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 welcome relief for investors

Following seven successive poor quarters for global stockmarkets, culminating with a particularly worrying plunge at the start of this year, the recent market rally has come as a most welcome relief for investors. However, the key question as always is "where do we go from here?", and as well as our usual round up of global markets on page 2, we assess the sustainability of the current rally.

We are also pleased to report that the Heritage Funds have had a very good quarter, with gains ranging from 2.7-6.0% for the Absolute Return Funds and a 7.7% return for the Managed Portfolio Fund. Further details on the performance and strategies for our funds can be found on page 3.

The advantages of a managed fund approach

Most investment management groups offer a large number of funds to their clients, reflecting the very wide range of asset classes that are available. Over the years, in addition to the major asset classes of blue chip shares, bonds, property and cash it has been increasingly possible to gain exposure to more specialist areas such as emerging markets smaller companies, convertible bond hedge funds and commodities to name but a few.

However, most individuals who are not investment professionals feel ill equipped to weigh up the relative merits and risks associated with such a diverse range of asset classes against an ever changing economic backdrop, and this is why we believe that an actively managed multi-asset fund can provide a useful solution for most people's needs. With a managed fund, these key asset allocation decisions are made by an investment professional, taking into account factors such as historical returns, interest rates, bond and property yields, economic statistics and forecasts and share valuation measures including PE ratios and dividend yields. Furthermore, as all the activity takes place within the fund itself, there is no need for the client to be constantly making or approving switches between investments. It also helps to keep paperwork and administration to a minimum.

This approach makes a managed fund suitable as a core holding and in fact many people find it the most appropriate home for most of, or even their entire portfolio. In addition to this it can also be used by more sophisticated investors as part of a core/satellite approach - where a core holding in a managed fund is supplemented with other specialist funds of their choice in order to tailor their overall portfolio.

There are a number of factors that we consider go into making a good managed fund. These include taking a long-term approach without any constraints on the range of possible investments or placing an undue emphasis on risky equities, independence so that investments are chosen purely on merit, substantial participation by the fund manager to demonstrate commitment and alignment of interests, and keeping costs to a minimum. Clients will hopefully recognise these factors as the key ingredients of our own Heritage Managed Portfolio Fund.

Heritage Capital Management Limited

Review for the quarter ended 30th June 2009

Market Commentary

In a remarkable turnaround following a terrible start to the year, the MSCI ($) World Index gained over 20% in the second quarter, which together with many of the major indices was actually the best quarterly performance on record.

It would be nice to think that this strong rally meant that we can categorically say that the worst is now over. However, there is good reason to believe that a more cautious view is appropriate. The recovery is off a very low base from the depressed levels reached as investors feared that the whole global financial system was in danger of imploding. This is evidenced by the fact that the strongest performers have recently been those in the most troubled sectors, including most financials and cyclical operating companies with very high levels of debt.

The unprecedented amounts of monetary stimulus injected into the global economy by governments and central banks around the world have at least stabilised the system, and the resultant rally has certainly been impressive, but will be increasingly difficult to sustain as relief at the news that the patient is not dead is replaced by the reality that he is still in very poor shape and could take a very long time to recover. A crisis that was created by years of excessive build up of personal, corporate and now government debt cannot simply be reversed in such a short space of time.

However, as always there are opportunities as well as pitfalls in markets and shares in defensive sectors, that look set to survive the downturn in better shape than the cyclical and highly geared shares that have led the current rally, have been overlooked and now offer potentially attractive long-term returns with less risk of a serious setback.

United Kingdom

The UK market has finally managed to stage a recovery after an unusually long run of seven successive negative quarters, with the FTSE 100 index gaining 9.8% in the second quarter. Over half of its constituents were up by more than 10% and 11 actually gained more than 50%, as there were some signs of improvement in several leading economic indicators.

However, there is still plenty of bad news around with the governor of the Bank of England issuing a gloomy assessment of the UK economy, government debt increasing to over 50% of GDP and further dividend cuts from blue chips such as Mark & Spencer and BT. It is also not helpful that at a time when strong leadership is required, the UK's politicians have become embroiled in a damaging expenses scandal.

United States

The S&P 500 index rebounded by just under 16% this quarter. Whilst there was some better news for financial companies with successful fund raisings by the likes of Bank of America, General Motors was finally forced into filing for Chapter 11 bankruptcy as part of a restructuring package which places it under government control.

The US Dollar has weakened over the past few months, weighed down by unprecedented government bond issuance and concerns over unemployment which is now at a 25 year high.

Europe

European equity markets were up around 18% with financials and cyclical stocks leading the rally.

Whilst most central banks had already cut rates to virtually zero, the European Central Bank had been slower off the mark and was therefore able to cut rates by a further quarter point in both April and May. With figures out showing that Eurozone GDP contracted by 2.5% in the first quarter of 2009 it is likely that rates could be cut below the current 1% later this year.

Japan

The Japanese Nikkei index was the best performing major market with a 22.8% gain, aided by some good news on stabilising export figures.

Emerging markets

Emerging markets have also enjoyed a strong recovery and any sign of good news was rewarded enthusiastically by stockmarkets, a good example of this being the remarkable 17% gain in one day for the Indian market in response to the recent election result.

Investment Statistics - 30/06/2009

Equity Markets	Q2 2009	Ytd 2009	2008	2007	2006	2005
Global - MSCI World ($)	20.89%	6.58%	-40.30%	7.09%	17.95%	7.56%
UK - FTSE 100	9.84%	-1.30%	-27.93%	3.80%	10.71%	16.71%
US - S&P 500	15.91%	3.19%	-36.91%	3.53%	13.62%	3.00%
Europe - FTSE Eurotop 100	18.05%	4.77%	-40.57%	2.41%	12.41%	21.56%
Japan - Nikkei 225	22.85%	13.57%	-41.03%	-11.13%	6.92%	40.24%

Other	UK	US	Europe	Japan
PE Ratio	9	13	16	26
Dividend Yield	4.6%	2.8%	3.8%	2.1%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	3.69%	3.53%	3.39%	1.45%
Exchange rates (vs GBP)	-	1.6458	1.1729	158.57
Exchange rates (vs USD)	1.6458	-	1.4033	96.36
Gold ($ per ozs)		927		

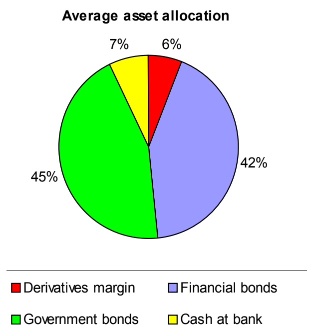
Source: Bloomberg/FT

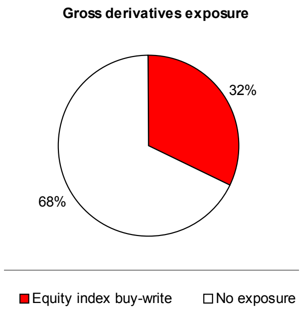
Heritage Investment Fund Limited

Review for the quarter ended 30th June 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 30 June 2009	£143.66	US$118.88	€91.72	£136.44		
Return for quarter (net)	2.72%	6.00%	3.73%	7.71%	0.00%	5.00%
Return for year to date (net)	-1.76%	-5.24%	0.65%	-0.26%	0.13%	-5.65%
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)	4.63%	1.94%	-5.92%	3.80%	3.83%	-3.85%
Annual volatility	10.4%	13.4%	10.9%	10.1%	0.6%	25.4%
Size of Fund (millions)	£40.5	US$16.0	€5.6	£30.2		

Absolute Return Funds





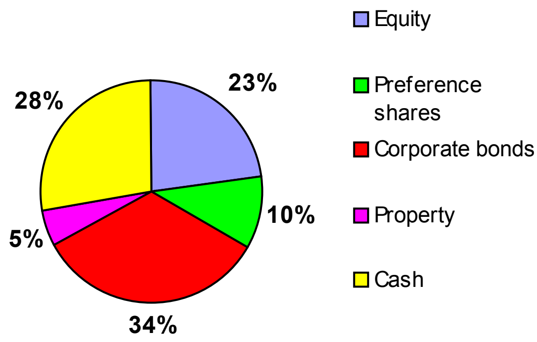
The Absolute Return Funds aim to generate positive returns in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated investment grade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

The core bond portfolios currently yield 2.2% (GBP), 1.7% (USD) and 1.3% (EUR) per annum gross to maturity and have average durations of 1.3, 1.5 and 1.1 years respectively. A number of the financial bond prices rose during the quarter on an improved outlook for these banks with government support, particularly in the United States.

Our futures exposure to UK, US and European equity market indices benefited from the global equity market rally during the quarter. We have been selling options against these positions in order to generate income, so that we are less dependent on market direction to produce returns.

It appears that we may have passed the low point in the markets and our revised fixed-income and derivatives strategies should ensure that the Funds are relatively defensively positioned going forward and well placed to generate steady positive returns provided that equity markets do not undergo further abnormally large falls.

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.

Global markets have staged a strong rally in recent months which has helped the Managed Portfolio Fund to record its best quarter since 2006. The Fund was up by 7.71% compared to a 5.0% return for the MSCI £ World Index, and for the year-to-date the Fund is now down just 0.26%, with the index having lost 5.65%.

Virtually all of our individual equity and preference share holdings made a positive contribution with the majority up by more than 10% this quarter. Following the sharp recovery in cyclical stocks we have been reducing our exposure in favour of more defensive sectors.

Encouragingly, our corporate bond holdings have now also started to recover from the depressed prices that they have been trading at, producing a good contribution to the Fund's performance this quarter. With an average yield to maturity of over 10% there is still potential for further good returns from our bond portfolio.

Overall, we continue to maintain our conservative stance and significant liquidity, allowing us the flexibility to take advantage of attractively valued investments as and when opportunities arise.

Risk and the Absolute Return Funds

Any investment fund which targets returns higher than the risk-free rate (ie the short-term bank deposit rate) carries a degree of risk. Our Absolute Return Funds target a net annual return after expenses of approximately 2.5% above the bank deposit rate and we rate our risk profile as moderate, as disclosed in our quarterly investment newsletters.

Although the preservation of capital is of paramount importance to us in the management of our mutual funds, this cannot unfortunately be guaranteed and there will occasionally be periods when the value of their shares will fall, despite our best efforts to control and minimise risk. Such a situation has occurred over the past year as the credit crisis has led to a fall in the values of all assets classes.

There are two principal areas of risk in our Absolute Return Funds. The core of the Funds is invested in a diversified spread of short to medium-dated investment-grade financial and, more recently, government bonds. Bonds carry credit, interest-rate and liquidity risks. Many of these bank bonds have suffered a fall in value due to the credit crisis and, whilst we did realise some of them at losses in the depths of the financial crisis to reduce risk, the values of those remaining bonds held will hopefully recover as the crisis recedes.

The other area is market risk, where we have limited exposure of approximately 30% to UK, US and European equity market indices. Although we were premature in opening these positions late last year and incurred initial losses on them, they have made significant gains over the past quarter. We have reduced the market risk inherent in these positions by selling options against them to generate regular income, which would offset some of the losses in the event of further markets falls.

As the returns of our Absolute Return Funds have been relatively stable and positive over many years, investors may perhaps not have fully appreciated that these Funds do carry moderate risk and that the value of their investment may fall in value. It would, however, appear that the low point in the prices of our Funds' shares was passed at the end of March, as the Fund valuations have now stabilised and the June quarter has produced significant positive results.

Increasing regulation

In a recent newsletter we highlighted the fact that one of the consequences of the current turmoil in financial markets would inevitably be an increase in regulation in the financial system. This has now already started to impact on areas such as banking, offshore investment and hedge funds.

Keeping up to date with and ensuring compliance with the regulatory environment is an onerous requirement for firms such as ourselves, but we believe that it does at least provide a level of assurance and protection to our clients.

Thankfully most of the recent changes and proposals are more targeted at the banking system and larger, geared hedged funds that pose possible systemic risks. However, we will of course continue to monitor the situation and take necessary action to ensure ongoing compliance, whilst also trying to minimise any disruption or inconvenience caused to our clients.

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%	-9.6%	4.4%	9.2%
Balanced	50%	50%	5.0%	-11.1%	4.2%	8.7%
Growth	25%	75%	6.0%	-12.6%	4.0%	9.1%
Benchmarks:						
3 month interest rate				1.9%	3.8%	0.6%
5 yr Government bonds (total return)				10.3%	5.3%	2.4%
MSCI World Equity Index (total return)				-14.5%	-3.9%	25.4%

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