Quarterly Newsletter & Investment Review

Issue 32 Combined news & investment review from Heritage Quarter 4 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, trusts, companies and pension funds.

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2005 proves to be another good year for investors

The year ended with a decent quarter for all the main equity markets, resulting in another good overall year for investors. The only disappointment this year was the US market, which was held back by a combination of rising interest rates and a stronger US Dollar.

We are also pleased to report that all of the Heritage Funds have continued to produce good, positive returns this year and further details can be found as usual on page 3, with our assessment of the prospects for 2006 on page 4.

Heritage Managed Portfolio Fund passes 5 year milestone

Equity based investment is really only appropriate for those investors with a reasonably long-term outlook and certainly our approach to the management of equities is based around taking a long-term view. Looking at the short term performance figures of equity funds can therefore often be of little relevance and it is only once a period encompassing both bull and bear market conditions has been completed that any meaningful conclusions can be drawn.

The Heritage Managed Portfolio Fund has now established a 5 year track record, and whilst we would say that in equity investment terms it is still early days, we are pleased to report that the progress to date has been encouraging.

Although when it comes to the management of the Fund we pay no attention to stock market indices and prefer to seek individual investments that will offer a better return than cash and bonds over the longer term, the performance of the MSCI World Equity Index provides a good indication of the background against which we are investing.

Since the Fund was launched the World Index initially suffered a very significant fall in the severe bear market of 2000-2002 before making a good recovery over the last three years with the overall result that for the 5 year period the Index is still down by approximately 14%.

The Managed Portfolio Fund by contrast has generated a positive return of 35% over this same period. Whilst it is has certainly been pleasing to participate in the good returns enjoyed by general stock markets over the past few years, the significant outperformance of the Fund over the 5 year period is mainly due to the avoidance of serious losses during the bear market. The key to this is the management of risk. Our approach is that we consider risk to be the possibility of suffering a real loss. By contrast the view taken by most fund managers is that risk should be measured in terms of deviation from their benchmark index, which in our opinion is a dangerous approach that can result in poor decisions and excessive risk of loss.

Of course investors should be aware that past results are not a guide to future performance, but what we can guarantee is that that we will continue to implement the same investment approach that has proved successful in what have been testing times for investors over the past 5 years.

Market Commentary

2005 has turned out to be another good year for global investors with Japan, Europe and the United Kingdom together with most emerging markets enjoying double-digit gains. However, the US Dollar denominated MSCI World Index was restricted to a rise of just 7.55% for the year as it was held back by the relatively weak performance of the large US market.

With valuations still reasonable due to robust corporate earnings growth and a largely benign economic and political background, it is not surprising to see that for now at least the consensus view appears to be that things are set fair for equity markets as we head into 2006.

However, more cautious and contrarian investors will be aware that the problem with any consensus view is that it often turns out to be wrong, as current prices already have the prevailing consensus built in to them but do not take account of the unanticipated events and different views that invariably materialise. A classic example of this was when this time last year nearly all the experts agreed that the US Dollar would continue to fall in 2005, whilst in reality it turned out to be a year of Dollar strength.

United Kingdom

The FTSE 100 index had a solid final quarter, rising by 2.6% and bringing the full year gain to 16.7%.

A combination of takeover activity lead by foreign companies and private equity groups, major share buy-backs and strong dividend growth mean that UK fund managers are currently receiving plenty of cash which could help to underpin share prices in the first half of next year as they look to re-invest it. However, global investors may be concerned by the UK Chancellor's recent decision to impose an ad hoc "windfall" tax on oil companies.

United States

The US was the weakest of the major markets this year with the widely followed Dow Jones Industrial index actually ending below where it started the year, and an uninspiring 3.0% return for the broader market as represented by the S&P 500 index.

A background of rising interest rates is not generally helpful to equity markets and US Dollar rates were again increased by 0.5% this quarter. The outgoing Federal Reserve Chairman, Alan Greenspan, has therefore now raised rates on 13 occasions since June 2004 taking the rate from just 1% to its current level of 4.25% and investors will be hoping that his successor, Ben Bernanke, will not feel the need to demonstrate his anti-inflationary credentials by raising them much further in 2006.

Europe

Another solid return of 3.4% in the final quarter for European markets took the full year rise in the FTSE Eurotop 100 index to 21.7%.

After leaving interest rates on hold at 2% since June 2003 the European Central Bank finally felt that there was sufficient evidence that inflationary pressures and economic growth may be beginning to emerge in the Eurozone to lift rates by 0.25% to 2.25%.

Japan

Japan was comfortably the best performing of the major equity markets in 2005 with a full year return of just over 40% helped by an excellent fourth quarter return of 18.7%.

Whether this rally can develop into a longer running bull market will depend on if the economy can now deliver the sustained growth that the recent reforms appear to have started.

Emerging markets

Emerging markets have had another excellent year with impressive returns achieved from a wide range of regions including Asia, Latin America, Eastern Europe and South Africa. In fact if progress continues at the current pace it will be interesting to see which country's stock market will be first to graduate and lose the "emerging" tag, with possible contenders including South Korea which is already home to global multinationals such as Samsung.

Investment Statistics - 31/12/2005

Equity Markets	Q4 2005	2005	2004	2003	2002	2001
Global - MSCI World ($)	2.72%	7.55%	13.01%	30.61%	-21.47%	-17.29%
UK - FTSE 100	2.58%	16.71%	7.54%	13.62%	-24.48%	-16.15%
US - S&P 500	1.73%	3.00%	8.99%	26.38%	-23.37%	-13.04%
Europe - FTSE Eurotop 100	3.38%	21.66%	6.59%	11.38%	-33.51%	-18.64%
Japan - Nikkei 225	18.69%	40.24%	7.61%	24.45%	-18.63%	-23.52%

Other	UK	US	Europe	Japan
PE Ratio	14	19	15	35
Dividend Yield	3.1%	1.7%	2.0%	0.9%
Interest rates - base	4.50%	4.25%	2.25%	0.00%
Bond Yields - govt. 10 year	4.09%	4.40%	3.30%	1.48%
Exchange rates (vs GBP)	-	1.7168	1.4554	202.63
Exchange rates (vs USD)	1.7168	-	1.1796	118.03
Gold ($ per ozs)		$512		

Source : Financial Times

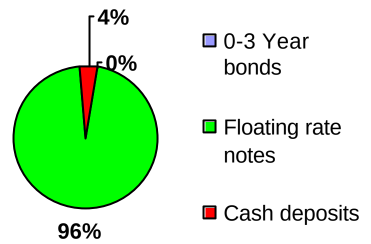
Heritage Investment Fund Limited

Review for the quarter ended 31st December 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 31 December 2005	£151.75	£135.69	US$126.48	£135.16		
Return for quarter (net)	0.91%	1.28%	1.04%	3.84%	0.75%	5.85%
Return for year (net)	4.29%	6.24%	3.72%	14.28%	3.17%	20.27%
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%
5 year compound annual return	4.11%	6.57%	4.51%	6.17%	3.10%	-2.17%
Annual volatility	0.5%	0.9%	1.2%	4.6%	0.0%	12.6%
Size of Fund (millions)	£3.8	£39.6	US$22.0	£23.6		

Enhanced Bond Fund

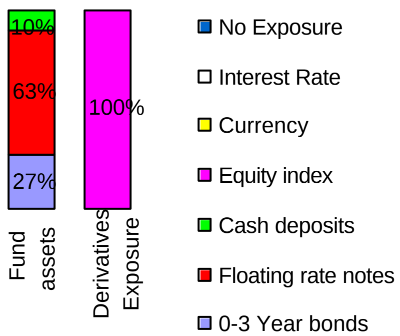


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 4.9% per annum gross to maturity and has an average duration of 0.25 years.

During the year UK bond yields fell by around 30 basis points across the curve, as interest rates were reduced by 0.25%, with a possible further reduction expected. European yields rose at the short end due to an increase in interest rates of 0.25% during the year. US Dollar interest rates were increased by 2.0% over the year, resulting in bonds yields rising significantly at the short end.

The Sterling Enhanced Bond Fund produced a pleasing return for the year, which exceeded our target and was ahead of that obtainable on cash deposits.

Absolute Return Funds

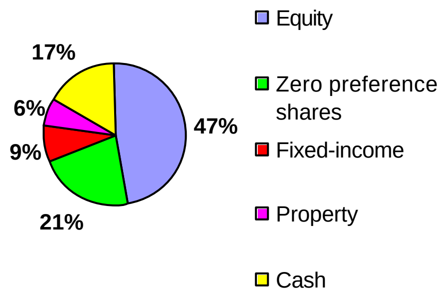


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices by employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

During the year our derivatives overlay produced an incremental return of 3.1%, slightly behind our target of 4%. These gains were mostly generated from a mix of directional and non-directional equity index positions. We did take limited currency and bond index positions early in the year, which made mixed contributions to the overall return.

The annual returns of both Absolute Return Funds ended slightly behind our targets, especially in the case of the US Dollar Fund where bond prices were adversely affected by the rise in US interest rates during the year.

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 3.84% in the quarter resulting in a full year return of 14.3% which is above target but below the MSCI £ World Index. The Fund is now just over 5 years old and has returned 35% since inception, whilst the index has fallen by around 14%.

After a setback in October global equity markets rallied strongly over the final two months of the year. Most of our holdings benefited from this recovery with particularly strong returns coming from the Far Eastern investments.

The Fund's fixed-income weighting has continued to fall as maturing bonds have been re-invested into other areas of the portfolio that we feel offer better value at present.

Overall, our main focus continues to be on finding good individual investments that offer potentially attractive returns in relation to the risks involved.

Target returns for 2006

Interest rate and inflation expectations for the coming year will largely determine the outlook for bond (and to a certain extent equity) markets over the next 12 months. In the UK, the futures markets are indicating that short-term interest rates have peaked and will remain at their present level during the year. US interest rate futures are forecasting that short term rates will rise by a further 0.5% during the first quarter and then stabilise, whilst in Europe short-term interest rates are expected to rise progressively by a further 0.75% to 3% by the end of the year, as European economies slowly recover. Having surprised most forecasters by strengthening during 2005 supported by rising short-term interest rates, the US Dollar appears vulnerable this year as the cycle of interest rate tightening nears an end and the increasing US current account deficit again comes under scrutiny.

Our Sterling Enhanced Bond Fund will be focusing on investing in short-dated Sterling bonds and floating rate notes, which presently offer the most attractive yields, to generate income as the UK yield curve remains inverse with longer-dated bonds yielding less than short-term fixed-income securities. The outlook for the Enhanced Bond Fund appears relatively unexciting as there is little opportunity for generating capital appreciation without taking on excessive risk 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 well positioned to continue to generate consistent positive net returns over the coming year significantly in excess of bank deposit rates. With US interest rates having increased by 2% over the past year, the US Dollar Fund should be better placed to target a more attractive return this year. The Absolute Return Funds currently target a margin of approximately 4% over short-term bank deposit rates, which translates into net target returns of just over 7% for the year for both Funds. However, the challenge will be to generate this incremental return from our derivatives-based investment strategies in a climate of low overall market volatility, where short-term directional trends are becoming increasingly difficult to anticipate.

The outlook for equity markets for the coming year appears to be generally positive, but the key to superior performance will be active investment in the right market sectors and individual stocks. Our Managed Portfolio Fund targets the long-run average/expected annual return delivered by equities of approximately 10%, but with substantially lower volatility. However, with the bull market run extending to almost 3 years, it will be a challenge for our Managed Portfolio Fund to beat its target return again.

Investors will appreciate that the above target returns are indicative only and that there is obviously no guarantee that they will be achieved over the coming year.

Mark Glew appointed a director of Heritage Capital Management

It is now just over a year since Roy's son, Mark Glew, joined the team at Heritage.

As a reminder, Mark holds an Economics degree and has also previously qualified as a chartered accountant with Deloitte in London, as well as becoming a member of the Chartered Institute of Taxation. Since joining Heritage Mark has passed his Investment Management Certificate and is currently part way through his CFA (Chartered Financial Analyst) qualification. He has also developed his practical experience through undertaking a wide range of investment related activities including assisting Roy to advise the Enhanced Bond and Absolute Return Funds.

Following this progress, we are pleased to announce that Mark will become a director of Heritage Capital management with effect from the beginning of 2006.

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	57%	43%		5.0%	5.1%	1.3%
Balanced	23%	50%	27%	7.0%	8.0%	1.5%
Growth		33%	67%	9.0%	11.6%	2.7%
Benchmarks:						
3 month interest rate					4.6%	0.2%
5 year government bonds (total return)					5.7%	2.6%
MSCI World Equity Index					20.3%	12.6%

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