Heritage

Quarterly Newsletter & Investment Review

Issue 57 Quarterly news & investment review from Heritage Quarter 1 2012

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A good start to the year for investors

Despite a small setback at the end of March, it has been a very good start to the year for investors with most of the major markets producing decent gains overall for the first quarter.

We are pleased to report that the Heritage Funds have also had a good quarter and further details on the performance and strategies for our funds can be found as usual on page 3.

The benefits of our Absolute Return Funds over structured products

Structured products are currently marketed widely in view of their seemingly attractive offer of partial or full protection of your original capital if held to maturity and potential returns typically based on the performance of a market index or basket of securities. These market-linked investments are generally packaged by large banks and invest the majority of their cash in bonds which grow to provide the capital guaranteed on maturity, with the balance being used to purchase options on a market index to provide the return if it goes up over the term of the investment.

Our Absolute Return Funds provide many of the benefits of structured products without the downsides. Approximately 90% of the funds are invested in short-dated government bonds and cash deposits to protect most of the capital invested. The remainder is invested in a separate special purpose company as margin to support balanced and partly hedged exposure to the US equity market, US Treasury bonds and gold using derivatives.

The biggest risk with structured products is counterparty risk, as the return of your capital is normally guaranteed by a different company to the one you invest with and you may not get your capital back if it goes insolvent (like Lehman Bros in 2008). The Absolute Return Funds hold their own government bonds directly to provide the return of at least 90% of investors' capital. Investors in our Funds are not locked in for 5 or more years as with many illiquid structured products, and can withdraw their investments at any month-end without penalty. There is a distinct lack of transparency with most structured products, whereas investors in our Funds are kept fully informed about the securities held and market exposures. Finally, as there are a number of parties involved, structured products have multiple layers of fees which reduce the net return to the investor, whereas our Funds invest directly themselves.

The bottom line is that investors should never put their funds into any investment which they do not understand and that is not fully transparent. At Heritage, we strive to keep investors fully informed as to how and where their money is invested, and we are always available to provide investors with more information should they require it.

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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Heritage Capital Management Limited

Review for the quarter ended 31st March 2012

Market Commentary

2012 has got off to a positive start for investors, with all of the major markets making good progress in the first quarter.

Looking at this strong recovery one might reasonably expect that it was based on improving fundamentals. However, whilst there have been pockets of better news in the underlying global economy, the main reason for the rising markets is in fact the massive injection of liquidity into the financial system by central banks.

The European Central Bank has provided the biggest impact this quarter with its LTRO (Long Term Refinancing Operations) programme now having provided over €1trillion in cheap funding to European banks. Unlike the US and UK central banks which have boosted liquidity via their quantitative easing (QE) operations, the ECB is not allowed to effectively print money but has achieved a similar liquidity boost by allowing banks to borrow vast amounts at just 1% for up to three years.

These interventions have undoubtedly helped to stabilise the fragile financial system but the jury remains out as to whether it is just another sticking plaster rather than a proper cure. The danger is that we are witnessing a temporary triumph of liquidity over reality, which is why we continue to prefer a cautious investment approach for now.

United Kingdom

Although the FTSE 100 index managed a creditable return of 4.8%, it was outpaced by the other major markets in the first quarter.

The FTSE often lags other international indices at times when global markets generally are having a strong run, although this is not necessarily a bad thing as it highlights the defensive qualities of many UK listed large cap companies, which also maintain generally higher dividend yields than their international peers.

Encouragingly, the UK's inflation rate has finally started to fall back and the Bank of England expects this trend to continue over the rest of the year. However, with base rates still at just 0.5%, holding all your savings in cash generates little income and will result in the continuing erosion of the real value of your capital.

United States

The S&P 500 index has climbed back over 1400 to give a total return of just over 12.5% for the US market this quarter.

One of the biggest contributors to the strong rise in the overall US market has been the recently resurgent technology sector. In particular, Apple has cemented its position as the world's most valuable company with a share price increase of nearly 50% so far this year, and with a market cap of now well over $500bn it is worth more than the entire stock markets of most countries.

US economic news has been generally improving and the recent upwards revision to the previous quarter's GDP growth figures to an annualised 3% has lessened the likelihood of further quantitative easing by the Federal Reserve.

Europe

It has also been a good start to 2012 for European markets with the FTSE Eurotop 100 index gaining 6%.

Greece finally secured approval for its second bail out in February and with sentiment now improving as a result of this combined with the ECB's liquidity operations, the hope is that Europe will be able to avoid a repeat of the rolling crisis which paralysed the region for much of last year.

Japan

After a disastrous 2011 for Japan, the 20% gain by the Nikkei index makes it the best performing major market so far this year and despite suffering many false dawns and years of deflation, there is some cause for optimism as the Bank of Japan's recent more constructive policies and a weakening of the Yen have boosted prospects.

Emerging markets

Most emerging markets had a good first quarter and encouragingly, and by contrast to more mature markets, it is improving domestic economic growth rather than central bank liquidity that is the major driving force.

Investment Statistics - 31/03/2012

Equity Markets	Q1 2012	2011	2010	2009	2008	2007
Global - MSCI World ($)	11.72%	-5.01%	12.47%	30.57%	-40.30%	7.09%
UK - FTSE 100	4.79%	-1.56%	13.05%	27.89%	-27.93%	3.80%
US - S&P 500	12.58%	2.09%	15.08%	26.47%	-36.91%	3.53%
Europe - FTSE Eurotop 100	6.04%	-5.93%	8.15%	29.97%	-40.57%	2.41%
Japan - Nikkei 225	20.29%	-15.65%	-1.46%	21.05%	-41.03%	-11.13%

Total returns - including dividends

Other	UK	US	Europe	Japan
PE Ratio	11	15	13	26
Dividend Yield	3.8%	2.0%	4.1%	1.8%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	2.20%	2.21%	1.85%	0.99%
Exchange rates (vs GBP)	-	1.6008	1.1999	132.64
Exchange rates (vs USD)	1.6008	-	1.3343	82.87
Gold ($ per ozs)		1668		

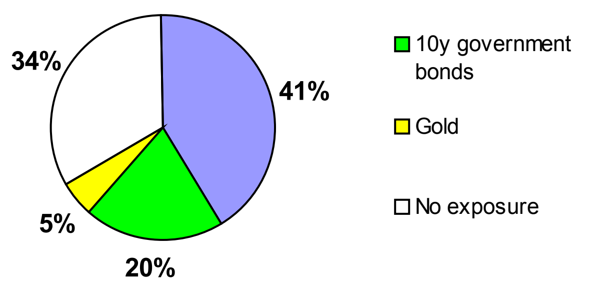
Source: Bloomberg/FT

Heritage Investment Fund Limited

Review for the quarter ended 31st March 2012

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 March 2012	£156.75	US$129.89	€100.53	£174.65		
Return for quarter & 2012 ytd (net)	2.29%	2.52%	2.18%	4.41%	0.06%	8.35%
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)	4.28%	2.26%	0.13%	5.14%	2.93%	2.49%
Annual volatility	5.7%	6.1%	5.5%	6.4%	0.0%	13.0%
Size of Fund (millions)	£33.1	U$19.0	€1.1	£48.7		

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, when considered appropriate. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds to provide capital protection and limited income.

The core UK, US and German government bond portfolios currently yield an abnormally low 0.47% (GBP), 0.20% (USD) and 0.42% (EUR) per annum gross to maturity and have short average durations of 0.8, 0.8 and 0.5 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 good gains for the quarter on the back of a rising market. However, the overall return was reduced by losses on our negatively correlated defensive hedges in volatility, government bond and gold futures.

The Funds produced solid positive returns for the quarter and continue to be well positioned to generate attractive risk-adjusted annual returns in the future significantly in excess of short-term interest rates.

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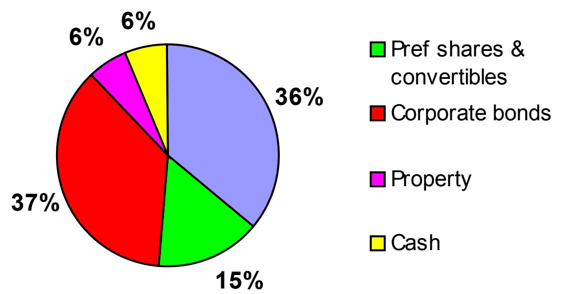
Managed Portfolio Fund



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 good first quarter, generating a gain of 4.41%, helped by a strong performance by global markets with the MSCI £ World Index returning 8.35%.

Although our defensive large caps have lagged the rising indices, our smaller cap holdings have done particularly well this quarter and we also received an additional boost from takeover offers for two of our holdings.

Our bond holdings have also made a good start to the year as investor sentiment continues to improve and spreads tighten and on a running yield of around 7% they also make a significant contribution to the Fund's income. Our zero dividend preference shares have also been making good progress as their asset backing (or cover) improves as markets rise and interest rates remain low.

Despite an encouraging start to the year we remain wary of the risks facing global markets and continue to adopt a relatively cautious approach, which nevertheless remains capable of producing attractive returns for a long-term investor.

Investment trusts

Having been around since the late 1860's, investment trusts are the oldest form of collective investment funds, and despite recent research providing further evidence of what most investment professionals have long understood, i.e. that they offer superior returns and lower costs to typical unit trusts, it is the open ended funds that have continued to dominate the investment industry in recent years.

Of course the main reason for this is that unit trusts and OEICS (open ended investment companies) are established by the marketing teams of large fund management groups who then use a distribution network of financial advisors to sell the funds on a commission basis. Investment trusts on the other hand have a fixed number of shares and once launched can only be bought and sold on the stock exchange like any other listed share and it is this unique fund structure that provides many benefits;

Closed-end structure – with a fixed number of shares, investment trusts are not forced to sell assets to meet sudden outflows for redemptions in a falling market, nor are they under pressure to invest new subscriptions if there are no suitably priced investments available.

Independent boards – With unit trusts it is the fund management group that has complete control of the fund. Investment trusts on the other hand have an independent board of directors who are responsible for ensuring that the trust is run for the benefit of the investors, including the ability to change the manager if necessary and to oversee strategic issues such as the use of gearing.

Costs – Investment trust charges are highly competitive and annual management charges tend to average well below those of comparable unit trusts, which often have the added disadvantage of high initial charges.

Stability – The longevity demonstrated by investment trusts is reassuring in a financial world that has become increasingly concerned with short term issues.

Specialist areas – as well as being a good vehicle for a general equity portfolio, investment trusts are particularly well suited to specialist areas such as property and private equity where liquidity can be an issue. This was again highlighted during the financial crisis on 2008 when many high profile property unit trusts had to suspend dealing when they received a flood of redemptions whilst similar investment trusts were able to continue unaffected by such pressures.

Discount factor – as the price of an investment trust is set by the market, it may differ from the Net Asset Value of the underlying investments. If, as is often the case, the price is below the NAV the trust is said to trade at discount and this may present a good buying opportunity. However, this is a complex area and discounts can widen further, so experience and expertise is required before attempting to benefit from the discount phenomenon.

The combination of these advantages has resulted in investment trusts having a consistently superior performance record when compared to unit trusts as well as pension and life funds. Astute investment professionals have often described investment trusts as the City's best kept secret but there are now some signs that their profile may finally be increasing.

In particular it will be interesting to see how the regulator's Retail Distribution Review will effect the market, as this will impose a ban on the use of commissions for fund sales from 2013, which in theory should level the playing field and potentially increase interest in investment trusts.

Overall, although at Heritage we generally prefer to invest directly into shares and bonds rather than other funds, there are times when it is appropriate to make use of specialist fund managers or to seek to benefit from the discount opportunities presented by investment trusts and as it is an area that we have built considerable expertise in over the years, we continue to make use of investment trusts for a number of client portfolios and within our Managed Portfolio Fund.

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	80%	20%	6.0%	-0.6%	4.5%	5.3%
Balanced	40%	60%	7.0%	1.1%	4.8%	5.4%
Growth	0%	100%	8.0%	2.7%	5.1%	6.4%
Benchmarks:						
3 month interest rate				0.9%	3.5%	0.0%
5 yr Government bonds (total return)				5.0%	4.9%	2.4%
MSCI World Equity Index (total return)				1.6%	2.5%	13.0%

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