Heritage

Quarterly Newsletter & Investment Review

Issue 58 Quarterly news & investment review from Heritage Quarter 2 2012

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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Eurozone crisis weighs on markets

Despite a partial recovery in June, the second quarter of 2012 has been a poor one overall for investors as the ongoing uncertainty over the future of the Eurozone has weighed heavily on markets.

However, we are pleased to report that against this background the Heritage Funds have held up reasonably well, with the Managed Portfolio Fund actually producing a positive return for the quarter. Further details on the performance and strategies for our funds can be found as usual on page 3.

The importance of diversification

Diversification has long been recognised as one of the necessary cornerstones for protecting your wealth as well as producing good returns, as when it comes to investment the old adage that it makes sense not to “place all of your eggs in one basket” really does apply.

In diversifying your investment portfolio, you distribute your capital among various asset classes to protect your capital should one of them incur a loss. There are a number of strategies you can follow, but they typically involve spreading your investments between the major asset classes such as bonds, equities, property and cash and investing in a number of different companies operating in a variety of sectors as well as obtaining exposure to foreign economies and currencies.

However, actually implementing a well diversified investment strategy is not as simple as it may sound and we see many examples of flawed thinking when it comes to diversification. A common failing is to simply buy an index fund such as a FTSE tracker, which on the face of it is a good way of achieving a diverse spread of holdings at a low cost. In reality, as well as missing out on international equity diversification the major drawback is that other asset classes such as fixed interest securities are completely overlooked. In fact the ability to appropriately allocate funds between asset classes is probably the most fundamental investment decision that needs to be addressed, as numerous studies over the years have demonstrated that the major driver of returns and levels of risk within a portfolio is down to the overall asset allocation rather than the individual holdings that are selected.

At Heritage, we recognise that it takes a lot of effort to establish and maintain such a diverse portfolio for an individual account and so we offer clients the opportunity to invest in our funds which operate as collective investment vehicles. Clients are able to participate by buying shares in the funds, which then use the proceeds to invest in many different securities, markets and currencies according to the fund’s investment objective.

The Heritage Managed Portfolio Fund is particularly well diversified with over 100 holdings spread between equities, fixed interest securities, property and cash. Furthermore within each asset class there are additional levels of diversification. Our equity holdings are spread between geographic and industry sectors, large companies and small and within our fixed interest portfolio we hold a diverse range of securities including fixed and floating rate corporate bonds, preference shares, convertibles and a mixture of investment grade and higher yielding holdings across a variety of sectors.

Of course the use of our funds to provide diversification needs to be balanced with the ability to ensure that individual client portfolios can be tailored to meet specific objectives and requirements – something that we are always available to discuss in more detail if necessary.

Heritage Capital Management Limited

Review for the quarter ended 30th June 2012

Market Commentary

The investment landscape has once again been dominated by the ongoing Eurozone crisis, with the MSCI World Index losing nearly 5% over the second quarter. May was a particularly bad month for markets, although the quarter finished on a positive note following an unexpectedly well received EU leaders summit at the end of June.

Cynics might argue that expectations leading up to European summits have now become so low, after a series of disappointments, that this was a just a relief rally rather than a reaction to genuinely positive solutions. Certainly there is a danger that the necessary follow up action required will not be forthcoming and that there will be a return to the more difficult market conditions that have prevailed for much of the past year.

One welcome development for investors has been the emergence of a so called "shareholder spring". The owners of businesses finally seem to be waking up to the realisation that the directors have managed to rig the system too far in their favour with overly generous remuneration packages and we have now seen the start of the necessary corrective action being taken by shareholders during the recent AGM season. So far this has mainly been a UK phenomenon and it will be interesting to see whether it can maintain momentum and spread to other countries.

United Kingdom

The FTSE 100 index gave up all of its gains in the second quarter ending at 5,571, almost exactly where it started the year. In fact the FTSE has now crossed the 5,500 level more than 25 times since it first reached that level back in 1998.

This does neatly demonstrate the importance of dividends, as despite the index struggling to make any progress it has still been possible to generate positive returns through the accumulation and ideally reinvestment of the dividend income stream, with a positive total return of 2.56% for the year to date for the UK market and substantially more since we first entered this trading range.

With the news that the UK has now technically slipped back into recession, the hope is that the upcoming Olympic games may give the country a much needed boost this summer.

United States

The S&P 500 index was down by 2.75% in the second quarter but still leads the rest of the major markets with a decent year-to-date return.

This robust performance is due to the fact that the US continues to be seen as a relatively safe haven for investors, despite fairly lacklustre progress from its economy and the uncertainty surrounding the elections later this year.

In corporate news, JPMorgan's reputation as being one of the most shrewdly managed banks took a severe blow as it admitted it had suffered around $5bn in trading losses. Also, the much anticipated IPO for Facebook has turned out to be a debacle with the share price falling well below its initial inflated level and the blame from angry investors now being pointed in multiple directions.

Europe

Despite Europe being the epicentre of the problems that have plagued markets this quarter, the FTSE Eurotop itself was down a relatively modest 2.26% after a strong relief rally in June.

On the plus side, the recent Greek election and the latest EU summit have provided some cause for optimism, but the Eurozone's problems remain deep rooted and with Spain now requiring a €100bn banking bailout there is still no end in sight to the crisis.

Japan

After an encouraging start to the year Japan was the worst performing major market this quarter with the Nikkei index falling by 10.6%. However, there are signs that their new prime minister, Noda, will be able to finally start to push through the necessary reforms required on issues such as consumption taxes.

Emerging markets

Most emerging markets also had a difficult quarter, falling on average by around 7% and Brazil suffering particularly badly with the Bovespa index down over 18%.

Investment Statistics - 30/06/2012

Equity Markets	Q2 2012	2012	2011	2010	2009	2008
Global - MSCI World ($)	-4.85%	6.30%	-5.01%	12.47%	30.57%	-40.30%
UK - FTSE 100	-2.12%	2.56%	-1.56%	13.05%	27.89%	-27.93%
US - S&P 500	-2.75%	9.48%	2.09%	15.08%	26.47%	-36.91%
Europe - FTSE Eurotop 100	-2.26%	3.64%	-5.93%	8.15%	29.97%	-40.57%
Japan - Nikkei 225	-10.62%	7.53%	-15.65%	-1.46%	21.05%	-41.03%

Total returns - including dividends

Other	UK	US	Europe	Japan
PE Ratio	11	14	12	22
Dividend Yield	4.1%	2.1%	4.0%	2.2%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	1.75%	1.64%	1.58%	0.84%
Exchange rates (vs GBP)	-	1.5707	1.2401	125.32
Exchange rates (vs USD)	1.5707	-	1.2667	79.79
Gold ($ per ozs)		1597		

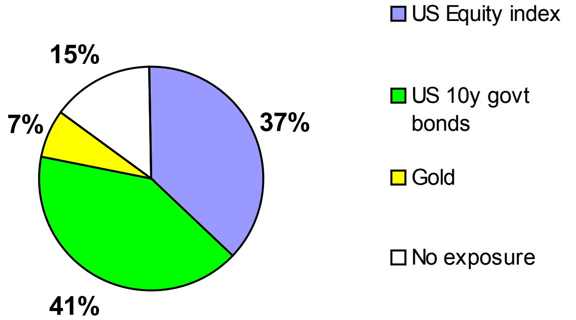
Source: Bloomberg/FT

Heritage Investment Fund Limited

Review for the quarter ended 30th June 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	+4%			+6%		
Price at 30 June 2012	£155.99	US$129.39	€99.90	£175.20		
Return for quarter (net)	-0.48%	-0.38%	-0.63%	0.31%	0.06%	-2.97%
Year 2012 return year to date	1.79%	2.12%	1.53%	4.73%	0.13%	5.13%
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%
Compound annual return (from 1/01)	4.15%	2.18%	-0.02%	5.06%	2.88%	2.17%
Annual volatility	5.8%	6.4%	5.6%	6.4%	0.0%	14.2%
Size of Fund (millions)	£31.4	U$13.9	€0.6	£51.6		

Absolute Return Funds



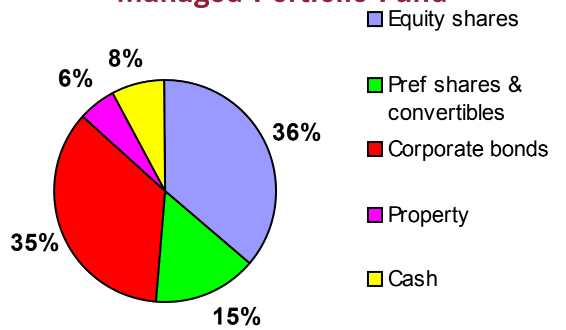
The Absolute Return Funds aim to generate positive annual returns by employing a macro investment strategy primarily focused on non-correlated buy-write positions in equity index, government bond and currency (including gold) derivatives. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds to provide capital protection and income.

The core UK and US government bond portfolios, which constitute 84% of the funds under management, currently yield an historically low 0.29% (GBP) and 0.24% (USD) per annum gross to maturity and have short average durations of 0.8 and 0.9 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 options derivatives positions in US equity market indices and gold incurred modest losses for the quarter, depressed by falls of 3.3% in the US equity market index and 4.3% in gold. These losses were partly offset by gains made on our non-correlated exposure to US 10 year government bond derivatives, which rose 3% over the quarter.

The Funds produced modest losses for the quarter, significantly less than equity markets, and are defensively positioned to generate attractive risk-adjusted annual returns in the future significantly 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 managed to produce a gain of 0.31% over the second quarter whilst the MSCI £ World Index lost 2.97%. For the year to date the Fund is now up by 4.73% compared to 5.13% for the World index.

Despite it being a poor quarter overall for markets generally, the Fund's positioning in defensive sectors enabled its equity portfolio to hold up relatively well, with a number of holdings including our utilities and pharmaceuticals actually rising. Corporate activity has continued to be a factor this year, as a further take-over approach for one of our holdings was agreed to add to the two already received in the first quarter.

Our fixed interest portfolio had a solid quarter and with an attractive running income yield of over 7% it is well positioned to continue to make a meaningful contribution to the Fund's overall return.

The market weakness over the quarter has allowed us to add to a few positions in our favoured companies at more attractive prices, although we continue to adopt a relatively cautious approach and have not increased overall exposure as these purchases have been funded from the receipt of new cash subscriptions into the Fund.

The Protection of Capital in these uncertain times

This past quarter has seen the markets focus again on the possibility of a Eurozone breakup, led by Greece, with Spain and possibly Italy needing financial bailouts. These unpredictable macro economic events have resulted in significant falls in equity markets and a rush by investors into the relative safety of government bonds. Highly-rated government bonds such as US Treasuries, UK Gilts and German Bunds have provided investors with a haven from the turbulent equity markets, despite the record low yields on offer.

Sophisticated investors have focused on the protection of their capital, rather than the return on their capital. The fact that yields on these so-called haven government bonds are less than 0.25% per annum has not deterred investors and, in some instances, short-dated securities have been issued at negative nominal yields. Aside from the preservation of capital, these government bond markets offer investors immediate liquidity which, after the credit crisis of 2008, has become of paramount importance.

There are very few investment havens which offer liquidity and security of capital. Even the US, UK and, to a lesser extent Germany, all have high total debt to GDP ratios and are running budget deficits. The major beneficiary of the rush into the haven of US Treasury bonds has been the US Dollar, which has appreciated significantly this quarter. Gold, which has been a traditional refuge for risk-averse investors in troubled times, has lost some of its lustre as past gains have been largely driven by falling interest rates and monetary easing, which make gold a more attractive investment as it does not produce any income. Without more stimulus, it is difficult to see how gold can improve on its previous gains. Banks do not offer the security that they once did in the past as they are burdened with varying exposure to the debt of southern Eurozone countries and other non-performing loans.

The cornerstone of our investment policy at Heritage is the protection of investors' capital, with its enhancement in real terms being a secondary objective. In our Absolute Return Funds, the core of the funds is invested in short-dated government bonds issued by the UK, US and Germany to protect approximately 90% of investors' capital, with the balance being used as margin to take non-correlated derivatives positions in equity indices, government bonds, gold and currencies. Our Managed Portfolio Fund protects investors' capital by spreading its exposure among various diverse asset classes and, further, holding a well diversified spread of securities within each asset class.

ISA Portfolio Management

It makes sense for individuals to maximise their tax-free investments and with the annual allowance having recently been increased to £11,280, many investors in the UK will have already built up substantial ISA (Individual Savings Accounts) portfolios.

Traditionally most individuals have tended to subscribe to various ISA plans based on funds provided by the UK's large fund management groups. For clients of Heritage we are able to offer a service that allows us to manage ISAs as part of their overall portfolio. A client simply opens a "self-select" ISA account and appoints Heritage as their agent which allows us to manage the ISA account, providing the following benefits;

- All ISA money accumulated from successive years' contributions are held and managed within a single portfolio.
- We can ensure that a client has a correctly balanced portfolio as we are able to consider their overall position, including pension and other funds.
- Clients can avoid the high initial charges associated with most ISA investments as we typically use investment trusts rather retail unit trusts.
- We take care of the management, dealing, and administration which is all included in our usual standard annual management fee.

Further information and the relevant application forms are available on request. Finally, it is important to note that Heritage is an investment manager and not a financial advisor, so if a client requires any advice as to the suitability of ISAs and how this fits into an overall financial plan they should seek appropriate financial advice – which we are happy to arrange through an association we have with a well established regulated advisor.

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	50%	50%	4.0%	-1.5%	4.6%	5.3%
Balanced	30%	70%	5.0%	-0.9%	4.8%	5.6%
Growth	0%	100%	6.0%	-0.1%	5.1%	6.4%
Benchmarks:						
3 month interest rate				1.0%	3.5%	0.0%
MSCI World Equity Index (total return)				-2.0%	2.2%	14.2%

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