Heritage

Quarterly Newsletter & Investment Review

Issue 47 Quarterly news & investment review from Heritage Quarter 3 2009

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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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The recovery gains momentum

The old adage that investors should “sell in May” and not return until September would have proved costly this year as markets continued to build on the recovery from their low point earlier this year, rallying strongly over the summer.

We are pleased to report that the Heritage Funds have benefitted from this, with the Absolute Return and Managed Portfolio Funds having one of their best ever quarters. Further details on the performance and strategies for our funds can be found as usual on page 3.

Keeping faith with investment - the follow up

The front page of our newsletter from the first quarter of this year urged readers to keep faith with their investment strategies despite the worryingly bad state of the global economy at the time, commenting that:

“….encouragingly the prospective (long-term) 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.”

We were therefore relieved that our clients overwhelmingly did keep faith with their investments and pleased to report that they have been well rewarded as all of the Heritage Funds have recorded their best ever six month returns as markets have subsequently recovered strongly.

However, unlike many fund managers and investors who are now becoming increasingly bullish as markets rise ever higher, we feel that it is important not to drop our guard. The recipe for producing the best returns according to one of the greatest investors, Warren Buffet, is to be “fearful when others are greedy and greedy when others are fearful”. This is another way of saying that it is important to maintain a discipline when it comes to valuations and that it seldom pays to follow the herd. Whilst we admittedly find it tough to be too brave when things look bleak for markets, we have no hesitation in adopting a more cautious approach when we see others becoming overconfident.

Whilst most fund managers are worried about missing out in a rising market and consider risk to be the danger of underperforming the index and their competitors over short periods, we prefer to take a contrarian, long-term value approach. This may result in us occasionally lagging behind the market when it is running strongly, but this is a risk that we are more comfortable with and we believe that it leads to a better chance of avoiding the risk that really matters – substantial loss of capital.

Market Commentary

The remarkable turnaround for markets has continued over the summer, with the MSCI World $ Index gaining 17.6% in the third quarter, making the current rally one of the most impressive in stock market history.

Our summary analysis of the current situation is as follows. The complete meltdown of financial markets which looked like a possibility at the beginning of the year has been averted thanks to the massive and concerted stimuli from governments and central banks around the world. Stock markets subsequently rallied strongly from very depressed levels in the second quarter and this recovery has now been sustained over the latest quarter by some signs of improving economic data and investor confidence.

The outlook for the future, as ever, is much harder to predict but it seems likely to us that any economic recovery will be more muted than usual as the stimuli are withdrawn as the financial system stabilises and it will take many years for the huge debt burden that built up to be paid down by individuals, companies and governments alike.

United Kingdom

The FTSE 100 index had its best quarter since it was formed in 1984, with a return of over 20%, eclipsing even the dotcom fuelled millennium rally in Q4 1999. There have also been renewed signs of life in the mergers and acquisition markets with Kraft's £10bn bid for Cadbury currently playing out.

Although share prices have made a robust recovery, the underlying economy remains fragile and the Bank of England has extended the policy of "quantitative easing" by a further £50bn to £175bn with base rates remaining at just 0.5%. Sterling has fallen back recently, as markets become increasingly worried about the combination of an unsustainable fiscal position and an exceptionally loose monetary policy, although it should be noted that the UK is not alone in facing these challenges.

United States

The S&P 500 index continued its recovery with an impressive 15.6% gain this quarter with markets appearing to enjoy a return of stability and the re-appointment of Ben Bernanke as chairman of the Federal Reserve for another term.

Unemployment remains a major problem in the US, but there are at least some signs that the economy has bottomed out, with house prices and production figures stabilising. The "cash for clunkers" policy has also provided a boost, although this looks more like a case of simply bringing future capital expenditure forward rather than a cause for real optimism.

Europe

European equities were up around 17% this quarter and the return of over 22% for the year-to-date is the best of the major markets, boosted by the unexpectedly good news that France and Germany were the first of the developed economies to emerge from recession, with modest GDP growth in the second quarter.

Elsewhere in Europe the news is still less positive, with Spain and Ireland in particular still struggling with the effects of the bursting of their property market bubbles.

Japan

Japan lagged behind most other markets this quarter, with a rise of just over 2% for the Nikkei index, although foreign investors' returns have been boosted by the strengthening Yen.

Japan's fifth new prime minister in the last two years has just taken office but the big change this time is that the LPD party has finally been ousted after controlling Japan virtually uninterruptedly since 1955, and it will be very interesting to see to what extent things change under the new Democratic Party.

Emerging markets

Emerging markets have continued to enjoy a remarkable recovery with an overall rise of around 25% in the third quarter, although there have recently been some signs of a levelling off in some of the more overheated areas such as China.

Investment Statistics - 30/09/2009

Equity Markets	Q3 2009	Ytd 2009	2008	2007	2006	2005
Global - MSCI World ($)	17.56%	25.29%	-40.30%	7.09%	17.95%	7.56%
UK - FTSE 100	21.96%	20.37%	-27.93%	3.80%	10.71%	16.71%
US - S&P 500	15.59%	19.27%	-36.91%	3.53%	13.62%	3.00%
Europe - FTSE Eurotop 100	17.03%	22.61%	-40.57%	2.41%	12.41%	21.56%
Japan - Nikkei 225	2.30%	16.18%	-41.03%	-11.13%	6.92%	40.24%

Other	UK	US	Europe	Japan
PE Ratio	14	17	14	21
Dividend Yield	3.8%	2.4%	3.8%	2.1%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	3.59%	3.31%	3.22%	1.48%
Exchange rates (vs GBP)	-	1.5982	1.0917	143.38
Exchange rates (vs USD)	1.5982	-	1.4640	89.70
Gold ($ per ozs)		1008		

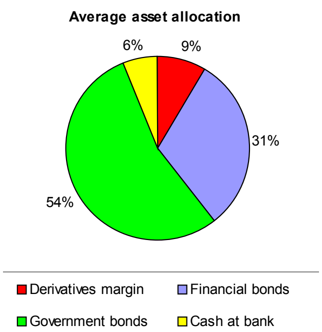
Source: Bloomberg/FT

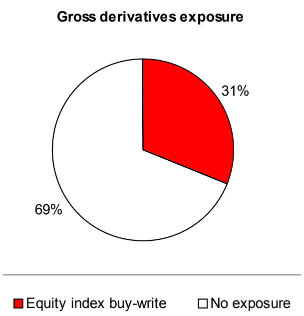
Heritage Investment Fund Limited

Review for the quarter ended 30th September 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 September 2009	£149.69	US$124.69	€95.19	£149.53		
Return for quarter (net)	4.20%	4.89%	3.78%	9.59%	0.00%	20.84%
Return for year to date (net)	2.37%	-0.61%	4.46%	9.31%	0.13%	14.02%
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)	4.99%	2.44%	-2.91%	4.78%	3.72%	-1.70%
Annual volatility	10.8%	14.1%	11.3%	11.0%	0.4%	24.9%
Size of Fund (millions)	£40.9	US$20.6	€6.1	£33.2		

Absolute Return Funds





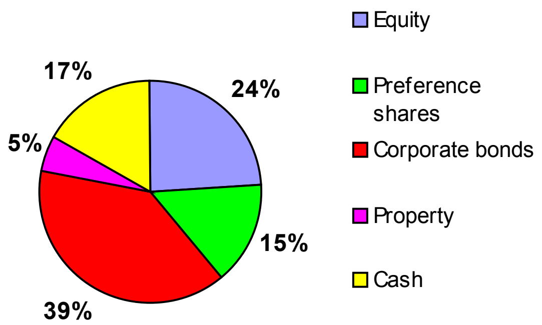
The Absolute Return Funds aim to generate positive returns in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated investment grade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

The core bond portfolios currently yield 1.2% (GBP), 0.9% (USD) and 1.2% (EUR) per annum gross to maturity and have average durations of 1.1, 1.5 and 1.8 years respectively. We continue to add to our government bond positions as financial bonds mature.

Our 31% futures exposure to UK, US and European equity market indices benefited from the continuing global equity market rally and generated 3.1% 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 and to provide some downside protection.

With the exception of a small loss on the US Dollar Fund, our Absolute Return Funds are now showing positive returns for the year in excess of cash deposits.

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.

The Fund had its best quarter since 2003, with a 9.59% gain taking the year-to-date return to 9.31%, boosted by a remarkable stock market recovery.

The summer's market rally has enabled over half of our equity holdings to rise by more than 10% this quarter, as well as assisting our preference shares, convertibles and property holdings to make further progress.

Credit markets have also continued to improve and our portfolio of corporate bonds has performed very strongly, and on an average yield to maturity of over 9% there is still scope for further good returns.

Although we have been reducing the cash weighting in order to take advantage of the more favourable yields available on selected equities where we believe the dividends are sustainable and some interesting opportunities in the bond markets, we continue to position the fund relatively defensively in order to protect the portfolio against a possible setback after a very strong run.

Are equity markets over-valued?

Global equity markets have made their strongest recovery since the Second World War over the past 6 months from the lows of March 2009. Of the developed markets we actively invest in, the broader US equity market is up nearly 60%, the UK market is up 50% and the European market is up 65%. This constitutes a remarkable V-shaped recovery from a recession that has lasted barely a year and may not be over yet. Early in the year, it looked like the world was on the brink of depression, with the global financial system on the verge of collapse, but the co-ordinated massive economic stimulus injected by governments around the world, in the form of abnormally low interest rates and quantitative easing, appears to have averted the crisis. Equity markets took these measures as a strong signal that the worst was over. The recent gains have also partly been fuelled by the momentum of investment managers and investors not wanting to get left behind.

There are numerous valuation methods used to attempt to determine whether equity markets are over or undervalued from an historical perspective, but the classic evaluation methods are dividend yield, price earnings ratio and book to market value.
Whilst price can be observed with certainty, it is impossible to determine the true current value with any degree of certainty and one can only calculate the relative degree of over or undervaluation of an equity.

The dividend yields on the US, UK and EU equity market indices are currently 2.4%, 3.8% and 3.8% respectively. Historically, dividend yields below 3% have been followed by declining equity prices. The estimated price to earnings ratios of the US, UK and EU equity market indices are currently 17, 14 and 14, where historically ratios approaching 20 are considered to signal that equity market valuations are at high levels. The price to book value ratios of the US, UK and EU equity market indices are currently 2.2, 1.9 and 1.8 respectively, which means that investors are paying approximately 2 times the intrinsic net worth of the companies making up the indices.

Whilst it is extremely hard to forecast where equity markets are headed, what is clear is that the recent almost-uninterrupted rate of recovery is unlikely to be sustainable and that, at best, a levelling off in market appreciation is to be expected. Equity markets typically discount an economic recovery by up to 12 months and some of the above valuation indicators are approaching high valuation levels. Of great concern is what will happen to equity markets when governments commence tightening once they judge that economic recovery is established and they raise interest rates to ensure that inflation is contained.

At Heritage, we are exercising caution in our equity market exposure. In the Absolute Return Funds, our equity index exposure has been reduced to around 30% and we are selling options against these positions to provide us with some downside protection. In the Managed Portfolio Fund, our direct equity exposure is limited to approximately 25%, with a significant balance held in cash and bonds.

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%	-4.1%	4.9%	9.7%
Balanced	50%	50%	5.0%	-1.6%	4.9%	9.3%
Growth	25%	75%	6.0%	0.9%	4.8%	9.8%
Benchmarks:						
3 month interest rate				0.8%	3.7%	0.4%
5 yr Government bonds (total return)				9.3%	5.6%	3.7%
MSCI World Equity Index (total return)				9.0%	-1.7%	24.9%

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