Quarterly
Newsletter
& Investment Review

Issue 29 Combined news & investment review from Heritage Quarter 1 2005

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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 lacklustre start to the year

Both equity and bond markets have failed to make any significant progress during the first quarter of the year. The falling US stockmarket has dragged down global equities and bonds have been impacted by rising US interest rates.

Although the above combination held back the US Dollar Absolute Return Fund the other three Heritage Funds have all made a solid start to the year with gains of between 1-2% for the first quarter.

Keep it simple – why investment products are often best avoided

As investment managers we are often asked what we think of some new investment product that is being promoted. There is a vast range of different products on offer these days, from with profits bonds and other insurance linked products, to so-called "guaranteed" products and other structured products that are often linked to one or more indices.

There are usually a few common features behind all of these products. Firstly on the plus side, and highlighted prominently in the promotional material, will be a seemingly attractive headline rate of return. However, in our experience these products also contain a number of other features which the banks or insurance companies and their network of salesmen are less keen to point out including ;
Complexity - although the sales emphasis will simply highlight the attractive potential returns, actually understanding what you are investing in is much harder. Also, the small print often reveals that so called "guarantees" only apply to either the capital or income, whilst the risks to the other are conveniently ignored in the sales material.
Poor value - You can be sure that the product is not offering a free lunch and that on top of the cost of the product itself the high marketing costs will also be built into the product either via high initial charges or ongoing hidden charges.
Illiquidity - unlike a simple investment fund, investment products usually have a set life-time with restrictions on cashing in your investment or penalties for early redemption.
Marketing rather than investment driven - As these products invariably originate from the marketing department (rather than from investment professionals) and will be promoted via a sales campaign, they often will be plagued by the tendency to launch flawed products right at the top of the market.

Finally, the very fact that a product is being sold and actively promoted should be a warning sign. As with most things in life, if someone appears very keen to sell you something you will probably find that he will have more to gain from the sale than you will benefit from the purchase. In our experience good investments are more likely to be found by hunting for value in areas that are currently out of fashion with the large financial institutions, and that simple funds are better than complex products.

Heritage Capital Management Limited

Review for the quarter ended 31 March 2005

Market Commentary

The current year has got off to a rather disappointing start with the fall in the MSCI World Index hurting equity investors and rising interest rates impacting bond investors. In order to try and understand where we are today and what the future might hold for investors it is useful to look back on what has happened in recent years.

Two years ago things appeared fairly bleak following a savage equity bear market and with the world seemingly in crisis and on the brink of war in Iraq. However, the combination of investors risk aversion driving down prices and the ultra low interest rates available resulted in an impressive rally in 2003 and 2004. Investors began to use the low borrowing rates to gear up and invest in all kinds of risky assets including global equities, emerging market and high yield bonds and property.

Unfortunately all good things come to an end and this wonderful period for risky assets now appears to be stalling. The liquidity which fuelled the rally is being stemmed by rising interest rates and the significant rise in prices already seen means that valuations are no longer as attractive as they were. We therefore believe that the current conditions will favour those investors who are able to combine a measure of caution and good judgement over those that continue to indiscriminately buy risky assets.

United Kingdom

The UK market usually takes its lead from the dominant US so it was a welcome change to see the FTSE 100 index gaining 1.66% in a quarter in which the US market fell.

The market has been supported by a combination of the reporting of good growth in company earnings and dividends during the recent results season and continued merger and acquisition activity.

The UK general election on May 5th is unlikely to have a major impact on markets, although it does appear likely that taxes and government borrowing will both need to rise further to cover the large increases in public spending initiated by the current government.

United States

The US was the worst performer of the major markets this quarter with a 2.59% fall by the S&P 500 index and the Nasdaq falling by around 8% to close back below 2,000.

As usual there was also some particularly bad news for a few individual major companies with General Motors warning on profits and having its bonds relegated to junk status, and the insurer AIG embroiled in a scandal after becoming the latest target of the New York Attorney General, Eliott Spitzer.

The biggest drag on the overall market at present is the continued rise in interest rates with a further two 0.25% increases this quarter taking the total number of quarter percent rises to seven since the Federal Reserve started tightening monetary policy last year. Furthermore, although reported corporate earnings have continued to generally be good, expectations for further growth in 2005 are currently being scaled back.

Europe

Europe managed to achieve the best performance of all the major markets with a rise of 3.72% in the first quarter.

European companies have recently been delivering decent increases in earnings and dividends, although this is unlikely to be sustainable as much of the improvement has been down to one-off cost cutting and productivity gains. Top line growth will be harder to achieve whilst the overall European economy continues to struggle, particularly now that the impact of a significantly higher Euro is starting to feed through.

Japan

The Nikkei index started the year with a 1.57% rise in the first quarter.
Investors in Japan are hoping that the recent weakening in the economy is just a minor cyclical downturn and that the longer term trend in structural improvements will continue to develop.

Emerging markets

Emerging markets started the year on a very positive note with good gains in January and February but have since then fallen back sharply. Despite this not unusual volatility, the fundamental attractions of many emerging markets remains in place, with for example the emergence of the domestic Asian consumer continuing to be a developing theme.

Investment Statistics - 31/3/2005

Equity Markets	Q1 2005	2004	2003	2002	2001	2000
Global - MSCI World ($)	-1.54%	13.01%	30.61%	-21.47%	-17.29%	-14.05%
UK - FTSE 100	1.66%	7.54%	13.62%	-24.48%	-16.15%	-10.21%
US - S&P 500	-2.59%	8.99%	26.38%	-23.37%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	3.72%	6.59%	11.38%	-33.51%	-18.64%	-3.82%
Japan - Nikkei 225	1.57%	7.61%	24.45%	-18.63%	-23.52%	-27.19%

Other	UK	US	Europe	Japan
PE Ratio	15	19	15	28
Dividend Yield	3.1%	1.7%	2.2%	1.1%
Interest rates - base	4.75%	2.75%	2.0%	0.0%
Bond Yields - govt. 10 year	4.69%	4.51%	3.62%	1.33%
Exchange rates (vs GBP)	-	1.8896	1.4540	202.11
Exchange rates (vs USD)	1.8896	-	1.2996	106.96
Gold ($ per ozs)		$428		

Source : Financial Times

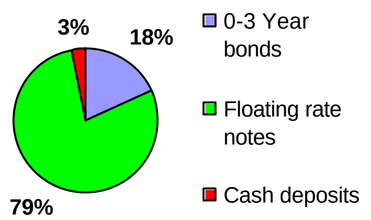
Heritage Investment Fund Limited

Review for the quarter ended 31 March 2005

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 March 2005	£147.33	£129.03	US$121.74	£120.51		
Return for quarter (net)	1.25%	1.03%	-0.16%	1.89%	0.81%	0.03%
Return for year to date (net)	1.25%	1.03%	-0.16%	1.89%	0.81%	0.03%
Year 2004 return (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)	£4.7	£37.0	US$17.0	£18.7		

Enhanced Bond Fund

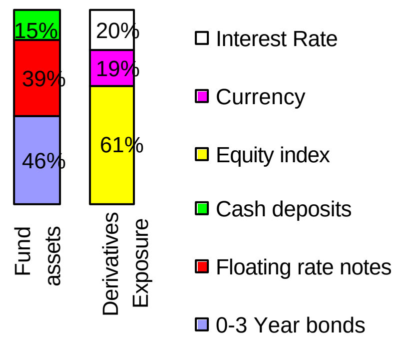


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 5.7% per annum gross to maturity and has an average duration of 0.3 years.

During the quarter, UK bond yields rose across the curve by around 25 basis points, based on the view that UK interest rates may have further to rise as the economy continues to grow. US Dollar bond yields rose more significantly by up to 70 basis points at the short end on the widely signalled outlook for further progressive rises in interest rates. However, there was little change in European bond yields, with the strong Euro stifling economic growth.

The Sterling Enhanced Bond Fund produced a solid return for the quarter much in line with expectations, with the year-to-date return ahead of that obtainable on cash deposits.

Absolute Return Funds

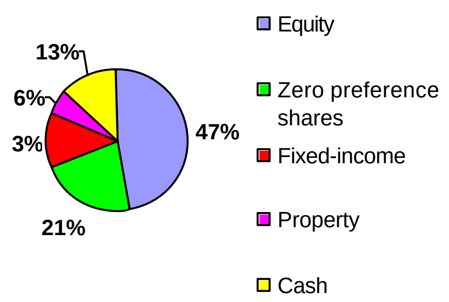


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment grade bonds to provide underlying income for the Funds.

During the quarter, our derivatives overlay produced a disappointing incremental return of only 0.5%, well below our target of 1%. Our directional positions in the Euro currency, US Treasury Notes and the US equity market index produced mixed returns, owing to an unexpected recovery in the US Dollar, an anticipated weakening of US Treasury bonds and a range-bound US equity market.

Both Absolute Return Funds produced disappointing returns for the quarter, particularly in the case of the US Dollar denominated Fund where rising US interest rates severely depressed short-term bond prices.

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 1.89% in the first quarter despite a lacklustre 0.03% return for the MSCI £ World Index.

Our equity positions have benefited from being in the UK and Far Eastern markets which have started the year positively unlike the large US market which has fallen, and also from being overweight in smaller cap stocks which have continued to outperform.

Although Sterling bonds were impacted by rising yields, our zero dividend preference shares again made a positive contribution as spreads continued to narrow.

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.

What moves the markets

Bonds constitute the core investments of the Absolute Return Funds and, although they provide a steady flow of income, the historic returns of the Funds have been significantly greater than that which would have been earned from bonds alone. The Funds earn incremental returns by taking positions using derivatives that reflect our view of the future performance of the major equity, bond and foreign exchange markets. We consider numerous factors when forming our forecasts and outline below the major factors that influence these markets.

Economic statistics, the level of interest rates, commodity prices and the earnings of major corporations, among others, influence equity markets. Investors buy stocks when they perceive the economy is growing and will examine corporate profits, the level of GDP growth, the unemployment rate and consumer spending figures to assess the likely direction of economic growth. High commodity prices (especially oil) can increase production costs and threaten consumer spending, causing company profits to falter and equity markets to retreat.

Investors attempt to determine the direction of bond markets by examining interest rates, inflation and the performance of equity markets. Bond prices are inversely related to the return required by investors – if interest rates advance or inflation rises, investors will require a higher return from bonds, which is achieved by a fall in price. Consequently, bond markets are sensitive to changes in interest rates or signs of inflationary pressure in the economy. Another factor investors consider is the performance of the equity markets. If the equity markets are weak, investors often seek sanctuary in the lower risk bond market, causing prices to rise.

One of the key influences on the direction of foreign exchange rates is the interest rate differential between currencies – currencies with higher interest rates may attract investment from overseas and often appreciate against those with lower rates. Investors also closely follow the balance of payments for each country – if it is in deficit, the currency may have to devalue in the longer term to correct this imbalance. Inflation is also a factor in determining the exchange rate between two currencies. In the long term, a currency with higher inflation will devalue against currencies with lower inflation as its purchasing power in the world market diminishes.

The above are some of the statistics we research to enable us to form an opinion of how the markets might possibly move, from which we formulate derivative positions that might be expected to earn the incremental return targeted by the Absolute Return Funds.

The use of investment trusts

In addition to individual trading companies the Managed Portfolio Fund also holds investment trusts. These are investment companies that are listed on the London Stock Exchange, and trade in exactly the same way as company shares.

We recognise that we cannot spread our expertise across every sector and every country across the globe and so investment trusts provide a very useful way in which to gain exposure to areas that we feel offer good investment opportunities but where we lack sufficient in-house resources. One example of this is our use of investment trusts to gain exposure to the Far East and other emerging markets. Also, because unlike open ended investment funds they have a fixed capital base, investment trusts are well suited for holding illiquid investments such as private equity and property that we also have allocations to.

Having identified specialist sectors or geographic regions that we would like to have exposure to, we will then choose suitable investment trusts with managers whose investment style and approach is similar to our own. Furthermore, investment trusts also often trade at a discount to their underlying net asset values which allows astute investors to potentially benefit from both a rise in the asset value and a narrowing of the discount.

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%	5.0%	1.3%
Balanced	19%	50%	31%	8.0%	7.0%	1.5%
Growth		40%	60%	10.0%	9.2%	2.7%
Benchmarks:						
3 month interest rate					4.7%	0.2%
5 year government bonds (total return)					4.6%	0.8%
MSCI World Equity Index					5.8%	6.6%

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