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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A difficult year for investors

A combination of weaker than expected global economic growth and the ongoing sovereign debt crisis in the Eurozone made it a very difficult environment for investors in 2011, with virtually all of the major and emerging markets ending down for the year and the MSCI World Index losing 5%.

Despite this challenging background we are pleased to report that the Heritage Managed Portfolio Fund was able to produce a small positive return this year and all of our funds were up by around 2% in the final quarter. Further details on the performance and strategies for our funds can be found as usual on page 3.

Target returns for 2012

The third quarter of 2011 proved to be an abnormally volatile period for equity markets, with major indices falling over 25% from peak to trough and record daily moves of up to 5%, and whilst equity markets have recovered somewhat in the final quarter, most major markets are showing losses for the year. Although corporate earnings have generally held up well during a year of low economic growth, the Eurozone sovereign debt crisis and the failure to resolve it has overshadowed the markets. Interest rates have remained at or near historical lows during the year and futures are currently forecasting that short-term rates in the UK and US will remain flat in 2012, but will fall by 0.25% in Europe.

Our Absolute Return Funds will target higher net annual returns of 5% over short-term interest rates, by investing in a core of short-dated government bonds for income and security, supplemented by exposure of approximately 50% of the funds under management to equity index derivatives, partially hedged with other non-correlated asset classes (for further details on how we have revised our approach please see the article on page 4). Based on anticipated average central bank interest rates during the year of 0% to 0.75% for the UK, US and Europe, our target net annual returns after fees and expenses are expected to be in the order of 5% to 6% for our Sterling, US Dollar and Euro Absolute Return Funds. However, markets are expected to be volatile as a result of the ongoing problems in the Eurozone and, consequently, our monthly returns may fluctuate more than they have done in past years.

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 upside in equity and corporate bond markets, whilst being well positioned to weather possible weakness arising from further trouble in the Eurozone or earnings disappointments. Based on an expected average risk-free rate of around 0.5% plus a risk premium of around 5 to 6%, we believe that 6 to 7% 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 2011

Market Commentary

The year ended with a decent final quarter but the damage done from an exceptionally poor third quarter meant that overall 2011 was a poor year for equity markets.

It was a year when taking on risk was not rewarded as emerging markets suffered far greater losses than the major markets and small cap stocks performed substantially worse than large blue chips. This was neatly demonstrated by the UK market where the FTSE 100 index fell by around 5%, the FTSE 250 mid caps fell 12.5%, the small cap index was down around 15% and the junior AIM market was down by over 25%.

A similar effect was seen in bond markets where the prices of relatively safe government bonds (the US, Germany and the UK) rose, confounding the expectations of most experts who felt that yields would be more likely to rise from their already historically low levels. And it was the same in corporate bond markets where riskier high yield bonds were outperformed by lower yielding but more secure investment grade bonds.

Whilst maintaining a lower risk profile may for now appear to be the most sensible approach, at some point the valuations for riskier assets will become compelling and brave investors will reap the rewards.

United Kingdom

The FTSE index managed a robust rebound in the final quarter, rising from 5,128 to end the year at 5,572, although this is still well down on where it started the year at 5,900.

At present the UK is benefitting from not being part of the Eurozone, with the FTSE outperforming the major European bourses this year and the UK government still able to borrow money at around 2%, whilst Italian yields have risen to 7% and French government debt is threatened with a downgrade. However, the UK still has many of its own issues to deal with, including the possibility that the economy is currently re-entering recession.

United States

The US did well to be the only major market not to lose ground in 2011, with the S&P 500 index both opening and closing the year at 1,257.6, although this flat result masked a wide trading range of over 20% and bouts of quite severe volatility.

The flight to relative safety by investors this year has also helped the US Dollar, which still benefits from being the world's dominant reserve currency. However, with the US taking longer than most to tackle its deficit and the political uncertainty associated with a presidential election later this year, it could find its status as a safe haven coming under pressure in 2012.

Europe

A positive final quarter for FTSE Eurotop 100 was not enough to save 2011 from being a poor year for European equity markets and although the Euro remained surprisingly steady for much of the year it has recently started to slip further against the other major currencies.

Despite numerous political summits, the creation of the European Financial Stability Facility rescue fund and changes to the leaders of seven Eurozone countries including Greece, Italy and Spain, there was still no end in sight to Europe's sovereign debt problems at the end of 2011. Furthermore, even if a major crisis is avoided it now looks likely that most of the region will enter into recession in 2012.

Japan

2011 was a particularly bad year for Japan, from the devastating earthquake in the first quarter, to the uncovering of a major corporate fraud at Olympus, to being the only major market to not participate in the final quarter rally, the net result being a full year loss of over 15% for the Nikkei index.

Emerging markets

It was also a very disappointing year for emerging markets with losses averaging over 20% and all the leading markets of China, Brazil, Russia and India suffering major setbacks, as investor aversion to perceived risk outweighed any positive impact from their relatively sound economic fundamentals and prospects.

Investment Statistics - 31/12/2011

Equity Markets	Q4 2011	2011	2010	2009	2008	2007
Global - MSCI World ($)	7.73%	-5.01%	12.47%	30.57%	-40.30%	7.09%
UK - FTSE 100	9.63%	-1.56%	13.05%	27.89%	-27.93%	3.80%
US - S&P 500	11.80%	2.09%	15.08%	26.47%	-36.91%	3.53%
Europe - FTSE Eurotop 100	9.68%	-5.93%	8.15%	29.97%	-40.57%	2.41%
Japan - Nikkei 225	-2.71%	-15.65%	-1.46%	21.05%	-41.03%	-11.13%

Total returns - including dividends

Other	UK	US	Europe	Japan
PE Ratio	10	13	11	17
Dividend Yield	3.8%	2.1%	4.1%	2.2%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	1.98%	1.88%	1.83%	0.99%
Exchange rates (vs GBP)	-	1.5543	1.1987	119.54
Exchange rates (vs USD)	1.5543	-	1.2961	76.91
Gold ($ per ozs)		1564		

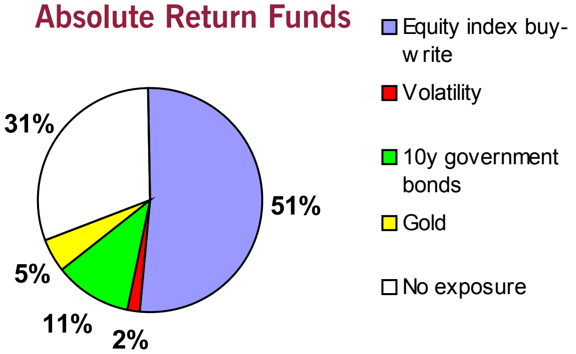
Source: Bloomberg/FT

Heritage Investment Fund Limited

Review for the quarter ended 31st December 2011

Performance	Absolute Return Funds			Managed Portfolio Fund	Cash Deposits (£)	MSCI World Index (£ total return)
Risk profile	Moderate			High /Moderate		
Minimum investment horizon	3 years +			5 years +		
Target return over bank deposit rate	+5%			+5%		
Price at 31 December 2011	£153.24	US$126.70	€98.39	£167.28		
Return for quarter (net)	2.09%	1.99%	2.29%	2.12%	0.06%	8.69%
Year 2011 return (net)	-2.22%	-2.28%	-2.28%	0.06%	0.25%	-4.50%
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)	4.17%	2.08%	-0.41%	4.85%	3.00%	1.81%
Annual volatility	5.4%	5.7%	5.1%	6.3%	0.0%	11.9%
Size of Fund (millions)	£32.8	U$19.1	€1.2	£44.9		

Absolute Return Funds



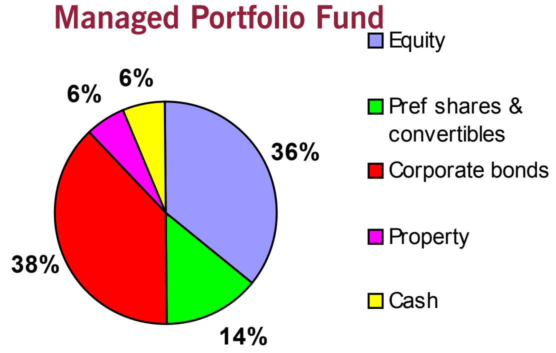
The Absolute Return Funds aim to generate positive returns on an annual basis by employing a macro investment strategy using derivative instruments, based on equity index buy-write positions, partially hedged with volatility, government bond and currency (including gold) futures. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds to provide security and income.

The core UK, US and German government bond portfolios currently yield an abnormally low 0.34% (GBP), 0.13% (USD) and 0.03% (EUR) per annum gross to maturity and have short average durations of 0.8, 0.9 and 0.7 years respectively.

The gross derivatives exposure of the Funds at the end of the quarter, which is limited to the funds under management, is shown in the pie chart above. Our long futures, short call options buy-write derivatives positions in US equity market indices produced a strong net gain for the quarter, despite a peak to trough market fall of 12% during the quarter, with the index gaining 11% overall. This gain was reduced by losses on our non-correlated hedges in volatility and gold futures, whilst our hedge in 10 year US government bond futures ended up flat over the quarter.

The Funds produced a solid return for the quarter and are now well positioned to generate attractive risk-adjusted annual returns in the future 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 was up by 2.12% in the final quarter of 2011, enabling it to end the full year with a small gain, compared to the MSCI World Index which lost 4.50% this year.

Our share portfolio generally tends to lag the index when markets are stronger (as they were in the fourth quarter), as in the current environment we continue to avoid companies that are too economically sensitive, preferring to mainly focus on defensive areas such as utilities, insurance and food in the mature western economies, balanced with some exposure to longer term growth trends in emerging markets.

Our holdings of well covered zero dividend preference shares have continued to perform solidly, although it has been a difficult time for bonds as fears of contagion from the sovereign debt markets took their toll and ratings agencies continued to downgrade a number of issuers.

Overall the Fund remains well positioned to cope relatively well if markets continue to struggle in 2012, whilst remaining capable of producing good long-term returns from the well diversified portfolio of attractively valued securities that we hold.

Revised investment approach for Absolute Return Funds

The disappointing performance of the Absolute Return Funds in the third quarter, when equity markets were abnormally volatile, has prompted us to review and revise the investment approach for these Funds. Our investment objective remains to generate positive absolute returns in excess of short-term interest rates, but we will be targeting higher returns of approximately 5% over bank rates and we will aim to achieve this each calendar year. As a result, the monthly returns of the Funds may be more volatile and there will be periods when we incur losses, but we believe that the overall result will be improved performance on an annual basis.

The Absolute Return Funds employ a macro investment approach based on the analysis of the economic fundamentals of the major global economies, supported by technical indicators, and take positions using derivatives based on our views. For the past year, we have focused our derivatives exposure on the US as we believe that it has the best chance of avoiding recession and we have been concerned about the problems in Europe. Unfortunately, however, the US has not been immune from the sovereign debt crisis in the Eurozone as the major economies and financial markets are very much inter-linked.

As our core investment in short-dated government bonds, held for liquidity and security, is only generating meagre returns of less than 0.5% per annum, we rely on our derivative strategies to produce most of the target return. This is focused around our buy-write equity index strategy, where we sell options against equity market indices to generate income. Our exposure to this strategy will, in future, be limited to around 50% of the funds under management, being significantly less than our past exposure, but we will aim to generate substantially more income than in the past, with the result that we will be less well protected on the downside.

To partially hedge this downside risk, we will introduce positions in other asset classes that have negative or no correlation with equity indices, such as volatility, government bonds and gold. These non-correlated asset classes will be positioned to produce positive returns during periods of equity market weakness. The Funds will hold only long positions in these asset classes for hedging purposes and will not enter into any speculative positions.

We believe that this revised investment strategy for the Absolute Return Funds has the potential to deliver consistent higher returns on an annualised basis, with substantially lower risk than equity markets, which will reward the patience of investors in these Funds.

Managed Portfolio Fund approach unchanged

As a fund that generally takes a long-term approach, the Managed Portfolio Fund has not been affected to the same extent by the short term volatility that has hampered many trading strategies this year. Our approach therefore remains to identify investments that offer long-term growth opportunities or compelling value, whilst avoiding areas of the markets that appear overvalued or are in decline. An example of this can be seen from the way in which our relative exposure to large and small caps has changed over time.

When the fund was launched over 10 years ago most large caps were trading on very high valuations following an extended bull run in the 1990's and consequently we held very few "blue chips", as we were finding better valuations in relatively neglected small and mid cap stocks. However, more recently we have been able to find a number of large multinationals with strong market positions and growth opportunities in emerging markets that are trading on attractive PE ratios and dividend yields and the Fund's relative weightings between large and small caps has consequently now been reversed. We believe that adopting this type of long-term but flexible approach gives the Fund the best chance of coping with the ever changing market conditions.

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%	4.3%	5.0%
Balanced	50%	50%	6.0%	-1.1%	4.5%	5.1%
Growth	25%	75%	7.0%	-0.5%	4.7%	5.5%
Benchmarks:						
3 month interest rate				0.9%	3.6%	0.0%
5 yr Government bonds (total return)				4.7%	5.0%	2.9%
MSCI World Equity Index (total return)				-4.5%	1.8%	11.9%

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