Heritage

Quarterly Newsletter & Investment Review

Issue 40 Quarterly news & investment review from Heritage Quarter 4 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.

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 port folios 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

A difficult year for investors

With losses across the board in a weak final quarter, none of the major equity indices managed to rise more than 4% for the full year, and the credit crisis has also made it a difficult year for bond investors.

We are pleased to report that against this background the Heritage Funds have held up well, with our largest fund, the Sterling Absolute Return Fund, producing a particularly creditable return of over 7% this year.

Target returns for 2008

The key investment issue in 2008 will be how the current credit crisis unfolds and whether central bank efforts to inject liquidity into the financial system will ease the funding shortage. Central bankers presently appear more concerned about slowing economic growth than the threat of higher inflation, and are expected to lower interest rates over the coming year in an attempt to prevent a recession. In the UK, the futures market indicates that short-term interest rates are expected to fall from 5.5% to 5.0% by the end of 2008, whilst in the US short-term interest rates are expected to be reduced by as much as 1.0% to 3.5% during the year ahead. In contrast, European short-term interest rates are expected to remain unchanged at 4.0% during 2008, as the central bank remains hawkish on inflation.

Our Absolute Return Funds will position themselves to continue to generate consistent positive returns over the coming year, in excess of bank deposit rates. The core of each of the Absolute Return Funds will continue to be invested in floating rate notes where the liquidity squeeze has pushed up Libor rates. We aim to generate net annual returns for each Fund of approximately 2.5% over bank rates. Based on anticipated central bank rates of 5.0%, 3.5% and 4.0% for the UK, US and Europe, our target net returns after fees and expenses are expected to be approximately 7.5%, 6.0% and 6.5% for our Sterling, US Dollar and Euro Absolute Return Funds respectively. However, it will prove very challenging to generate the required incremental return from derivatives-based strategies in today's volatile and uncertain equity and bond markets.

Investors are generally cautious about the outlook for equity markets for the coming year, as slowing economic growth will have a negative impact on corporate profits and the liquidity crisis will put a brake on business expansion and acquisitions, although on the positive side valuations appear reasonably attractive. The returns for the year ahead for equity markets and our Managed Portfolio Fund are, as always, very difficult to predict and we would encourage investors to take a longer-term view. A return of around 8-9%, based on a risk free rate of 5% plus an additional 3-4% 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.

Heritage Capital Management Limited

Review for the quarter ended 31st December 2007

Market Commentary

It was a disappointing end to the year for most investors with all the major equity markets suffering losses, as the relief rally following the initial summer weakness gave way to concerns over the prolonged credit crisis and the prospect of a possible US recession next year.

With all the recent bad news, many investors will automatically assume that the outlook for markets in 2008 is poor. However, stockmarkets are generally very efficient at discounting the implications of all known information, as a more detailed look behind the headline numbers for the UK market demonstrates. Although the FTSE 100 index showed a small gain for 2007, this was largely due to a very strong performance from the large mining and resources sector offsetting severe weakness in other areas.The banking sector was down by over 20%, resulting in the average dividend yield rising to well over 5%, property shares (or REITs) fell by around 40% leaving them on huge discounts to their underlying net asset values, the Small Cap index was down by 20% and over the whole UK market the fallers outnumbered the risers by over 3 to 2 this year.

Therefore, it would be fair to say that much of the bad news has already been factored into current prices, making short term predictions for the outlook for markets for the year ahead as difficult as ever.

United Kingdom

Although the FTSE 100 index fell marginally in the final quarter, it outperformed the other major markets and for the full year it also had the best return with a rise of 3.80%.

However, as explained above this does not tell the whole story and many areas of the UK economy are now encountering very trying conditions, as a falling property market and weakening consumer spending begin to bite.

United States

The US market finished the year on a poor note, with a 3.82% drop in the S&P 500 index in the final quarter.

US banks have suffered a particularly torrid time and announcements of billions of dollars of subprime related losses has led to several CEOs losing their jobs, including the heads of Merrill Lynch and Citigroup. With the ongoing credit crisis, and the US property market suffering its worst downturn in decades, the Federal Reserve continues to cut interest rates.

Europe

In common with the other major markets, Europe had a poor final quarter, leading to a disappointing full year return for the FTSE Eurotop 100 index of just 2.41%.

However, unlike its US and UK counterparts, the European Central Bank has not felt the need to reduce interest rates to support the economy in the face of the recent financial turmoil, with its stated focus remaining control over inflation.

Japan

For the second year in a row Japan has been the weakest of the major markets, with a very poor final quarter resulting in a fall of 11.1% in 2007 for the Nikkei index.

A spate of negative business and consumer surveys, weakening economic data and political uncertainty account for this poor performance, but on a more positive note Japan's banks have largely avoided the credit crisis afflicting western financial institutions and many Japanese companies are well placed to benefit from the growing economies of its Asian neighbours.

Emerging markets

Emerging markets comfortably outperformed the major markets in 2007 and their ability to avoid the problems encountered by the major markets in the recent financial turmoil has been impressive. However, whilst over the past few years we have been unequivocally bullish on emerging markets due to their combination of superior growth prospects and cheaper valuations, the latter has no longer applies as PE ratios for emerging markets are now higher than those for the major markets.

Investment Statistics - 31/12/2007

Equity Markets	Q4 2007	2007 ytd	2006	2005	2004	2003
Global - MSCI World ($)	-2.74%	7.09%	17.95%	7.56%	12.84%	30.81%
UK - FTSE 100	-0.15%	3.80%	10.71%	16.71%	7.54%	13.62%
US - S&P 500	-3.82%	3.53%	13.62%	3.00%	8.99%	26.38%
Europe - FTSE Eurotop 100	-2.50%	2.41%	12.41%	21.56%	6.46%	11.38%
Japan - Nikkei 225	-8.80%	-11.13%	6.92%	40.24%	7.61%	24.45%

Other	UK	US	Europe	Japan
PE Ratio	12	18	12	29
Dividend Yield	3.7%	2.1%	3.5%	1.3%
Interest rates - base	5.50%	4.25%	4.00%	0.50%
Bond Yields - govt. 10 year	4.51%	4.02%	4.31%	1.50%
Exchange rates (vs GBP)	-	1.9910	1.3620	222.40
Exchange rates (vs USD)	1.9910	-	1.4620	111.70
Gold ($ per ozs)		$834		

Source : Bloomberg/FT

Heritage Capital Management Limited is authorised and regulated by the Financial Services Authority. Investors should be aware that past investment performance is not a guide to future performance, and that the value of investments may fall as well as rise. An investor may get back less than the original amount invested.

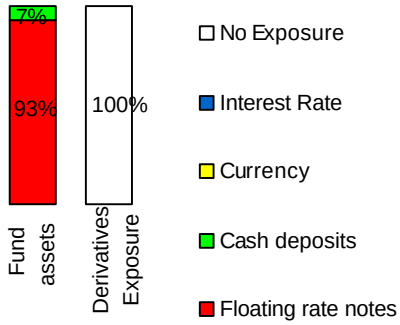
Heritage Investment Fund Limited

Review for the quarter ended 31st December 2007

Performance

	Absolute Return Funds		Managed Portfolio Fund	Cash Deposits	MSCI World Index
Risk profile	Moderate		High / Moderate	(£)	(£)
Minimum investment horizon	3 years +		5 years +		
Typical range of returns	4% to 8%		0% to +12%		
Price at 31 December 2007	£155.25	US$144.12	£162.18		
Return for quarter	2.05%	1.51%	-0.78%	1.17%	0.56%
Return for year 2007 (actual)	7.14%	6.09%	2.74%	4.62%	8.24%
Year 2006 return (net)	6.79%	7.41%	16.79%	3.23%	6.01%
Year 2005 return (net)	6.24%	3.72%	14.28%	3.17%	22.69%
Year 2004 return (net)	7.15%	4.46%	10.92%	3.06%	7.30%
Year 2003 return (net)	5.71%	3.65%	16.10%	2.69%	20.82%
Year 2002 return (net)	7.95%	5.82%	-0.41%	3.04%	-27.08%
Compound annual rtn (from 1/01)	6.83%	5.21%	7.25%	3.52%	-0.29%
Annual volatility	2.1%	2.4%	5.1%	0.1%	8.5%
Size of Fund (millions)	£51.4	US$26.1	£35.7		

Absolute Return Funds



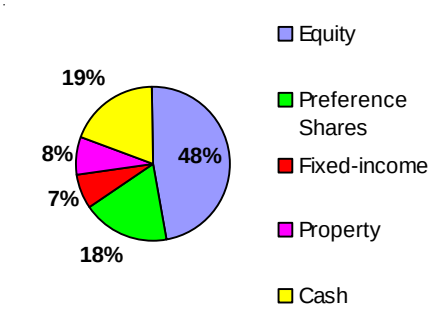
The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to equity indices, interest rates, and currencies employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

The core bond portfolios currently yield 6.3% (£) and 5.2% (US$) per annum gross to maturity and have average durations of 0.25 years. The continuing credit crisis significantly affected the values of the financial bonds held by the Funds as credit spreads widened, particularly on US banks and longer maturities. Expectations are for a reduction of 0.75% and 1.00% in short-term UK and US interest rates respectively over the next 12 months due to slowing economic growth, but European rates are expected to be held at current levels on inflation concerns.

During the quarter our equity derivative positions in S&P500 and FTSE100 index futures benefited from the volatility in equity markets and contributed 125 basis points to the period's performance. We did not take any positions in currencies or US Treasury notes during the month as the return to risk ratios did not justify doing so.

The Absolute Return Funds generated solid returns for the year much in line with expectations, with the US Dollar Fund results being depressed by declines in the prices in some of the US investment bank bonds held.

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 fell by 0.78% in the final quarter, resulting in a full year return of just 2.74%, which is a little disappointing compared to the double digit returns achieved in each of the previous four years.

Our emerging market and resources based holdings produced the best returns this year, whilst property and financial shares on the other hand have done less well.

As well as operating companies, our equities also include exposure to specialist listed investment companies that provide further diversification to the portfolio. These include funds with exposure to timber, infrastructure investments, agricultural and energy commodities, and base metals.

Our zero dividend preference shares are well covered and have held up well despite the current difficult market conditions.

We have taken profits in a number of holdings that have done well over the past few years and the resultant high cash weighting should provide us with the ability to take advantage of opportunities that may arise from further market volatility.

This report is not an invitation to subscribe for shares in the Heritage Investment Funds and is for the information of investors only. Investors should be aware that past investment performance is not a guide to future performance, and that the value of investments may fall as well as rise. An investor may get back less than the original amount invested.

Launch of Heritage Euro Absolute Return Fund

For many years we have successfully managed Sterling and US Dollar versions of our Absolute Return Fund. With the Euro now widely regarded as one of the world's major reserve currencies and following enquiries by investors, we feel that it is appropriate to launch a Euro version of our Absolute Return Fund. This will enable investors to diversify their currency allocation and gain exposure to the Euro, whilst targeting a return substantially higher than that available on Euro-denominated bonds or bank deposits.

The investment strategy will follow the same format as the Sterling and US Dollar Absolute Return Funds. Approximately 90% of the funds will be invested in short-dated investment grade bonds and bank deposits denominated in Euros. The remaining funds up to 10% will be invested in Heritage Absolute Return SPV Limited, which takes positions in equity indices, interest rates and currencies using futures and options to enhance the return of the Fund. In common with our other Absolute Return Funds, the Euro Fund will target a net annual return of the central bank rate (currently 4.0%) plus 2.5%, giving a total target of 6.5% per annum net of costs.

We anticipate that the new Euro Absolute Return Fund will open for investment during the first quarter of 2008, once the necessary approval has been granted by the regulatory authorities. Investors who wish to invest in the Euro Fund or switch portion of their existing investments into this Fund, should contact us to make the necessary arrangements.

Closure of Heritage Enhanced Bond Fund

Over the past year, the funds under management in our Enhanced Bond Fund have unfortunately fallen to the level where it is no longer viable to continue to run the Fund, as the fixed costs consume a disproportionate percentage of the income. We have, therefore, reluctantly decided to close this Fund at 31 December 2007. Many investors in this Fund have already switched their investments to either or both of our Sterling Absolute Return and Managed Portfolio Funds in recent months.

For those investors who remain in the Enhanced Bond Fund, we intend to automatically switch their investments into our Sterling Absolute Return Fund unless we hear to the contrary from them. Our Sterling Absolute Return generates its income from short-dated investment grade bonds in a similar manner to the Enhanced Bond Fund, and only carries slightly higher risk than the Enhanced Bond Fund based on its derivatives exposure. It has a long history of stable returns superior to bank deposits.

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

	Suggested asset allocation			Last 12 Months	Last 5 Years	
	Absolute Return Fund	Managed Portfolio Fund	Target Returns £	Actual Return £	Actual Return £	Average Volatility
Model portfolios:						
Cautious	75%	25%	8.0%	6.0%	47.4%	2.2%
Balanced	50%	50%	9.0%	4.9%	57.1%	2.9%
Growth	25%	75%	10.0%	3.8%	66.9%	3.9%
Benchmarks:						
3 month interest rate				5.6%	23.0%	0.1%
5 year government bonds (total return)				7.9%	21.8%	3.0%
MSCI World Equity Index (total return)				8.2%	82.5%	8.5%

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

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