Heritage

Quarterly Newsletter & Investment Review

Issue 53 Quarterly news & investment review from Heritage Quarter 1 2011

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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Robust start to the year for markets

Despite a potent cocktail of worrying geopolitical events and natural disasters, global markets have proved to be surprisingly resilient and following a sharp setback in mid March, have actually ended the quarter in positive territory.

We are pleased to report that the Heritage Funds have made a good start to the year and further details on the performance and strategies for the Funds can be found as usual on page 3.

The importance of investment income

It is a common misconception that the income from investments is of primary importance to retired individuals who need to produce a regular income stream from their investment portfolio and that longer term investors are more concerned with capital growth. In fact income is a vital part of the total return for all investors, as the following statistics from the latest annual Barclays Equity Gilt Study demonstrate ;
The real value (i.e. after taking into account inflation) of £100 invested in equities at the end of 1945 without reinvesting the dividend income would be worth £255 today. With the income re-invested the final figure becomes £4,370.

This startling difference proves beyond doubt just how vital it is for long-term investors to reinvest the income from their portfolio in order to maximize returns and there are a number of practical issues that need to be considered to ensure that investors fully benefit from this effect.

Firstly, the vital significance of dividends to investment returns becomes clear. Secondly, it helps if income is automatically re-invested rather than being paid out. Finally, the figures above assume that it is the gross income that is re-invested although a typical portfolio will generate taxable income and even if the net income is reinvested after taxes have been suffered, the final results will be considerably lower due to the inefficiency and tax drag.

Unlike most portfolios and other funds, the Heritage Funds are set up in a way that derives maximum benefit from the powerful effects of reinvested income. Our Managed Portfolio Fund has a strong bias towards profitable companies that have established and sustainable business models that enables them to pay an attractive level of dividends. Also, as offshore "roll-up" funds all income generated by the Funds' assets are retained within the Funds themselves for reinvestment and furthermore, because income received in the Funds is not taxed, it is the gross rather than net income that is reinvested.

This structure is not only helpful for those seeking to maximize long-term returns, but is also efficient for those who do require an income, as the exact amount and specific timing of the required "income" can be generated through regular or ad-hoc small redemptions, which is more tax efficient than automatically receiving an arbitrary distribution as happens with distributing funds. Overall we therefore believe that these advantages make the Heritage Funds a useful tool in helping investors to reap the maximum benefit from the powerful effects of compounding and reinvested income.

Heritage Capital Management Limited

Review for the quarter ended 31st March 2011

Market Commentary

Overall it has been a good start to the year for investors when you consider the combination of geopolitical issues and natural disasters that markets have had to contend with. With the list so far in 2011 including the Japanese earthquake/tsunami/nuclear disaster, the New Zealand earthquake, Australian floods, the Egyptian crisis, the ongoing Libyan conflict and rising civil unrest throughout the Middle East, it seems remarkable that markets have held up as well as they have. Certainly, if markets had suffered a fall this quarter commentators would have had no hesitation in rationalising the setback by reference to these events.

Perhaps this demonstrates that markets have the ability to be robust when they are in a bull market phase and bad news can be shrugged off – particularly if it relates to natural disasters which do not create long-term problems to the global economy. With interest rates still being kept at historically low levels and investor sentiment positive after a recovery that has continued for two years the stock market appears to remains well supported for now.

As an investor it is important not to become complacent at times such as these as history shows that the pendulum does invariably eventually swing the other way. However, the timing of these swings as always remains impossible to predict and so overall the best strategy for longer-term investors is to maintain a conservative and diversified portfolio of attractively valued assets.

United Kingdom

Despite a temporary plunge to just below 5,600 in mid March, the FTSE 100 index ended the first quarter at 5,909 to register a small gain of 1.3%.

With wage growth still very weak and inflation increasing to 5%, British workers are currently suffering their first fall in real income since the early 1980's recession and with additional austerity measures now starting to bite it is not surprising that retail sales that have remained strong for so long are finally showing signs of weakening.

United States

The US was the best performing major market this quarter with the S&P 500 index gaining 5.9%.

Economic data has been improving and in particular a drop in the unemployment rate has helped sentiment. However, rising share prices have been offset by a weaker currency, as although increased risk aversion from geopolitical uncertainty often creates a flight to the US Dollar, the rise in oil prices this year has led to fears that this will lead to significant transfers from the US, as a net importer, to the oil producing nations.

Europe

European markets struggled to make much progress in the first quarter with the FTSE Eurotop 100 up by just under 1%.

Overall, corporate earnings have been stronger than expected in Europe with Germany in particular continuing to lead the way. However, the latest GDP figures show that some of the weaker Eurozone countries continue to struggle with Portugal currently in the spotlight as speculation mounts over the need for a bailout following the downgrade of its government debt and the failure of the prime minister to force through austerity measures leading to his resignation.

Japan

Not surprisingly, given the scale of damage and uncertainty caused by the massive earthquake and associated tsunami and nuclear crisis, Japan was the weakest of the major markets this quarter with the Nikkei falling 3.8%, although hopefully the resilience and rebuilding effort of the Japanese people will produce a recovery in due course.

Emerging markets

Although overall emerging markets were flat this quarter, it is becoming much harder to generalise when on the one hand you have the economic powerhouse that is China having just overtaken Japan to become the world's second largest economy and is still growing rapidly, and on the other you have economic minnows with huge political uncertainty including much of North Africa and the Middle East.

Investment Statistics - 31/3/2011

Equity Markets	Q1 2011	2010	2009	2008	2007	2006
Global - MSCI World ($)	4.92%	12.47%	30.57%	-40.30%	7.09%	17.95%
UK - FTSE 100	1.31%	13.05%	27.89%	-27.93%	3.80%	10.71%
US - S&P 500	5.92%	15.08%	26.47%	-36.91%	3.53%	13.62%
Europe - FTSE Eurotop 100	0.98%	8.15%	29.97%	-40.57%	2.41%	12.41%
Japan - Nikkei 225	-3.81%	-1.46%	21.05%	-41.03%	-11.13%	6.92%

Other	UK	US	Europe	Japan
PE Ratio	15	16	13	18
Dividend Yield	3.1%	1.8%	3.4%	1.8%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	3.69%	3.47%	3.35%	1.26%
Exchange rates (vs GBP)	-	1.6028	1.1321	133.24
Exchange rates (vs USD)	1.6028	-	1.4158	83.13
Gold ($ per ozs)		1432		

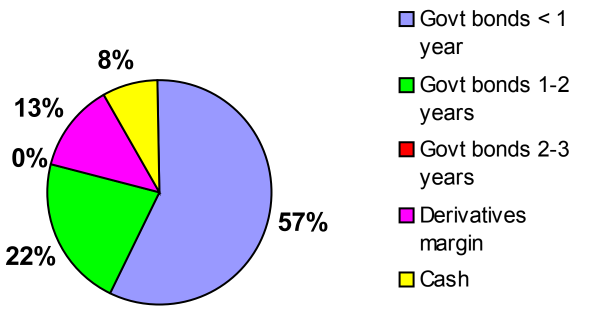
Source: Bloomberg/FT

Heritage Investment Fund Limited

Review for the quarter ended 31st March 2011

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 March 2011	£158.98	US$131.43	€101.57	£170.08		
Return for quarter (net)	1.44%	1.37%	0.87%	1.73%	0.06%	1.83%
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)	4.86%	2.60%	0.49%	5.38%	3.20%	0.16%
Annual volatility	1.8%	2.2%	1.5%	5.6%	0.0%	13.7%
Size of Fund (millions)	£39.2	U$18.8	€3.2	£43.9		

Absolute Return Funds



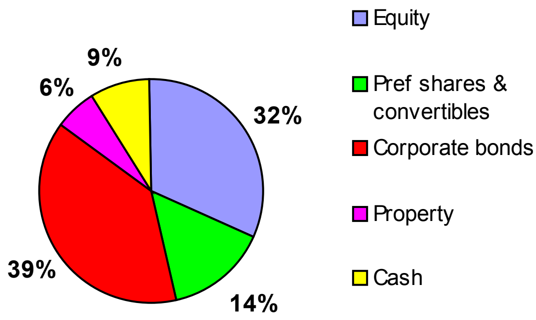
The Absolute Return Funds aim to generate positive returns in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds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

Government bond yield curves continue to flatten, with yields on short-dated bonds rising faster than those on longer maturity bonds. The core government bond portfolios currently yield a low 0.89% (GBP), 0.32% (USD) and 1.30% (EUR) per annum gross to maturity and have short average durations of 0.7, 0.9 and 0.9 years respectively.

The US equity market continued its strong bull run for the opening two months of the new year, but faltered in March, with the index gaining 5.4% for the quarter. Our long futures, short call options derivatives positions in US equity market indices gained a net 1.60% for the quarter, with the gain on our futures exposure of 87% of the funds under management 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 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.

The Fund has had a decent start to the year, returning 1.73% for the first quarter, as equity markets advanced with the MSCI £ World Index gaining 1.83%.

Despite a sharp setback following the Japanese disaster in mid March, our equity holdings recovered well by the end of the quarter. Preference shares struggled to make progress as the negative impact of rising government bond yields outweighed the effect of the improved cover from marginally higher equity markets.

Our corporate bonds made a positive contribution as spreads tightened and we captured the income that we receive on our portfolio, which has an attractive running yield of 7%. Furthermore, a number of our bond holdings have floating rate coupons which will help to protect the portfolio should interest rates rise.

Although we remain wary of the outlook for markets generally, we are still able to find some attractively priced investments across the wide range of securities that we analyse, and have continued to make additional purchases where we find value.

The impact of inflation on investment returns

Inflation represents one of the major threats to investors, as it erodes returns and the value of investments. When assessing the performance of investments, it is important to consider the real rate of return after allowing for inflation. This can be measured approximately by deducting the rate of inflation from the nominal return earned on the investment. An investor's real rate of return needs to be positive to maintain the purchasing power of their investments. In periods of low interest rates, rising inflation is a particular problem for savers and investors.

The preferred measure of inflation is the consumer price index, which measures the changes in prices of a group of goods and services, excluding mortgage interest and housing costs. In the UK, the inflation rate has been increasing steadily over the past 15 months and currently stands at 4.4% per annum, considerably in excess of the annual rate of 2% targeted by the Monetary Policy Committee. With the UK Bank Rate at an historical low of only 0.5% per annum, it is extremely difficult for investors to generate real returns in excess of inflation.

Cash deposits and fixed rate bonds are particularly vulnerable to the effects of inflation. Cash deposits generally pay rates less than inflation, the values of short-dated bonds are affected by the outlook for interest rates, whilst longer-term bonds are influenced by inflation expectations. The standard response of governments to periods of sustained inflation is to raise short-term interest rates, and this is expected to start to occur in the UK in the second quarter of this year. To generate real returns over the long run, investors should consider investing in equities, higher-yielding corporate bonds and inflation-indexed bonds, but these all carry increased risks.

The compound annualised rate of UK inflation over the past 1 and 10 years has been 2.9% and 2.0% respectively, whilst the return on bank deposits has only been 0.3% and 3.2%. By comparison, Heritage's Absolute Return Fund has generated nominal annualised returns of 4.0% and 4.9% over 1 and 10 years, whilst our Managed Portfolio Fund has returned a significant 7.6% and 5.4% over the same periods.

Both of our Heritage Funds have produced real returns significantly in excess of inflation over the last 1 and 10 years, demonstrating the soundness of our investment strategies based on investing in a mix of equities (and their derivative products), corporate bonds and preference shares.

Requirement to update client agreements for offshore accounts

As clients will no doubt be aware, we operate in a highly regulated industry and it is important to ensure that we remain compliant with all of the latest rules, regulations and best practice. A recent review relating to our offshore client accounts has resulted in the need to update the associated documentation and we will therefore shortly be writing to all relevant clients in this connection.

We understand that this can be a tedious process and we have therefore undertaken to make it as simple and painless as possible for clients by doing most of the work ourselves. All that should be required by clients is a review to ensure that the information that we hold is accurate and complete and once satisfied that all is in order, to sign and return the document to us in the reply paid envelope that we will provide. If you are unsure about anything or would like to discuss any matters arising in more detail we will of course be most happy to assist, so please do not hesitate to contact us.

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%	4.9%	5.0%	2.3%
Balanced	50%	50%	6.0%	5.8%	5.1%	3.3%
Growth	25%	75%	7.0%	6.7%	5.3%	4.4%
Benchmarks:						
3 month interest rate				0.7%	3.8%	0.0%
5 yr Government bonds (total return)				-2.1%	-0.9%	3.6%
MSCI World Equity Index (total return)				8.0%	0.2%	13.7%

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