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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2010 turns out to be another good year for investors

Despite a weak first half, 2010 turned out to be another decent year for investors, who have now enjoyed a second successive year of double digit returns following the 2008 financial crisis.

We are pleased to report that the Heritage Funds have also had another good year and further details on the performance and strategies for the funds can be found as usual on page 3, and on page 4 we also take a look back over the first ten years of the Managed Portfolio Fund.

Target returns for 2011

2010 proved to be a volatile year for equity markets, although markets recovered strongly in the last four months, with approximately half of the net annual gains being made in December. On the positive side, corporate earnings grew better than expected and interest rates remained low, but the European sovereign debt crisis in particular caused much uncertainty in the markets. 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 0.50% - 0.75%, at approximately 1.25%, 0.75% and 1.50% 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 bonds for income, supplemented by partially-hedged exposure of up to 100% of the funds under management to equity index derivatives. Based on anticipated average central bank interest rates during the year of 0.875%, 0.375% 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 3.375%, 2.875% and 3.75% for our Sterling, US Dollar and Euro Absolute Return Funds respectively which, although modest, are anticipated to be well above bank deposit 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.

The rate of growth of corporate earnings, no longer being off a low base, is expected to ease during 2011. As equity markets have already priced in much of the economic recovery, it leaves markets vulnerable to disappointments. The withdrawal of government stimulus and rising interest rates may also have a negative effect on the economic recovery, and consequently on equity and bond market returns. Returns for the year ahead are, as always, difficult to predict, but we would expect that the well-diversified equity and bond portfolio of the Managed Portfolio Fund should be favourably placed to benefit from any further upside in equity and corporate bond markets, whilst being well positioned to weather any market weakness on earnings disappointments or interest rate increases. Based on an expected average risk-free rate of just under 1% plus a 5% risk premium, we believe that 6% 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 2010

Market Commentary

Despite considerable volatility and a worrying plunge in the second quarter which resulted in markets being well down by the end of June, 2010 turned out to be a good year for investors overall with a particularly strong December rally resulting in most of the major indices ending the year with double digit returns.

Although there has been some improvement in the underlying fundamentals, particularly in emerging markets, it appears that the major reason for rising stock markets is the ultra low interest rates which have made cash a relatively unattractive alternative, and encouraged movement into riskier equities.

Whilst there is a strong possibility that this trend could continue to propel markets forward in 2011, we would also emphasise the need for caution, as European sovereign debt crises, a weak banking system and austerity measures all still have the potential to de-rail markets. Furthermore, even if all of these pitfalls are avoided and the global economy prospers, markets might still not have a smooth ride, as under this scenario interest rates would rise sharply, undermining both bond and equity markets.

United Kingdom

The FTSE 100 index finished the year strongly, briefly rising above 6,000 in late December and ending 2010 with a 13% return.

Corporate and economic news in the UK has generally been positive in recent months and so far the coalition government's austerity measures appear to be working reasonably well. On the flip side the housing market remains weak and the new VAT rate of 20% which comes into effect in 2011 could stifle the recovery.

United States

The US had a very strong final quarter with a 10.8% return from the S&P 500 index also helping the US to provide the best total return of the major markets in 2010.

As expected, the Federal Reserve Bank have initiated a further round of quantitative easing (QE2) by announcing the purchase of another $600bn of Treasury bonds to provide a fresh stimulus to the US economy. Their biggest concern is that unemployment has remained stubbornly high, although it remains difficult to predict if their actions will have the desired effect.

On the political front, the poor showing by the Democrats in the November elections can partly be explained by their handling of the economy – in particular, unlike many European countries they have not yet started to tackle the enormous budget deficit.

Europe

Despite lagging the US and UK in 2010, the European market still managed a reasonable return of 8% for the year.

The recovery in the German economy has continued to gather pace in the second half, but this good news has been overshadowed by the ongoing sovereign debt crisis enveloping the peripheral Eurozone nations. Recently it has been Ireland's turn in the spotlight as the sheer size of their banking problem has overwhelmed the entire state, forcing the Irish government to accept a €85bn bailout.

Japan

Despite a strong final quarter return of 9.3% for the Nikkei index, Japan was the only major market to suffer a negative return in 2010, although the strong Yen would have provided an overall positive return for international investors and the Japanese government has recently introduced additional fiscal stimulus packages which should help to sustain the recovery into 2011.

Emerging markets

Overall, emerging markets have had an excellent year with stronger economic growth and higher stock market returns than that achieved by the major established economies. However, returns have been widely dispersed and in fact the two highest profile markets have done relatively poorly with China ending the year down and Brazil flat in 2010.

Investment Statistics - 31/12/2010

Equity Markets	Q4 2010	2010	2009	2008	2007	2006
Global - MSCI World ($)	9.09%	12.47%	30.57%	-40.30%	7.09%	17.95%
UK - FTSE 100	6.98%	13.05%	27.89%	-27.93%	3.80%	10.71%
US - S&P 500	10.76%	15.08%	26.47%	-36.91%	3.53%	13.62%
Europe - FTSE Eurotop 100	5.35%	8.15%	29.97%	-40.57%	2.41%	12.41%
Japan - Nikkei 225	9.27%	-1.46%	21.05%	-41.03%	-11.13%	6.92%

Other	UK	US	Europe	Japan
PE Ratio	18	16	15	20
Dividend Yield	3.0%	1.9%	3.4%	1.7%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	3.40%	3.29%	2.96%	1.16%
Exchange rates (vs GBP)	-	1.5612	1.1664	126.67
Exchange rates (vs USD)	1.5612	-	1.3384	81.12
Gold ($ per ozs)		1421		

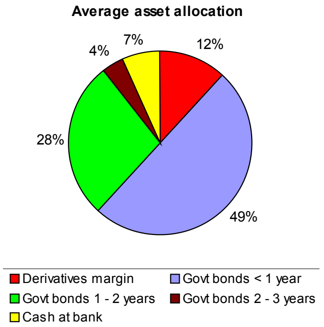
Source: Bloomberg/FT

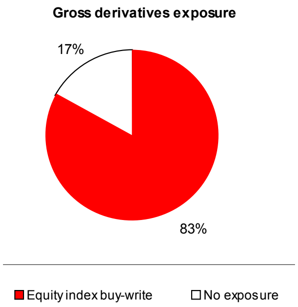
Heritage Investment Fund Limited

Review for the quarter ended 31st December 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 31 December 2010	£156.72	US$129.65	€100.69	£167.18		
Return for quarter (net)	1.54%	1.62%	1.71%	3.45%	0.06%	10.04%
Year 2010 return (net)	2.80%	2.06%	3.75%	10.78%	0.25%	16.49%
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)	4.83%	2.53%	-0.24%	5.34%	3.28%	0.04%
Annual volatility	2.2%	2.5%	1.9%	5.8%	0.0%	16.3%
Size of Fund (millions)	£39.7	U$20.3	€3.7	£39.7		

Absolute Return Funds





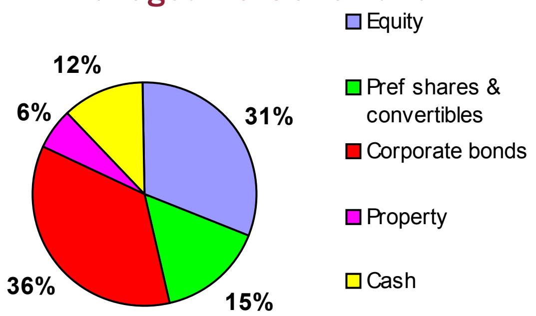
The Absolute Return Funds aim to generate positive returns in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds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

The historically low bond yields currently make it extremely difficult to generate positive returns from government bonds after expenses without taking on excessive risk, which we have avoided. The core government bond portfolios and cash deposits currently yield an historically low 0.66% (GBP), 0.27% (USD) and 0.55% (EUR) per annum gross to maturity and have average durations of 0.8, 0.9 and 1.0 years respectively.

The US equity market had a very strong last quarter, gaining 10.8%. Our long futures, short call options derivatives positions in US equity market indices gained a net 1.9% for the quarter, with the gain on our futures exposure being reduced by a loss on the sale of options against these positions to provide some downside protection.

Our hedged derivatives strategies produced attractive risk-adjusted returns for the quarter substantially ahead of their benchmarks, with the annual returns for all Funds showing positive returns for the year well 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.

Despite a dip in November it was a good final quarter for equity markets, enabling the MSCI £ World Index and the Managed Portfolio Fund to post a second successive year of double digit returns.

Most of our share holdings produced positive returns this quarter and our property shares also made a reasonable contribution.

Our preference shares had a good quarter, boosted by the improved cover from rising equity markets, but it was a more difficult period for bonds as the Irish crisis impacted debt markets.

Although we remain wary of the outlook for markets generally, we continue to seek out individually attractive investments across the wide range of securities that we analyse, and with a well balanced portfolio including equities with an average PE ratio of around 10 and a dividend yield of 5%, and a spread of bonds yielding over 8%, the Fund is well positioned to continue generating reasonable returns for long-term investors.

The Heritage Managed Portfolio Fund passes 10 year milestone

We are pleased to report that the Heritage Managed Portfolio Fund has recently celebrated its 10th anniversary. We often emphasise the need to take a long-term view with investments and a decade is a sufficiently long period to make a meaningful analysis of an investment strategy.

Despite a difficult start...

The Fund was established in December 2000 which turned out to be a difficult time to launch an equity based fund, as a savage bear market throughout 2001 and 2002 saw markets lose around half their value from their peak reached at the height of the technology bubble. In fact, overall the entire decade has been a poor one for equity markets, with the MSCI £ World Index and the FTSE 100 still trading below the levels that they were at when the Managed Portfolio Fund was launched.

..the Fund is up over 67%...

Fortunately, the Fund has performed rather better than the markets and has broadly achieved its objectives despite the severe headwinds.

The key measure of performance is of course the total return of just over 67%, encapsulated in the increase in the Fund's launch price of £100 per share to its current level of £167.18, but it is also interesting to analyse various aspects of this performance in a bit more detail to see how it was achieved.

… with lower risk

Our emphasis on risk management through a cautious and flexible approach has helped to protect the Fund from the wild swings periodically experienced by markets and the Fund's volatility (a statistical measure of risk based on the variability of returns) has been well under half that of the World Index. Furthermore, the worst 5 year period for the Fund still managed to produce a gain of 18%, whilst the worst 5 year return for the index has been a loss of 14%.

Some highlights ….

Crucially, despite our cautious approach we have also been able to take on more risk when we consider it appropriate. In fact the best return for the Fund over 5 years was a gain of 85% compared to the best 5 year rise in the index of 74%.

Our most successful investments have often come from taking advantage of the high yields and low prices offered by asset classes that have fallen out of favour with other investors. Examples of this include our purchases of shares in "boring, old economy" industries at the height of the dotcom bubble, insurance companies after 9/11, zero dividend preference shares following the split capital investment trust crisis, smaller companies and emerging markets in 2003 and corporate bonds during the more recent turmoil in financial markets.

…and some mistakes

Of course it has not all been plain sailing. The credit crisis of 2008 caused a fall in virtually all asset prices, rendering our portfolio of supposedly diversified good quality investments defenceless to falling markets. There have inevitably also been a few poor individual stock and bond selections that have hurt the Fund's performance, but fortunately overall we seem to have picked more winners than losers.

Growing bigger

Achieving good returns for our existing investors has always been a top priority for us, but it is interesting to note that producing decent returns at a lower risk has also encouraged a number of new investors into the Fund. In fact the combination of investment growth and new subscriptions has enabled the Fund to grow from just £2m at launch to it current size of approximately £40m.

On we go…

Looking back at our first ten years, we feel that we have made a decent start, and as we continue to believe that over long periods the tortoise will beat the hare, we will strive to maintain and enhance our existing cautious approach and look forward to reporting back again after our next ten years.

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%	5.0%	4.8%	5.0%	2.7%
Balanced	50%	50%	6.0%	6.8%	5.1%	3.7%
Growth	25%	75%	7.0%	8.8%	5.2%	4.8%
Benchmarks:						
3 month interest rate				0.3%	3.9%	0.0%
5 yr Government bonds (total return)				-0.5%	-0.7%	2.8%
MSCI World Equity Index (total return)				16.5%	-0.0%	16.3%

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