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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2009 turns out to be a good year for investors

After a very poor start to the year and despite the global economy suffering a severe recession, the strong rebound in financial markets has resulted in 2009 turning out to be a surprisingly good year for investors.

We are pleased to report that the Heritage Funds have also recovered well, with the Absolute Return and Managed Portfolio Funds producing returns in excess of their targets this year. Further details on the performance and strategies for our funds can be found as usual on page 3.

Target returns for 2010

In 2009, we were surprised on the upside by the strength of the equity market recovery since the lows of March. There is still much debate about whether the recovery is sustainable and much scope for disappointment on corporate earnings in the year ahead. Interest rate futures are currently forecasting that short-term rates in the UK, US and Europe will start rising around the middle of the year and end the year up about 1.0% - 1.5%, at approximately 2.0%, 1.5% and 2.0% respectively.

Our Absolute Return Funds will continue to target net annual returns of 2.50% over bank rates, by investing in a core of short-dated government and financial bonds for income, supplemented by partially-hedged exposure of approximately 30% to equity index derivatives. Based on anticipated average central bank interest rates during the year of 1.25%, 0.75% and 1.50% for the UK, US and Europe, our target net annual returns after fees and expenses are expected to be in the order of approximately 3.75%, 3.25% and 4.00% for our Sterling, US Dollar and Euro Absolute Return Funds respectively which, although modest, are anticipated to be above expected inflation rates. However, markets may be volatile after such a strong recovery and, consequently, our monthly returns may fluctuate more than they have done in past years.

Corporate earnings are expected to continue to improve during 2010 as global economies recover but, as equity markets have already risen in anticipation of this, it leaves markets vulnerable to disappointments. The withdrawal of government stimulus and rising interest rates are also expected to have a negative effect on the economic recovery, and the equity and bond markets. Returns for the year ahead are, as always, difficult to predict, but we would expect that the well-diversified portfolio of the Managed Portfolio Fund should be favourably placed to benefit from any further recovery in equity and corporate bond markets, whilst being well positioned to weather any market weakness on earnings disappointments. Based on an expected average risk-free rate of 1.25% plus a 5% - 6% equity risk premium, we believe that 7% would be a reasonable annual average target return for long-term planning purposes.

Investors will appreciate that the above target returns are for guidance only and that there is obviously no guarantee that they will be achieved over the coming year.

Heritage Capital Management Limited

Review for the quarter ended 31st December 2009

Market Commentary

Following a small setback in October, stock markets resumed their rally to end a remarkable year on a high note. Despite initially plunging by over 20% in February, the major markets have all recorded their best annual returns of the decade in 2009.

The performance of the equity indices is all the more remarkable, as it was set against the background of the ongoing credit crunch and a global economic recession. With hindsight this performance can be rationalised as the being the result of a combination of exceptionally low interest rates, other government stimuli and the fact that markets are forward looking and were anticipating the start of an economic recovery. However, the fact that virtually no-one was expecting such a strong recovery at the beginning of the year serves to demonstrate that making predictions about short term market movements is an extremely difficult and largely futile exercise.

United Kingdom

The FTSE 100 index was up by 6.2% in the final quarter to give an impressive full year return of 27.9%. The market was led by the cyclical sectors that had fallen the most last year, with the more defensive sectors such as utilities and pharmaceuticals lagging behind.

The UK economy has not yet emerged from recession as revised Q3 GDP figures showed that the economy has now shrunk for six consecutive quarters. Against this background it is not surprising that interest rates have been left at their historic low of 0.5% and that quantitative easing was increased by a further £25bn in November to take the total to £200bn.

With an election due in 2010, action to tackle the huge and rising deficit has been delayed, leaving some very tough but necessary policy decisions to be made later this year.

United States

The S&P 500 index ended the year at 1,115 (compared to the low point of 666 which it briefly touched in February) to give it a return of 6.0% in quarter 4 and 26.5% for the full year.

After such a good run the US market now trades on a dividend yield of just 2.1% and although this still compares well with short term interest rates which remain at around zero, longer bond yields are now rising, increasing the likelihood of a correction to the equity market.

The US economy has shown signs of strengthening this quarter with improvements in manufacturing, retail sales and housing data, and in corporate news Citigroup and Wells Fargo banks have announced that they will repay the bailout funds received under the Troubled Asset Relief Program.

Europe

European equities also managed a 6% return in the final quarter making it the best performing major market of 2009 with a return of just under 30%.

With Germany leading the way, the Eurozone as a whole has now emerged from recession. However, there is still a long way to go before many of the weaker members are out of the woods and the admission by the Greek prime minister in December that his country is facing a financial crisis and that drastic action is required to restore stability led to a widening of the spreads on Greek government debt and a weakening of the Euro.

Japan

Although the Nikkei was the weakest of the major indices for both the final quarter and the full year it still managed to produce strong returns of 4.2% and 21.0% respectively. Japan's economy has also now recovered from its recession, boosted by increasing demand from its Asian neighbours.

Emerging markets

The major markets may have had an excellent year, but their returns look quite pedestrian when compared to emerging markets which recorded average gains of around 70% in 2009. However, the debt crisis in Dubai this quarter has acted as a reminder that any investment in emerging markets needs to be undertaken with caution due to the nature and range of risks involved.

Investment Statistics - 31/12/2009

Equity Markets	Q4 2009	2009	2008	2007	2006	2005
Global - MSCI World ($)	4.20%	30.57%	-40.30%	7.09%	17.95%	7.56%
UK - FTSE 100	6.24%	27.89%	-27.93%	3.80%	10.71%	16.71%
US - S&P 500	6.04%	26.47%	-36.91%	3.53%	13.62%	3.00%
Europe - FTSE Eurotop 100	6.00%	29.97%	-40.57%	2.41%	12.41%	21.56%
Japan - Nikkei 225	4.16%	21.05%	-41.03%	-11.13%	6.92%	40.24%

Other	UK	US	Europe	Japan
PE Ratio	15	18	15	41
Dividend Yield	3.4%	2.1%	3.6%	1.5%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	4.02%	3.84%	3.39%	1.45%
Exchange rates (vs GBP)	-	1.6170	1.1275	150.42
Exchange rates (vs USD)	1.6170	-	1.4321	93.02
Gold ($ per ozs)		1097		

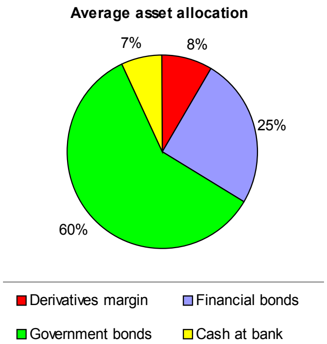
Source: Bloomberg/FT

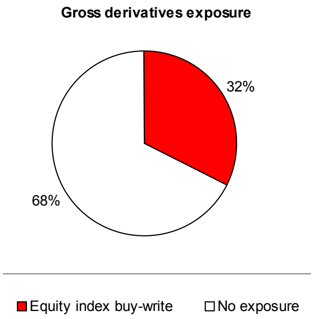
Heritage Investment Fund Limited

Review for the quarter ended 31st December 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 December 2009	£152.45	US$127.03	€97.05	£150.91		
Return for quarter (net)	1.84%	1.88%	1.95%	0.92%	0.00%	3.35%
Return for year (net)	4.25%	1.26%	6.50%	10.32%	0.13%	17.56%
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)	5.06%	2.58%	-1.55%	4.75%	3.62%	-1.35%
Annual volatility	4.9%	9.6%	4.5%	8.6%	0.1%	21.4%
Size of Fund (millions)	£40.7	US$18.7	€7.4	£32.8		

Absolute Return Funds





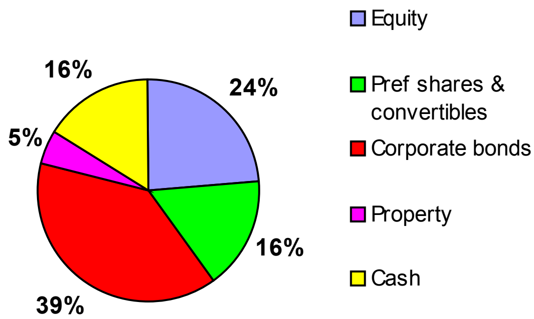
The Absolute Return Funds aim to generate positive returns significantly in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated government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

The core bond portfolios currently yield 1.0% (GBP), 0.8% (USD) and 1.0% (EUR) per annum gross to maturity and have average durations of 1.1, 1.3 and 1.4 years respectively. We continue to add to our short-dated government bond positions for security and liquidity, as financial bonds mature. Government bond prices weakened over the quarter as yields rose.

Our 32% futures exposure to UK, US and European equity market indices gained 1.8% over the quarter. The gains made on our futures positions were restricted by the sale of options against these positions, providing us with some downside protection against market falls.

The Absolute Return Funds made strong gains for the quarter, are all now showing positive returns for the year in excess of cash deposits and are relatively defensively positioned going forward .

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 finished 2009 with another positive quarter resulting in a good return of 10.32% for the full year, despite a weak start. The performance was helped by a strong recovery in markets with the £ World Index ending the year with a 17.56% return.

The performance of our equity holdings was mixed this quarter and overall our defensively weighted portfolio has not kept up with the sharp bounce enjoyed by more cyclical shares.

There have been some positive developments within the zero dividend preference share market recently and we have been able to re-invest the proceeds of maturing preference shares into new issues with good cover and reasonably attractive yields.
Our portfolio of corporate bonds has performed very well this year, and with an average yield to maturity of over 9% there is still the potential for further decent returns.

Overall we are maintaining a relatively defensive portfolio in order to protect the Fund against a possible setback after a strong recovery this year.

A time for reflection

At Heritage we often refer to the need to take a long-term approach to investment but inevitably for most of the time people's attention is focussed on what markets are currently doing, what the returns have been like over the recent past and what the prospects look like for the immediate future.

The end of the decade is therefore a good time to step back from this short term focus and reflect on a longer period to assess what returns have been like, what lessons can be learned and what might reasonably be expected for the decade ahead.

Review of the past decade

After an optimistic start…

As we celebrated the turn of the millennium 10 years ago stockmarkets were buoyant. During the 1990s the FTSE 100 index had risen from 2,423 to close at a record high of 6,930 - an impressive 286% over the decade and the story was similar for other major markets. The consensus view was that despite occasional setbacks, shares always rise over the long-term and provide the best returns for investors.

… things went badly wrong

However, it soon became clear that valuations were too optimistic. The bursting of the dotcom bubble was followed by the September 11th terrorist attacks in 2001 and the onset of war in Iraq in early 2003 and by March of that year the FTSE index plunged to under 3,300 – a savage bear market fall of over 50%.

.. followed by a recovery

From that low point markets were able to stage a robust recovery as corporate profits recovered strongly and towards the end of 2007 markets had climbed back within touching distance of their previous highs.

...that turned out to built on debt

However, much of this apparent growth had been built upon an ever increasing mountain of debt and when the credit bubble burst in 2008 the fallout was severe with markets falling by over 40%. Although indices have subsequently bounced in 2009 as a result of historically low interest rates, the FTSE ended the decade 22% below its level 10 years ago, at 5,413.

Lessons learned

Although the past decade has clearly not been a vintage one for investors, it has still been possible to produce a positive return in excess of cash deposit rates by adopting a cautious investment approach, as demonstrated by the Heritage funds.

Some of the keys to this have been;

- An emphasis on absolute rather than relative returns
- Diversification into and tactical use of other asset classes such as bonds, derivatives, property and cash
- Avoiding overvalued shares provided protection against bursting of the dotcom bubble and avoiding over-indebted companies provided some protection in the credit crisis
- Favouring faster growing emerging markets over mature Western markets.

Prospects for the next decade

As to the decade ahead, whilst it would be understandable to adopt a pessimistic outlook given the current economic situation and the poor results of the most recent decade, history shows that the chances of two successive poor decades are quite low and that we are actually more likely to experience something based on reasonable expectations, in line with long-term averages.

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	70%	30%	5.0%	6.1%	5.0%	5.2%
Balanced	47%	53%	6.0%	7.5%	4.9%	6.0%
Growth	23%	77%	7.0%	8.9%	4.8%	7.2%
Benchmarks:						
3 month interest rate				1.2%	4.2%	0.2%
5 yr Government bonds (total return)				1.0%	5.6%	3.7%
MSCI World Equity Index (total return)				17.9%	-1.4%	21.4%

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