Heritage

Quarterly Newsletter & Investment Review

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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.

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A bad start to the year for investors

Unfortunately 2009 has not got off to a good start for investors, with further double digit percentage falls for the major stock markets in the first quarter and a continuation of weakness in corporate bond markets due to the ongoing credit crisis.

Although the Heritage Funds have continued to hold up better than average, it is nevertheless disappointing to experience further losses. Within the rest of this newsletter we explain how our funds are positioned (page 3) and how we are dealing with the current situation (page 4), as well as our usual round up of global markets (page 2).

Putting things into perspective - reasons to keep faith with investment

There has quite naturally been a tendency for investors to become despondent as the current financial crisis has caused the destruction of wealth on a scale not seen in most of our lifetimes. Global stock markets have fallen by over 50% from their highs in late 2007 and even taking a longer term view does not give much comfort, as markets are now also below their level of 10 years ago. Amid all this doom and gloom it is important that investors keep faith in their long-term investment strategies as there remain good reasons for doing so.

Firstly, ten year periods with negative returns are thankfully very rare, having occurred only a few times in the past 100 years, with the only periods worse than today's ending in 1974 in the UK and in the 1930's depression in the US.
The recent decade of poor returns highlights the importance of valuations when it comes to investing. In the late 1990's both earnings and asset based valuations rose way above their long-term averages as investors were effectively overpaying to access corporate earnings and assets, leading to a decade of poor returns for those entering at the peak. In fact, the relationship between starting valuations and future returns is strong enough to be used as a good predictive model of returns over longer periods and encouragingly the prospective returns from today's depressed valuations do look attractive.

There are even some reasons to believe that equities may not be such a bad option over a shorter time-frame as the yield on equities is now significantly higher than that on cash deposits and government bonds, meaning that equities could move sideways in a volatile manner over the next year or so and still outperform due to the attractive income yield. Furthermore, stock markets tend to bottom out well before the end of a recession and so it should not be necessary to wait until the economy recovers before seeing an improvement in financial markets.

Overall, although markets may remain weak in the short-term, there is rational cause for optimism that the long-term returns for the ten years ahead will be considerably better than those of the previous decade. Furthermore, it is important to note that it is possible to significantly outperform the market indices by taking into account equity valuations and actively managing the mix of assets between equities, bonds and cash, as evidenced by the positive returns generated by Heritage clients over the past decade despite the background of falling markets.

Heritage Capital Management Limited

Review for the quarter ended 31st March 2009

Market Commentary

Global stock markets have had a very poor start to the year with the MSCI World Index falling by around 12% in the first quarter. Furthermore, volatility has remained very high with major indices such as the S&P 500 plunging more than 25% at its worst point, before making a partial recovery towards the end of March. This level of volatility is not that surprising when you consider that markets are caught between a sharply deteriorating economy and collapsing corporate profits on the one hand and an unprecedented level of government and central bank stimulus and rescue plans on the other.

It is now clear that the initial policy response of cutting interest rates, which can help to stimulate the economy in mildly recessionary conditions by encouraging credit flow to revive, will not be sufficient this time as banks remain unwilling or unable to lend, whilst consumers and businesses are not keen to take on increased debt in the current environment. What is required is for the damage caused to balance sheets by excessive borrowing and lending to be repaired and unfortunately this can be a slow and painful process, making it likely that the current downturn will be deeper than most post-war recessions.

On a more positive note, the cleansing of the financial system of the excesses of the past decade is both necessary and desirable in order to form a more solid foundation for future economic growth and for investment generally.

United Kingdom

The FTSE 100 index fell by just over 10% in the first quarter. Most companies are clearly struggling operationally in the current environment, but the worst performers have tended to be those companies that have high gearing and are now also suffering from financing issues. The previous trend of returning capital to shareholders via share buybacks has been emphatically reversed as companies are now competing to raise additional share capital via rights issues and placings in order to repair and bolster their balance sheets.

Base rates have been cut all the way down from 5% a year ago to just 0.5% today, and with the economy set to contract by around 3% this year and February's headline inflation figure at 0% for the first time in 50 years, the likelihood is that rates will remain low for at least the rest of this year.

United States

There have been very few signs from the stock market of a honeymoon period for the new President, Obama, and his Treasury team, as the S&P 500 index has continued its downward trend, falling a further 11% so far this year.

With US Dollar rates already effectively cut to zero at the end of 2008, attempts to stimulate the economy have become increasingly more unconventional, including quantitative easing (where the central bank buys government or corporate debt in an attempt to drive down rates further down the yield curve) and complex plans to help clear up toxic debt held within financial institutions. Not surprisingly investor interest is keenly focused on these measures as their success or otherwise will play a large part in determining how long it will take before the US economy can start to recover.

Europe

European equity markets fell by around 11% in the first quarter in line with the US and UK.

The European Central Bank has been slower to cut interest rates, which means it at least has some scope to reduce rates a bit further. However, there are serious concerns for both European governments with their ballooning deficits (resulting from a combination of sharply lower tax receipts as a result of the slowdown at the same time as increased stimulus spending plans) and Western European banks which have overextended their lending to their now severely faltering Eastern bloc neighbours, which will need to be addressed.

Japan

The Japanese Nikkei index was the only major market to fall by less than 10% in the first quarter. However, the Japanese economy has actually suffered the sharpest slowdown as a result of its large dependence on exports which have collapsed by a staggering 50% so far this year and with its ageing population it will be difficult to create a self-sustaining recovery without a pick up in global demand.

Emerging markets

Following a very turbulent year in 2008, emerging markets indices have so far fared relatively well this year with certain markets such as Brazil and China even managing to produce positive returns despite continuing economic concerns.

Investment Statistics - 31/03/2009

Equity Markets	Q1 2009	2008	2007	2006	2005	2004
Global - MSCI World ($)	-11.84%	-40.30%	7.09%	17.95%	7.56%	12.84%
UK - FTSE 100	-10.14%	-27.93%	3.80%	10.71%	16.71%	7.54%
US - S&P 500	-10.98%	-36.91%	3.53%	13.62%	3.00%	8.99%
Europe - FTSE Eurotop 100	-11.25%	-40.57%	2.41%	12.41%	21.56%	6.46%
Japan - Nikkei 225	-7.55%	-41.03%	-11.13%	6.92%	40.24%	7.61%

Other	UK	US	Europe	Japan
PE Ratio	17	12	16	26
Dividend Yield	5.3%	3.6%	6.1%	2.3%
Interest rates - base	0.50%	0.00 - 0.50%	1.50%	0.10%
Bond Yields - govt. 10 year	3.17%	2.66%	2.99%	1.18%
Exchange rates (vs GBP)	-	1.4324	1.0810	141.73
Exchange rates (vs USD)	1.4324	-	1.3250	98.96
Gold ($ per ozs)		919		

Source: Bloomberg/FT

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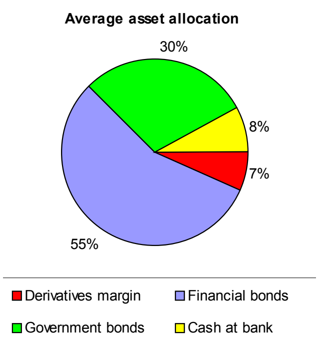
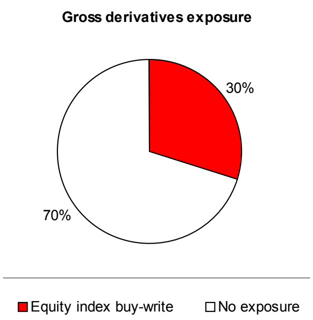
Heritage Investment Fund Limited

Review for the quarter ended 31st March 2009

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 2009	£139.85	US$112.15	€88.42	£126.67		
Return for quarter (net)	-4.36%	-10.60%	-2.97%	-7.40%	0.13%	-10.14%
Year 2008 return (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%
Compound annual return (from 1/01)	4.43%	1.28%		2.99%	3.95%	-4.41%
Annual volatility	10.1%	12.3%	10.1%	7.7%	0.5%	25.9%
Size of Fund (millions)	£40.3	US$14.1	€6.9	£28.2		

Absolute Return Funds





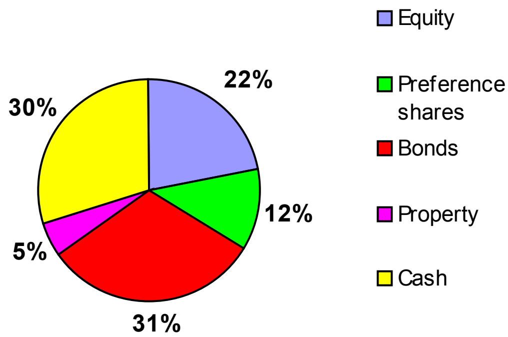
The Absolute Return Funds aim to generate positive returns in excess of cash deposits by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated investment grade and government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

The core bond portfolios currently yield 3.9 % (GBP), 2.9% (USD) and 3.0% (EUR) per annum to maturity and have average durations of 1.3, 1.5 and 1.4 years respectively. During the quarter, we realised many of the longer-dated bonds to reduce our overall exposure to financial bonds, and invested the proceeds in lower-yielding government bonds for capital preservation and liquidity.

Deteriorating global equity markets, unfortunately, meant our futures exposure to equity market indices proved to be premature and resulted in some losses, but we commenced selling options against these positions during the quarter in order to generate regular income

The Funds have made a disappointing start to the year, but we have adjusted our investment strategies to take account of the current financial market crisis. The Funds are now relatively defensively positioned going forward and well placed to generate steady positive returns provided that equity markets do not fall substantially further.

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 was a very volatile start to the year for equity markets with most of the major markets off more than 20% at their low points and despite a sharp rally at the end of March, the MSCI £ World Index still lost over 10% in the first quarter of 2009. The Managed Portfolio Fund has held up a bit better than this, but the 7.40% fall is still a disappointing result.

Whilst holding significant cash balances has continued to help protect the Fund's capital in difficult markets our position in corporate bonds has not yet paid off as spreads have continued to widen. However, with a running yield on the bonds of nearly 10% and an average yield to maturity of around 15%, there is potential for excellent returns going forward.

Until there are signs of some stability returning to financial markets we will continue to maintain our conservative stance and significant liquidity in order 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.

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.

How the Heritage Funds are dealing with the current financial crisis

The **Absolute Return Funds** aim to generate positive returns significantly in excess of cash deposit rates by limited exposure to derivative products. With the UK bank rate at a low of 0.5%, our target net return for the current year is in the order of 3%. With a history of no significant negative quarters for the past 9 years in our main Sterling Fund, it is understandable that investors are concerned about the exceptional negative returns of the Funds for the past 2 quarters. However, it must be borne in mind that we are experiencing a very severe financial crisis not before seen in our lifetimes, with the prices of all assets classes falling dramatically.

The core of the portfolio has, in the past, been invested in a diversified spread of senior bonds issued by the major banks for steady income generation. The current unanticipated banking crisis has revealed that this policy is too narrowly concentrated on the financial sector and, over the past 6 months, we have been realising longer-dated bank bonds when opportunities have arisen in order to protect capital and reduce the risk in the bond portfolio. These proceeds, together with those from maturing bonds, are being invested in short-dated government bonds, where the trade-off is a substantially lower income in return for security and liquidity.

The incremental return of the Funds is generated by taking positions in the derivatives markets using futures and options. We have now adopted a much more defensive futures and options strategy involving the major equity indices. Although our directional bets on the equity markets are mildly bullish, we will be limiting our gross exposure to around 33% of the funds under management and will be writing options against our positions to generate regular income. This income will partially shield the Funds from any losses which may arise from any further substantial falls in the equity markets.

The Absolute Return Funds are now clearly more defensively structured to better weather any further deterioration in global financial markets, but at the same time they are positively positioned to benefit from any stability or improvement in equity markets. Despite the first quarter's negative result, the Funds still have a reasonable probability of achieving overall positive returns for the current year approaching our targets.

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. This strategy has proved successful as a risk management tool, helping to smooth returns in most market conditions. For example, although the major equity indices lost approximately half their value during the last major bear market in 2000-2002, the Managed Portfolio Fund was able to protect its capital by holding bonds, property and cash as well as moving into undervalued sectors of the equity market which held up relatively well. However, the current financial crisis has given rise to a "perfect storm", severely impacting all financial assets and sectors of the stock market and so diversification and sector positioning have not been as effective as usual. Thankfully, these circumstances are extremely rare and we would expect the traditional benefits of diversification and value investing to reassert themselves, in due course.

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	75%	25%	4.0%	-12.3%	4.1%	8.6%
Balanced	50%	50%	5.0%	-14.7%	3.7%	7.5%
Growth	25%	75%	6.0%	-17.1%	3.3%	7.2%
Benchmarks:						
3 month interest rate				3.9%	4.5%	0.3%
5 yr Government bonds (total return)				8.7%	5.5%	3.8%
MSCI World Equity Index (total return)				-19.8%	-4.4%	25.9%

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