whilst US and European short-term rates are predicted to rise by a further 1.5% and 0.5% respectively over the coming year. The fall in the US Dollar is likely to create inflationary pressure and, should the external funding of the US current account deficit come under pressure, this could result in even higher US bond yields.

For this reason, our Enhanced Bond Fund will be focusing on investing in Sterling and European bonds, whilst avoiding exposure to US bonds. However, UK bonds yields are not very attractive at present as the yield curve is inverse, with longer-dated bonds yielding less than short-term deposits. European bonds are more attractive as they presently offer a premium for going longer. Based on the above scenario, the outlook for the Enhanced Bond Fund appears unexciting and it is probable that its net return this year may only match that obtainable on short-term bank deposits.

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 currently target a margin of 4% over short-term bank deposits, which translates into net target returns of approximately 7.25% and 5% for Sterling and US Dollars respectively. However, strong market reversals, coupled with low overall market volatility, as experienced during the past year, are less than ideal conditions for our derivatives-based investment strategies and these may prove difficult targets to achieve this year.

The consensus forecast for equity markets for the coming year is for similar total returns as in 2004, being in the high single-digits. Our Managed Portfolio Fund targets the long-run average annual return delivered by equities of approximately 10%, but with substantially lower volatility. However, the strong equity market gains of around 10% in the last 5 months of 2004 could restrain this year's returns and it is anticipated that the performance of our Managed Portfolio Fund may only be in the high single digit range for 2005.

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.

Heritage Capital Management Limited

Review for the quarter ended 31 December 2004

Market Commentary

After trading in a fairly narrow range for the first three quarters of 2004, equity markets finally came to life in the final quarter with a decisive move upwards following the November US presidential election.

Although global economic growth and corporate earnings growth are both expected to slow slightly in 2005, following a very good 2004, inflation and real interest rates remain supportively low and equity valuations are reasonable compared to bonds. Oil prices have also fallen back after surging above $50 earlier in the year. Against this fairly benign macroeconomic background and with markets currently trending higher, the general consensus is fairly bullish going into 2005.

As ever though there remain risks to this rosy scenario. One of the major themes in financial markets in 2004 was the decline in the US Dollar. Whilst this has so far taken place in a relatively calm manner there remains a risk that a more severe adjustment to the underlying structural economic imbalances will take place at some point, throwing currency markets into turmoil as well as adversely impacting bond and equity markets.

United Kingdom

The FTSE 100 index had a good final quarter, rising by 5.33% to give an overall gain of 7.54% for the year.

Despite the rise in the UK market, valuations are still at the same level as they started the year, on a PE ratio of 16, as earnings growth has matched the rise in the index. Also, with a well-covered dividend yield of over 3% and reasonable prospects for continued dividend growth the UK market looks fair value.

The major risk in the UK for the year ahead is a severe downturn in the housing market which in turn could knock the confidence and spending of the already over-extended consumers.

United States

After a flat first three-quarters of the year, the US market led the final quarter global stockmarket surge with a 8.73% rise in the S&P 500 index. The recovery in US corporate earnings this year has been impressive and corporate profits as a proportion of US gross domestic product is now at an historically high level.

After a “soft patch” earlier this year the Federal Reserve appears confident that the economic recovery is now back on track and it increased interest rates in November and December taking the current rate to 2.25% with the likelihood of further increases to come.

However, with this tightening of monetary policy, a waning of the impact of tax cuts, increasing labour and raw material cost pressures and stubbornly high valuations, the US equity markets have the potential to disappoint the generally bullish expectations for 2005.

Europe

At the previous quarter end Europe was ahead of the other major markets for the year-to-date but it ended the year at the bottom of the table following a more muted final quarter rally.

The strength of the Euro has provided a boost for international investors who have made good currency gains on top of reasonable investment returns. However, for Europeans the worry is that a combination of a strong currency, weaker global growth and competition from lower cost manufacturing regions will further harm its already fragile economy.

It is for these reasons that in contrast to the US and UK where rates have been rising this year, Euro interest rates have now been held at just 2.0% since June 2003.

Japan

Japanese equity markets recovered from a very poor third quarter with the Nikkei index ending the year up by 7.61%.

For more than a decade Japanese PE ratios have been much higher than those for Western markets as Japanese corporate earnings have been desperately low. However, things finally appear to be improving and if current earnings forecasts are met the PE ratio may fall below 20 next year. This equates to an earnings yield of over 5%, which in a country where inflation and interest rates are effectively zero and bond yields are below 1.5%, may begin to look attractive to even the most cynical investors.

Emerging markets

Although the recent earthquake and tsunamis caused widespread devastation across much of the Asian region, the economic impact was less severe and stockmarkets have hardly been affected. Furthermore, the combination of good earnings growth prospects and lower valuations than the major markets continue to make the Far East/Asian region attractive.

Investment Statistics - 31/12/2004

Equity Markets	Q4 2004	2004	2003	2002	2001	2000
Global - MSCI World ($)	11.80%	13.01%	30.61%	-21.47%	-17.29%	-14.05%
UK - FTSE 100	5.33%	7.54%	13.62%	-24.48%	-16.15%	-10.21%
US - S&P 500	8.73%	8.99%	26.38%	-23.37%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	3.27%	6.59%	11.38%	-33.51%	-18.64%	-3.82%
Japan - Nikkei 225	6.15%	7.61%	24.45%	-18.63%	-23.52%	-27.19%

Other	UK	US	Europe	Japan
PE Ratio	16	20	15	28
Dividend Yield	3.1%	1.6%	1.9%	1.0%
Interest rates - base	4.75%	2.25%	2.0%	0.0%
Bond Yields - govt. 10 year	4.54%	4.22%	3.68%	1.43%
Exchange rates (vs GBP)	-	1.9199	1.4125	196.73
Exchange rates (vs USD)	1.9199	-	1.3593	102.47
Gold ($ per ozs)		$438		

Source : Financial Times

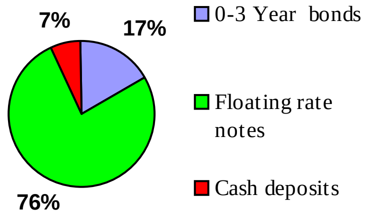
Heritage Investment Fund Limited

Review for the quarter ended 31 December 2004

Performance

	Enhanced Bond Fund	Absolute Return Funds		Managed Portfolio Fund	Cash Deposits (£)	MSCI World Index (£)
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 31 December 2004	£145.51	£127.72	US$121.94	£118.27		
Return for quarter (net)	0.92%	2.27%	1.66%	5.75%	0.81%	5.38%
Return for year to date (net)	3.49%	7.15%	4.46%	10.92%	3.06%	5.21%
Year 2003 return (net)	2.49%	5.71%	3.65%	16.10%	2.69%	17.64%
Year 2002 return (net)	5.19%	7.95%	5.82%	-0.41%	3.04%	-29.01%
Year 2001 return (net)	5.51%	6.83%	5.38%	-7.19%	3.78%	-15.11%
Year 2000 return (net)	9.59%	6.53%	6.89%	-0.64% (1 mth)	4.72%	-7.11%
Annual volatility	2.9%	1.0%	1.3%	3.8%	0.1%	6.6%
Size of Fund (millions)	£5.0	£36.0	US$13.5	£17.5		

Enhanced Bond Fund

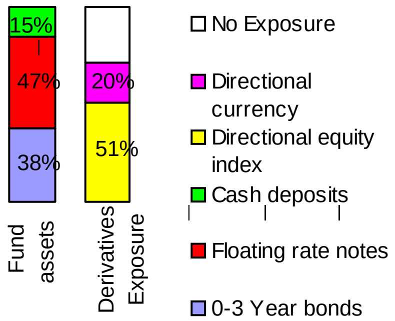


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 5.3% per annum gross to maturity and has an average duration of 0.3 years.

During the quarter, UK and European bond yields fell progressively across the curve by up to 30 basis points, as short-term interest rates appear to have peaked. US Dollar interest rates were increased by 0.50% during the quarter, resulting in bonds yields rising particularly at the short end. As a result of investors switching out of the US Dollar Bond Fund into other Heritage Funds, this Fund closed at the end of November in view of its small size and uneconomic cost base.

The Sterling Enhanced Bond Fund produced an average return for the quarter, and a slightly disappointing annual return comparable to that obtainable on cash deposits.

Absolute Return Funds

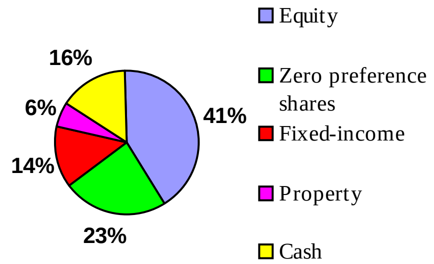


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross exposure of these derivatives positions is limited to the total funds under management.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

During the quarter, we reduced our exposure to non-directional equity index positions, as continuing low market volatility has led to a fall in option premiums, making this strategy less attractive. Our positive directional positions in the Euro currency and US equity market indices during the last two months produced strong positive results, boosting the overall quarterly returns.

Both Absolute Return Funds produced positive above trend returns for the quarter, and generated returns significantly in excess of cash deposits for the year close to their targets.

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 finished the year strongly with a 5.75% return in the final quarter and for the full year the Fund was up by 10.92% compared to a 5.21% rise in the MSCI £ World Index.

Virtually all of our equity holdings performed well, assisted by the post US election rally in global stockmarkets. The Fund's best performers this year have been diversely spread across areas such as utilities, small cap stocks, emerging markets, property companies and private equity.

Fixed interest securities have again done reasonably well and our zero dividend preference shares have continued their good run which has been helped by improving cover and lower bond yields.

We continue to concentrate on finding good individual investments that offer potentially attractive returns and maintain a reasonable level of liquidity to take advantage of any opportunities that may arise.

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

Mark Glew Joins Heritage

It is with pleasure that we wish to advise that Roy's son, Mark, has joined Heritage with effect from the beginning of this year. Mark holds a BSc (Hons) degree in Economics from the University of Bristol and qualified as a chartered accountant with Deloitte in the City of London in 2002. He is also a member of the Chartered Institute of Taxation and has been working as a consultant in the corporate tax department at Deloitte for the past 5 years. Mark has also now passed his Investment Management Certificate and with his strong academic background should add further skills and depth to our investment team. He will initially be involved in assisting Roy in advising Heritage Investment Fund.

Deadlines for subscriptions, redemptions and switches

Now that Heritage Investment Fund is regulated by the Guernsey authorities, it is appropriate to remind investors of the more stringent deadlines that must be adhered to with regard to subscriptions, redemptions and switches between our Funds. Our Funds are valued at the end of each month and investors can subscribe for, redeem or switch shares between Funds at that date.

Requests for subscriptions to, redemptions from and switches between Funds must be received by Heritage by the close of business on the last business day of the month. In the case of subscriptions, we must be in receipt of cleared funds by the last business day of the month in order to meet the above requirements. As a reminder, the minimum investment in the Heritage Investment Fund is £20,000.

Redemptions of shares in our Funds are paid out on the 5th business day after the month-end and can only be paid into an account in the name of the investor (which is usually maintained with Heritage).

Unfortunately, no exceptions can be made if these deadlines are missed for any reason. It is, therefore, important that clients plan their cash flow requirements with these monthly deadlines in mind and, if necessary, hold slightly larger cash balances in our cash management facility if there is any chance that they may require funds between month-ends.

Model asset allocation table

The objective of the asset allocation table below is to provide a guide as to how you might best allocate your investments between the three classes of our Heritage Funds (ie Enhanced Bond, Absolute Return and Managed Portfolio) in order to position your overall portfolio to generate your desired target return with the lowest amount of risk. No matter how good the historical performance of any one Fund appears, it important that you consider diversifying your portfolio by spreading your investments over more than one class of our Funds, in order to minimise the risk of loss by not having "all your eggs in one basket". As we continually bring to your attention, past performance is not a reliable guide to future performance. You will note that for the 2004 calendar year, the actual net returns earned were very close to the estimated target returns.

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 £	Actual return £	Average volatility
Model portfolios:						
Cautious	33%	67%		6.0%	5.9%	1.3%
Balanced	19%	50%	31%	8.0%	7.6%	1.5%
Growth		40%	60%	10.0%	9.4%	2.7%
Benchmarks:						
3 month interest rate					4.4%	0.1%
5 year government bonds (total return)					5.3%	2.5%
MSCI World Equity Index					5.2%	6.6%

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