Quarterly Newsletter & Investment Review

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In this issue

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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A quarter of strong returns

The third quarter of this year has seen a continuance of the equity market rally which began in May. Apart from the United States, which was held back by the combination of severe hurricanes, higher oil prices and rising interest rates, virtually all global equity markets posted significant gains this quarter.

We are pleased to report that all of the Heritage Funds have continued to perform well. Further details can be found as usual on page 3.

Heritage Absolute Return Funds consistently beat their targets over past 5 years

As our Sterling Absolute Return Fund has produced its 30th consecutive positive monthly return, we thought it a good opportunity to reflect on the returns generated by both the Sterling and US Dollar Absolute Return Funds over the last 5 years.

The Absolute Return Funds target net returns of approximately 3% in excess of short-term cash deposit rates, irrespective of general market movements, by taking a much lower risk approach than most ‘hedge funds’. The results show that both funds have achieved this target - the Sterling Fund producing an average annualised return of 7.18% and the US Dollar Fund of 4.61% over the period, with both Funds exceeding the average returns on cash holdings by in excess of 3%. The incremental returns generated by our Absolute Return Funds are limited as no leverage is employed and the total market exposures are restricted to the funds under management.

More importantly, the Funds have achieved returns in excess of their targets whilst maintaining an acceptable level of risk, as shown by the low volatility of returns for each Fund. The volatility of returns is a useful indicator of risk and the results show that the returns for our Funds have actually been less volatile than bonds over the period, which is in stark contrast to the high risk strategies implemented by many ‘hedge funds’ in the market place today.

Our findings also show that neither Fund was closely correlated with global equity markets over the last 5 years. A correlation coefficient of either + / - 1 would have inferred that the returns of the Funds closely followed the movements in the equity markets (either directly or inversely), but with correlation coefficients close to 0, both Funds were able to generate positive returns irrespective of falls in the equity markets during the period.

Of course, it is not possible to generate returns in excess of cash deposits without risk. Although the Sterling and US Dollar Absolute Return Funds produced monthly positive returns 87% and 78% of the time respectively, there have been months when losses were incurred by these Funds, but these have not exceeded 1.22%. Despite our success over the years, investors should be aware that past results are not a guide to future performance and that the value of investments can fall as well as rise. A detailed schedule of the returns, volatility and correlations over the past 5 years can be seen on page 4.

Market Commentary

The pick-up in equity markets that began in May has continued through the summer, with global equity markets having a very good third quarter.

Equity investors have certainly enjoyed a good recovery from the recent bear market with the MSCI World Equity Index rising by 35% over the past two years. It is interesting to note the contrast between the recent rise in the index, which has been accompanied by robust earnings growth, to the run-up in share prices in the late 1990's which was based on expanding PE ratios.

In the late 1990's the increase in prices was not matched by the underlying growth in profits and instead it was simply the result of overconfidence of investors which pushed the markets and valuations ever higher. This lack of fundamental support for the market meant that it was highly susceptible to a reversal in investor sentiment and indeed over the next few years equities fell dramatically.

By contrast, despite the large recent rises in the indices, the PE ratios for the major markets are all actually below their levels two years ago – in other words the gains have been more than justified by the earnings growth making shares arguably cheaper today. However, this should not be interpreted as a sign for complacency as although there is not the same risk due to overvaluation present today, there is the risk that earnings may have peaked and may even fall – a real risk given the huge increase in oil prices and the sluggish outlook for global economic growth.

United Kingdom

The FTSE 100 index had an excellent quarter, rising by just over 7.1% and bringing the year-to-date gain to 13.8%.

It now turns out that 4.75% was the peak in UK base rates for the current cycle as the Monetary Policy Committee reduced rates to 4.50% in August as evidence grew that the economy was starting to slow down. Retailers are certainly having a very tough time at the moment as consumers have finally began to tighten their belts and the proposed merger between Boots the chemist and Alliance Unichem may be just the start of the sector's consolidation in response to this.

United States

Although the S&P 500 index managed a 3.0% gain this quarter it is only marginally up for the year-to-date and in fact the Dow Jones and Nasdaq indices are actually still below where they started the year.

The severe damage wreaked by Hurricane Katrina was a vivid reminder that even the most powerful nation on earth is susceptible to natural catastrophes. The immediate impact was of course overwhelmingly negative for both the individuals affected and the economy but the hope is that for the latter this will to a certain extent be mitigated by the huge reconstruction effort that will be required.

Interest rates were increased by a further 0.5% to 3.75% this quarter and with further rises anticipated and the long bond yield just above 4% the yield curve may soon become inverted (i.e. longer interest rates fall below short rates) , which in the past has often been the precursor to an economic contraction.

Europe

European equity markets continued to build on the gains made so far this year with a rise of 7.9% for the Eurotop 100 index this quarter taking the year-to-date gain to 17.7%.

On the economic front there is still little sign that Europe can establish a reasonable level of growth and interest rates remain where they have been for over two years now, at just 2%. Furthermore, the current political stalemate in Germany does not provide grounds for optimism.

Japan

In contrast to Germany, where the reforming candidate was unable to secure the necessary majority, Japan's prime minister Junichiro Koizumi was able win a commanding mandate to continue with his economic reforms in the recent election.

This result has helped Japan to comfortably be the best performing of the major equity markets this quarter with the Nikkei rising by an impressive 17.2%.

Emerging markets

In contrast to the above major markets which are all still well below their all time highs despite the recent recovery, long term bulls of emerging markets will be encouraged by the fact that stockmarkets in several countries including South Korea, India, Brazil, Russia and South Africa have been setting new record highs.

Investment Statistics - 30/9/2005

Equity Markets	Q3 2005	2005 ytd	2004	2003	2002	2001
Global - MSCI World ($)	6.61%	4.70%	13.01%	30.61%	-21.47%	-17.29%
UK - FTSE 100	7.13%	13.78%	7.54%	13.62%	-24.48%	-16.15%
US - S&P 500	3.00%	1.25%	8.99%	26.38%	-23.37%	-13.04%
Europe - FTSE Eurotop 100	7.85%	17.68%	6.59%	11.38%	-33.51%	-18.64%
Japan - Nikkei 225	17.18%	18.15%	7.61%	24.45%	-18.63%	-23.52%

Other	UK	US	Europe	Japan
PE Ratio	15	19	13	33
Dividend Yield	3.1%	1.7%	2.1%	1.0%
Interest rates - base	4.50%	3.75%	2.00%	0.00%
Bond Yields - govt. 10 year	4.29%	4.33%	3.15%	1.49%
Exchange rates (vs GBP)	-	1.7691	1.4673	200.51
Exchange rates (vs USD)	1.7691	-	1.2057	113.34
Gold ($ per ozs)		$471		

Source : Financial Times

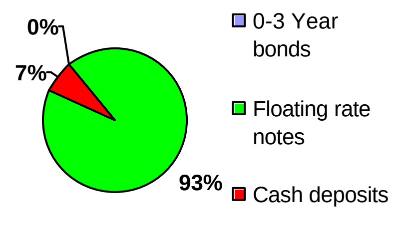
Heritage Investment Fund Limited

Review for the quarter ended 30 September2005

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 September 2005	£150.38	£133.97	US$125.18	£130.16		
Return for quarter (net)	1.20%	2.01%	1.53%	3.35%	0.75%	7.98%
Return for year to date (net)	3.35%	4.89%	2.66%	10.05%	2.40%	13.63%
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	0.9%	1.1%	1.2%	4.5%	0.0%	11.0%
Size of Fund (millions)	£4.3	£38.7	US$21.8	£22.0		

Enhanced Bond Fund

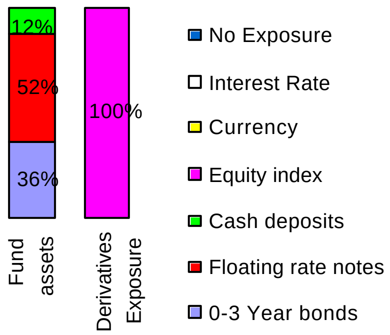


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 5.0% per annum gross to maturity and has an average duration of 0.25 years.

During the quarter, UK bond yields rose by around 15 basis points at the long-end, due to expectations that rising inflationary pressure will ensure that UK interest rates are not significantly reduced. US Dollar bond yields rose by 50 basis points across the curve, on the widely signalled outlook that interest rates will continue to rise at a 'measured pace'. European bond yields rose in the medium term by around 30 basis points, as the market expects an increase in interest rates in 2006 to reduce inflationary pressure.

The Sterling Enhanced Bond Fund produced a good return for the quarter, beating our target, and the year-to-date return remains ahead of that obtainable on cash deposits.

Absolute Return Funds

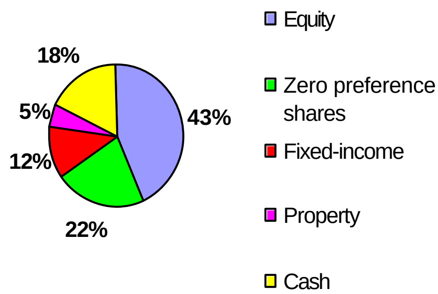


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

During the quarter, our derivatives overlay produced an incremental return of 1.2%, beating our target of 1%. Our directional and non-directional equity index strategies generated all of the incremental return for the quarter, as we did not take 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. Market volatility continues to remain low, limiting the appeal of certain strategies.

Both Absolute Return Funds produced returns that exceeded our targets for the quarter, thereby narrowing the gap between their year-to-date returns and our 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 had a good quarter, gaining 3.35% which takes the year-to-date return to just over 10%.

The Fund was helped by an excellent quarter for equity markets (the MSCI £ World Index rose by 8.0%) with the strongest performances in our portfolio coming from our holdings in Japan and emerging markets. Our zero dividend preference shares have also benefited as rising share prices have improved their cover.

Our fairly low weighting in fixed interest securities reflects our view that bond yields are not particularly attractive at present although we are always on the lookout for interesting corporate issues or convertibles which might offer a better return.

As markets have had a very strong run recently we are happy to hold a reasonable level of liquidity to enable us take advantage of any opportunities that may arise.

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

Reasons for investing in UK listed companies

The equity holdings within the Heritage Managed Portfolio Fund are predominantly listed on the London Stock Exchange. It is therefore appropriate to explain why we consider this to be the basis for a sound investment strategy that offers sufficient diversification for international investors.

Firstly, it should be noted that UK listed companies often have significant non-UK operations. London is a well established and attractive location for the headquarters of global businesses. Many of the leading companies within the FTSE 100 index such as HSBC, Vodafone and GlaxoSmithkline derive the majority of their earnings from outside of the UK and others such as Anglo American and SABMiller have virtually no UK operations but have chosen to be headquartered and listed in London. The UK market has even benefited from the recent rise in oil prices due to its high weighting in oil companies through BP and RD Shell.

Secondly, the UK itself still offers some good investment opportunities with a reasonably stable economic, legal and political background. The UK market also has a strong dividend culture which results in a higher yield on UK equities than the other major markets. Studies have shown that the majority of long-term equity returns arise from re-invested dividends so this should be seen as a significant benefit. A further advantage is that the UK market offers some niche areas that are simply not available in other stock markets – such as the listed Lloyd's insurance companies.

Finally, it is important to note that there is a significant sector of companies apart from the many listed operating businesses – i.e. investment companies. These are also known as investment trusts and are basically professionally managed investment portfolios which cover a wide range of geographic, specialist or sector mandates. They have the benefit of allowing investors to obtain worldwide exposure whilst also providing better liquidity than most open ended mutual funds through real time trading on the London Stock Exchange. Experienced investors in investment trusts can also benefit from the discounts to net asset value at which these funds sometimes trade.

In conclusion, a significant focus on the UK listed market should not be seen as being a narrow or restrictive approach, as it provides a wealth of opportunities to build the core of a well diversified portfolio.

Continued from page 1:

Absolute Return Funds consistently beat their targets over past 5 years

	Sterling			US Dollar		
	Absolute Return Fund	Cash	Surplus over cash	Absolute Return Fund	Cash	Surplus over cash
Starting value at 1 Oct 2000	98.57			101.73		
Current value at 30 Sept 2005	133.97			125.18		
Return over the 5 year period	35.91%	17.24%	18.67%	23.05%	7.24%	15.81%
Average annualised return	7.18%	3.45%	3.73%	4.61%	1.45%	3.16%
Highest monthly return	2.33%	0.39%		1.51%	0.41%	
Lowest monthly return	-1.09%	0.21%		-1.22%	0.04%	
Number of months with positive return in the 60 months	52(87%)			47(78%)		
Volatility of returns in the period	1.76%	0.16%		1.76%	0.34%	
Correlation with equity markets	-0.03	-0.44		-0.08	-0.27	

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%	9.5%	1.5%
Growth		40%	60%	10.0%	12.7%	2.7%
Benchmarks:						
3 month interest rate					4.7%	0.1%
5 year government bonds (total return)					6.8%	2.5%
MSCI World Equity Index					19.7%	11.0%

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