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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Contrasting fortunes for equities and bonds

After a flat start to the year, global equity markets managed to produce solid gains in the second quarter, whilst bond markets on the other hand have continued to struggle.

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, and on page 4 we describe in more detail how we have been dealing with the bearish bond market conditions.

Heritage Fund reaches £100m milestone

During the quarter the Heritage Investment Fund reached a significant milestone when the total amount invested in the Fund passed the £100 million mark.

The Fund, which consists of the Absolute Return Funds, the Managed Portfolio Fund and the Enhanced Bond Fund, has doubled in size from the £50m mark that we announced it had reached in our July 2003 newsletter.

This progress can be attributed to a combination of new subscriptions and good investment returns.

New subscriptions have come from both existing and new clients. For existing clients our funds have proved a popular alternative to having a separately managed portfolio consisting of numerous individual equity and bond holdings, and the proportion of Heritage's funds under management held within our own Funds has increased to over 60% of the more than £150m of total funds that we have under management. New investors have also been attracted by the combination of performance, simplicity and below average charges that our fund range offers. As most new investors tend to be referrals from existing clients, it is with thanks that we recognize the contribution made by our loyal clients who have helped to spread the word.

The performance derives from our conservative investment approach and our disciplined investment processes, which are designed to produce consistent positive returns in the Absolute Return and Enhanced Bond Funds and long-term capital growth at a lower risk than pure equity alternatives in the Managed Portfolio Fund. Our track record now covers a full investment cycle and we are pleased to have demonstrated that our approach can cope well with a wide variety of market conditions.

Although it is pleasing to see how our Fund has grown over the years, unlike many other fund management groups that appear to be driven by the need to grow bigger and allocate a large proportion of their resources to this end, our focus will continue to be concentrated on looking after our existing clients and ensuring that we maintain our long-term consistent investment performance.

Market Commentary

It was a decent quarter for global equities with all of the major markets making solid progress.

One of the major factors that has been driving financial markets for some time now is that a long period of low interest rates has allowed investors, particularly hedge funds, to borrow money cheaply to invest in a range of riskier instruments. The difference this time is that it is not just the traditional higher risk assets such as equities and property that have benefited, but there has been a huge increase in the appetite for complex structured credit products such as CDOs and CLOs (collateralised debt/loan obligations) and highly geared investments based on risky assets such as sub-prime mortgages.

As cautious investors we tend to avoid these areas and although our short-term returns may occasionally lag behind those that participate in the latest fashions we do not wish to expose ourselves, or our clients, to the downturn that inevitably follows. As interest rates continue to rise it will be interesting to see how things unfold this time - as the legendary American investor, Warren Buffet, once commented – “it is only when the tide goes out that you get to see who has been swimming without their trunks on”.

United Kingdom

The FTSE 100 index gained 4.75% in the second quarter. By contrast, the mid and small cap indices were respectively down and flat which could be a sign that the long period of relative underperformance by the global megacaps might be coming to an end.

Although Britain has a new Prime Minister, the fact that Gordon Brown spent his previous ten years as Chancellor of the Exchequer means that for now there will probably not be any significant changes in the UK’s economic policy.

The Bank of England have continued to raise rates, with the latest move to 5.5% in May, and with the likelihood of further increases to come, Sterling has continued to be strong, particularly against the US Dollar where the rate has now moved above 2 to the pound.

United States

After a flat first quarter the US market rose by 5.8%. In fact the S&P index has now finally regained the level originally reached at the peak of the last bull market over seven years ago in 2000.

The solid performance by the US equity market was in marked contrast to the weak performance by US Dollar bonds as the yield on the benchmark 10 year Treasuries moved sharply higher, to over 5%, pushing bond prices lower.

Europe

The FTSE Eurotop 100 index gained 6.5% making Europe the best performing major market this quarter.

The victory in the French elections of Nicholas Sarkozy is generally considered to be a good result for the French economy and financial markets. German companies will also receive a boost from the upcoming cut in the corporation tax rate.

Japan

In common with the other major markets, Japan also had a good second quarter with the Nikkei index rising 4.9%.

However, the Japanese Yen has continued to weaken against the other major currencies and most international investors will have seen a loss on their Japanese holdings so far this year.

Emerging markets

Emerging Markets have bounced back strongly after a slow start to the year, and with overall double digit gains for the year-to-date, they are now well ahead of the major developed market indices.

Investment Statistics - 30/6/2007

Equity Markets	Q2 2007	2007 ytd	2006	2005	2004	2003
Global - MSCI World ($)	5.82%	8.01%	17.95%	7.56%	12.84%	30.81%
UK - FTSE 100	4.75%	6.22%	10.71%	16.71%	7.54%	13.62%
US - S&P 500	5.81%	6.00%	13.62%	3.00%	8.99%	26.38%
Europe - FTSE Eurotop 100	6.47%	7.63%	12.41%	21.56%	6.46%	11.38%
Japan - Nikkei 225	4.92%	5.30%	6.92%	40.24%	7.61%	24.45%

Other	UK	US	Europe	Japan
PE Ratio	13	20	15	23
Dividend Yield	2.8%	2.5%	2.4%	1.0%
Interest rates - base	5.50%	5.25%	4.00%	0.50%
Bond Yields - govt. 10 year	5.46%	5.02%	4.57%	1.88%
Exchange rates (vs GBP)	-	2.0064	1.4856	247.77
Exchange rates (vs USD)	2.0064	-	1.3506	123.50
Gold ($ per ozs)		$650		

Source : Bloomberg/FT

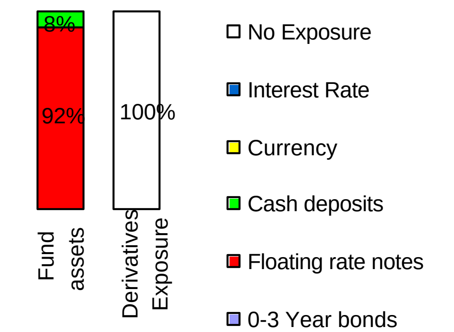
Heritage Investment Fund Limited

Review for the quarter ended 30th June 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 30 June 2007	£159.98	£150.10	US$140.83	£161.75		
Return for quarter	1.10%	2.19%	2.28%	1.67%	1.00%	3.45%
Return for year to date	2.03%	3.58%	3.66%	2.47%	1.95%	5.36%
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%
Compound annual rtn (from 1/01)	4.03%	6.82%	5.25%	7.78%	3.22%	-0.34%
Annual volatility	0.2%	0.8%	0.9%	4.69%	0.1%	6.1%
Size of Fund (millions)	£3.4	£49.9	US$23.7	£35.7		

Enhanced Bond Fund

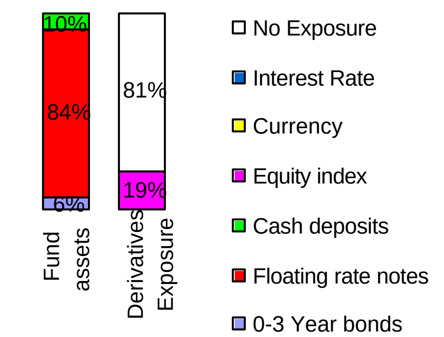


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 5.9% per annum gross to maturity and has an average duration of 0.25 years. When opportunities arise we seek to enhance this return by taking conservative positions using futures and options to gain exposure to interest rates and currencies.

Inflation remains the predominant concern within the US, UK and Euro-zone economies and upward shifts in their respective yield curves during the quarter reflect expectations of further monetary tightening in the UK and Euro-zone, and that rates in the US will not fall by as much as expected. As yields are still rising, the Fund continues to be invested in floating rate notes to reduce our interest rate exposure.

The Fund missed its target return for the month but the year-to-date return is above that available on cash deposits.

Absolute Return Funds

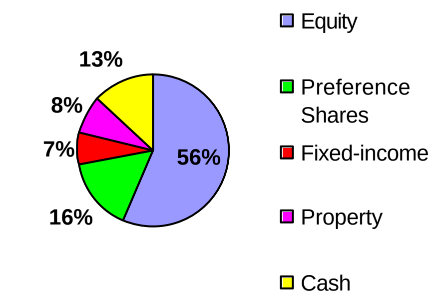


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to interest rates, currencies and equity indices by employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

The derivatives overlay contributed 157 basis points for the quarter, significantly in excess of our target of 100 basis points, ensuring that our Funds had a successful quarter. Taking positions in major equity indices to benefit from the neutral or rising market conditions of the last quarter generated this income. Our non-directional equity index strategies generated all of the incremental return for this month, as we did not take any positions in currency or US Treasury Notes.

Both Absolute Return Funds produced strong returns for the quarter, in excess of our quarterly targets, and as a consequence the US Dollar Absolute Return Fund is now beating its year-to-date target with the Sterling Absolute Return Fund only marginally behind its year-to-date target.

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 1.67% this quarter, compared to a 3.45% rise in the MSCI £ World Index, and for the year-to-date the Fund is up by 2.46% compared to 5.36% for the World Index.

The Fund's equity holdings had a reasonable quarter assisted by the current strength of global equity markets. The best performances came from our Far eastern and emerging markets holdings.

Recent activity in the portfolio has been based on taking profits on holdings that have done well, and re-investing the proceeds into new or existing holdings that appear to offer better value. Within our equity holdings we have switched some of our mid cap exposure to undervalued large caps, and within our property exposure we have re-invested profits from the UK market into Europe where yields are still at more attractive levels.

How we have handled the bearish bond markets

Over the past couple of years bond prices have been falling in the US, Europe and UK, making it very difficult to generate higher returns and many of the 'top-rated' bond funds have incurred losses for their clients as result. So what has caused this sustained fall in the bond markets and how have we at Heritage been able to maintain a positive, consistent level of performance for our Enhanced Bond and Absolute Return Funds during this tricky period?

There are two main ways to earn higher returns when investing in the bond market – you can attempt to make capital gains by trading bonds or you can seek to earn a higher yield by buying bonds with different characteristics, such as a longer maturity. Due to the sustained fall in bond prices, it has become very difficult to make capital gains by trading bonds, especially the less risky, investment grade bonds that our Funds invest in. Prices have been falling as investors seek higher yields, in response to rising interest rates due to inflationary pressure; in fact it would appear that we have now seen the lows in the current cycle for inflation and consequently for interest rates. Investors are concerned that interest rates have further to rise on both sides of the Atlantic, as seen by the recent volatility in the bond markets and so the bear market appears to have further to go.

The other way to earn a higher return is to buy bonds with different characteristics, such as an imbedded call option or longer duration (longer date to maturity). In normal conditions one would expect an upward sloping yield curve, whereby an investor can earn a higher return by buying a bond with a longer duration (taking on additional risk for additional return) but in recent years the yield curve has been inverted, meaning the yield for longer, riskier bonds is less than that of shorter, less risky bonds and hence investors cannot earn additional return by 'going long'. This has been partly due to pension funds trying to match their liabilities and driving the longer yields down but also due to the pessimistic nature of the bond markets expecting an economic downturn and therefore lower interest rates and yields. In the past months the yield curves have normalised but investors cannot yet earn sufficient additional return for the extra risk taken by 'going long'.

Within these tricky market conditions we have been able to produce consistent, positive returns for our aforementioned Funds by investing in floating rate notes. These bonds have coupons that are linked to short-term interest rates and reset each quarter, to reflect changes in these interest rates. As the coupons reset, the yields adjust and therefore the prices of the bonds are not affected by changes in interest rates and their prices remain fairly stable no matter what the market conditions.

On the downside this means that investors will not be able to make significant capital gains but they do yield a return in line with current interest rates. We began switching our straight bond holdings to floating rate notes some years ago prior to this sustained fall in bond prices and now are fully invested in floating rate notes. We are not content to 'rest on our laurels' however and are seeking other ways to generate higher returns in this difficult environment.

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	50%	50%	0%	5.0%	5.4%	29.6%	1.4%
Balanced	20%	50%	30%	7.0%	9.4%	45.8%	2.6%
Growth	0%	40%	60%	9.0%	13.0%	60.1%	4.0%
Benchmarks:							
3 month interest rate					5.2%	22.1%	0.6%
5 year government bonds (total return)					1.5%	20.2%	3.1%
MSCI World Equity Index					11.9%	35.9%	13.8%

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