Quarterly Newsletter & Investment Review

Issue 36 Combined news & investment review from Heritage Quarter 4 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.

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Another good year

An excellent final quarter has cemented another good year for investors, with all of the major equity markets making positive progress for the fourth year in a row.

We are pleased to report that it has also been another good year for the Heritage Funds, with the Managed Portfolio Fund leading the way with a return of 16.8%. Further details on all our Funds can be found, as usual, on page 3.

Target returns for 2007

As in 2006, interest rate expectations and enduring concerns over inflation will determine the outlook for bond markets for the year ahead. In the UK, the futures markets indicate that short-term interest rates have further to rise and expect rates to rise from 5.0% to 5.5% during the first half of 2007 and remain stable thereafter. In contrast, US interest rate futures indicate that short-term interest rates have peaked at 5.25% and will fall by 25 basis points in the second half of the year. European short-term interest rates are expected to rise by 50 basis points to 4.0% in the first half of 2007 and remain at that level for the remainder of 2007, as the ECB is expected to take further action to contain inflationary pressures.

Investors expect the US Dollar to face increasing pressure this year, as it will become less attractive to investors if US short-term interest rates fall and central banks continue to show signs that they are looking to reduce their exposure to the US Dollar by diversifying their holdings.

Our Sterling Enhanced Bond Fund will focus on investing in Sterling floating rate notes to generate income, as they have a short duration at a time when the UK yield curve remains inverted (with longer-dated bonds yielding less than short-term fixed interest securities) and their coupons are adjusted in line with interest rates, ensuring that prices will not fall significantly if interest rates rise. As current conditions mean that there is little opportunity to generate capital appreciation in the bond markets without taking on excessive risk, we expect the Fund to earn a net yield from floating rate notes and cash, after allowing for fees and expenses, of approximately 3.6%. We will seek to enhance this by approximately 1.2% by employing futures and options to gain exposure to interest rate and currency indices, maintaining a cautious strategy to ensure capital is preserved. This gives a total net target return of 4.8% for the year.

Our Absolute Return Funds should be positioned to continue to generate consistent positive returns over the coming year, significantly in excess of bank deposit rates. As the core of each of the Absolute Return Funds is invested in floating rate notes, we expect the Funds to earn a net yield of approximately 3.75%, after allowing for fees and expenses, and an incremental return of approximately 3.25% from taking positions using derivatives. This gives net target returns of 7.0% for both Funds. The current trend of low market volatility will ensure it continues to be a challenge to generate this incremental return from our derivative-based strategies however.

The returns for the year ahead for equity markets and our Managed Portfolio Fund are, as always, much harder to predict and we would encourage investors to take a longer- term view. A return of around 9%, based on a risk free rate of 5% plus an additional 4% for the equity risk premium and active management, would be a reasonable annual average target for long-term planning purposes.

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.

Market Commentary

A strong final quarter for global equity markets has ensured that 2006 will be remembered as another good year for investors. In fact we have now had four consecutive years of good returns following the severe bear market of 2000 to 2002 and most of the major western markets are now within striking distance of their all time highs, which they reached at the peak of the last bull market.

Part of the reason why 2006 turned out to be a good year was that many of the pitfalls that were predicted did not materialise – bird flu did not develop into a major pandemic, there were no major terrorist attacks, the hurricane season was much quieter this year, there were no large financial disasters or scandals and oil prices did not continue their exponential rise.

Furthermore, the global economy has continued to be robust, corporate earnings growth has been very strong and equity markets have been further buoyed by increasing merger and acquisition activity, with the bidding often led by the large and increasingly aggressive private equity groups. With such a supportive background it easy to see why the general consensus remains positive for the prospects for equity markets. However, these benign conditions will not last forever and it worth remembering that many of the risks that did not materialise last year could still pose a threat in 2007.

United Kingdom

A 4.4% rise in the FTSE 100 index in the final quarter, takes the full year return to a creditable 10.7%, although the small and mid cap indices have once again outpaced the larger stocks.

Takeover activity has been exceptionally high this year and even a number of the larger blue chips such as BAA, Corus, ITV, BOC, Scottish Power and Gallaher have succumbed to bids. Many of the buyers have been foreign predators who continue to view UK companies as attractive and relatively cheap in a global context. Only the largest "megacaps" such as HSBC, BP, Shell and GlaxoSmithkline appear to be immune from the takeover speculation, which has boosted the rest of the UK market, and this neglection could result in some good buying opportunities for long-term value investors.

United States

The US market put in another strong performance this quarter, with the 6.2% rise in the S&P 500 index making the US the best performing of the major markets for the year with a 13.6% gain. However, with the Dollar weakening over the year against the Euro and Pound by a similar amount, the net result for many foreign investors was less impressive.

The most important question for the US market going forward is how the growth and inflation profile develops. The optimistic view is that there will be a soft landing, with any housing and consumer weakness being counteracted by increasing business investment and that the economy can continue to grow against a background of lower inflation resulting from the Federal Reserve's rate rises over the past few years. However, the risks to this delicate balancing act will need to be closely monitored.

Europe

Europe also had another good quarter, resulting in a 12.4% gain for the year in the FTSE Eurotop 100 index.

Setting a single interest rate for such a range of diverse economies continues to be a difficult challenge. For example, structural improvements in Germany appear to finally be improving its competitiveness, perhaps at the expense of France's manufacturing industry, whilst Spain appears vulnerable to a slowdown in it's construction boom and Ireland's economy continues to excel. On balance, the European Central Bank decided to raise interest rates by another 0.25% percent this quarter, as it considers keeping the overall inflation rate under control to be the most important factor.

Japan

After an excellent year in 2005 the consensus at the start of the year was virtually unanimous that Japan would continue its impressive recovery. However, despite a strong final quarter, the Japanese market was the most disappointing of the major markets this year and the only one not to make a double digit return. To make matters worse, most foreign investors have actually lost money this year as the Yen has weakened.

Emerging markets

Although, as usual, the volatility has been much higher in the emerging markets than the developed world this year, the returns have once again been impressive. Overall, the combination of better long-term growth prospects and lower valuations should continue to provide better returns for those who are prepared to accept the risks of investing in these rapidly developing economies.

Investment Statistics - 31/12/2006

Equity Markets	Q4 2006	2006 ytd	2005	2004	2003	2002
Global - MSCI World ($)	8.02%	17.95%	7.56%	12.84%	30.81%	-21.06%
UK - FTSE 100	4.36%	10.71%	16.71%	7.54%	13.62%	-24.48%
US - S&P 500	6.17%	13.62%	3.00%	8.99%	26.38%	-23.37%
Europe - FTSE Eurotop 100	4.86%	12.41%	21.56%	6.46%	11.38%	-33.51%
Japan - Nikkei 225	6.81%	6.92%	40.24%	7.61%	24.45%	-18.63%

Other	UK	US	Europe	Japan
PE Ratio	14	18	15	26
Dividend Yield	2.9%	1.8%	2.5%	1.0%
Interest rates - base	5.00%	5.25%	3.50%	0.25%
Bond Yields - govt. 10 year	4.74%	4.70%	3.95%	1.69%
Exchange rates (vs GBP)	-	1.9572	1.4842	233.20
Exchange rates (vs USD)	1.9572	-	1.3187	119.16
Gold ($ per ozs)		$637		

Source : Bloomberg/FT

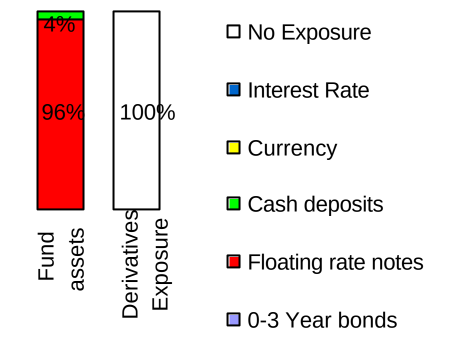
Heritage Investment Fund Limited

Review for the quarter ended 31st December 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 31 December 2006	£156.80	£144.91	US$135.85	£157.86		
Return for quarter (net)	0.86%	1.77%	2.03%	7.95%	0.88%	3.10%
Return for year to date (net)	3.33%	6.79%	7.41%	16.79%	3.23%	3.46%
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)	4.04%	6.78%	5.06%	8.02%	3.16%	-1.23%
Annual volatility	0.1%	0.8%	0.6%	5.75%	0.1%	9.0%
Size of Fund (millions)	£3.5	£44.0	US$22.7	£32.7		

Enhanced Bond Fund

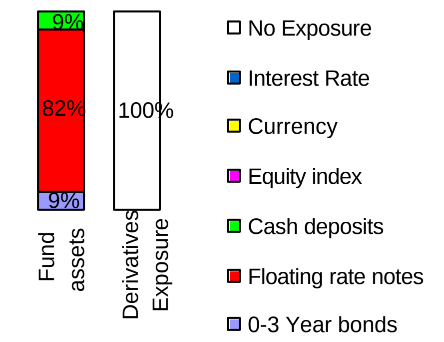


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 5.4% per annum gross to maturity and has an average duration of 0.25 years. When opportunities arise we seek to 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.

During 2006 UK bond yields rose across the curve, as interest rates were increased by 0.5%, with a possible further increase expected. European yields also rose across the curve due to interest rates increasing by 1.25%, again with further increases expected. US Dollar interest rates were increased by 1.0% over the year, resulting in bond yields rising notably at the short end.

The Fund produced a disappointing return for the year, although it was ahead of that obtainable on cash deposits.

Absolute Return Funds

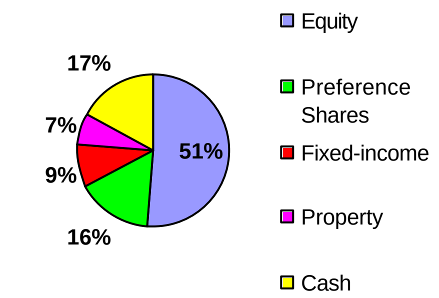


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices by employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

During the year our derivatives overlay produced an incremental return of 4.0%, exactly meeting our target return. These gains were mostly generated from bullish equity index positions, although we did take a bond index position early in the year. During December, before the year-end, we closed our derivatives positions to protect our returns hence there is no exposure as at 31 December 2006.

Both Absolute Return Funds produced good returns for the year, significantly in excess of cash deposits. The US Dollar Absolute Return Fund exceeded its target return for the year and although Sterling Absolute Return Fund narrowly missed its target, it has now generated 45 consecutive months of positive returns.

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.

A very strong final quarter return of just under 8.0% has resulted in another good year for the Managed Portfolio Fund, which finished up by 16.8% compared to a 3.5% rise in the MSCI £ World Index.

Our equity holdings have continued their good run, with insurance, utilities, property, and Asian equities making particularly strong contributions this quarter. We have also benefited from a number of takeover bids this year.

Our fixed interest securities include preference shares and convertibles, which have also performed well.

Despite the recent strength, we remain fairly cautious and have a reasonable cash weighting, which reduces the Fund's overall risk profile and provides flexibility as and when opportunities may arise.

London office move

After many years at 40 Broadway the time has finally come for us to move to new premises. Fortunately, we do not have far to move as our new office is in the building next door. The new address is;

Heritage Capital Management Limited
6th Floor
Broadway House
Tothill Street
London
SW1H 9NQ

All our other contact details, including telephone and fax numbers and e-mail addresses will remain the same. We look forward to seeing many of you at our new office after we move in February.

The Heritage approach to equity investment

As most of our clients are aware, the Heritage investment approach could be described as conservative. We believe that this cautious style is appropriate, as our clients' investments usually represent a substantial portion of their accumulated wealth and may often be pension or trust moneys which they are looking to us to preserve and enhance.

The Heritage Managed Portfolio Fund was established with the aim of allowing investors the opportunity to benefit from the superior long-term capital growth that equities can provide, without exposing them to the same level of risk that you would find in most equity funds, as the problem with investing in shares is that although they have proved over the long-term they can produce higher returns than cash and bonds, there is always the risk that their prices can fall sharply, and many people feel uncomfortable taking on this level of risk.

Our approach to equity investment differs to most fund managers. At Heritage we prefer to ignore the indices, which most other equity fund managers tend to be obsessed by, and simply assess individual investments on their own merits. Our starting point is that it is only worth investing in equities (which are inherently riskier assets than cash or bonds) if they offer the prospect of generating a positive return ahead of the risk free rate over the longer term. We analyse individual companies and only invest in those that meet our criteria - generally they will need to have a combination of attractive business fundamentals and reasonable valuations.

We recognise that good investment returns are only possible if a certain amount of risk is undertaken. However, we feel that it is important not to underestimate the considerable risks involved in equity investment and we therefore seek to manage and control this risk through diversification of equity risk, as well as investing in less risky alternatives such as preference shares, bonds, convertibles and property based investments.

Flexibility is also important to our approach. We are distrustful of following particular investment styles or fashions and prefer to maintain a more flexible and pragmatic approach based on our own criteria of value. We also believe that investment management is not a pure science and we therefore use a combination of rigorous financial analysis and straightforward common sense.

We like to emphasise that it is important to take a long-term view when investing in equities, as good investment ideas often take time to reach fruition and that a short-term approach based on significant trading merely serves to add to the costs and reduce the expected returns. We do not profess to know which way the markets are going in the short term and are very sceptical of those who claim that they can. However, we do believe that a well-researched investment, purchased at a discount to its underlying intrinsic value, will more often than not result in a satisfactory return if held for a decent period of time.

One might reasonably expect that the likely trade-off to taking a low risk approach is that the returns would be lower. However, the results since we launched the Managed Portfolio Fund just over 6 years ago have been encouraging, with the Fund now up by 58%, whilst the MSCI £ World Equity Index has actually fallen over the same period. Although there are of course no guarantees as to future performance, we are committed to continuing to implement this low risk approach to equity investment.

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

	Suggested asset allocation: Enhanced Bond Fund	Absolute Return Fund	Managed Portfolio Fund	Target returns £	Last 12 months Actual return £	Last 5 years Actual return £	Average volatility
Model portfolios:							
Cautious	40%	60%	0%	5.0%	5.4%	31.3%	1.4%
Balanced	33%	34%	33%	7.0%	8.9%	42.9%	2.9%
Growth	0%	40%	60%	9.0%	12.8%	58.2%	4.1%
Benchmarks:							
3 month interest rate					4.6%	21.4%	0.5%
5 year government bonds (total return)					0.9%	23.1%	3.1%
MSCI World Equity Index					3.5%	9.4%	15.0%

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