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.

Contacts - directors

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

Roy Glew
Roy is responsible for advising the Heritage Absolute Return Funds.
roy@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

Sovereign debt problems derail markets

The downgrading of the US national debt, coupled with the ongoing sovereign debt crisis in the Eurozone, has resulted in a period of extreme volatility for financial markets and the 16.5% loss by the MSCI World Index was the worst quarterly performance since 2002.

The Heritage Funds have not been immune to these problems but have at least managed to hold up relatively well, with losses for the year-to-date within a 2% to 4.5% range, compared to a loss of around 12% for the World Index. Further details on the performance and strategies for the Funds can be found as usual on page 3.

Investing in index funds

The recent growth in index tracking funds, or exchange traded funds (ETFs) as they are also known, has been impressive and they undoubtedly have a number of attractive features. They offer good diversification as they replicate the performance of all the underlying constituents of an index and as they can be run using computer modeling, rather than relying on managers to select investments, they usually have cost advantages over actively managed funds. Furthermore, as the number of exchange traded funds expands to cover a wider range of indices based on geographic region, industry sector, asset class or even specific commodities, they allow investors to efficiently manage their exposure to underlying markets with a greater level of sophistication.

However, it is important to understand that there are also a number of potential pitfalls associated with index funds. The original index funds tracked the underlying index by actually holding the underlying shares in their relevant weightings, whereas many new ETFs use derivative based replication strategies that introduce counterparty risk, or lend out the stock that they own to try and enhance returns and others include gearing as a feature. The combination of costs and tracking errors can lead to a serious underperformance of the relevant index, particularly over longer time-frames.

Perhaps the biggest disadvantage for long-term investors is that index funds will always be subject to distortion by overvalued sectors and shares. The fact that the FTSE 100 index currently trades well below the peak that it reached at the end of 1999 is due to the fact that it was heavily weighted in inflated technology, media and telecom shares back then and after finally recovering it entered the credit crisis of 2008 with banks as its largest constituent. The FTSE's current bias towards resources stocks again imposes risks and from virtually nothing a few years ago, gold ETFs now hold approaching $2trn in assets, which is in excess of the reserves held by the most major central banks.

Overall, whilst we believe that index funds are a useful tool for experienced investors who fully understand them and their limitations, most investors would be better served by finding a manager with the ability to avoid overvalued shares and select a well balanced portfolio of attractively valued investments that will outperform index funds over the long-term.

Heritage Capital Management Limited

Review for the quarter ended 30th September 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 - 30/9/2011

Equity Markets	Q3 2011	2011	2010	2009	2008	2007
Global - MSCI World ($)	-16.50%	-11.82%	12.47%	30.57%	-40.30%	7.09%
UK - FTSE 100	-12.83%	-10.20%	13.05%	27.89%	-27.93%	3.80%
US - S&P 500	-13.87%	-8.69%	15.08%	26.47%	-36.91%	3.53%
Europe - FTSE Eurotop 100	-15.74%	14.24%	8.15%	29.97%	-40.57%	2.41%
Japan - Nikkei 225	-10.74%	-13.46%	-1.46%	21.05%	-41.03%	-11.13%

Other	UK	US	Europe	Japan
PE Ratio	10	12	10	16
Dividend Yield	4.0%	2.3%	4.5%	2.1%
Interest rates - base	0.50%	0.00%	1.50%	0.10%
Bond Yields - govt. 10 year	2.43%	1.92%	1.89%	1.03%
Exchange rates (vs GBP)	-	1.5584	1.1640	120.08
Exchange rates (vs USD)	1.5584	-	1.3387	77.06
Gold ($ per ozs)		1624		

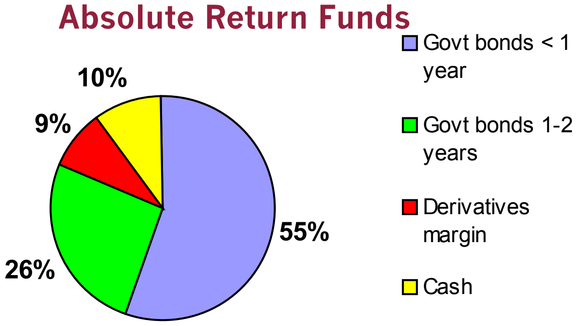
Source: Bloomberg/FT

Heritage Investment Fund Limited

Review for the quarter ended 30th September 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 September 2011	£150.10	US$124.23	€96.19	£163.80		
Return for quarter (net)	-6.49%	-6.40%	-6.18%	-6.61%	0.06%	-14.26%
Year 2011 return year to date (net)	-4.22%	-4.18%	-4.47%	-2.02%	0.13%	-12.14%
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)	4.07%	1.94%	-1.05%	4.76%	3.06%	1.06%
Annual volatility	4.5%	4.5%	4.3%	6.4%	0.0%	12.1%
Size of Fund (millions)	£35.1	U$17.0	€3.0	£43.3		

Absolute Return Funds



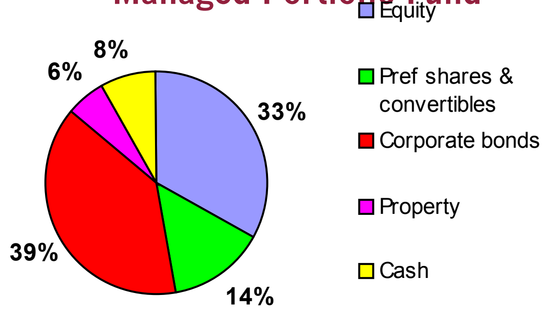
The Absolute Return Funds aim to generate positive returns in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds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

Government bond yields continued to fall across the yield curve during the quarter as investors sought a haven from turbulent equity markets. The core government bond portfolios currently yield an abnormally low 0.6% (GBP), 0.1% (USD) and 0.3% (EUR) per annum gross to maturity and have short average durations of 0.9, 0.5 and 0.6 years respectively.

US equity market futures fell by a net -14.4% during the quarter, with a peak to trough fall of -25.9%, on global economic recession and European sovereign debt concerns. Our long futures, short call options derivatives positions in US equity market indices incurred a net loss of 4.5% during the quarter, being partly offset by gains on hedging positions opened early in the quarter in gold and volatility futures. The net loss for the quarter was exacerbated by the premature opening of a position to benefit from a fall in equity market volatility.

Our partially-hedged derivatives strategies produced disappointing performance for the quarter as a result of the significant falls and volatility in equity markets, but the Funds are well positioned to benefit from any stabilisation of equity markets and fall in volatility.

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.

It was a difficult quarter for the Fund which lost 6.61%, as all the major markets suffered severe falls and the MSCI World Index lost 14.26%. For the year-to-date the Fund is now down by 2.02%, compared to the index which is down by 12.14%.

Share prices in virtually all sectors fell over the quarter, although the Fund's focus on defensive industries meant that overall our portfolio has held up relatively well.

Higher yielding corporate bonds also suffered this quarter as investors became more risk averse. However, the potential returns are now looking quite attractive, with scope for our bond portfolio's current running yield of 7.4% to be further enhanced by capital gains as it matures. Our zero dividend preference have continued to hold up well despite the recent market falls, as their cover remains solid at well over 3 times.

Overall the Fund remains well positioned to hold up relatively well in the current volatile environment, whilst we remain optimistic that the portfolio of attractively valued securities that we own will produce good returns in the long-term.

The impact of the recent market volatility on the Absolute Return Funds

The past quarter has seen an unprecedentThe past quarter has seen an unprecedented period of market volatility, affecting not only equities, but also bonds and commodities. The initial catalyst was the impasse over raising the US debt ceiling and the subsequent downgrading of US government debt, since when markets have increasingly focused on the growing European sovereign debt problems, which remain unresolved. Markets dislike uncertainty and the failure of the EU to come up with a credible plan to deal with the European debt crisis is exacerbating this volatility. Equity markets, in particular, have experienced extreme volatility, both on the downside and upside, with a number of daily moves of over 5% during the quarter. Historically, daily equity market moves have averaged around 1%, whilst 90% of monthly market moves have been less than 5%.

In particular, the frequency of equity market reversals has been extremely testing, where a number of days of severe market falls are followed by significant market gains, and vice versa. Over the quarter, there were 8 periods where the US equity market moved by 8% or more, either down or up. Overall, the peak to trough fall of the US equity market during the quarter was 26%, with 10 days experiencing intra-day moves of over 4%.

This period of extreme volatility has made it very difficult for the Absolute return Funds to generate their steady monthly returns in excess of cash deposits. As the core short-dated government bonds held by the Funds yield no more than 0.6% per annum, the Funds currently seek to generate their incremental return by taking positions in the US equity market index using derivatives. These positions normally allow for a monthly fall in the market of around 5%, but some daily moves alone during the past quarter have exceeded this. These extreme moves have made it necessary for the Funds to roll their positions more frequently that normal, often at a loss, either to contain the losses on the downside in falling markets or to benefit from rising markets on an upside reversal.

Although the performance of our Absolute Funds has been disappointing this quarter, investors are encouraged to take a slightly longer term view, as our current US equity market buy-write positions do contain potential gains of about 2% if the index does not fall significantly further over the next few weeks. In addition, we are showing losses of 2.5% on a position which was opened prematurely to benefit from a fall in equity market volatility, which should generate a profit in due course when volatility returns to more normal levels. The Absolute Return Funds are well positioned to recover this quarter's losses over the coming months should equity markets stabilise and volatility decline, but investors will have to be patient as the European sovereign debt crisis needs to be resolved.

...and on the Managed Portfolio Fund

As a fund that prefers to build a portfolio of attractively valued holdings and then take a long-term "buy and hold" approach, bouts of volatility such as we are currently experiencing inevitably do impact the fund price but are not necessarily a cause for major concern. Whilst it is important during periods of increased uncertainty to not be complacent and to constantly question and re-evaluate the rationale for our major positions within the Fund, price volatility can actually be of benefit as it presents opportunities to buy solid investments at reduced prices. For example, in normal conditions share prices tend to move in response to specific news relevant to individual companies, whereas at present the correlation between shares is exceptionally high as all shares move together in response to the macro economic news that is dominating markets. In the long-run we are confident that the normal order will be restored and that the market will recognise the differences between the stronger and weaker companies and in the short-term we are able to use our cash to top-up on our preferred investments at attractive prices.

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%	-1.7%	4.2%	4.4%
Balanced	50%	50%	6.0%	-0.7%	4.4%	4.7%
Growth	25%	75%	7.0%	0.3%	4.6%	5.4%
Benchmarks:						
3 month interest rate				0.8%	3.6%	0.0%
5 yr Government bonds (total return)				2.9%	5.0%	3.6%
MSCI World Equity Index (total return)				-3.3%	1.1%	12.1%

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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