Heritage

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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A tough start to the year for investors

Equity markets have suffered their worst first quarter for many years, with all of the major markets falling by around 10% or more. Furthermore, the ongoing credit crisis has also made it a difficult quarter for bond investors.

Against this background the Heritage Funds have held up relatively well and we are pleased to report that our newly launched fund, the Euro Absolute Return Fund, has made a positive start.

The advantage of small independent investment managers

Despite an initial tendency to assume that bigger might be better, numerous studies have demonstrated that when it comes to investment management, the opposite is in fact true. There are sound underlying reasons for this and below we have listed the key factors that help to explain the results of the studies and the successful track record that we have established here at Heritage ;

Independence – Smaller, independent investment houses are free from the often conflicting pressures within larger organisations. This allows them to select the best investments from a truly independent perspective. Our clients have therefore not been exposed to the various complex new structured products that are pushed onto those dealing with the large institutions, with often disastrous results.
Flexibility – Large funds can become constrained and unwieldy as a result of their sheer size. The flexibility offered by smaller fund managers is an important aspect of their competitive advantage. At Heritage, it also allows us to offer some interesting investment opportunities that are simply not available via larger institutions.
Personal service – With more lucrative fees on offer from large corporate clients, most multinational investment institutions now allocate less experienced staff to individual private clients. At Heritage, we continue to build our business around the concept of long-standing relationships and a high level personal service .
Management participation - Investors should be cautious of funds that are managed by individuals who are not prepared to commit a significant proportion of their own wealth to the fund, as is so often the case with large retail funds. A large personal stake in the fund does not automatically guarantee success but investors in Heritage's funds can take some comfort from the knowledge that we do "eat our cooking" and that our interests are aligned with our clients.
Stability - A further advantage of having a manager with a personal interest in both the fund and the management company is that it provides better stability. Too often fund managers and investment advisors who are simply employees of a large company lack the commitment and loyalty to stay with a company for more than a few years.
Lower charges – Smaller companies that maintain a low profile do not spend large amounts on advertising, or carry the overheads associated with a large sales force. Most fund managers recover these marketing costs from investors by charging initial fees (often much as 5% up-front), whereas Heritage clients do not suffer any entrance or exit charges and even our annual management fees are below the industry average.

We believe that the benefits outlined above mean that smaller, privately owned investment companies such as Heritage will continue to offer clients the more attractive alternative, with the prospect of superior performance and an overall better service.

Market Commentary

With an initial severe plunge in January, followed by further overall weakness through the rest of the quarter it has been the worst start to the year for equity markets for decades.

During previous downturns it has been possible for astute (or fortunate) investors to mitigate the impact of the overall market falls by positioning their portfolio appropriately – for example by being in value rather than growth stocks during the previous bear market, or being in resources rather than financial stocks, and emerging markets rather than the developed world markets for most of 2007. An interesting and unusual feature of the current market weakness is that is has affected all areas in almost equal measure. In fact the only reason that the indices in the table and commentary below differ for this quarter is due to the different currencies that they are quoted in and once this effect has been accounted for the performances measured in a common base currency are virtually the same, and even at the sector or style level returns have been very similar.

Irrespective of the movement of the overall market for the rest of this year, it is highly unlikely that all regions, sectors and styles will continue to track each other as closely as they have done in the first quarter and that opportunities will arise for the well positioned investors to beat the market averages.

United Kingdom

The FTSE 100 index (which was established in 1984) suffered its worst ever start to the year, with a fall of 10.35% in the first quarter.

Against an already challenging background, the UK's new Chancellor, Alastair Darling, has made a less than impressive start. In particular, the upheaval of the well established regime for non-domiciles threatens to have a negative impact at a time when the faltering economy can ill afford it and the Northern Rock debacle and the poorly implemented changes to the capital gains tax regime have not helped either.

United States

Although the US was the only major market to avoid a double digit percentage decline in the first quarter, the 9.44% fall in the S&P 500 index was still pretty severe and after the weakness of the US Dollar is taken into account the losses for international investors were in line with other markets.

The Federal Reserve has been the most proactive of the central banks in its efforts to alleviate the credit crisis and not only have interest rates been slashed to the current 2.25%, but a whole range of additional lending mechanisms have been introduced to try and improve liquidity in the financial system. However, for now the bad news has continued to flow with the weakening economy, falling housing market and the collapse of one of Wall Street's largest banks, Bear Stearns, making the headlines.

Europe

The FTSE Eurotop 100 index fell by just over 16% in the first quarter.

Although, the European Central Bank has not yet felt the need to reduce interest rates to support the economy in the face of the recent turmoil, the pressure does appear to be building which could result in cuts later this year.

Japan

After underperforming the other major markets in 2006 and 2007, the initial signs for Japan in 2008 are no better with a massive 17.5% fall in the Nikkei Index for the year-to-date. The only positive is that the recent strength of the Yen has at least softened the blow a little for international investors.

Emerging markets

After holding up much better than the major developed markets in the second half of last year, 2008 has not started as well for emerging markets. In particular the Chinese market has suffered a sharp correction this quarter after showing signs of becoming overvalued last year.

Investment Statistics - 31/03/2008

Equity Markets	Q1 2008	2008	2007	2006	2005	2004
Global - MSCI World ($)	-8.91%	-8.91%	7.09%	17.95%	7.56%	12.84%
UK - FTSE 100	-10.35%	-10.35%	3.80%	10.71%	16.71%	7.54%
US - S&P 500	9.44%	-9.44%	3.53%	13.62%	3.00%	8.99%
Europe - FTSE Eurotop 100	-16.06%	-16.06%	2.41%	12.41%	21.56%	6.46%
Japan - Nikkei 225	-17.54%	-17.54%	-11.13%	6.92%	40.24%	7.61%

Other	UK	US	Europe	Japan
PE Ratio	12	20	11	14
Dividend Yield	4.2%	2.3%	4.0%	1.6%
Interest rates - base	5.25%	2.25%	4.00%	0.50%
Bond Yields - govt. 10 year	4.35%	3.41%	3.90%	1.60%
Exchange rates (vs GBP)	-	1.9875	1.2543	197.83
Exchange rates (vs USD)	1.9875	-	1.5846	99.54
Gold ($ per ozs)		$917		

Source : Bloomberg/FT

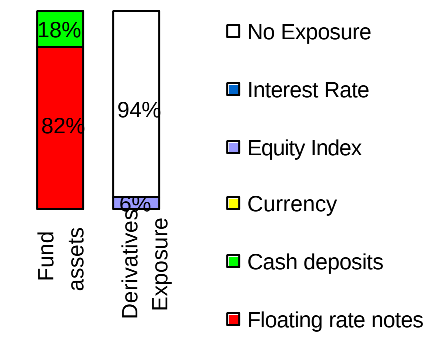
Heritage Investment Fund Limited

Review for the quarter ended 31st March 2008

Performance

	Absolute Return Funds			Managed Portfolio Fund	Cash Deposits (£)	MSCI World Index (£)
Risk profile	Moderate			High / Moderate		
Minimum investment horizon	3 years +			5 years +		
Target return over bank deposit rate	+2.5%			+5%		
Price at 31 March 2008	£155.18	US$139.89	€100.72	£157.41		
Return for quarter & ytd (net)	-0.05%	-2.94%	0.72%	-2.94%	1.21%	-9.09%
Year 2007 return (net)	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%	3.71%		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)	6.58%	4.60%		6.55%	4.07%	-1.67%
Annual volatility	2.6%	3.5%		6.0%	0.1%	11.6%
Size of Fund (millions)	£45.2	US$23.7	€11.0	£35.7		

Absolute Return Funds



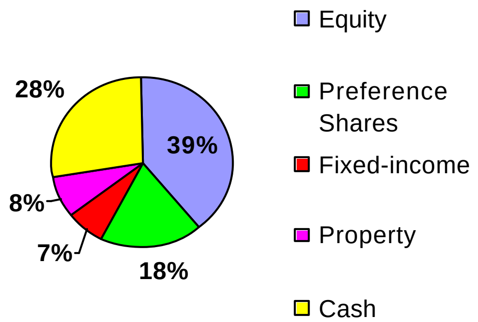
The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to equity indices, interest rates, and currencies employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

The core bond portfolios currently yield 6.3% (GBP), 4.9% (USD) and 4.8% (EUR) per annum gross to maturity and have average durations of 1.8, 4.5 and 2.0 years respectively. The credit crisis continues to significantly affect the values of the financial bonds held by the Funds as liquidity has dried up and credit spreads have widened to extreme levels, particularly on US banks and longer maturities.

During the quarter our equity derivative positions in S&P500 and FTSE100 index futures lost a net 0.56%. After early losses in January, our positions showed gains in the following two months as equity markets stabilised and remained range bound.

The Absolute Return Funds have made a disappointing start to the year, but the Sterling and new Euro Funds recovered well in February and March after initial losses. The US Dollar Fund results have been depressed by falls in the prices of US investment bank bonds held, which are marked to market.

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 through active management of a well diversified portfolio.

It has been the worst start to a year for equity markets for many years, with the MSCI World £ Index falling by 9.09% in the first quarter. The Managed Portfolio Fund has held up reasonably well against this background with a loss of 2.94%.

A certain amount of volatility has to be expected with an equity based fund and although we had reduced our overall equity exposure, the majority of our remaining long-term holdings were inevitably affected by the general market weakness.

Our zero dividend preference shares have performed well despite the current difficult conditions, although individual corporate fixed interest securities have suffered from widening spreads due to the ongoing credit crisis.

The large discounts to net asset values that all listed property companies now trade on could provide good value for long-term investors, particularly in European and Asian property markets which have held up better than the UK and US.

We currently have an historically high cash weighting and our focus is on searching for ways to invest this in areas that we feel should recover from the recent market turmoil.

The impact of the current credit crisis on our bond portfolios

The credit (or bond) markets are currently undergoing the most severe crisis since the Depression. Traditionally, in times of market upheavals, higher-quality bonds perform better than weaker-quality ones as investors move into safer assets. However, in the current credit crisis, investment grade bonds are performing just as badly as more risky high-yield debt. The reason for this is that investment banks and hedge funds have in the past significantly leveraged up their investments in investment grade bonds as they were perceived to be the most stable. In the last six months, however, banks have tightened their credit requirements and investors, who had used leverage to buy bonds, are now having to unwind such positions. These forced sales into a weak market have driven prices down to historically cheap levels.

The spread of investment grade bonds over government bonds has risen from around 0.30% a year ago to record levels of around 2.00% (US) and 1.60% (Europe), which has had the effect of severely depressing bond prices. On a relative basis, these measures of investment grade credit risk have widened by more than those of non-investment grade (or junk) debt. Financial bonds issued by the major international banks, which traditionally have been more secure than corporate bonds and which have been our preference, have been particularly hard hit.

Liquidity has also become scarce in the current climate of tighter credit. Banks are rapidly reducing their risk profiles and have imposed higher borrowing costs to repair their balance sheets. There is little trading and liquidity in the fixed-income markets and when investors are forced to sell bond positions, they have to liquidate the higher-quality bonds first as there is no market for lesser-grade credits. All this forced selling has had the effect of driving the prices of high-quality investment grade bonds down to historically cheap levels. However, although these bonds presently look good value, no buyers are emerging as the consensus view is that bonds may get cheaper still as it appears that there is more deleveraging that must take place.

Our Absolute Return Funds hold approximately 90% of their assets under management in fixed-income securities to generate an underlying income for the Funds. We have favoured floating rate notes issued by major international banks which pay interest every three months based on a margin over LIBOR. These bonds have always been the most stable as they carry no interest rate risk, are rated high investment-grade and, in the past, their prices have traded around par. In recent months, the prices of these bonds have been significantly marked down as banks have revealed substantial losses on sub-prime mortgages, particularly in the case of US investment banks which are held by our US Dollar Absolute Return Fund. Those bonds with maturities of longer than three years have been marked down in price by as much as 8% and a few much longer ones by even more. Fortunately, we have a well-diversified portfolio of bonds with a laddered range of maturities which has helped to cushion the impact of the credit crisis. We tend to adopt a buy and hold approach to investing in bonds and we plan to continue to hold these bonds through the current credit crisis until they mature. They are presently showing very attractive yields to maturity significantly (1% - 2%) in excess of bank interest rates. We strongly believe that investors' patience will be rewarded by riding out the current credit crisis until more normal market conditions prevail again, but it is possible that market conditions may get worse before they start to improve.

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

	Suggested Asset Allocation: Absolute Return Fund	Suggested Asset Allocation: Managed Portfolio Fund	Target returns £	Last 12 Months Actual return £	Compound annual return since 1/1/01 £	Average volatility
Model portfolios:						
Cautious	75%	25%	8.0%	4.0%	6.6%	2.7%
Balanced	50%	50%	9.0%	2.3%	6.6%	3.5%
Growth	25%	75%	10.0%	0.6%	6.6%	4.7%
Benchmarks:						
3 month interest rate				5.5%	4.1%	0.1%
5 year government bonds (total return)				10.9%	4.1%	2.7%
MSCI World Equity Index (total return)				-3.5%	-1.7%	8.5%

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