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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Markets begin to make some progress

Following a poor start to the year for global investors, both equity and bond markets have improved over recent months, although the World Equity Index which is dominated by the large US market is still down for the year-to-date.

We are pleased to report that all of the Heritage Funds produced positive returns this quarter. Further details can be found as usual on page 3.

A conservative approach - why the tortoise might make a better investor than the hare

As most people are probably well aware, Heritage has positioned itself at the conservative end of the investment spectrum. Our clients' investments often represent a substantial portion of a family's hard earned wealth and in most cases their priority is to preserve and enhance their capital. We therefore feel that a conservative approach is appropriate. Notwithstanding this however, there are also sound reasons for not taking excessive or undue risk when it comes to investing generally.

A consideration of the basic mathematics of compound returns demonstrates the importance of avoiding significant losses. Many who take a high risk approach do not appreciate that if you make a 50% loss on your portfolio you subsequently require a 100% gain simply to get back to your starting capital. Also, it is interesting to note that an investment that returns a consistent 10% per annum produces a higher overall return than any other combination with an average annual return of 10% made up of more volatile returns (e.g. alternative years with 20% and 0% returns).

Of course good investment returns cannot be achieved without taking some risk and it is therefore the careful management of risk that is the key. This can be demonstrated by looking at the Heritage Funds, which have produced good returns with unusually low volatility over many years.
Our Absolute Return Funds have generated consistent positive returns irrespective of general market movements by taking a much lower risk approach than most "hedge funds". This has been achieved by supplementing the core capital, which is invested in short dated investment grade bonds, with carefully selected riskier positions - and without employing any gearing.
Our Managed Portfolio Fund's objective is to generate long-term capital growth at a lower risk than that associated with pure equity market investment. This approach allowed us to avoid the very significant fall in stock markets during the 2000-2002 bear market, and since its inception in 2000 the Fund is up by 26% compared to a fall of 25% in the MSCI £ World Equity Index over this same period.

In summary, we believe that over the long run a conservative, low risk approach to investing has much to commend it, and that we at Heritage are quite happy to be likened to the tortoise rather than the hare.

Heritage Capital Management Limited

Review for the quarter ended 30 June 2005

Market Commentary

Following a lacklustre start to the year, the performance of equities and bonds has improved in the second quarter. However, partly as a result of Dollar strength, the MSCI World Equity Index is still down by 1.8% for the year-to-date.

Many strategists have been confounded by the US Dollar's recovery, with the consensus at the start of this year being that it would continue to weaken further. However, the currency markets' focus on the US current account deficit has switched to concern for the Eurozone's prospects, and with US interest rates now rising comfortably above Euro rates the Dollar has staged a decent comeback.

Investors are currently finding it difficult to make sense of markets and the Federal Reserve chairman, Alan Greenspan, has expressed his surprise at the "conundrum" whereby longer bond yields have actually fallen despite the continued and well flagged increases in short term US Dollar interest rates. A possible answer to this is that bond investors do not share the equity market's or Fed Chairman's confidence in the sustainability of economic growth and are anticipating a weakening economy and lower interest rates in the medium term. With oil prices continuing to rise there is a danger that the more pessimistic scenario that the bond market is signalling could prevail.

United Kingdom

The UK market has continued to outperform the larger US market and the FTSE 100 index is now up by 6.2% this year, with the recent weakening of the pound being a contributing factor.

With most companies having reported an increase in earnings and dividends, the UK market remains at a reasonable valuation based on PE ratios and dividend yields, despite the rise in the index. However, the recent £5bn IPO of a new online poker company, Party Gaming, as well as numerous small oil and mining company listings on AIM shows that some areas of the market are still not immune to outright speculation.

Interest rates have been on hold at 4.75% since the previous rise in August last year and expectations have now swung in favour of possible rate cuts, as consumer confidence and the housing market have both shown further signs of weakening.

United States

Despite the S&P 500 index managing a small gain of 0.9% this quarter, the US is the only major market down for the year-to-date, although much of this year's relative weakness of the US stock market can be attributed to the strengthening of the dollar.

The US market continues to look expensive compared to other areas such as the UK, Europe and emerging markets. Furthermore, the recent dramatic rise of Google from its already highly rated offer price of $85 to over $300 to produce an $80bn company with a sky high PE ratio has certainly not helped to correct this.

Interest rates were increased by a further 0.5% to 3.25% this quarter and with the 10 year bond yield falling sharply to below 4% there has been a continued flattening of the US Dollar yield curve.

Europe

Europe again managed to achieve the best performance of all the major markets with a rise of 5.2% in the second quarter.

However despite the current reasonable performance at the corporate level, the wider economy continues to struggle with Italy now in recession and French and German unemployment remaining above 10%. It is now two years since the ECB last raised interest rates and most commentators now feel that a cut in rates is needed to boost the economy. On top of this, the French and Dutch rejection of the European Constitution has certainly harmed overall confidence in the future of the Eurozone.

Japan

The Japanese Nikkei Index slipped back by 0.7% in the second quarter although it is still just above the year's starting level.

Although the valuations of Japanese companies has improved due to the recent increase in corporate profitability, PE ratios are still higher than for the other major markets and Japan remains particularly susceptible to a slowdown in exports.

Emerging markets

After a setback in March and April emerging markets have recovered very strongly and are now generally well up for the year-to-date. Further evidence of the increasing importance of these markets was demonstrated recently when the China National Offshore Oil Corporation made a bid for Unocal, the 9th largest US Oil company.

Investment Statistics - 30/6/2005

Equity Markets	Q2 2005	2005 ytd	2004	2003	2002	2001
Global - MSCI World ($)	-0.25%	-1.79%	13.01%	30.61%	-21.47%	-17.29%
UK - FTSE 100	4.47%	6.21%	7.54%	13.62%	-24.48%	-16.15%
US - S&P 500	0.91%	-1.70%	8.99%	26.38%	-23.37%	-13.04%
Europe - FTSE Eurotop 100	5.20%	9.11%	6.59%	11.38%	-33.51%	-18.64%
Japan - Nikkei 225	-0.73%	0.83%	7.61%	24.45%	-18.63%	-23.52%

Other	UK	US	Europe	Japan
PE Ratio	15	19	14	28
Dividend Yield	3.1%	1.7%	2.5%	1.2%
Interest rates - base	4.75%	3.25%	2.00%	0.00%
Bond Yields - govt. 10 year	4.17%	3.98%	3.13%	1.28%
Exchange rates (vs GBP)	-	1.7925	1.4806	198.62
Exchange rates (vs USD)	1.7925	-	1.2106	110.81
Gold ($ per ozs)		$439		

Source : Financial Times

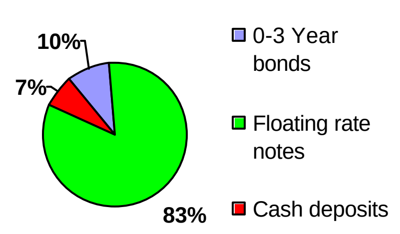
Heritage Investment Fund Limited

Review for the quarter ended 30 June 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% to 5%	0% to 8%		-9% to +12%		
Price at 30 June 2005	£148.60	£131.33	US$123.29	£125.94		
Return for quarter (net)	0.86%	1.78%	1.27%	4.51%	0.81%	5.19%
Return for year to date (net)	2.12%	2.83%	1.11%	6.49%	1.64%	5.23%
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	1.1%	1.1%	1.2%	4.5%	0.0%	10.0%
Size of Fund (millions)	£4.4	£38.0	US$20.0	£20.4		

Enhanced Bond Fund

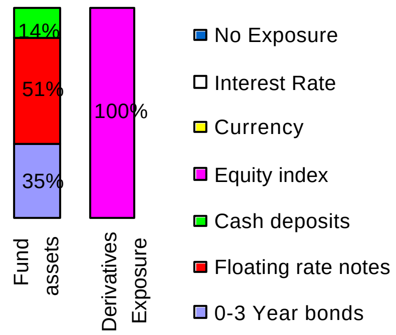


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 6.0% per annum gross to maturity and has an average duration of 0.3 years.

During the quarter, longer UK bond yields fell by around 50 basis points, based on the view that UK interest rates will be cut amid signs of a sharp fall in consumer spending. US Dollar bond yields rose by 30 basis points at the short end, on the widely signalled outlook that interest rates may rise several more times before the end of the year. European bond yields fell across the curve as interest rate cuts are being considered to encourage economic growth.

The Sterling Enhanced Bond Fund produced a steady return for the quarter, not quite reaching our target, but the year-to-date return is ahead of that obtainable on cash deposits.

Absolute Return Funds

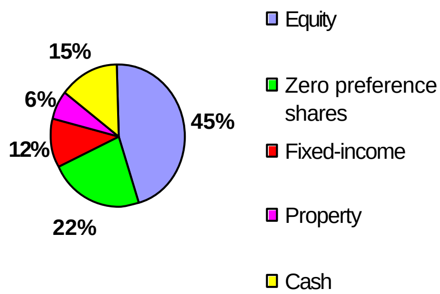


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

During the quarter, our derivatives overlay produced an incremental return of 1%, in line with our target. We closed our directional positions in the Euro currency and US Treasury Notes in view of the extreme moves in these markets and the current difficulty in forecasting future moves. Our non-directional equity index strategies generated most of the incremental return for the quarter.

Both Absolute Return Funds produced satisfactory returns for the quarter, but their year-to-date returns are lagging behind our targets, particularly in the case of the US Dollar denominated 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 good quarter, gaining 4.5%, helped by a strong performance by equity markets. For the first half of the year the Fund is up by 6.5%, compared to a 5.2% rise in the MSCI £ World Index.

Most of our equities produced positive returns in May and June as global stock markets rallied strongly following a couple of poor months in March and April. In particular the utilities, insurance and emerging market holdings all performed well.

The zero dividend preference shares benefited from a combination of improving cover (as a result of good equity performance) and lower bond yields, with the latter also assisting our other fixed interest securities.

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.

The Impact of the New EU Savings Tax Directive

You may be aware that the new EU Savings Tax Directive came into force on 1 July 2005. The aim of this Directive is to ensure the exchange of information between the tax authorities of EU Member States regarding EU residents who earn interest on savings and debt securities in one Member State but reside in another.

Whilst the legal scope of the Directive does not extend beyond the EU, certain other jurisdictions, such as the Channel Islands, have put in place legislation that supports the aim of the Directive. The legislation for the Channel Islands and the Isle of Man differs from the Directive in that the investors can opt to pay a ‘retention tax’ (initially 15%), deducted at source, instead of permitting the exchange of information.

The Directive only affects clients who are resident in an EU Member State and earn savings income in another Member State or supporting jurisdiction. Clients who are not EU resident would fall outside the scope, as do those clients who reside in the UK but have non-domicile status here, providing that they do not make taxable remittances into the UK.

Furthermore, the Directive only applies to individuals and trust beneficiaries who have immediate and absolute entitlement to trust income (i.e. an interest-in-possession settlement) and reside in an EU Member State. Other legal entities, such as discretionary trusts and companies, fall outside the scope of the Directive.

Although Heritage Investment Fund Limited (“HIFL”) is a Guernsey regulated mutual fund, legal opinion has confirmed that HIFL falls outside the scope of the Guernsey legislation, as it is a private fund and not a ‘recognised fund’ for the purposes of the Directive. HIFL is, therefore, not required to exchange information concerning redemptions nor deduct tax at source from redemptions.

UK resident and domiciled clients who hold accounts with and receive interest from Heritage Capital Management Limited (“HCML”) are also outside the scope of the Directive, as they are obliged to declare this income themselves under existing UK tax law. However, it would appear that, for those clients who reside in other EU Member States and earn interest on their cash balances and fixed-income securities held with HCML, we may be obliged to submit information to the tax authorities on their interest income (equity investments are not included in the scope of the Directive). This exchange of information is automatic and clients do not have the option of paying a withholding tax, as that option only applies to certain jurisdictions, such as the Channel Islands.

Heritage web site update

Our web site continues to provide a wide range of regularly updated information.

Amongst the recent new features added are two which might be of particular interest ;

Individual Fund factsheets – as well as the consolidated Heritage Investment Fund monthly report, our web site now also includes individual monthly factsheets for each sub fund containing additional information and performance graphs etc.

Newsletter back copies - previous editions of our quarterly newsletter and investment review contain many articles and statistics which may be of interest and are now all available online.

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%	6.3%	1.3%
Balanced	19%	50%	31%	8.0%	9.3%	1.5%
Growth		40%	60%	10.0%	12.3%	2.7%
Benchmarks:						
3 month interest rate					4.8%	0.1%
5 year government bonds (total return)					9.1%	0.6%
MSCI World Equity Index					9.8%	10.0%

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