Quarterly Newsletter & Investment Review

Issue 35 Combined news & investment review from Heritage Quarter 3 2006

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, trusts, companies and pension funds.

Contacts - directors

Roy Glew
E-mail : roy@heritage-capital.co.uk
Roy is responsible for advising the Heritage Absolute Return Funds.

Graeme Olsen
E-mail : graeme@heritage-capital.co.uk
Graeme is responsible for client portfolios and advising the Heritage Managed Portfolio Fund.

Mark Glew
E-mail : mark@heritage-capital.co.uk
Mark is responsible for a range of investment related activities including advising the Enhanced Bond and Absolute Return Funds.

Heritage

www. heritage-capital.co.uk
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
40 Broadway, London, SW1H OBT

Markets recover over the summer

After a fairly major setback in May, global equity markets have regained their upwards momentum this quarter, with all of the major indices producing positive returns.

We are pleased to report that it has also been a good quarter for the Heritage Funds, and further details can be found, as usual, on page 3.

The size debate - an update

In a previous newsletter, a number of years ago, we quoted a leading financial publication that highlighted the attractions of smaller, privately owned investment management companies. A recent study of returns over the past 10 years published by the Financial Analyst Journal has now provided evidence to support this view. It found that the top seven performing groups were all privately owned whilst none of the bottom eight were private. Furthermore, six of the seven best performers managed 15 or fewer funds, whilst the worst five managed an average of 39 funds each.

Below are listed the key factors that we believe help to explain the results of the study and the successful track record that we have established here at Heritage ;

Independence – Smaller, independent investment houses are free from the often conflicting pressures within larger organisations. This allows them to select the best investments from a truly independent perspective.
Flexibility – Large funds can become constrained and unwieldy as a result of their sheer size. The flexibility offered by smaller fund managers is an important aspect of their competitive advantage. At Heritage, it also allows us to offer some interesting investment opportunities that are simply not available via larger institutions.
Personal service – With more lucrative fees on offer from large corporate clients, most multinational investment institutions now allocate less experienced staff to individual private clients. At Heritage, we continue to build our business around the concept of long-standing relationships and a high level of personal service.
Management participation - Investors should be cautious of funds that are managed by individuals who are not prepared to commit a significant proportion of their own wealth to the fund, as is so often the case with large retail funds. Investors in Heritage's funds can take some comfort from the knowledge that we do "eat our cooking".
Stability - A further advantage of having a manager with a personal interest in both the fund and the management company is that it provides better stability. Too often fund managers and investment advisors who are simply employees of a large company lack the commitment and loyalty to stay with a company for more than a few years.
Lower charges – Smaller companies that maintain a low profile do not spend large amounts on advertising, or carry the overheads associated with a large sales force. Most fund managers recover these marketing costs from investors by charging initial fees (often as much as 5% up-front), whereas Heritage clients do not suffer any entrance or exit charges.

We believe that the benefits outlined above mean that smaller, privately owned investment companies such as Heritage will continue to offer clients the more attractive alternative, with the prospect of superior performance and an overall better service.

Market Commentary

The negative sentiment that caused equity markets to fall sharply back in May, appears to have been replaced by a new found investor confidence, as all of the major indices have rebounded strongly over the third quarter. The rationale for the current positive outlook appears to be that the earlier worrying signs of higher inflation have subsided and that US interest rates may therefore not need to rise much further, if at all, from their current level.

This scenario also has also been good for bonds, with prices rising as yields have fallen. In fact 10 year US Treasuries now yield just over 4.5%, which is well below the current Fed Funds interest rate of 5.25% and UK gilts also yield less than the current Sterling base rate of 4.75%.

The risk to investors is therefore that equity markets appear to be focussing on the positive aspect of anticipated lower interest rates, without taking account of the implication of slower economic growth or the possibility of a recession. A particular major concern is that the US housing market finally appears to be faltering, with prices falling for the first time in over a decade. Should this weakness lead to a slowdown in US consumer spending, the repercussions for the global economy could be severe.

United Kingdom

Although the UK market has slightly lagged the other major indices over the past quarter, the 2.2% rise in the FTSE, taking the year-to-date return to 6.1%, is still a reasonable performance. International investors into the UK will also have had their returns boosted from the appreciating Pound.

One explanation for the UK's currency strength is that in recent years, Sterling has become an increasingly favoured reserve currency for central banks around the world. The Bank of England's MPC (Monetary Policy Committee) has built a solid reputation since it gained its independence in 1997, and its decision to raise interest rates by 0.25% in August has not done Sterling any harm either.

United States

The US market put in a strong performance this quarter, with the S&P 500 index gaining 5.2%. The Dow Jones Industrial index often receives more attention in the popular press, most recently for the fact that it is has recovered to its previous peak reached back in the year 2000. However, the S&P index is the one followed by serious investors, as it consists of the largest 500 US companies weighted by their market capitalisation, whereas the Dow is an index of just 30 stocks selected by a committee with a rather arbitrary weighting system. The S&P index is still around 15% below its all time high.

Following seventeen consecutive 0.25% interest rate rises from their low point of 1% in 2003, the Federal Reserve finally left interest rates unchanged last month, as recent evidence shows that the risk of rising inflation appears to be moderating.

Europe

Europe also had a good quarter, and for the year-to-date the 7.2% rise in the FTSE Eurotop 100 index is the best of the major global markets.

The European Central Bank has again raised interest rates by 0.25% percent this quarter. The fact that ECB believes that the European economy is robust enough to require rising interest rates is encouraging from a global economic perspective as it might mean that Europe could take over the baton at a time when the US economy is showing signs of slowing down. However, it is quite likely that this line of thinking may turn out to be a triumph of hope over experience, as Europe continues to struggle to resolve its long-standing structural deficiencies.

Japan

Although the Japanese market also had a better quarter, the Nikkei index has only just crept back into positive territory for the year-to-date.

Investors will be hoping that the newly elected prime minister, Shinzo Abe, will continue with the progressive policies of his predecessor, and that Japan can finally fully emerge from years of economic stagnation.

Emerging markets

Whilst most of the major markets have recovered to around their previous peaks reached in May, most emerging markets still remain well off their highs for the year, and the recent coup in Thailand has served as a reminder of the inherent risks that remain within developing countries.

Investment Statistics - 30/09/2006

Equity Markets	Q3 2006	2006 ytd	2005	2004	2003	2002
Global - MSCI World ($)	4.05%	9.19%	7.56%	12.84%	30.81%	-21.06%
UK - FTSE 100	2.18%	6.09%	16.71%	7.54%	13.62%	-24.48%
US - S&P 500	5.17%	7.01%	3.00%	8.99%	26.38%	-23.37%
Europe - FTSE Eurotop 100	5.34%	7.20%	21.56%	6.46%	11.38%	-33.51%
Japan - Nikkei 225	4.01%	0.10%	40.24%	7.61%	24.45%	-18.63%

Other	UK	US	Europe	Japan
PE Ratio	12	17	13	40
Dividend Yield	3.9%	2.3%	3.4%	1.0%
Interest rates - base	4.75%	5.25%	3.00%	0.25%
Bond Yields - govt. 10 year	4.52%	4.63%	3.71%	1.68%
Exchange rates (vs GBP)	-	1.8680	1.4764	220.54
Exchange rates (vs USD)	1.8680	-	1.2668	118.07
Gold ($ per ozs)		$598		

Source : Bloomberg

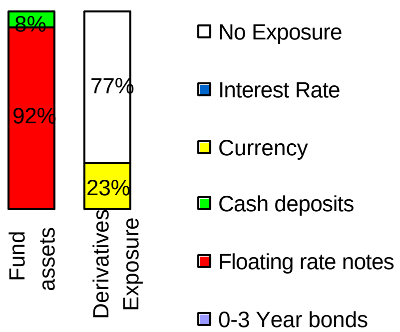
Heritage Investment Fund Limited

Review for the quarter ended 30th September 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 September 2006	£155.46	£142.38	US$133.15	£146.24		
Return for quarter (net)	0.85%	1.59%	1.83%	5.76%	0.81%	2.92%
Return for year to date (net)	2.44%	4.93%	5.27%	8.20%	2.34%	0.36%
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)	4.07%	6.75%	4.92%	6.95%	3.15%	-1.81%
Annual volatility	0.1%	0.8%	0.9%	5.4%	0.0%	11.0%
Size of Fund (millions)	£3.7	£42.5	US$22.3	£28.6		

Enhanced Bond Fund



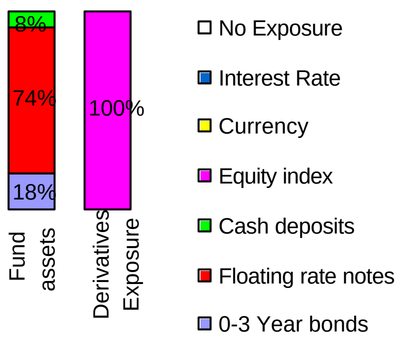
The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 5.1% per annum gross to maturity and has an average duration of 0.25 years.

We seek to enhance this return by employing futures and options to gain exposure to interest rates and currencies. Potential losses are limited to the net premium paid for positions. Our positions generated a net profit for the quarter.

During the quarter UK interest rates rose by 25 basis points and a further rise is expected before the year-end. European rates also rose by 25 basis points but bond yields flattened in the medium term, as rates may be nearing their peak. US rates have remained at 5.25% and investors now expect rates to fall in 2007.

The Fund missed its target return for the quarter but the year-to-date return remains above that obtainable on cash deposits.

Absolute Return Funds

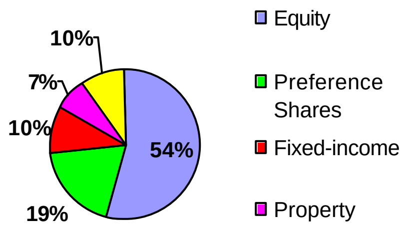


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices by employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

Our derivatives overlay generated 0.95% for the quarter, narrowly missing our target of 1%, as we had to close out a bullish position when the markets fell sharply in July. Since then we were positioned to profit from the strong bull-run in August and September and by beating our target return in August, we have made up for the lower returns in July. 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 satisfactory returns for the quarter, although the Funds do still remain behind our year-to-date 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.

It was a good quarter for the Fund which appreciated by 5.8% compared to a 2.9% rise in the MSCI £ World Index. For the year-to-date the Fund is up by 8.2% compared to a 0.4% rise in the World Index.

Our equity holdings have performed well this quarter, boosted by bids for a couple of our holdings and a good run by our insurance companies.

Although the opportunities within the zero dividend preference share market has continued to decline, we are also now finding some interesting synthetic zeros and other preference shares to invest in. Overall, our combined portfolio of preference shares and bonds currently offer a yield to maturity of just under 7%.

The increasing correlation between Hedge Funds and Equity Markets

The main aim of a hedge fund is to generate positive returns in all market environments and their perceived ability to do so has attracted many investors seeking absolute returns. However, the ability of hedge funds to deliver absolute returns is now being questioned, following the correction in the major equity markets during May and June.

Equity markets fell over 10% during the period, but hedge funds should have generated positive returns irrespective of market conditions. The performance of most hedge funds deteriorated over this period, however, and highlights the growing concern that there is significant correlation between the performance of hedge funds and movements in the equity markets. This questions the effectiveness of hedge funds, as they are not performing as they should.

The correlation coefficient measures the relationship between two variables. If there is a significant positive correlation between two variables (meaning the variables move in the same direction and by a similar proportion on average) the coefficient of correlation will be close to +1. If the variables move in opposite directions, but by a similar proportion, there is significant negative correlation between the two and the correlation coefficient will be close to –1. If there is no correlation between the two variables, the coefficient will be close to zero. We would normally expect the correlation coefficient between the equity markets and hedge funds to be close to zero over the long term.

Strong correlation between equity markets and hedge funds is not always a cause for concern. Indeed, it is desirable for positive correlation between the two when equity markets are on a bull run. It does, however, become a concern when equity markets fall because it means that hedge fund performance is deteriorating. Correlation in the short run should not be a concern, as it may be impossible to avoid without excessive cost. However, long-term correlation can and should be managed appropriately.

Hedge funds have become more positively correlated with equity markets as the advantages that they once enjoyed have receded. The growing numbers of hedge funds have made it harder to find unique trades, meaning higher returns are ‘crowded out’. Fund managers use similar investment techniques and so the performance of many ‘copy-cat’ funds suffers when the techniques fail. Through increased regulation, there is now less information for investors to capitalise on as well.

At Heritage, we seek to distance ourselves from the alternative investment strategies employed by hedge funds, whilst still striving to generate positive returns and limit losses using our proprietary approach. As hedge funds have become more correlated with equity markets, the correlation coefficient between the Heritage Sterling Absolute Return Fund and the MSCI World Equity Index is –0.04 over the life of the Fund. When equity markets were falling from mid 2000 to early 2003 the correlation coefficient was 0.14 and for the subsequent bull run (which is still ongoing) the coefficient is 0.44.

Over the long term, our investment style has been successful and our Heritage Absolute Return Funds have performed as they should, generating consistent positive returns regardless of the direction of the world equity indices.

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%	4.6%	28.3%	1.4%
Balanced	23%	50%	27%	7.0%	7.3%	42.3%	2.2%
Growth	0%	33%	67%	9.0%	10.3%	57.8%	4.3%
Benchmarks:							
3 month interest rate					4.5%	21.2%	0.4%
5 year government bonds (total return)					2.2%	23.1%	3.3%
MSCI World Equity Index					6.2%	16.7%	15.4%

Heritage

Heritage Capital Management Limited
40 Broadway, London SW1H 0BT
Tel: +44 (0) 20 7799 2110 Fax: +44 (0) 20 7222 1599
General Email: info@heritage-capital.co.uk
Website www.heritage-capital.co.uk