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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Tough times

A combination of a slowing global economy, the continuing credit crisis and rising inflation has made it a very tough quarter for equity, property and bond markets.

Against such a difficult environment for investors, we are pleased to report that our Absolute Return Funds have managed to produce positive returns this quarter and further details of how we are attempting to cope with the current market conditions can be found as usual on page 3.

Back to basics

Despite the current turbulence in financial markets, the basic principles of sound investment remain constant. We therefore thought it might be a helpful reminder to review the pros and cons of the major investment asset classes;

Cash – Although cash is generally viewed as the safest form of saving it is not suitable as a long-term investment as the real value of your capital is constantly eroded over time by the effects of inflation. However, over shorter periods it can offer a combination of safety and liquidity that cannot be matched by other investments.

Bonds – Fixed interest securities, such as government or corporate bonds, will generally offer a better yield than cash, whilst also providing some security of the nominal value of your capital. However, as with cash, bonds do not provide protection against inflation over long periods. Furthermore, there are many different types of bonds (e.g. straight, convertibles, zeros, high-yield) and risks to consider (e.g. credit, duration, currency, liquidity) which will usually require professional management.

Property – Property has the advantage of being a physical asset that people can see and understand. It can also produce an income in the form of rent and generally offers good protection against inflation as capital values rise in the long run. However, most people already have a significant part of their net wealth exposed to property through their own house (usually with further gearing via a mortgage), which means that further exposure as part of an investment portfolio should probably be limited.

Equities – Owning shares in a spread of listed companies that make profits that can be paid out as dividends and re-invested to fund further growth has tended to provide the best long-term returns for investors. However, share prices can be very volatile and stock markets can suffer severe bear markets, which means that equity investment is really only suitable for those prepared to take a long-term view.

In addition to the above main traditional asset classes it is also possible to invest in a number of alternative assets including derivatives, commodities, hedge funds and private equity.

With such a wide range of asset classes to choose from, the key to a successful investment strategy is selecting the most appropriate blend to suit your individual circumstances – which is why it is something that we place such importance on at Heritage.

Market Commentary

After a very poor first quarter global equity markets managed to stage a brief recovery before plunging again in June, resulting in the worst first half since 1982 for the World Index.

The rally was based on the hope that the Bear Stearns failure in March marked the low point for markets and that things would return to normal as the credit crisis eased. However, it has since become apparent that the effects are in fact spreading into the wider economy and investors have taken fright at the prospect of slower economic growth coupled with rising inflation (due primarily to surging energy costs).

Many of the problems that we are currently encountering are as a result of a massive build up of debt over the past few years. Cheap finance was readily available from the banks which fuelled a bubble in property prices and a consumer spending boom. However, it is now clear that the party is over. Having got themselves into trouble, the banks are now demonstrating a far more cautious approach to lending and consumers are having to tighten their belts. The danger is that this can create a downwards spiral, with contracting debt causing falling asset prices and a weakening of consumption that cannot be easily reversed.

Investors who are tempted by the apparently attractive PE ratios and dividend yields that the current market weakness has produced need to bear in mind that these could be a classic value trap, as the tough economic environment could cause a collapse in earnings and dividend cuts.

United Kingdom

The FTSE 100 index was only marginally down this quarter but the year-to-date fall is 10.6%.

However, if it wasn't for the fact that a number of large international resources companies have chosen to list in London, the FTSE would have fared substantially worse. Most of the major domestic banks, retailers and housebuilders have had a torrid time with many issuing profit warnings, cutting dividends and suffering share price falls of over 50% from their previous peaks.

United States

Having held up better than most markets in the first quarter, the US was the weakest of the major markets this time leaving the S&P 500 index down by just under 12% at the half-year.

Although the Federal Reserve has been the most aggressive of the central banks in its efforts to alleviate the effects of the credit crisis and stimulate economic growth, the latest 0.25% interest rate cut to 2.0% in April will probably be the last for now, as the Fed appears to have belatedly appreciated the need to consider the risk of rising inflation.

Europe

Although the FTSE Eurotop 100 index only slipped by around 2.2% this quarter, the year-to-date fall is now 17.9% making it the worst performing major market so far this year.

Up until now the European Central Bank had looked out of line with the other central banks, as it refused to cut interest rates, but rising global inflationary pressures have perhaps vindicated their position. Despite a robust monetary policy and the strength of the Euro compared to the Pound and US Dollar, the recent Irish vote against a revised EU constitution was a reminder of the potential political pitfalls that exist within the Eurozone.

Japan

Japan was the only major market that produced a positive return this quarter with the Nikkei index doing well to buck the general trend with a 7.7% rise.

However, this was just a partial recovery from its particularly oversold position in the first quarter and the year-to-date fall of 11.2% is in line with other markets.

Emerging markets

There has been a large divergence in the major BRIC (Brazil, Russia, India and China) markets this year with dramatic falls in the Chinese and Indian markets contrasting with much better performances by Brazil and Russia, which have benefitted from having predominantly resources based economies.

Investment Statistics - 30/06/2008

Equity Markets	Q2 2008	2008	2007	2006	2005	2004
Global - MSCI World ($)	-1.42%	-10.20%	7.09%	17.95%	7.56%	12.84%
UK - FTSE 100	-0.24%	-10.57%	3.80%	10.71%	16.71%	7.54%
US - S&P 500	-2.72%	-11.91%	3.53%	13.62%	3.00%	8.99%
Europe - FTSE Eurotop 100	-2.18%	-17.89%	2.41%	12.41%	21.56%	6.46%
Japan - Nikkei 225	7.70%	-11.19%	-11.13%	6.92%	40.24%	7.61%

Other	UK	US	Europe	Japan
PE Ratio	11	21	11	16
Dividend Yield	4.7%	2.4%	4.3%	1.6%
Interest rates - base	5.00%	2.00%	4.00%	0.50%
Bond Yields - govt. 10 year	5.13%	3.97%	4.62%	1.61%
Exchange rates (vs GBP)	-	1.9923	1.2647	211.62
Exchange rates (vs USD)	1.9923	-	1.5755	106.21
Gold ($ per ozs)		$925		

Source : Bloomberg/FT

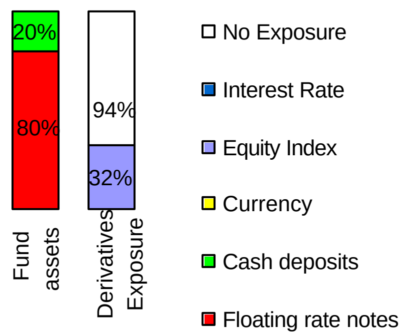
Heritage Investment Fund Limited

Review for the quarter ended 30th June 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 30 June 2008	£157.50	US$142.55	€101.62	£152.05		
Return for quarter (net)	1.50%	1.90%	0.89%	-3.41%	1.13%	-1.62%
Return for year to date (net)	1.45%	-1.09%	1.62%	-6.25%	2.36%	-10.56%
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%
Compound annual rtn (from 1/01)	6.56%	4.70%		5.84%	4.09%	-1.97%
Annual volatility	2.6%	3.7%	1.2%	6.4%	0.1%	14.4%
Size of Fund (millions)	£46.2	US$24.6	€11.3	£34.9		

Absolute Return Funds



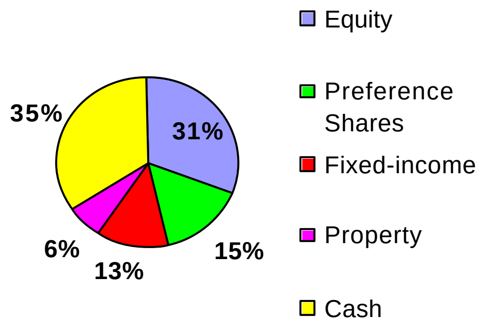
The Absolute Return Funds seek to generate consistent positive returns irrespective of market direction by exposure to equity indices, interest rates, and currencies employing futures and options. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment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

The core bond portfolios currently yield 6.6% (GBP), 4.0% (USD) and 5.4% (EUR) per annum gross to maturity and have average durations of 1.4, 4.0 and 2.1 years respectively. The credit crisis continues to depress the values of the financial bonds held by the Funds as liquidity is limited and credit spreads remain at historically wide levels, particularly on US banks and longer maturities.

During the quarter, our equity derivative positions in S&P500 and FTSE100 index futures contributed a net 0.70% to performance as equity markets resumed their downtrend after a two month bear market recovery. We did not open any positions in bonds or currencies as the return to risk ratio did not justify it.

The Absolute Return Funds had a reasonable quarter, generating positive returns in a very difficult period. The Sterling and Euro Funds are showing positive returns for the year to date, but the US Dollar Fund results have been depressed by continuing weakness in the prices of 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 through active management of a well diversified portfolio.

After a brief recovery in April, global markets have succumbed to renewed weakness, leading to a disappointing quarter with the Fund down by 3.41%. For the year-to-date the Fund is now down by 6.25% compared to a 10.56% loss for the MSCI £ World Index.

Equity markets have experienced their worst first half for 26 years as the effects of the credit crisis continue to spill over into the wider economy. Furthermore, whilst property and bonds often act as a useful means of diversification, both of these markets have also been suffering in the current environment.

Our defence against these exceptionally poor conditions has been to reduce our exposures and raise our cash balances. At 35% our current cash weighting is the highest it has ever been.

Overall, we continue to maintain a defensive stance, which will help to protect the portfolio against any further market weakness whilst also allowing us the flexibility to build positions in attractively valued investments when opportunities arise.

Inflation versus economic growth

It has become very apparent in recent months that inflation is increasing significantly in most countries, principally driven by the huge surge in oil (ie 52%) and commodities (ie 30%) prices this year. These price rises are the largest first-half increases for the past fifty years, beating even the increases experienced during the first oil crisis in 1973 that presaged double digit inflation rates.

Although the increases in the official consumer price indices published by governments are relatively modest, the reality is that inflation for the average household is far higher and is having an impact on their consumption of goods and services. Published inflation rates in most economies are now exceeding their targets and central banks currently look poised to fight this increase in inflation by raising short-term interest rates. However, only a month ago central banks were concerned about the economic slow down, falling house prices, declining consumer confidence and the credit crisis, and the outlook was for a reduction in interest rates. These conflicting signals are the result of the intense debate about the balance of risks to the world economy between inflation and recession.

The simultaneous rise in energy and food prices, combined with slowing economic growth, has raised the spectre of stagflation, last experienced in the 1970's with disastrous consequences. However, the 4% inflation of today is very different from inflation of over 20% three decades ago. The challenge for central banks is not to raise interest rates so high that they tip the economy into recession, nor reduce them too far that inflation accelerates. Underlying inflation, stripped of the increase in oil and food prices, is not nearly as bad as the headline figures suggest, and should decline sharply once oil and food prices stop rising. The concern is that consumers expect inflation to keep rising and are making increased wage demands which, in turn, will exacerbate the inflation problem.

The borrowings built up by corporations and households over the past decade on the back of easy credit and low interest rates has fuelled the substantial rise in asset prices that has occurred. Normally business cycles are self-correcting as, when deleveraging occurs and debt is reduced, asset prices fall. The deleveraging that is taking place with banks restructuring and households reducing borrowings will take some time to feed through into the economy. Although major write-offs of losses incurred on securitised assets have taken place, it is probable that further losses on commercial, property and household loans will have to be written off by financial institutions, which will have to recapitalise further.

This anticipated contraction in assets could mean that the economic downturn being experienced lasts some time. Monetary conditions are likely to remain restrictive with the result that consumption will decline, taking the pressure off inflation. In this scenario, central banks need to be wary of raising interest rates as such an increase could accentuate and prolong the downturn. For the moment, interest rates in the UK and US are on hold, but the European Central Bank has opted for an increase in short-term rates at a difficult time. The likelihood is that global economic weakness and an end to accelerating energy and food prices will see inflation decline next year, but the cost will be stagnant economies, higher unemployment and pay increases below the rate of inflation.

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

	Suggested Asset Allocation			Last 12 Months	Compound annual	Average
	Absolute Return Fund	Managed Portfolio Fund	Target returns £	Actual return £	return since 1/1/01 £	volatility
Model portfolios:						
Cautious	75%	25%	8.0%	2.2%	6.4%	3.2%
Balanced	50%	50%	9.0%	-0.5%	6.2%	4.1%
Growth	25%	75%	10.0%	-3.3%	6.0%	5.2%
Benchmarks:						
3 month interest rate				5.3%	4.6%	0.1%
5 year government bonds (total return)				6.8%	4.7%	4.6%
MSCI World Equity Index (total return)				-9.4%	-2.0%	14.4%

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