Quarterly Newsletter & Investment Review

Issue 37 Combined news & investment review from Heritage Quarter 1 2007

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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 volatile quarter - but a dull result

Overall, markets finished the quarter broadly unchanged from their levels at the start of the year. However, this does not tell the whole story, as there was considerable volatility within this period with markets plunging at the end of February before making a recovery.

We are pleased to report that all of the Heritage Funds have continued to make positive progress and further details can be found as usual on page 3.

Advantages of using investment funds

Originally mutual funds were set up to allow the not-so-wealthy to "pool" their resources in order to allow access to a professionally managed and well diversified spread of investments which would not otherwise be available cost effectively on an individual basis.

This logic still applies today, but other considerations such as simplicity of administration, costs and tax planning advantages now mean that even the wealthiest of private clients tend to choose a fund based approach in preference to direct investment. The main advantages of investing through a fund can be summarised as follows;

Diversification and security – A fund allows individual investors to obtain exposure to a wide range of investments through a single holding. Additionally, many asset classes such as private equity, property and hedge funds are not easily accessible to an individual investor but can be accessed through a liquid pooled fund. Also, investors in the fund benefit from the assurance that their assets are securely held with separately appointed and regulated auditors, custodians, administrators and managers involved.

Management– Investment decisions can be taken purely on the basis of the investment merits, rather than being complicated by tax related concerns, as a fund is not liable to taxes such as capital gains tax that can apply to individuals. Also, the fund's portfolio will receive the full time attention of a professional manager, whereas an individual portfolio will quite often only be reviewed and managed on an occasional or ad-hoc basis. Furthermore, in the case of a fund where the managers have their own wealth invested in the fund, the investor can take further comfort from the fact that the manager is happy to "eat his own cooking".

Tax planning and efficiency – Holding a portfolio of investments within a single fund is also simpler and more flexible from a tax planning point of view. For example, a non-distributing ("roll-up") fund can be held for a number of years, or even indefinitely, without giving rise to any tax liability. This allows the investments to compound tax-free for many years as well as providing the investor with the ability to plan to only pay tax at a future time and date that suits him – for example, when he becomes a lower rate tax payer or becomes non-resident.

Administration and simplicity - A further benefit, which should not be underestimated, is the reduction in record keeping, administration and calculations required to keep track of many individual holdings, trades, dividends and interest etc., thereby eliminating the need to incur additional accountancy fees.

Costs – The economies of scale that are available to a pooled fund give rise to cost advantages that are not available to individual portfolios. For example dealing within the fund should be at institutional commission rates rather than the higher rates usually charged to individual investors.

At Heritage, we continue to offer both an individual portfolio management service and our own fund-based service for our investment clients. However, for the reasons outlined above we believe that the funds approach offers the best solution for the majority of clients.

Heritage Capital Management Limited

Review for the quarter ended 31st March 2007

Market Commentary

All of the major stock markets ended the first quarter of 2007 slightly above the level at which they started the year, but there was a lot more excitement than these seemingly dull overall figures imply, with considerable volatility following a sharp set-back at the end of February.

Although the stock market falls of around 7% in the space of a few turbulent weeks were not unusually severe in an historic context, the interesting difference with past corrections was that this time the major markets took their lead from a sudden drop of 9% in the Chinese market.

In fact, there is increasing evidence that emerging markets are playing a more significant role in both the global economy and stockmarkets. In the past, it would have been inconceivable that a fall in the previously insignificant Chinese stock market could give rise to a global sell off. Furthermore, although the US economy is currently showing signs of slowing down, a situation that in the past would have spelled a similar weakening of the global economy, the continued buoyancy of the overall global economy can in part be attributed to the increasingly significant and robust growth of the emerging market economies.

United Kingdom

The FTSE 100 index has started 2007 with a first quarter rise of 1.40%, which is slightly ahead of the other major market indices.

Takeover activity has continued to give the UK market a boost with this quarter's major activity involving approaches for Alliance Boots and Sainsbury, and consolidation amongst the leading players in the housebuilding and travel industries.

Although the decision by the Bank of England to raise interest rates to 5.25% in January took virtually all the experts by surprise, it is now widely anticipated that sterling rates will continue to rise to counteract the threat of inflation.

United States

The US market ended the first quarter at much the same point as it started the year with the S&P 500 index rising by just 0.18%.

The major issue in the US this quarter has been the slowdown in the property market, which has led to the collapse of the sub-prime lending market. Whilst property markets were buoyant, lenders were keen to advance mortgage loans to borrowers who often had no realistic chance of servicing these loans, let alone repaying the capital, and the turn in the housing market has exposed this weakness. The big question now is whether the worst is over or whether further weakening of the property market could have severe knock-on effects for the overall US economy.

Europe

European markets also struggled to make progress, with the FTSE Eurotop 100 index gaining just 1.09% in the first quarter.

The European economy appears to be maintaining its reasonably positive momentum with recent figures revealing that even Italy was showing signs of decent growth. In response to this the European Central bank has continued to raise Euro interest rates, by a further 0.25% to 3.75% in March.

Japan

Japan was the weakest of the major markets in 2006 and has so far failed to catch up this year with the Nikkei index up by just 0.36% in 2007.

The Bank of Japan raised rates by 0.25% to 0.50% in February, encouraging the view that the Japanese economy may at last be emerging from years of deflationary depression.

Emerging markets

In common with the major markets, the global MSCI Emerging Markets index also made little progress this quarter. However, there were widely diverging returns at the individual country level with China and India seeing significant falls whilst at the other end of the spectrum Turkey and Russia both made impressive gains.

Investment Statistics - 31/3/2007

Equity Markets	Q1 2007	2006	2005	2004	2003	2002
Global - MSCI World ($)	2.06%	17.95%	7.56%	12.84%	30.81%	-21.06%
UK - FTSE 100	1.40%	10.71%	16.71%	7.54%	13.62%	-24.48%
US - S&P 500	0.18%	13.62%	3.00%	8.99%	26.38%	-23.37%
Europe - FTSE Eurotop 100	1.09%	12.41%	21.56%	6.46%	11.38%	-33.51%
Japan - Nikkei 225	0.36%	6.92%	40.24%	7.61%	24.45%	-18.63%

Other	UK	US	Europe	Japan
PE Ratio	15	17	15	37
Dividend Yield	2.8%	1.8%	2.3%	1.0%
Interest rates - base	5.25%	5.25%	3.75%	0.50%
Bond Yields - govt. 10 year	4.97%	4.64%	4.06%	1.66%
Exchange rates (vs GBP)	-	1.9614	1.4735	231.59
Exchange rates (vs USD)	1.9614	-	1.3312	118.08
Gold ($ per ozs)		$664		

Source : Bloomberg/FT

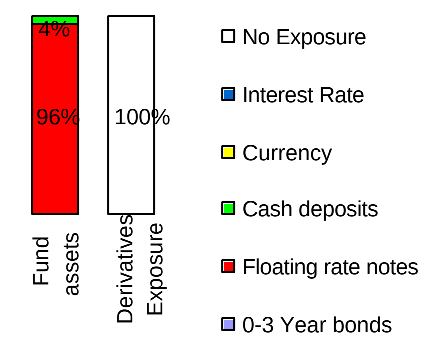
Heritage Investment Fund Limited

Review for the quarter ended 31st March 2007

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 March 2007	£158.24	£146.88	US$137.69	£159.09		
Return for qtr & year to date (net)	0.92%	1.36%	1.35%	0.78%	0.94%	1.84%
Year 2006 return (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)	4.03%	6.73%	5.08%	7.82%	3.19%	-0.89%
Annual volatility	0.1%	0.9%	0.9%	5.9%	0.1%	8.6%
Size of Fund (millions)	£3.5	£47.1	US$23.0	£35.7		

Enhanced Bond Fund



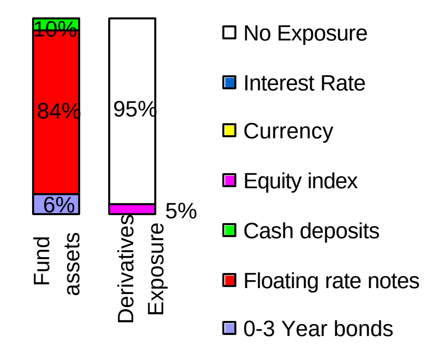
The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 5.6% per annum gross to maturity and has an average duration of 0.25 years.

When opportunities arise we seek to enhance this return by taking conservative positions using futures and options to gain exposure to interest rates and currencies.

Despite recent monetary tightening in both the UK and EU, inflationary pressures remain and have increased expectations of further tightening, meaning the yield curves have shifted upwards across the curve by some 20 basis points over the quarter. In the US, concerns over a possible economic slowdown have meant that the yield curve has shifted downwards in the medium term by 10 basis points over the quarter.

The Fund missed its quarterly target return and the year-to-date return is slightly below that available on cash deposits.

Absolute Return Funds

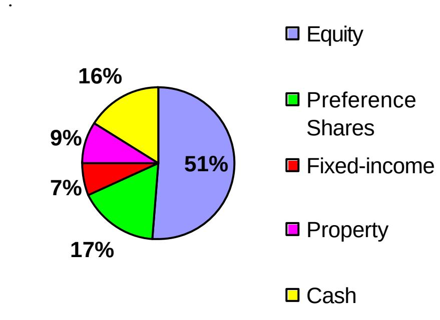


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices by employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

Our derivatives overlay generated 0.49% for the quarter, missing our target of 1% by some way, as we had to close out an equity index position when the markets fell sharply at the end of February. Unfortunately this meant that the gain made in January was lost but our position in March, which was conservatively placed to protect against a further fall and to take advantage of a rising or sideways market, beat our monthly target of 0.33%. We did not take any positions in currency or US Treasury Notes.

Despite beating our monthly target returns for both January and March, the loss incurred in February means that both Absolute Return Funds disappointingly failed to meet their quarterly target returns and the Funds are subsequently 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.

The Fund was up by 0.78% in the first quarter, compared to a rise of 1.84% in the MSCI £ World Index.

The performance of our equity holdings was mixed this quarter, with a number of the strongest performers from the end of last year suffering a correction. On the positive side our Far Eastern holdings have continued their good run and we benefited from a further takeover of a Fund holding.

Our fixed interest securities were impacted by a rise in Sterling base rates that was felt necessary to counter the recent surprisingly strong rise in inflation.

Although we remain fairly cautious and hold a reasonable cash weighting, we are also now finding some interesting new investment opportunities which offer the prospect of attractive long-term capital growth.

Does our conservative investment style work?

Here at Heritage, we adopt a conservative investment approach, with the preservation of capital of paramount importance to us. Whilst we do have to take some risk in order to generate higher returns than holding cash, we strive to achieve this with the least risk possible.

Following the recent fall in the equity markets, we thought we would take this opportunity to assess how our conservative investment style has performed. To do so, we have compared the results of our two largest Funds, the Heritage Absolute Return Fund (ie H£ARF) and the Heritage Managed Portfolio Fund (ie H£MPF) against the returns of the MSCI World Equity Index (in Sterling terms) from 1 December 2000 to 31 March 2007. For our conservative style to be effective, our Funds must have outperformed the MSCI World Equity Index on a risk-adjusted basis. The period examined runs from the inception of our Heritage Managed Portfolio Fund and covers both bull and bear market periods.

The results of our study are shown in the table above and can be summarised as follows:

- A 'drawdown' measures the percentage decline from 'peak to trough' when an asset price falls and there have to be at least two consecutive losing periods for a drawdown to occur. The H£ARF did not experience any drawdowns in the period and although the H£MPF did, both the average and maximum losses incurred were almost half those incurred in the world equity markets.

- Whilst the average annual return for the world equity markets over the period was a loss, both our Funds generated positive average annual returns, in line with their target returns and substantially greater than that obtainable on cash deposits.

- The volatility of returns for our Funds, a measure of risk, is significantly lower than that of world equity markets.

- The 'Sharpe Ratio' is a key investment performance statistic and measures the return in excess of the risk free rate (ie cash) per unit of risk. The Sharpe ratio of cash on deposit is approximately zero. Whilst the world equity markets show a negative ratio over the period, meaning that they performed worse than just holding cash on a risk-adjusted basis, both our Funds display positive ratios, confirming that they beat cash on a risk-adjusted basis and that the controlled investment risks taken were justified in that they generated positive returns in excess of cash.

This study highlights that our conservative investment style has produced consistently better performance than the world equity index over the past 6 years both in absolute terms and on a risk-adjusted basis. We can, accordingly, conclude that our conservative style has proved effective in both bull and bear market cycles, although it should be noted that past performance is not necessarily a guide to future performance.

	MSCI World (£)	H£ARF	H£MPF
Percentage of losing months	42%	9%	30%
Average loss in losing months	-4.04%	-0.15%	-1.89%
No of drawdowns over 10%	5	0	1
Average drawdown	-10.52%	n/a	-4.31%
Maximum total drawdown	-49.43%	n/a	-13.82%
Average monthly return since 1/12/00	-0.03%	0.54%	0.64%
Average annual return since 1/12/00	-0.31%	6.51%	7.68%
Volatility	15.65%	1.46%	8.01%
Sharpe ratio	-0.30	1.43	0.41

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	40%	60%	0%	5.0%	5.4%	30.6%	1.4%
Balanced	20%	50%	30%	7.0%	7.4%	44.8%	2.7%
Growth	0%	40%	60%	9.0%	9.5%	59.0%	4.1%
Benchmarks:							
3 month interest rate					4.9%	21.8%	0.5%
5 year government bonds (total return)					1.6%	23.4%	3.1%
MSCI World Equity Index					0.3%	9.3%	14.9%

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