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, trusts, companies and pension funds.

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A difficult quarter for investors

After a good start to the year equities suffered a major setback in May, resulting in losses for virtually all markets in the second quarter. Evidence of increasing inflationary pressures has also impacted bonds making it a difficult overall environment for investors.

Against this background the Heritage Absolute Return Funds have done well to continue their long run of positive quarterly returns, and further details of these and our other funds can be found as usual on page 3.

Diversification achieves better results in the long run

Over the past five years, investors have experienced a bear market followed by a long bull run. As certain investors are now beginning to question whether this bull run has come to an end, given the sharp correction in the equity markets in the past few months, we thought it would be an opportune time to reflect on how a diversified portfolio would have fared against a portfolio holding only equities over the past five years and to consider whether not ‘putting all your eggs in one basket’ remains sound investment advice.

In diversifying your investment portfolio, you distribute your capital among various asset classes to protect your capital should one of them incur a loss. There are a number of strategies you can follow, but they typically involve spreading your assets between bonds, equities, commodities and property, or investing in a number of different companies operating in a variety of sectors, or obtaining exposure to foreign economies and currencies, or indeed a combination of the above.

At Heritage, we recognise that it takes a lot of effort to establish and maintain such a diverse portfolio and so we offer clients the opportunity to invest in our range of mutual funds. The funds operate as collective investment vehicles in which clients are able to participate by buying shares, which use the proceeds to invest in many different securities, markets and currencies according to the fund’s investment objective. Clients can further diversify their portfolios by investing in more than one of our funds.

The following table compares the performance of the MSCI world equity index, with our current balanced and growth asset allocations (in which the investments have been spread over three of our funds) over a number of periods. **– (continued on page 4).**

Market Commentary

Following a long period of rising equity markets, sentiment suddenly turned negative in May, causing global equity markets to fall sharply. The falls were not precipitated by any major financial or geopolitical shocks and it seemed more a case of investors deciding to reduce their exposure to riskier assets where prices had got a bit extended, as evidenced by the particularly sharp falls in more speculative areas such as commodities and emerging markets.

Although sudden weakness in equity markets and increased volatility are considered to be unwelcome developments for most investors, our attitude is that it is not necessarily a bad thing. Firstly, it acts as a reminder that investment does involve risk – a fact that can easily be forgotten as complacency sets in during an extended upswing in markets - and that an important aspect of investment is the continual management of that risk. Secondly, volatility can create opportunities for long-term investors to buy solid investments at lower prices. Furthermore, as conservative investors we are not that comfortable when hordes of naïve investors are making easy money in momentum led bull markets, as we subscribe to the old adages that a rising tide will lift all boats and the quality of a ship cannot be tested in calm waters.

United Kingdom

Up until its setback in May, the UK had been enjoying its longest period without a correction of around 10% since the 1950's. However, with a good first quarter and the FTSE 100 index recovering in June, the UK is still the best performing major market so far this year with a gain of 3.8%. The London Stock Exchange continues to add some interesting listings with the de-mutualisation of Standard Life and the IPO of state-owned Russian oil giant, Rosneft, the latest examples.

Sterling interest rates have been on hold at 4.5% for nearly a year now, as the potential threats of inflation or economic slowdown continue to remain fairly evenly balanced.

United States

The S&P 500 index fell by just under 2% this quarter, with the trigger for the recent sell off appearing to have been evidence of slightly higher inflation. However, most market commentators appear to be more worried by a possible overreaction to the inflation numbers by the new Federal Reserve Chairman and the impact that higher interest rates would have on economic growth, than they are by inflation itself.

Despite US interest rates rising by another half a percent this quarter to 5.25%, the Dollar has come under renewed pressure recently, falling significantly against the Euro, Yen and Pound.

Europe

European markets also suffered a setback this quarter with a 3.7% fall in the FTSE Eurotop 100 index, although it remains up by just under 2% for the year-to-date.

The European Central Bank has again raised interest rates by a further 0.25% percent this quarter as economic indicators and industrial surveys have continued to improve – and with all four World Cup semi-finalists coming from the Eurozone, for now at least the upbeat mood continues.

Japan

Japan was the worst performing major market in the second quarter with a fall of 9.1% in the Nikkei index leaving it in negative territory for the year-to-date.

At present the market appears to have been unsettled by the prospect of rising interest rates, but offsetting this are the positive aspects of improving domestic economic conditions in Japan, coupled with the continued impressive growth of its neighbours in the Far Eastern region.

Emerging markets

The falls in emerging markets during the sell-off were quite severe, with several markets falling by more than 20% from their recent highs. However, given how far these markets had risen over the past few years a correction was not altogether unexpected and the underlying long-term drivers to most emerging economies remain in place.

Investment Statistics - 30/06/2006

Equity Markets	Q2 2006	2006 ytd	2005	2004	2003	2002
Global - MSCI World ($)	-1.13%	4.94%	7.56%	12.84%	30.81%	-21.06%
UK - FTSE 100	-2.20%	3.82%	16.71%	7.54%	13.62%	-24.48%
US - S&P 500	-1.90%	1.76%	3.00%	8.99%	26.38%	-23.37%
Europe - FTSE Eurotop 100	-3.71%	1.76%	21.56%	6.46%	11.38%	-33.51%
Japan - Nikkei 225	-9.11%	-3.76%	40.24%	7.61%	24.45%	-18.63%

Other	UK	US	Europe	Japan
PE Ratio	13	17	14	37
Dividend Yield	3.9%	2.3%	3.5%	1.0%
Interest rates - base	4.50%	5.25%	2.75%	0.00%
Bond Yields - govt. 10 year	4.71%	5.14%	4.07%	1.93%
Exchange rates (vs GBP)	-	1.8484	1.4450	211.54
Exchange rates (vs USD)	1.8484	-	1.2791	114.42
Gold ($ per ozs)		$616		

Source : Bloomberg

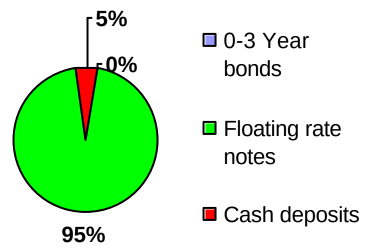
Heritage Investment Fund Limited

Review for the quarter ended 30th June 2006

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 2006	£154.15	£140.15	US$130.76	£138.28		
Return for quarter (net)	0.77%	1.76%	1.86%	-3.12%	0.75%	-7.28%
Return for year to date (net)	1.58%	3.29%	3.38%	2.31%	1.51%	-2.58%
Year 2005 return (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%
Compound annual rtn (from 1/01)	4.14%	6.76%	4.81%	6.19%	3.14%	-2.42%
Annual volatility	0.3%	0.8%	0.8%	5.1%	0.0%	12.7%
Size of Fund (millions)	£3.6	£41.0	US$22.1	£26.3		

Enhanced Bond Fund

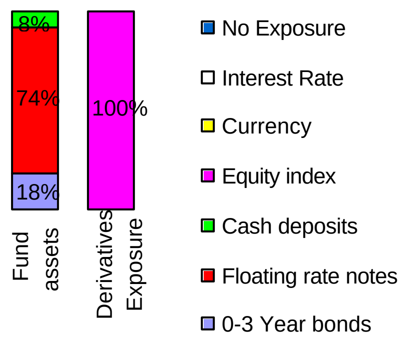


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 4.8% per annum gross to maturity and has an average duration of 0.25 years.

During the quarter UK bond yields rose by around 30 basis points in the medium term, as investors now expect interest rates to rise later in the year. European bond yields rose across the curve by around 25 basis points as the ECB stated that it might raise rates to dampen inflationary pressure, as the economy strengthens. The FOMC raised US interest rates to 5.25% during the quarter and although investors expect rates to rise once more by 25 basis points, that may be the last rise of this tightening cycle.

The Sterling Enhanced Bond Fund produced a steady return for the month, slightly below our target but the year-to-date return remains above that obtainable on cash deposits.

Absolute Return Funds

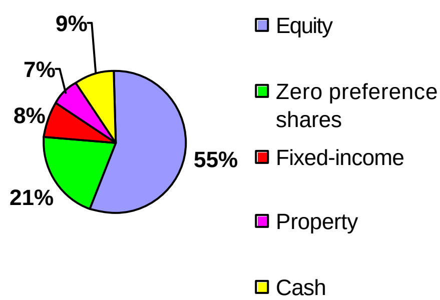


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices by employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

Despite the sharp fall in the equity markets during May and June, our derivatives overlay produced an incremental return of 1.2% for the quarter, beating our target of 1%. The incremental return for the year to date is 2.1% and is also ahead of our target of 2%. Our non-directional equity index strategies generated all of the incremental return for this quarter, as we did not take any positions in currency or US Treasury Notes.

Both Absolute Return Funds produced good returns for the quarter and are only lagging slightly behind our target returns for 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. It was a difficult quarter for the Fund which lost 3.1% as equity markets suffered their first serious setback for over three years, with the MSCI £ World Index falling by 7.3%. For the year-to-date the Fund is up by 2.3% compared to a 2.6% fall in the World Index.

Virtually all equity markets and sectors fell during the quarter with emerging markets being the hardest hit part of the Fund's portfolio. The zero dividend preference shares held up well due to their strong asset cover and the reasonable cash weighting helped to cushion the overall falls, as well as providing liquidity for any opportunities that may arise.

Our main focus continues to be on building a diversified portfolio of good investments that offer potentially attractive returns in relation to the risks involved, which in the present environment includes identifying quality stocks that have been oversold.

Diversification

(continued from page 1)

	MSCI World	Heritage Balanced	Heritage Growth
Returns:			
Last 3 months	-7.3%	0.2%	-1.5%
Last 12 months	11.4%	6.9%	8.8%
Last 3 years	35.2%	22.8%	32.0%
Last 5 years	-7.7%	35.0%	38.6%
Volatility over last 5 years	16.3%	2.6%	5.6%

It can be seen that diversification has achieved significantly better results over the last 5 years and that is why we continue to advise clients to diversify their investment portfolios through investing in one or more of our funds. Although the returns of a diversified investment portfolio can lag pure equity investment in a bull market, over a longer-term full investment cycle incorporating a bear market as well, a diversified portfolio will normally outperform a single asset class. The returns of a diversified portfolio are also more consistent and less volatile than those of a single asset class. We would be happy to assist clients in establishing and managing such a diversified investment portfolio using our range of Heritage investment funds.

The specific markets that the Heritage Absolute Return Funds invest in

Our **Heritage Absolute Return Funds** invest approximately 90% of their funds in short-dated, high investment grade bonds and cash deposits, normally in the denominated currency of the Fund (ie Sterling or US Dollars). The remaining balance of 10% is invested in a single special purpose company, which uses these funds as margin to take positions in equity indices, bonds and currencies using futures and options to generate an incremental return for the Absolute Return Funds.

Although there is no restriction on the markets in which positions can be taken using derivative instruments, in practice the special purpose company limits it’s exposure to the US, UK and European securities markets. These markets are the most familiar to us as investment advisors and have well-regulated investment exchanges. In particular, the US investment market is where most of our derivative positions are established as it has the widest range of derivatives instruments encompassing all sectors of the equity, bond and currency markets. The US derivatives markets are also very liquid and transparent, which is of prime importance when taking short-term trading positions. The US releases the largest range of economic data and financial news, which is vital to us when establishing directional derivatives positions. It must be remembered that we can recommend either long or short positions in the US markets, which position the special purpose company to profit from both rises or falls in the equity, bond and currency markets.

Whilst our Absolute Return Funds generate their incremental returns from the US markets, the Managed Portfolio Fund on the other hand invests predominantly in UK companies, bonds and investment trusts. This provides very useful diversification of risk for those investors holding shares in both our Absolute Return and Managed Portfolio Funds.

Model risk-adjusted asset allocations for Heritage’s mutual funds:

	Suggested asset allocation				Last 12 months	Last 5 years	
	Enhanced Bond Fund	Absolute Return Fund	Managed Portfolio Fund	Target returns £	Actual return £	Actual return £	Average volatility
Model portfolios:							
Cautious	57%	43%	0%	5.0%	5.0%	29.0%	1.4%
Balanced	23%	50%	27%	7.0%	6.9%	35.0%	2.6%
Growth	0%	33%	67%	9.0%	8.8%	38.6%	5.6%
Benchmarks:							
3 month interest rate					4.5%	21.2%	0.4%
5 year government bonds (total return)					5.2%	26.0%	3.4%
MSCI World Equity Index					26.3%	-7.7%	16.3%

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