Heritage

Quarterly Newsletter & Investment Review

Issue 51 Quarterly news & investment review from Heritage Quarter 3 2010

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.

Contacts - directors

Roy Glew
Roy is responsible for advising the Heritage Absolute Return Funds.
roy@heritage-capital.co.uk

Graeme Olsen
Graeme is responsible for client portfolios and advising the Heritage Managed Portfolio Fund.
graeme@heritage-capital.co.uk

www. heritage-capital.co.uk
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
Broadway House, Tothill Street,
London SW1H 9NQ

Investor optimism boosts returns

Following a weak second quarter markets recovered strongly over the summer months, as fears of a double-dip in the global economy receded and equity markets adopted a more optimistic outlook.

We are pleased to report that Heritage Funds have also made good progress this quarter and further details on the performance and strategies for the Funds can be found as usual on page 3.

A simple, tax efficient and flexible way to invest

The first port of call for many investors is usually the tax advantaged schemes that most governments use to encourage a certain level of saving. In the UK we have ISAs (Individual Savings Accounts) and personal pensions, but these are subject to a multitude of complex and regularly changing regulations and crucially the amounts that can be invested are restricted.

For anyone with an additional lump sum to invest the commonly used alternatives can be problematical. A savings account will generate a pitiful return with interest rates at historic lows and the net return will be further reduced by tax. For longer-term investors prepared to take on some risk, a distributing investment fund, including most unit trusts and OEICs, will generate an annual tax liability, whether or not the income is actually required. An individual portfolio of shares and bonds will also produce returns that are taxable and comes with the additional disadvantage of being burdensome to manage and administer. Other alternatives offering tax-efficiency, such as the products of insurance companies sold by financial advisors, are usually difficult to understand, inflexible and expensive to buy.

An offshore gross roll-up fund such as the Heritage Funds could provide the answer. The roll-up fund automatically retains income and capital gains within the fund without the deduction of tax. These returns produce an increase in the net asset value and price of the fund and subsequent re-investment enables returns to compound tax free within the fund itself. On an ongoing annual basis there is no need for the individual investor in the fund to account for or pay any tax.

When you require access to your funds you simply sell sufficient shares to raise the required amount. Although a tax charge is triggered at this point, you do not pay tax on the full amount sold but just on the top-slice of it that represents growth, with the balance representing a return of capital. Of course you could choose to simply let the returns roll-up tax free indefinitely, or at least until a stage in your life when you actually require the funds and are perhaps subject to a lower tax rate.

We therefore believe that investors looking for a simple way to invest an uncapped sum in a tax efficient vehicle which allows you access to your money whenever it suits you would do well to consider an offshore gross-roll up fund - and with no initial charges or exit fees the Heritage Funds offer an unusually simple and efficient such alternative.

Heritage Capital Management Limited

Review for the quarter ended 30th September 2010

Market Commentary

Investors currently appear to be taking a very optimistic view on the outlook for markets, as evidenced by the impressive rises in the major equity indices over the past quarter.

On the one hand they are taking encouragement from the signs of a receding risk of a double-dip in the global economy and the improving outlook for a rebound in corporate profits, whilst on the other hand they are taking comfort from the fact that even if the economy struggles, additional support will be forthcoming from central bankers.

This view is not without merit as it appears that the impressive growth and increasing importance in a global context of the emerging markets is providing an effective counterbalance to the more sluggish mature markets. Also, the Federal Reserve has recently made it clear that if necessary, they are prepared to take additional policy action to help the economy.

However, in our opinion investors still need to tread carefully, as upgraded earnings estimates may now prove to be overly optimistic given that the outlook for the economy still remains clouded at best and markets could therefore be vulnerable to any shortfall from the higher expectations that are currently being formed.

United Kingdom

Following a poor second quarter, the FTSE 100 index had an excellent turnaround, gaining 13.87% for the quarter, boosted by the 34% rebound in BP's share price as it finally managed to contain the Gulf of Mexico oil leak. The year-to-date return for the FTSE is now 5.68%, the best of all the major markets.

The International Monetary Fund has backed the new coalition government's handling of the UK economy, which it says is "on the mend" and described the austerity measures as "credible" and "essential", adding that the deficit reduction plan "greatly reduces the risk of a costly loss of confidence in the public finances and supports a balanced recovery", and although the IMF itself is not infallible, the new Chancellor, George Osborne, will no doubt take encouragement from this endorsement.

United States

The US market also recovered well with an 11.3% increase in the S&P 500 index this quarter reversing the 11.4% fall in the second quarter and resulting in an overall gain of 3.9% for the year-to-date.

Many US corporations reported encouraging improvements in profits for the first half of the year but the macro-economic news was less encouraging as initial estimates of GDP growth were revised downwards and the Fed is likely to provide a further round of quantitative easing to support the economy later this year, although the exact form of this so called "QE2" has yet to be finalised.

Europe

Despite lagging the US and UK so far this year, the European market still managed a credible 6.84% return for the quarter and is back in positive territory for the year-to-date.

Although the Eurozone's largest economy, Germany, appears to be making a reasonably robust recovery, overall sentiment towards Europe is still being hampered by the weakness of the "PIGS" (Portugal, Ireland, Greece and Spain) where the effects of the tough austerity measures introduced to tackle the deficits have already provoked a series of damaging strikes and are starting to threaten social and political stability.

Japan

The Nikkei index was the weakest of the major indices with a rise of just 0.52% this quarter and Japan is now also the only major market that is still down for the year-to-date.

The strength of the Yen has been hampering the hoped for export-led recovery, leading the Japanese government to intervene in the currency markets for the first time in six years by selling over 2 trillion Yen (approx $25bn) in September in an attempt to halt the Yen's rise.

Emerging markets

Emerging markets also generally had a good third quarter and their growing importance in world markets was evidenced by the news this quarter that China has overtaken Japan as the world's second largest economy and that the Brazilian oil company, Petrobras, is currently undertaking the world's biggest ever rights issue.

Investment Statistics - 30/09/2010

Equity Markets	Q3 2010	2010 ytd	2009	2008	2007	2006
Global - MSCI World ($)	13.92%	3.11%	30.57%	-40.30%	7.09%	17.95%
UK - FTSE 100	13.87%	5.68%	27.89%	-27.93%	3.80%	10.71%
US - S&P 500	11.30%	3.91%	26.47%	-36.91%	3.53%	13.62%
Europe - FTSE Eurotop 100	6.84%	2.65%	29.97%	-40.57%	2.41%	12.41%
Japan - Nikkei 225	0.52%	-9.92%	21.05%	-41.03%	-11.13%	6.92%

Other	UK	US	Europe	Japan
PE Ratio	17	15	15	23
Dividend Yield	3.3%	2.0%	3.6%	1.8%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	2.95%	2.51%	2.28%	1.16%
Exchange rates (vs GBP)	-	1.5716	1.1524	131.27
Exchange rates (vs USD)	1.5716	-	1.3634	83.53
Gold ($ per ozs)		1308		

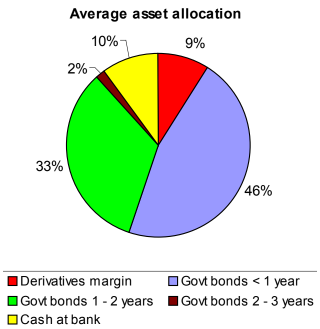
Source: Bloomberg/FT

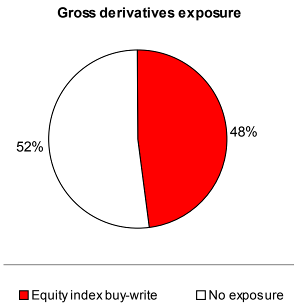
Heritage Investment Fund Limited

Review for the quarter ended 30th September 2010

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 2010	£154.34	US$127.58	€99.00	£161.60		
Return for quarter (net)	1.57%	1.67%	1.26%	5.44%	0.06%	8.38%
Return for year to date 2010 (net)	1.24%	0.43%	2.01%	7.08%	0.19%	5.86%
Year 2009 return (net)	4.25%	1.26%	6.50%	10.32%	0.13%	17.86%
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%
Compound annual return (from 1/01)	4.79%	2.43%	-0.38%	5.11%	3.35%	-0.88%
Annual volatility	2.4%	2.6%	2.1%	5.0%	0.0%	16.4%
Size of Fund (millions)	£38.3	U$22.6	€4.7	£36.4		

Absolute Return Funds





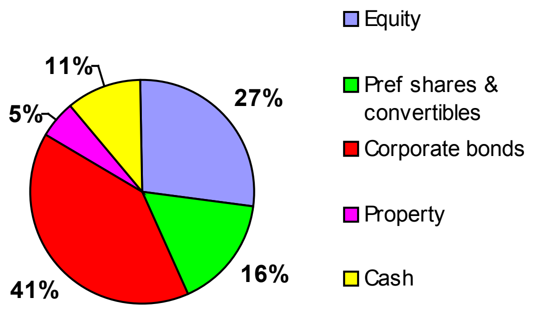
The Absolute Return Funds aim to generate positive returns significantly in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated government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

The historically low bond yields currently make it extremely difficult to generate positive returns after expenses without taking on excessive risk. The core government bond portfolios and cash deposits currently yield a low 0.58% (GBP), 0.24% (USD) and 0.69% (EUR) per annum gross to maturity and have average durations of 0.8, 1.0 and 1.0 years respectively.

The US equity market had one of its best quarters on record gaining 10.7%. Our long futures, short call options derivatives positions in US equity market indices gained a net 1.7% for the quarter, with the gain on our futures exposure being restricted by the sale of options against these positions.

Our hedged derivatives strategies produced positive returns for the quarter on the back of rising equity markets, with all Funds now showing positive returns for the year in excess of short-term interest rates.

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 equity markets have risen sharply recently, which has helped the Fund to produce a good return of 5.44% this quarter. For the year-to-date the Fund is now up by 7.08% compared to the 5.86% total return for the MSCI £ World Index.

Companies generally reported encouraging earnings growth for the first half of 2010 and all of the major equity markets have subsequently enjoyed a strong rally and despite the Fund's relatively defensive positioning our share portfolio has generated a decent return for the Fund this quarter.

After a slight setback earlier in the summer our corporate bonds and preference shares also rallied to produce a good quarter overall, and with an average yield to maturity of 7.75%, they are capable of continuing to make a meaningful contribution to future returns for the Fund.

Overall, the outlook for the economy remains quite clouded and we are therefore continuing to maintain a reasonably defensive portfolio, albeit we continue to invest in individual securities where we are able to identify good long-term value.

Excessive equity market volatility and its impact on the Absolute Return Funds return

Equity markets have experienced unprecedented volatility over the past 3 years. This excessive volatility was initially triggered by the credit crisis in 2007/8 and, although it has moderated, it is still running above the long-term average due to the uncertainty over whether the global economy really is on the road to recovery and concerns over sovereign debt. This year, equity markets have reacted in a very short-term manner to the release of economic and financial data, which is sometimes conflicting, and no clear trend in markets has been apparent.

Equity market volatility is measured as the annualised standard deviation of monthly equity market returns from the average return. The main quoted volatility measure is the VIX, which measures the implied volatility of one month options on the S&P500 index of the top 500 US companies. The VIX is often referred to as the "fear gauge" as it measures the market's expectation of volatility over the next month, but this has been shown to have no predictive reliability. Prior to the credit crisis, annual volatility was running below 10%, but reached a peak of 90% during 2008, and is currently over 20%. Daily and monthly returns have increased in magnitude, both on the up and downside, over the past few years. The range of monthly returns, defined as the difference between the highest and lowest return, has increased from 6% in 2005 to closer to 17% today, having peaked at over 20% in 2008/9.

The Absolute Return Funds currently generate their excess returns over cash by means of derivatives exposure to equity market indices, but sell options against these positions to generate income to set off against any loss on these futures positions. We are not concerned with upside volatility, as this is sold off in return for a premium. This means that, in the event of equity markets rising, the monthly returns of the Funds are limited to the premium received, which ranges between 0.5% - 0.8% of the funds under management.

However, an assessment of the downside risk in equity markets is of the utmost importance when establishing the levels at which these buy-write equity index positions are opened for the Funds. This year we have experienced 5 negative and 4 positive months in global equity market returns and this lack of a clear trend has made us overly cautious when setting up these derivatives positions, limiting the Funds' returns. This is evidenced by the fact that the Sterling Absolute Return Fund only lost 0.6% in the second quarter when global equity markets lost 11.1%. However, in the third quarter when global equity markets returned 8.4%, the Fund was able to generate a positive return of 1.6%, demonstrating that the Fund's returns are, nevertheless, modestly positively skewed.

We would encourage investors to be patient in the current uncertain economic climate, as our prime objective is to preserve capital and only to attempt to generate modest positive returns in a low risk manner.

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	71%	29%	4.0%	4.5%	4.9%	2.7%
Balanced	43%	57%	5.0%	5.9%	5.0%	3.5%
Growth	14%	86%	6.0%	7.4%	5.1%	4.5%
Benchmarks:						
3 month interest rate				0.0%	3.9%	0.0%
5 yr Government bonds (total return)				0.0%	-0.7%	2.8%
MSCI World Equity Index (total return)				9.4%	-0.9%	16.4%

Heritage

Heritage Capital Management Limited
Broadway House, Tothill Street, London SW1H 9NQ
Tel: +44 (0) 20 7799 2110 Fax: +44 (0) 20 7222 1599
General Email: info@heritage-capital.co.uk
Website www.heritage-capital.co.uk