Heritage

Quarterly Newsletter & Investment Review

Issue 43 Quarterly news & investment review from Heritage Quarter 3 2008

The crisis deepens

The turmoil in financial markets deepened even further this quarter with credit markets freezing up and equity markets plummeting. The MSCI World Index was down by over 15% this quarter leaving it down by 23.9% for the year-to-date.

We are pleased to report that despite these extremely testing market conditions the Heritage Funds have held up relatively well due to their defensive positioning. In fact our largest fund, the Sterling Absolute Return Fund actually managed to produce a positive return of 1.73% this quarter. Full details and commentaries on all of our funds can be found as usual on page 3 and the article on page 4 explains how we are attempting to deal with the current financial crisis.

The party is over

It is not often that we quote politicians in this newsletter, but George Bush's comment that "Wall Street got drunk and now it is suffering the hangover" actually sums up the current state of affairs quite well.

Last year the since departed head of Citigroup stated that "..as long as the music is playing, you've got to get up and dance - we're still dancing", demonstrating the attitude prevalent amongst most of the major investment banks at the time. Others that over indulged as the party was in full swing included UBS, Bear Stearns, Merrill Lynch, Lehman Brothers, AIG, Northern Rock, Wachovia and HBOS to name just a few that have since suffered severe reputational or even fatal damage.

The clients of the large financial institutions are now rightly asking the question - " If you have shown that you are incapable of properly managing your own financial affairs, why on earth should we trust you to manage our hard earned savings?" Fortunately, long standing clients of Heritage will not be surprised to know that we resisted the peer pressure and continued to adopt a more responsible and sober approach.

Whilst the bankers were gearing their balance sheets to the limit and then creating off balance sheet structures to further turbo charge their positions, we have maintained a simple and strong balance sheet with net cash balances.

Furthermore, this prudent approach to financial management extends not only to our own balance sheet but crucially also to our approach to the management of client funds. As the banks have been creating exotic but fatally flawed new products to sell to their clients (and then paid themselves huge bonuses based on the fees charged to their victims) we have stuck to our straightforward and transparent funds. Also within our funds we have avoided the toxic assets that have infected most of the industry and stuck to holding investments that we fully understand.

The extent of the damage caused by the irresponsible approach of the big banks is such that it is difficult to completely insulate ourselves from the fallout, but our consistent and conservative approach has at least enabled us to hold up much better than average and avoid a severe hangover.

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
Roy is responsible for advising the Heritage Absolute Return Funds.
E-mail: roy@heritage-capital.co.uk

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

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

Heritage Capital Management Limited

Review for the quarter ended 30th September 2008

Market Commentary

Investors expecting some relief after the worst first half in over 25 years for global markets have instead suffered a torrid time as the credit crisis has deepened, resulting in a further fall of 15.2% for the MSCI World Index this quarter.

The markets continue to be understandably volatile given the huge risks and uncertainty that currently exists. The actual underlying problems are bad enough, as the financial system is forced to deleverage against a background of falling asset prices, but things have been further exacerbated by a total collapse of confidence. Greed has turned to fear and investors have now become more concerned about the security of their capital rather than the return that they can earn on it, and banks are reluctant or incapable of lending to clients or each other.

One thing that is certain is that the level of regulation in financial markets will increase. The support that the banks are currently receiving is seen as necessary due to their importance to the wider economy and the quid pro quo will be a comprehensive review and re-writing of the rules. The danger is that government solutions to market problems are almost always sub-optimal and the more politicised the process becomes the more scope there is for unintended and undesirable consequences.

United Kingdom

The FTSE 100 index had its worst quarter since 2002 during the last major bear market, falling by 11.9% to leave it down by over 21% for the year-to-date.

Apart from the general global problems, the bad news specific to the UK this quarter included the partial nationalisation of Bradford & Bingley and the uncertainty over HBOS which has been coerced by the government into a merger with Lloyds TSB to create a UK banking giant, which under normal conditions would never be allowed due to competition concerns.

United States

The S&P 500 index actually outperformed the other major markets this quarter but still fell by over 8%.

However, not surprisingly given that it was US sub-prime mortgages that originally triggered the current credit crisis, the longest list of failed financial institutions belongs to the US. The list was lengthened considerably this quarter as Fannie Mae, Freddie Mac and AIG all were bailed out by the government, Merrill Lynch was rescued by a competitor and Lehman Brothers and Washington Mutual collapsed.

A great deal now depends on how the authorities react to the crisis and in particular the impact of the proposed $700bn TARP (Troubled Asset Relief Programme) which is designed to assist the struggling banks.

Europe

The fall in the FTSE Eurotop 100 index this quarter means that for the year-to-date Europe is actually the weakest of the major markets, down by nearly 26%.

Any hopes that Europe could emerge relatively unscathed compared to America have been dashed as European markets have deteriorated alarmingly. Several banks have required government support and Ireland has taken the drastic measure of guaranteeing all deposits in order to prevent a run on Irish banks.

Japan

Despite the Japanese banks so far avoiding the worst problems afflicting their western counterparts, the Nikkei was the worst performing major equity market this quarter falling by nearly 16%. Part of Japan's problem is the political uncertainty, with Taro Aso recently becoming the fourth different prime minister within the last two years.

Emerging markets

The predictions by some that the growing emerging market economies could decouple from the slowing mature markets are now looking optimistic, as after previously holding up relatively well the global emerging markets index fell by well over 20% this quarter.

Investment Statistics - 30/09/2008

Equity Markets	**Q3 2008**	**Ytd 2008**	**2007**	**2006**	**2005**	**2004**
Global - MSCI World ($)	-15.21%	-23.86%	7.09%	17.95%	7.56%	12.84%
UK - FTSE 100	-11.92%	-21.23%	3.80%	10.71%	16.71%	7.54%
US - S&P 500	-8.36%	-19.27%	3.53%	13.62%	3.00%	8.99%
Europe - FTSE Eurotop 100	-9.50%	-25.69%	2.41%	12.41%	21.56%	6.46%
Japan - Nikkei 225	-15.88%	-25.23%	-11.13%	6.92%	40.24%	7.61%

Other	**UK**	**US**	**Europe**	**Japan**
PE Ratio	10	22	10	14
Dividend Yield	5.1%	2.6%	4.3%	1.9%
Interest rates - base	5.00%	2.00%	4.25%	0.50%
Bond Yields - govt. 10 year	4.45%	3.82%	4.02%	1.47%
Exchange rates (vs GBP)	-	1.7806	1.2642	188.96
Exchange rates (vs USD)	1.7806	-	1.4092	106.11
Gold ($ per ozs)		$871		

Source : Bloomberg/FT

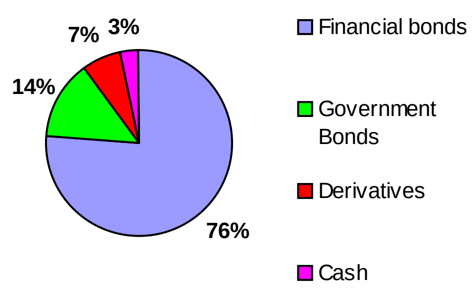
Heritage Investment Fund Limited

Review for the quarter ended 30th September 2008

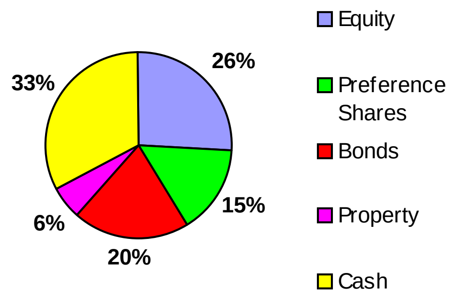
Performance

	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 September 2008	£160.22	US$140.98	€101.60	£144.62		
Return for quarter (net)	1.73%	-1.01%	-0.02%	-4.89%	1.13%	-5.18%
Return for year to date (net)	3.20%	-2.18%	1.60%	-10.83%	3.51%	-15.20%
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%	3.72%		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%
Compound annual rtn (from 1/01)	6.58%	4.40%		4.96%	4.11%	-2.64%
Annual volatility	2.1%	3.8%	2.2%	7.5%	0.1%	18.4%
Size of Fund (millions)	£46.9	US$25.1	€11.5	£32.0		

Absolute Return Funds



Managed Portfolio Fund



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, most of the funds are invested in short-dated investment grade bonds to provide underlying income for the Funds.

The core bond portfolios currently yield 6.2 % (GBP), 4.3% (USD) and 5.5% (EUR) per annum gross to maturity and have average durations of 1.2, 3.2 and 1.7 years respectively. The ongoing credit crisis continues to depress the values of the financial bonds held by the Funds as liquidity is very limited and credit spreads have widened again to historically record levels, particularly on US banks and longer maturities.

During the quarter, our equity derivative positions in S&P500 and FTSE100 index futures only contributed a net 0.47% to performance as equity markets plummeted in September. The total delta-adjusted exposure of these positions at the end of the quarter was 21% of the funds under management.

With the exception of the Sterling Fund, the Absolute Return Funds had a disappointing quarter as financial bond prices came under severe pressure during September as banks collapsed or had to be rescued by their peers or government due to funding difficulties.

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.

The credit crisis engulfing financial markets deepened even further in September with the failure of several large banks. This has adversely impacted prices across the board for equities, bonds and property making it very difficult to protect the value of a diversified investment portfolio.

Our large cash weighting has been the only real defence against these conditions, which has at least helped us to restrict the losses on the Fund to 4.9% for the quarter and 10.8% for the year-to-date, compared to more severe falls experienced by the major indices.

Recently we have started to build some positions in fixed interest securities, where due to the credit crisis, yields are at historically attractive levels. Our portfolio of bonds and preference shares currently yields over 10% and although not without risk, they do offer a greater degree of capital security than equities, which remain extremely volatile and difficult to value in the current environment.

Overall, we continue to maintain a defensive stance with a third of the Fund in cash, which will help to protect the portfolio against any further market weakness whilst also allowing us the flexibility to take advantage of attractively valued investments as and when opportunities arise.

Heritage Investment Fund and the current financial crisis

It is always easy with the benefit of hindsight to see what should have been done to avert the financial crisis that commenced more than a year ago. However, what started as the sub-prime mortgage crisis has deepened in magnitude into an international banking meltdown with unprecedented central bank and government intervention in order to avert a systemic collapse of the global financial system. The economic boom and resultant bubble in all asset classes over the past six years has burst and is being followed by severe asset price deflation.

Investors are understandably very anxious in the current climate of fear and uncertainty. Markets have become disconnected from underlying fundamentals and are being driven purely by emotion. This is reflected in the huge daily swings in equity market indices and the market volatility index is near its all-time high. Bond spreads have widened to extreme levels and liquidity has dried up in the credit markets.

At Heritage we have always emphasised capital preservation as being at the core of our investment philosophy. For this reason, our investment Funds are well diversified, with not more than 5% being invested in any security for our Absolute Return Funds and much less in our Managed Portfolio Fund, which holds riskier investments designed to generate higher returns in the longer term. The investments of each Fund are held by an independent custodian in a secure segregated account, separate from the assets of the custodian and its other clients. In terms of the scheme particulars, none of the securities can be lent out or pledged as security for any facilities and, in addition, our Funds are audited annually and overseen by the financial regulators.

Our Absolute Return Funds have traditionally spread their investments among twenty or so major international banks with high investment grade credit ratings to generate income for the Funds. Although we have been fortunate to have avoided some of the banks that have collapsed, the prices of our financial bonds have been significantly marked down as spreads over government yields have widened to extreme levels, particularly in the case of US banks and longer maturities. We have, however, diversified portion of the investments into the safety of short-term government securities and plan to increase this percentage as bonds mature, even though the yield is significantly less on government bonds. We have also reduced the exposure of our incremental derivatives positions as equity markets have been extremely volatile and bid/offer spreads are historically wide, making trading uneconomic.

Our Managed Portfolio Fund has positioned itself very conservatively to deal with the financial crisis by reducing its current equity and property exposure to 32% and holding an historically high weighting of 33% in cash. We have taken the opportunity to increase the weighting in bonds and preference shares as some very attractive yields are on offer.

Looking ahead, global equity markets certainly appear to have become extremely oversold as a result of the financial panic that has set in and may be near their lows. However, it is unlikely that equities will recover until liquidity in the capital markets improves. To date, injections of liquidity into the financial system by governments have failed to stimulate lending and it remains to be seen whether any US-led bailout package will provide the catalyst. The futures markets in the US, UK and Europe are all forecasting reductions in interest rates by the end of the year, as the spectre of looming recession has reduced inflationary pressures.

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%	1.1%	6.2%	3.2%
Balanced	50%	50%	9.0%	-3.1%	5.8%	4.7%
Growth	25%	75%	10.0%	-7.3%	5.4%	6.2%
Benchmarks:						
3 month interest rate				5.2%	4.6%	0.1%
5 year government bonds (total return)				8.0%	5.2%	4.9%
MSCI World Equity Index (total return)				-14.7%	-2.6%	18.4%

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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