Heritage

Quarterly Newsletter & Investment Review

Issue 39 Quarter 3 2007

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 and Enhanced Bond Funds.

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

www. heritage-capital.co.uk
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
Broadway House, Tothill Street,
London. SW1H 9NQ

Testing times

Following a lengthy period of fairly benign conditions, global financial markets were suddenly thrown into turmoil this quarter, with a credit crisis and severe equity market volatility.

We are pleased to report that against this background all of the Heritage Funds produced positive returns. Further details can be found as usual on page 3.

How the recent turmoil has caught out more aggressive investors

Regular readers of our investment reviews will be aware that our investment style is fairly conservative, and as recently as our last newsletter we commented that ;
" …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 …. it will be interesting to see how things unfold this time … as it is only when the tide goes out that you get to see who has been swimming without their trunks on".

Even we were surprised at the speed and extent to which the tide subsequently turned, and sure enough the recent turmoil in credit markets has revealed many naked swimmers. In particular several high profile hedge funds suffered huge losses resulting in investors' capital being completely wiped-out in the worst cases.

Many of the investments held by these funds were new innovations which had only a very short trading history in initially benign market conditions, or in some cases had only been priced according to theoretical models rather than using real market prices. The role of the Rating Agencies has also come into question, as they provided "AAA" ratings to newly created products based upon re-packaged sub-prime debt, which also encouraged a wide range of supposedly cautious investors to participate in this area without fully understanding the risks that they were taking.

However, as usual, the real cause of the worst losses was not purely down to poor investment choices, but the lack of diversification and the manager's use of excessive gearing. The use of aggressive, debt-financed investment into a concentrated portfolio can produce impressive returns in favourable market conditions, but is a sure recipe for disaster when the tide turns.

Inevitably, even cautious investors such as ourselves are impacted to a limited extent by events such as the recent credit crisis (which the article on page 4 deals with in more detail), but avoiding the temptation to chase higher returns certainly helps to avoid serious losses.

Market Commentary

After a relatively quiet first half to the year, markets were suddenly thrown into turmoil this quarter, with US sub-prime mortgage problems leading to severe equity market volatility and a credit crisis in the global financial system.

It may seem re-assuring that following the very sharp falls in August, equity markets have subsequently recovered to close to their previous highs. However, there is still a real danger that this may be just a temporary relief rally following US interest rate cuts, and that attention may now turn to the deteriorating underlying fundamentals and an increased risk of an economic slowdown.

The articles on page 1 and page 4 of this newsletter deal with further aspects of the fallout from the recent financial crisis and below we consider the key issues concerning the various regions that make up the global markets.

United Kingdom

Overall, the FTSE 100 index fell by 2.14% this quarter to end at 6,467, although during the summer things looked a lot worse as the FTSE plunged from a high of over 6,700 in June to below 5,900 at the low point in August.

The credibility of the three-way system of financial regulation involving the Bank of England, the Financial Services Authority and the Treasury has been severely tested by the crisis at Northern Rock created by the recent credit squeeze. With all banks now becoming much more cautious with their lending and individuals nerves tested by the first run on a high street bank in living memory, the risk of a slowdown in the UK has become more pronounced.

United States

The US was the only major market to produce a positive return this quarter with the S&P 500 index gaining 1.56%. However, the sharp fall in the US Dollar means that international investors would have still seen an overall fall in the value of their US holdings.

Both the rally in the market and the weakening Dollar can be explained by the Federal Reserve's decisive reaction to the credit crisis and rapidly weakening US housing market by cutting interest rates by 0.5% to 4.75%, giving the impression that it is more concerned with rescuing markets than fighting inflation.

Europe

The FTSE Eurotop 100 index fell by 2.41% this quarter. The ECB's reaction to the credit crisis was to inject huge amounts of liquidity into the banking system but has indicated that this will not deflect it from its course of interest rate rises to counter inflation.

For the past couple of years the European economy has been showing quite impressive growth, although there are now signs of a slowdown in certain areas, with the Spanish and Irish property markets coming under particular pressure. There are also concerns over the effect that the strong Euro is having on the regions exporters.

Japan

Bulls of the Japanese market have again been disappointed with the Nikkei index falling 7.46% this quarter, resulting in it being the only major market in negative territory for the year-to-date.

In addition to the global financial turmoil, Japan is also having to contend with political uncertainty following the recent sudden resignation of its prime minister.

Emerging markets

During previous bouts of turmoil in global markets it has often been emerging markets that have been hardest hit. However, the robustness of these markets has been a notable feature this time round and overall emerging markets have produced the best returns, both in the current quarter and for the year-to-date.

Investment Statistics - 30/9/2007

Equity Markets	Q3 2007	2007 ytd	2006	2005	2004	2003
Global - MSCI World ($)	1.95%	10.11%	17.95%	7.56%	12.84%	30.81%
UK - FTSE 100	-2.14%	3.95%	10.71%	16.71%	7.54%	13.62%
US - S&P 500	1.56%	7.65%	13.62%	3.00%	8.99%	26.38%
Europe - FTSE Eurotop 100	-2.41%	5.04%	12.41%	21.56%	6.46%	11.38%
Japan - Nikkei 225	-7.46%	-2.56%	6.92%	40.24%	7.61%	24.45%

Other	UK	US	Europe	Japan
PE Ratio	12	18	14	35
Dividend Yield	3.0%	1.8%	2.1%	1.1%
Interest rates - base	5.75%	4.75%	4.00%	0.50%
Bond Yields - govt. 10 year	5.01%	4.59%	4.33%	1.69%
Exchange rates (vs GBP)	-	2.0374	1.4326	234.33
Exchange rates (vs USD)	2.0374	-	1.4222	115.02
Gold ($ per ozs)		$744		

Source : Bloomberg/FT

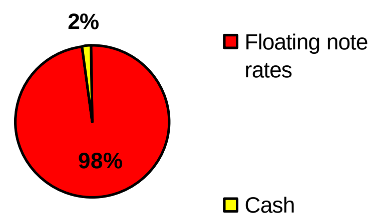
Heritage Investment Fund Limited

Review for the quarter ended 30th September 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 September 2007	£160.22	£152.13	US$141.97	£163.46		
Return for quarter	0.15%	1.35%	0.81%	1.06%	1.19%	0.40%
Return for year to date	2.18%	4.98%	4.50%	3.55%	3.40%	5.78%
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)	3.92%	6.77%	5.17%	7.65%	3.47%	-0.27%
Annual volatility	0.7%	2.0%	2.1%	4.6%	0.1%	7.9%
Size of Fund (millions)	£3.3	£50.9	US$23.7	£36.3		

Enhanced Bond Fund

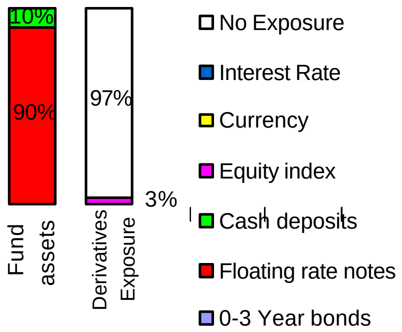


The Sterling Enhanced Bond Fund is invested in a diverse spread of high-quality investment grade bonds designated in the major international currencies. The bond portfolio currently yields 6.4% per annum gross to maturity and has an average duration of 0.25 years.

The credit and liquidity crisis experienced during the quarter has significantly affected the values of the financial bonds held by the Fund as credit spreads have widened considerably, particularly on longer dated issues. During the quarter, yields fell across the spectrum of the yield curve in the UK, US and Europe as investors anticipate slowing economic growth. Expectations are for no change in short-term UK and European interest rates, but US rates are expected to be reduced further in the coming months.

The Fund experienced a disappointing quarter due to the widening of credit spreads and the markdown of financial bonds, but is on an attractive gross yield going forward.

Absolute Return Funds

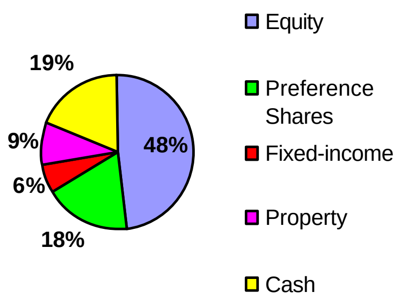


The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to equity indices, interest rates, and currencies employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

After initial losses in the first month of the quarter on our equity derivative positions, the new positions established in S&P500 and FTSE100 index futures benefited from the recovery in equity markets during the second half of the quarter and contributed a net 105 basis points to the period's performance. We did not take any positions in currencies or US Treasury notes during the quarter as the return to risk ratio did not justify doing so.

Both Absolute Return Funds generated positive returns for the quarter, but were short of their targets. The US Dollar Fund results were depressed by the markdown of prices in the US investment bank bonds held where spreads widened considerably, although they are rated high investment grade.

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 did well to produce positive returns in all three months this quarter despite the severe volatility in financial markets. The overall gain for the quarter was 1.06% which was higher than the 0.40% rise in the MSCI £ World Index, although for the year to date the Fund's 3.55% gain is behind the 5.78% for the index.

The best performances this quarter came from our emerging market and commodity holdings and we also received a boost from the takeover of a long-standing shareholding. On the other hand our financial holdings generally struggled due to the turmoil in credit markets.

Yields on preference shares have become more attractive recently and we have added to our portfolio of well-covered zeros and similar securities where our average yield to maturity is 8.9%. Our healthy cash balance helps to stabilise returns as well as providing a decent yield and allowing us to take advantage of any opportunities that might arise.

The impact of the recent global financial crisis on bond holdings

During 2006 there was a sharp rise in foreclosures in the sub-prime mortgage market in the US and this developed into a global crisis in July 2007. Rising interest rates left certain home-owners in the US unable to meet their financial commitments, which resulted in a severe credit crunch which threatened the solvency of a number of marginal private banks and other financial institutions. The effects of the meltdown spread beyond housing and disrupted global financial markets as banks and investors were forced to re-evaluate the risks they were taking. The abrupt tightening of the availability of finance caused increased volatility in the fixed income, equity and derivatives markets.

Wall Street investment banks and other financial institutions around the world have been significantly affected by their involvement in packaging sub-prime debt obligations for investors. Two Bear Stearns hedge funds involved in securities backed by sub-prime loans are now worthless, and hedge funds operated by Goldman Sachs, Citigroup and BNP Paribas (among others) all suffered huge losses. In the UK, Northern Rock required liquidity support from the Bank of England due to problems raising funds in the short-term money market to replace maturing borrowings, resulting in a run on the bank by anxious savers.

The recent global financial crisis has resulted in a re-rating of credit risk for fixed-income securities across the board. Independent companies such as Moody's and Standard & Poors analyse and rate the debt securities issued by governments, financial institutions and corporates. Investment grade securities (in which our Heritage Enhanced Bond and Absolute Return Funds only invest) range from the highest AAA down to BBB. There are very few financial institutions or corporates rated AAA, which mainly comprises government issued securities (eg US, UK). The credit risk of a bond is measured by the credit spread over the yield of a government bond of a similar maturity and reflects the additional yield earned from a security carrying more risk than a government bond, which is regarded as risk-free.

Our bond holdings are typically rated AA and A and mainly comprise global financial institutions, which have been consistently highly-rated. Our Funds may not hold more than 10% in any one security and generally hold a diversified spread of about 20 bonds with each bond holding constituting less than 5% of the funds under management. As interest rates have been rising over the past few years, we have favoured holding floating rate notes over fixed-coupon bonds, as the former bond yields move in line with interest rate changes and their prices are normally very stable. However, over the past quarter, the credit spreads of all financial bonds have widened considerably as a result of the global credit crisis. Prior to July 2007, the average credit spread over Libor of a AA floating rate note was around 10 basis points. Many of these have now widened to 75 to 100 basis points, resulting in the prices of these bank and building society bonds being severely marked down.

In particular, US investment banks and UK building societies suffered significant falls in their bond prices, with longer maturities falling further. This has unfortunately depressed the monthly prices of our mutual funds. However, we continue to hold these bonds as we believe that these institutions are financially sound, they are offering attractive yields, the interest is well covered and bond prices should recover when credit spreads return to more normal levels.

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	50%	50%	0%	5.0%	5.0%	28.0%	0.9%
Balanced	21%	50%	29%	7.0%	7.5%	47.4%	1.7%
Growth	0%	33%	67%	9.0%	10.1%	69.5%	3.2%
Benchmarks:							
3 month interest rate					5.4	22.6%	0.1%
5 year government bonds (total return)					4.0%	19.3%	3.0%
MSCI World Equity Index					9.1%	71.4%	7.9%

Heritage Capital Management Limited
Broadway House, Tothill Street, London SW1H 9NQ
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