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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Central banks propel markets higher

Although the underlying global economy continues to struggle, investment markets have received a welcome boost from the actions of the major central banks in Europe and America, leading to a strong recovery in both equity and bond markets over the third quarter.

We are pleased to report that the Heritage Funds have also been faring well, with the Managed Portfolio Fund having a particularly strong quarter. Further details on the performance and strategies for our funds can be found as usual on page 3.

Value investing

Fund managers are often classified as being either "value" or "growth" investors and long standing Heritage clients will no doubt be aware of the importance we place on seeking value when selecting investments. Of course a good case can be made for a growth approach that seeks to identify rapidly expanding companies and intuitively this also makes sense as the really big success stories in the stock market are often based on companies that have started small and gone on to become global titans. We therefore thought it would be useful to provide a real life case study which demonstrates the importance of valuations and why numerous studies have shown that "value" investing outperforms a "growth" approach in the long-term.

Going back just over 10 years to when our Managed Portfolio Fund was starting out, a good example of a typical "growth" company was Vodafone, as the mobile phone industry was taking off and prospects for future global growth looked very attractive. On the other hand we also analysed Scottish and Southern Energy, a dull but worthy looking UK electricity utility business. So how did things turn out and why did we choose SSE over Vodafone back then?

In fact, Vodafone has gone on to become a global giant in the mobile telecoms industry and this has resulted in impressive growth in its profits and earnings per share which have increased from just over 5p back in 2002 to a forecast 16p this year. Although SSE has not grown nearly as rapidly, a steady compounding of profits has at least enabled its EPS to rise from 50p to around 100p over the same period. So with both companies doing well and more or less as expected, one might reasonably expect them to have achieved similarly pleasing investment returns. However, whilst the SSE shares that we first bought at £6.83 in 2002 have subsequently more than doubled to £14.00, Vodafone shares today trade at around £1.80, which is still at the level they were at the beginning of 2002.

The reason for the vastly superior investment performance by SSE is entirely down to valuation. In 2002 Vodafone was simply too highly rated on a PE ratio of 36, whilst SSE's PE ratio was far less of a handicap at just 12. It is this focus on value that has enabled our Managed Portfolio Fund to double its own share price over the past 10 years, leaving it well ahead of the major stock market indices, that due to inherent human optimism, always include a number of expensive "growth" companies.

Heritage Capital Management Limited

Review for the quarter ended 30th September 2012

Market Commentary

Following a poor second quarter markets recovered strongly over the summer, as the European Central Bank took its most decisive action yet, demonstrating how far it is prepared to go to shore up the struggling Eurozone, swiftly followed by the initiation of another round of quantitative easing by the US Federal Reserve Bank (QE3).

Added to already historically low interest rates these are quite extreme measures and they are producing some interesting consequences for investment markets.

For example, pushing interest rates down to virtually zero has had the effect of forcing risk averse savers who would previously been able to generate an income from interest on their cash deposits, into higher yielding but riskier assets, such as corporate bonds or equities, as the alternative would be to face virtually no income and an ongoing erosion of the real value of their capital.

However, it is important for these new investors to understand the risks to capital that they are taking in their quest for higher yields. As this is a far from simple matter we also think that a good level of diversification is required to spread the risk and a flexible approach needs to be adopted as the global financial system continues to sail into unchartered waters.

United Kingdom

The FTSE 100 index had a good quarter, gaining 4.5%, and although this was behind most of the other major western markets, international investors would have also benefitted from the strength of Sterling which has been seen as a relatively safe haven recently.

With markets recovering and the country enjoying a successful hosting of the Olympic Games it has been a good summer for Britain. However, the major issues of tackling the deficit and the worryingly rising total level of government debt have not gone away and despite all the talk of spending cuts and austerity, the reality is that no significant progress has yet been made.

United States

The US was the best performing major market this quarter and the S&P 500 index is now also well ahead of other international indices for the year-to-date.

This robust performance is due to the fact that the US continues to be seen as a more dynamic economy by investors. This is emphasised by Apple's astonishing rise to become the world's most valuable company and the recent successful launch of the iPhone 5 is expected to provide a bigger boost to the still ailing economy than the Federal Reserve Bank's latest quantitative easing programme.

Europe

European markets have also enjoyed a strong recovery from the lows reached in May, putting them firmly back in positive territory for the year-to-date.

Europe continues to be the focus of global financial markets and perhaps the main reason behind the recent strong rally has been that the European Central Bank, headed by Mario Draghi, has finally backed up its rhetoric by providing what looks like an effective bailout mechanism for the struggling members of the Eurozone.

This should provide welcome relief for the likes of Spain, however it does need to be requested by the recipient and as it comes with a few politically sensitive strings attached it has yet to be put into practice.

Japan

Japan continues to be a huge disappointment for investors. It is the only market that was down in the third quarter and the Nikkei index is on course to be the worst performing major market for the seventh year in a row.

The only positive is that after years of being de-rated, the Japanese market now trades on a similar PE ratio and dividend yield to the US for the first time in decades.

Emerging markets

In line with most of the major indices, emerging markets also had a good quarter, although China was a notable exception due to a combination of political uncertainty and mounting concerns over economic data.

Investment Statistics - 30/09/2012

Equity Markets	Q3 2012	2012	2011	2010	2009	2008
TR Global	6.10%	11.07%	-5.01%	12.47%	30.57%	-40.30%
TR UK	4.45%	8.00%	-1.56%	13.05%	27.89%	-27.93%
TR US	8.97%	16.06%	2.09%	15.08%	26.47%	-36.91%
TR Europe	8.71%	12.78%	-5.93%	8.15%	29.97%	-40.57%
TR Japan	-4.02%	1.19%	-15.65%	-1.46%	21.05%	-41.03%

Total returns - including dividends

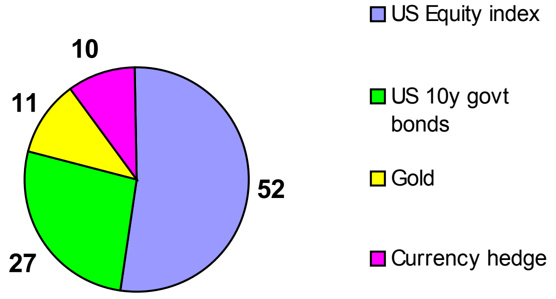
Other	UK	US	Europe	Japan
PE Ratio	12	15	13	15
Dividend Yield	4.3%	2.5%	4.4%	2.3%
Interest rates - base	0.50%	0.25%	0.75%	0.10%
Bond Yields - govt. 10 year	1.73%	1.63%	1.42%	0.77%
Exchange rates (vs GBP)	-	1.6167	1.2571	125.95
Exchange rates (vs USD)	1.6167	-	1.2859	77.90
Gold ($ per ozs)		1771		

Source: Thomson Reuters

Heritage Investment Fund Limited
Review for the quarter ended 30th September 2012

Performance	Absolute Return Funds			Managed Portfolio Fund	Cash Deposits (£)	TR Global World Index (£ total return)
Risk profile	Moderate			High /Moderate		
Minimum investment horizon	3 years +			5 years +		
Target return over bank deposit rate	+3%			+6%		
Price at 30 September 2012	£157.58	US$131.13	€100.87	£183.63		
Return for quarter (net)	1.02%	1.34%	0.97%	4.81%	0.06%	3.08%
Year 2012 return year to date	2.83%	3.50%	2.52%	9.77%	0.19%	6.69%
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%
Compound annual return (from 1/01)	4.14%	2.25%	0.18%	5.37%	2.82%	3.28%
Annual volatility	3.8%	4.7%	3.6%	4.2%	0.0%	9.0%
Size of Fund (millions)	£27.9	U$14.0	€0.3	£60.6		

Absolute Return Funds



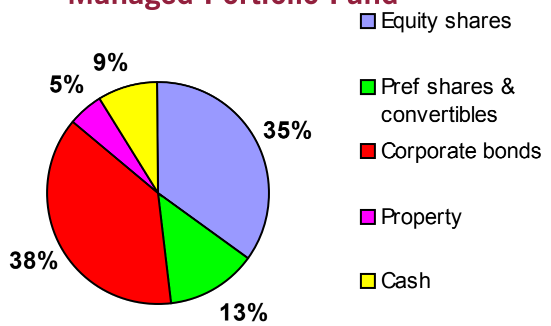
The Absolute Return Funds aim to generate positive annual returns by employing a macro investment strategy primarily focused on non-correlated buy-write positions in equity index, government bond and currency (including gold) derivatives. As these positions require limited margin outlay, most of the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

The core UK and US government bond portfolios, which constitute 77% of the funds under management, currently yield an historically low 0.29% (GBP) and 0.18% (USD) per annum gross to maturity and have short average durations of 0.6 and 0.6 years respectively. These short-dated bonds are held for security and liquidity, but currently disappointingly produce negligible income.

The gross derivatives exposure of the Funds at the end of the quarter is shown in the pie chart above. Our long futures, short options derivatives positions in US equity market indices and gold produced reasonable gains for the quarter, on the back of rising markets. However, premium income from selling derivatives has fallen substantially over the quarter as volatility has fallen to historically low levels.

The Sterling and US Dollar Funds produced modest gains for the quarter, but continue to be 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 had a good quarter with a gain of 4.81%, ahead of the £ World Index which returned 3.08%. For the year-to-date to the Fund is now up by 9.77% versus 6.69% for the World Index.

The majority of our equity holdings had a positive quarter, including pleasing gains for a few new holdings. Despite the recent good run valuations remain reasonable, with an average prospective dividend yield on our share portfolio of around 5%.

Our preference shares have continued to perform well, as their cover improves and interest rates remain low.

Corporate bonds also had a strong quarter as the spreads between our higher yielding bonds and low yielding government bonds continues to tighten, giving a good total return from a combination of rising prices as well as the income yield.

Overall we continue to maintain a relatively cautious approach, as we are mindful that despite a good year-to-date, markets remain vulnerable to a possible set back arising from further financial problems in the Eurozone and slowing global economic growth.

A reminder of the role of the Absolute Return Funds

It may be useful to remind investors that the objectives of the Absolute Return Funds are to protect investors' capital and to make it grow ahead of inflation so that investors' capital retains its value in real terms. To achieve these aims, the target return of these Funds has traditionally been set at 3% per annum above the central bank rate, which currently translates to around 3.5% per annum. With inflation running at 2.5% in the UK, the target return meets the objects set out above.

The Absolute return Funds are designed for risk-averse investors who wish to protect the value of their capital in real terms without the volatility and significant downside risk associated with traditional equity markets. The core of the funds under management (ie 90%) is invested in short-dated government bonds and cash for security and liquidity.

Prior to the credit crisis of 2008, bonds were yielding around 4% per annum, which made net annual returns of 7% achievable by the Funds. At today's historically low short-term yields of only about 0.20% per annum, it is not possible to generate net annual returns after fees and expenses in excess of around 4% without taking on additional risk, which we are reluctant to do. With the recent US announcement of the third round of ongoing quantitative easing and low interest rates through to 2015, there is unfortunately little prospect of these returns improving in the foreseeable future.

The return of the Absolute Return Funds is generated by taking modest non-correlated positions in equity indices, interest rate products, gold and major currencies. This is achieved by using futures and options which are extremely liquid and inexpensive. These derivatives strategies have returned 3.9% gross for the year to date and 2.3% over the past 7 years that we have been using a special purpose company to manage our derivatives, on average margin funds of only 10%.

The Absolute Return Funds will, understandably, underperform in rising markets because of the low-risk, partially hedged derivatives strategies they employ but, conversely, they should make smaller losses in bear markets as happened in 2008 when the Sterling Absolute Return Fund lost 5.8% compared with losses of 27.9% and 18.9% in the FTSE 100 and MSCI World Equity Index respectively. This Fund has had only 2 losing years in the past 12 years and 79% of it's monthly returns have been positive over that period.

For those investors seeking higher returns in the longer term who are prepared to accept some volatility, our Managed Portfolio Fund has built a good track record over more than 10 years through active management of a well-diversified portfolio of equities, preference shares, corporate bonds and property. This Fund is particularly well positioned in the current economic climate of low interest rates and has the potential to generate attractive future returns.

Closure of the Euro Absolute Return Fund

Over the past year, the funds under management in our Euro Absolute Return Fund have been significantly reduced by investors switching into one or more of our other Absolute Return or Managed Portfolio Funds. This is quite understandable given the Eurozone sovereign debt crisis that has prevailed over the past few years.

Our investors are predominantly Sterling-based given our geographical location, with some investors having a preference for US Dollars, which is the world's reserve currency and a haven in troubled times. Some years ago, certain clients expressed an interest in having a Euro-denominated fund for further currency diversification, and this led us to open a Euro version of our Absolute Return Funds.

More recently, the ongoing government debt crisis in the Eurozone, and the failure of the EU to come up with a credible rescue package, has led to speculation of a possible breakup of the Eurozone. This uncertainty has, rightly, concerned investors in our Euro Fund and most have switched their investments into more stable currencies in our other Funds.

The funds under management in the Euro Absolute return Fund have now fallen to a level where it is no longer viable to continue operating this Fund, given some of the fixed administrative costs involved, and we have therefore decided to close the Fund at the end of September.

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%	5.0%	8.5%	4.8%	3.4%
Balanced	30%	70%	6.0%	10.0%	5.0%	3.6%
Growth	0%	100%	7.0%	12.1%	5.4%	4.2%
Benchmarks:						
3 month interest rate				0.3%	2.8%	0.0%
MSCI World Equity Index (total return)				14.3%	3.3%	9.0%

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