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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Late rally provides relief

A sharp rally at the end of June managed to turn what was shaping up to be a very poor quarter for markets into a respectable one overall, with most major markets ending up marginally above where they started the quarter despite experiencing weakness for much of May and June.

We are pleased to report that the Heritage Funds have had a good quarter with all our funds producing positive returns in April, May and June despite the volatile markets, putting them comfortably ahead their benchmarks for the year-to-date. Further details on the performance and strategies for the Funds can be found as usual on page 3.

The perils of leverage

The developed Western economies, such as the UK, US and Europe, are currently experiencing historical lows in short-term interest rates and bond yields. Interest rates are being held at these low levels in an attempt to stimulate the slow economic growth in these countries, which resulted from the credit crisis of 2008. This is bad news for savers and investors, particularly as inflation is accelerating at the same time, making it extremely difficult to generate a positive real return after adjusting for inflation.

At times like these, it can be very tempting to use leverage (or gearing) to attempt to boost returns, especially as it is possible to borrow funds at low interest rates. However, this strategy is fraught with danger as it will amplify losses as well as gains, and has resulted in the demise of many so-called hedge funds, which name is a misnomer as many are not hedged, but leveraged funds.

This strategy of attempting to boost returns by using leverage does not fit in with the conservative investment philosophy that we follow at Heritage, where the preservation of capital and its sensible enhancement is paramount.

Although our Absolute Return Funds employ derivative strategies using futures and options to generate returns, we have resisted using leverage to enhance these returns, as we do not wish to increase the risk to investors' capital. This is despite the fact that 82% of the monthly returns of the Sterling Absolute Return Fund over the last 10 years have been positive.

Likewise, our Managed Portfolio Fund follows the traditional investment approach of a balanced fund of long equities and bonds, and does not use any borrowing in an attempt to boost returns. Furthermore, we prefer to invest in companies that do not themselves employ excessive gearing as a solid balance sheet provides the ability to withstand the periodic shocks and challenges that all businesses experience.

In times like these, sensible investors have to accept that they cannot expect to achieve the level of past returns, without taking on significant additional risk, which they would be unwise to do in these volatile and uncertain times.

Heritage Capital Management Limited

Review for the quarter ended 30th June 2011

Market Commentary

The major indices initially continued their upward path in April before falling back throughout May and most of June. However , a late rally on hopes that a Greek sovereign debt crisis could be avoided returned markets to more or less where they started the quarter.

The issue of government debt continues to be a major issue for markets. The situation in Europe is particularly critical as the yield on Greek government bonds has rocketed to over 20% implying that some form of default is a near certainty and although Greece is economically a relatively small part of the Eurozone and a crisis appears to have been averted for now, the fear is that its problems may ultimately prove insurmountable and contagious. There are also warning signs building in America, with the ratings agency, S&P, cutting its outlook on US government debt from stable to negative in April, and the IMF has warned that the political failure to reach agreement on raising the $14,300bn debt ceiling could cause a "severe shock" to markets.

At the moment most investors appear to be reasonably sanguine as governments and central banks have a wide range of tools at their disposal to avoid crises in the short term, but the worry is that most of their actions really only defer the problems to a later date, rather than solving the underlying issues.

United Kingdom

After falling to as low as 5,674, the rebound at the end of June took the FTSE back up to 5,945 which meant that it was actually the best performing major market with a 1.7% return for the quarter.

The biggest listing on the UK market for some time took place in May with the IPO of the mining and commodities trading giant, Glencore, making it the first company since the 1980's to go straight into the FTSE 100 index. On the economic front there has not been too much to cheer about and despite a temporary boost from the Royal Wedding the mood on the high street has been quite downbeat, with most retailers continuing to find conditions challenging.

United States

The US market also experienced volatile movements but the net result was a flat quarter for the S&P 500 index.

10 years after the bursting of the technology bubble there have been some interesting signs of life in the market for internet stocks this quarter, with LinkedIn shares doubling on their first day of trading and much excitement surrounding potential market debuts from the likes of Facebook and Groupon.

The US Federal Reserve ended its $600bn quantitative easing programme of Treasury bond purchases on 30th June and it will be interesting to see how markets cope, with the worry being that without this support Treasury yields may rise impacting negatively on both bond and equity markets.

Europe

European markets also struggled to make much progress this quarter and for the year-to-date Europe is the weakest of the major western markets.

Although the release of a further tranche of the bailouts funds to support Greece has now been agreed, concerns remain that this is more of a stay of execution than a solution, and the tough austerity measures that go with it have resulted in worrying bouts of civil unrest.

Japan

Following the devastating events in March, the Japanese market appears to have at least now stabilised as the rebuilding effort gets underway, and the Bank of Japan have announced that they will maintain the JPY 10 trillion asset purchase fund to help stimulate an economic recovery.

Emerging markets

Inflation is becoming an issue in emerging markets, with a number of countries raising interest rates in a bid to curb it. It will take some time to see if this action has the desired effects but in the short term higher rates have impacted investor sentiment, causing emerging markets to underperform so far this year.

Investment Statistics - 30/6/2011

Equity Markets	Q2 2011	2011 ytd	2010	2009	2008	2007
Global - MSCI World ($)	0.65%	5.60%	12.47%	30.57%	-40.30%	7.09%
UK - FTSE 100	1.69%	3.01%	13.05%	27.89%	-27.93%	3.80%
US - S&P 500	0.09%	6.01%	15.08%	26.47%	-36.91%	3.53%
Europe - FTSE Eurotop 100	0.79%	1.78%	8.15%	29.97%	-40.57%	2.41%
Japan - Nikkei 225	0.68%	-3.05%	-1.46%	21.05%	-41.03%	-11.13%

Other	UK	US	Europe	Japan
PE Ratio	14	15	13	18
Dividend Yield	3.3%	1.9%	3.5%	1.9%
Interest rates - base	0.50%	0.00%	1.25%	0.10%
Bond Yields - govt. 10 year	3.38%	3.16%	3.03%	1.14%
Exchange rates (vs GBP)	-	1.6053	1.1070	128.34
Exchange rates (vs USD)	1.6053	-	1.4502	80.56
Gold ($ per ozs)		1500		

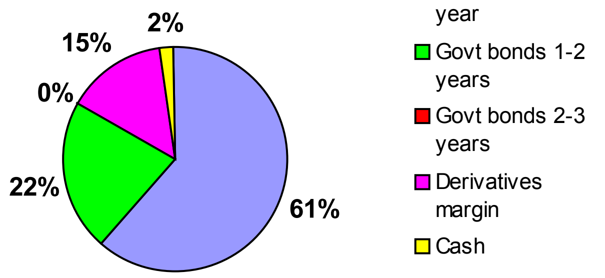
Source: Bloomberg/FT

Heritage Investment Fund Limited

Review for the quarter ended 30th June 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 30 June 2011	£160.51	US$132.72	€102.53	£175.40		
Return for quarter (net)	0.96%	0.98%	0.95%	3.13%	0.06%	0.63%
Year 2011 return year to date (net)	2.42%	2.37%	1.83%	4.92%	0.13%	2.47%
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%
Compound annual return (from 1/01)	4.83%	2.64%	0.73%	5.56%	3.13%	2.55%
Annual volatility	1.4%	1.6%	1.3%	3.9%	0.0%	12.3%
Size of Fund (millions)	£38.7	U$18.6	€3.2	£44.7		

Absolute Return Funds



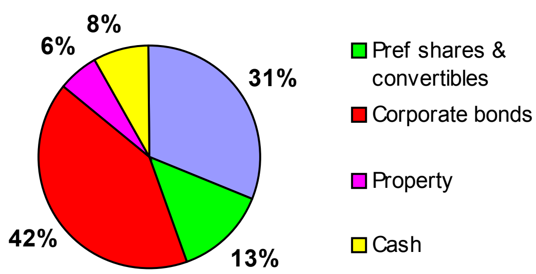
The Absolute Return Funds aim to generate positive returns in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds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

Government bond yields fell significantly across the yield curve during the quarter on expectations that short-term interest rate increases will be delayed as the global economic recovery is still very fragile. The core government bond portfolios currently yield a low 0.65% (GBP), 0.17% (USD) and 1.32% (EUR) per annum gross to maturity and have short average durations of 0.5, 0.7 and 0.7 years respectively.

The US equity market experienced a volatile quarter, with a peak to trough fall of -8.76%, resulting in the index losing -0.39% for the quarter. Despite this, our long futures, short call options derivatives positions in US equity market indices produced a net gain for the quarter, with the loss on our futures exposure of 88% of the funds under management being more than offset by a gain on the sale of options against these positions to provide some downside protection.

Our partially-hedged derivatives strategies have produced steady positive returns for both the quarter and year-to-date, 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 had a good quarter, gaining 3.13% compared to a 0.63% return for the MSCI £ World Index. For the year-to-date the Fund is now up by 4.92% versus 2.47% for the index.

Our equity holdings made good progress, helped by our bias towards more defensive companies and industries which have held up relatively well during the recent volatile market conditions.

Our corporate bonds also had a good quarter, with some capital appreciation to add to the running yield of around 7% and we received a boost from exercising an option to convert a loan into shares in a listed company, generating a significant gain on the original cost. All of our zero dividend preference shares are well covered and are trading more like good quality bonds than equities at present and they therefore benefitted from the fall in bond yields this quarter.

Overall the Fund is well positioned to hold up relatively well in weaker markets, and we remain optimistic about the long term prospects for the portfolio of attractively valued securities that we hold.

Our approach to bonds within the Heritage Managed Portfolio Fund

In addition to investing in equities for a combination of long-term capital growth and the dividend income, the Heritage Managed Portfolio Fund also invests in fixed income securities, more commonly known as bonds.

Generally bonds are less risky than equities but it is important to understand that there are many different types of fixed interest securities, each with their own characteristics.

Government bonds

In theory sovereign bonds are the most secure type of bond, as gilts (as they are termed in the UK) are backed by the government. However, the current crisis surrounding Greek and Irish government bonds shows that no investments are completely risk free and even for the most secure government bonds, prices can be seriously impacted by inflation and rising yields, particularly bonds with longer maturities.

In our view lending money to governments that are running huge deficits, for long periods, at the current low rates does not make an attractive investment and therefore the Managed Portfolio Fund currently has no exposure to government bonds.

Corporate bonds

These securities, issued by large companies, rank above the ordinary shareholders and usually offer a fixed return consisting of regular interest payments and a repayment of capital at the redemption date. Corporate bonds offer a higher yield than cash or government bonds and a good spread of bonds can therefore enhance the level of income in a portfolio whilst also providing a good level of capital stability.

Following the recent credit crisis we were able to buy a number of good quality investment grade corporate bonds on attractive yields. However, our exposure to this area has subsequently fallen as the bonds have matured or we have taken profits as prices have risen to levels where the yields are no longer as attractive.

Floating rate notes

Most conventional bonds pay a fixed coupon making them vulnerable to rising interest rates. However, it is also possible for bonds to pay coupons which reset periodically.

A large proportion of the bonds currently held within the Managed Portfolio Fund are currently either floating rate notes (or are bonds that will switch from a fixed to a floating rate at a future date), which will benefit from any increase in interest rates from their current historically low levels.

Convertible bonds

These are bonds that in addition to providing the usual interest payments, also offer the holder the option of converting the bond into shares of the issuing company as an alternative to the repayment of capital at redemption. This can provide the possibility of capital gains if the company does well, whilst still providing the additional security of a bond if the shares do not perform.

We recently converted a secured loan into shares in a listed company generating a return of over 50% on the original investment, demonstrating the additional returns that are possible from convertibles.

Preference shares

Another type of security held in the Managed Portfolio Fund exhibiting properties of both equities and bonds are preference shares, which despite the reference to "shares" in their name actually have characteristics that are more akin to bonds as they rank ahead of the ordinary shareholders, pay a fixed dividend and sometimes have a redemption date. Also, there are still a few well managed split capital investment trusts which offer attractive opportunities to investors with a good understanding of the zero dividend preference share sector.

Overall our fixed interest holdings in the Managed Portfolio Fund offer an average running yield of approximately 7% and a slightly higher yield to maturity of around 8%, which we believe offers the potential to provide decent returns with a lower level of risk than a pure equity portfolio.

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%	7.8%	5.0%	1.7%
Balanced	50%	50%	6.0%	10.0%	5.2%	2.3%
Growth	25%	75%	7.0%	12.2%	5.4%	3.1%
Benchmarks:						
3 month interest rate				0.8%	3.7%	0.0%
5 yr Government bonds (total return)				2.2%	5.0%	3.4%
MSCI World Equity Index (total return)				22.2%	2.6%	9.5%

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