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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An annus horribilus for investors

2008 has turned out to be probably just about the worst year for investors in living memory. Nearly all of the major equity indices suffered record falls of around 30-40%. In addition to this bond markets were severely impacted by the deepening credit crisis, world-wide property prices have slumped and commodity markets have suffered sharp reversals. Hedge funds also proved unable to protect investors' capital under these severe conditions, resulting in their worst ever year.

Whilst our conservative investment approach has meant that the Heritage Funds have held up much better than average, it is nevertheless disappointing to also record our worst year of returns. Full details on our own funds and the usual general market commentary can be found on the inside pages, as usual.

Target returns for 2009

Although we stated in last year's article on 2008 target returns that the key issue for the markets would be whether central banks would be able to inject liquidity into the financial system to restore credit, we never anticipated the extreme depths of the credit crisis or that central banks would be looking to reduce their interest rates to close to zero in an effort to stimulate their economies. Interest rate futures are currently forecasting that short-term rates in the UK and Europe will fall by another 1% by the middle of the year to 1% and 1.5% respectively, with US rates remaining at 0%.

Our Absolute Return Funds will continue to target net annual returns of approximately 2.5% over bank rates, by investing in a core of investment grade bonds supplemented by derivatives positions in the major equity, bond and currency markets. Based on anticipated central bank rates of 1%, 0% and 1.5% for the UK, US and Europe, our target net annual returns after fees and expenses are expected to only be approximately 3.5%, 2.5% and 4% for our Sterling, US Dollar and Euro Absolute Return Funds respectively, but they are still anticipated to be above expected inflation rates. However, we expect markets to be volatile for some time and, consequently, our monthly and quarterly returns may fluctuate more than they have done in past years.

Corporate profits are expected to be under severe pressure in 2009, which will have an adverse effect on equity valuations. There is no knowing how long the current credit crisis will continue and when an easing of liquidity will stimulate the economy. Returns for the year ahead are even more difficult to predict, but we would expect that the well diversified portfolio of the Managed Portfolio Fund should be well placed to weather any further market weakness, whilst being positioned to benefit from any recovery in markets. Based on a risk-free rate of 1% plus a 5% equity risk premium, we believe that 6% would be a reasonable annual average target return 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.

Market Commentary

The MSCI World Index plunged by a further 21.7% in the final quarter of 2008 taking the loss for the full year to over 40% - the largest annual loss since global stock indices have been compiled.

With the sheer magnitude of the market falls and the added factor that virtually no industrial sectors or geographic regions managed to escape the turmoil, it has been a particularly difficult year for investors.

Unfortunately, the outlook for 2009 is far from clear, as fundamental analysis of equities based on valuation ratios such as price to earnings ratios and dividend yields are less reliable in times such as these, where earnings are at the risk of a complete collapse and even the generally steadier flow of dividends is under severe pressure. However, it is worth bearing in mind that stock markets are discounting mechanisms, which means that even if the general economy and profits take a long time to recover, much of the bad news is already priced in and that share prices generally begin to make significant positive progress in anticipation of improving conditions, well before the actual recovery itself takes place.

United Kingdom

The FTSE 100 index had its worst year since its inception in 1985, with a fall of around 30%. Prior to this the worst decline was 24.5% in 2002, when the market was correcting from an overvalued peak. However, this time the problems in the economy are far more serious. The initial crisis in the financial sector, which led to varying degrees of nationalisation of the UK banking system, has now spread to the wider economy resulting in an increasing number of corporate failures, rising unemployment and a deepening recession.

In an attempt to combat these problems interest rates have been slashed from 5.5% earlier this year to just 2%, with expectations of further cuts in 2009.

United States

The S&P 500 index in the US has a longer history than most other countries' stock markets and you need to go back as far as the Great Depression, when the index fell by 47% in 1931, to find an annual return worse than the 37% loss in 2008.

The US government has deemed it necessary to bail out numerous financial institutions, at a potentially enormous cost, including the insurer AIG and what was once the world's largest bank, Citigroup, but it was perhaps its decision to let the 158 year old investment bank, Lehman Brothers, fail that caused the greatest shock for markets last year.

In addition to now considering extending government financial support to industrial companies such as the ailing car makers to help combat the current recession, the US has also gone further with its monetary policies than most, including slashing official interest rates in December to virtually zero.

Europe

European equity markets have suffered their worst year since European-wide indices were introduced in the 1980's, with a fall of just over 40% this year.

Having started the year with lower interest rates than the US Dollar and Sterling, Euro rates at 2.5% are now the highest of all the major currencies and the Euro has been one of the relative winners to emerge from the recent financial turmoil. However, European government bond markets are producing a more worrying signal, as a widening gap has emerged between the yields for the stronger Euro members such as Germany, and the relevant strugglers including Italy, Greece and Ireland, which implies a certain level of risk of a breakdown in the current Euro membership.

Japan

The Nikkei was actually the worst performing major equity index this year with a loss of just over 41%, which was also marginally more than its previous worst return in 1990. However, the strength of the Yen last year did at least cushion the blow slightly for international investors.

Emerging markets

The theory that emerging markets could somehow avoid the turmoil in the major markets by decoupling has unfortunately been proved emphatically wrong this year, as the record 55% fall in the MSCI Emerging World Index was even more severe than the falls in major markets, with the collapse in commodity prices in the second half of the year being a major contributing factor.

Investment Statistics - 31/12/2008

Equity Markets	Q4 2008	2008	2007	2006	2005	2004
Global - MSCI World ($)	-21.70%	-40.30%	7.09%	17.95%	7.56%	12.84%
UK - FTSE 100	-8.59%	-27.93%	3.80%	10.71%	16.71%	7.54%
UK - S&P 500	-21.95%	-36.91%	3.53%	13.62%	3.00%	8.99%
Europe - FTSE Eurotop 100	-20.14%	-40.57%	2.41%	12.41%	21.56%	6.46%
Japan - Nikkei 225	-21.24%	-41.03%	-11.13%	6.92%	40.24%	7.61%

Other	UK	US	Europe	Japan
PE Ratio	8	21	9	13
Dividened Yield	5.9%	3.2%	5.8%	2.5%
Interest rates - base	2.00%	0.05%	2.50%	0.10%
Bond Yields - govt. 10 year	3.02%	2.21%	2.93%	1.18%
Exchange rates (vs GBP)	-	1.4593	1.0461	132.55
Exchange rates (vs USD)	1.4593	-	1.3972	90.64
Gold ($ per ozs)		882		

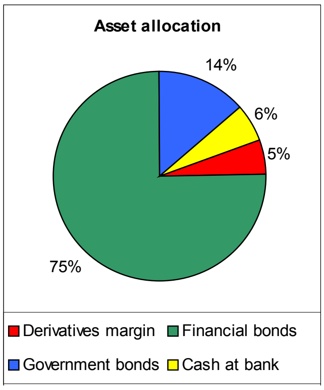
Source: Bloomberg/FT

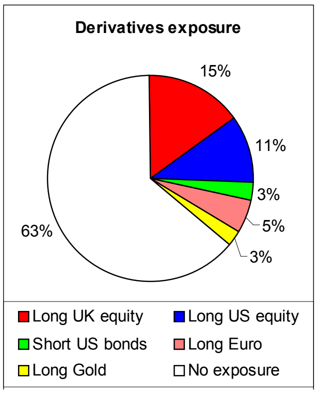
Heritage Investment Fund Limited

Review for the quarter ended 31st December 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 December 2008	£146.23	US$125.45	€91.3	£136.79		
Return for quarter (net)	-8.73%	-11.02%	-10.31%	-5.41%	0.67%	-4.37%
Return for year to date (net)	-5.81%	-12.95%	-8.87%	-15.66%	4.20%	-18.86%
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 return (from 1/01)	5.16%	2.75%		4.13%	4.06%	-3.18%
Annual volatility	3.9%	4.4%	10.7%	8.4%	0.3%	22.6%
Size of Fund (millions)	£46.5	US$16.5	€8.2	£30.4		

Absolute Return Funds





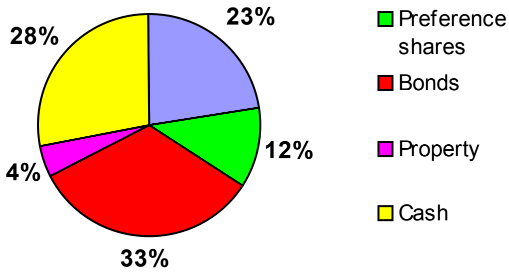
The Absolute Return Funds seek to generate positive returns in excess of cash deposits by limited exposure to derivative products based on underlying equity market indices, interest rates, and currencies. As these positions require limited margin outlay, most of the funds are invested in short-dated investment grade bonds to provide underlying income for the Funds.

The ongoing credit crisis continues to significantly depress the values of the financial bonds held by the Funds as liquidity is very limited and credit spreads have widened to historically record levels, particularly on US and European banks and longer maturities.

The severe fall in global equity markets during October unfortunately resulted in losses on our UK and US equity index option positions. We have opened long UK and US equity index futures positions to benefit from any recovery in equity markets from their historically low levels. We also opened small positions in US Treasury bonds, the Euro and gold futures during the quarter.

The Absolute Return Funds have had a disappointing year as all asset classes have been severely affected by the worst credit and equity market crisis in over seventy years, but they are now well placed to benefit from any recovery in bond and equity markets.

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.

Another poor quarter to end the year meant that 2008 was an historically bad year for investors. Nearly all the major equity indices fell by record amounts, bond markets were severely impacted by a deepening credit crisis and property and commodity markets suffered sharp reversals.

Although we have been defensively positioned and have held up relatively well, the Fund was still down by 5.4% for the quarter and 15.7% for the full year.

We have continued to build up our portfolio of fixed interest securities, where due to the credit crisis and the impact of forced sellers, prices have fallen substantially. Corporate bonds now offer a potentially attractive combination of significantly higher yields than cash and better security than equities.

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 take advantage of attractively valued investments as and when opportunities arise.

Price dislocation in the current markets

Like any asset, the market prices of equities and bonds are determined by supply and demand. Liquidity is what drives asset prices. The severe credit crisis of the past year has forced companies and investors to sell various securities in order to raise cash, repay debt and reduce leverage. In this liquidity squeeze, the fall in asset prices has been highly correlated across all classes and assets that cannot be readily realised have been severely marked down. It is only highly liquid and transparent securities, such as government bonds, that have provided a haven in these difficult times.

When valuing mutual funds, such as Heritage Investment Fund, the administrators are required to mark the securities to market value at each monthly valuation date. This means that securities prices are based on the last transaction that occurred, whenever that may have taken place.

Over the past year, the credit crisis has meant that most financial and corporate bonds have been extremely illiquid, with very limited trading taking place, mostly in small quantities and often not even on a daily basis. Often the sales that do take place are by investors desperate to raise cash and may be well below what is normally considered to be fair market value. Options prices have also experienced severe dislocation as volatility, the major determinant of option prices, has soared to more than double its previous all-time high, and bid/offer spreads have at times widened to four times their normal levels.

Equities listed on recognised stock exchanges have, generally, been reasonably liquid, but many of the shares of small/medium sized companies have suffered from the same problems as bonds. In addition, the spreads between buying and selling prices have widened considerably for all but the most liquid shares. Private equity investments are carried at cost, unless there has been permanent impairment to their value, and so are not subject to the same fair value requirements. Property, not normally a very liquid asset, has become almost impossible to deal in. Despite the percentage property falls published by the media, it is virtually impossible to transact at these levels as there is very little stock available.

The positive aspect of price dislocation, however, is that it can provide opportunities to purchase assets at prices below fair value, as is presently the case with corporate bonds, although the practicalities of doing so can be difficult. It is these opportunities that we are currently searching for and pursuing, where considered appropriate.

Safe custody of client assets

Following the recent high profile large losses suffered by many hedge fund investors due to the fraudulent behaviour of Bernard Madoff, we felt that it is worth reminding clients of the importance of having the appropriate combination of management and custodial arrangements in place to protect investors. It appears, from the limited information currently available from the Madoff case, that the major failing that enabled him to escape detection for so long was that the same person/organisation was effectively in control of both the management and the (supposed) custody of the funds.

In accordance with both best practice and the regulatory environment under which we at Heritage operate, the legal responsibility for the management and custody are separated. As managers we have an obligation to appoint eligible and separately regulated custodians to hold the client assets that we manage in client trust accounts. Of course it is almost impossible to prevent the most determined fraudsters but ensuring that suitable systems are in place that minimise the risks is an important part of investor protection.

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

	Suggested Asset Allocation		Target returns	Last 12 months Actual return	Compound annual return since 1/1/01	Average volatility
	Absolute Return Fund	Managed Portfolio Fund				
Model Portfolios:			£	£	£	
Cautious	86%	14%	4.0%	-7.2%	5.0%	3.9%
Balanced	57%	43%	5.0%	-10.0%	4.7%	4.8%
Growth	29%	71%	6.0%	-12.7%	4.4%	6.3%
Benchmarks:						
3 month interest rate				4.2%	4.1%	0.3%
5 yr Government bonds (total return)				9.9%	5.6%	5.4%
MSCI World Equity Index (total return)				-18.9%	-3.2%	22.6%

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