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 reasonable year for investors as worst fears avoided

Markets have managed to put in a fairly creditable overall performance during 2012 as the worst fears at the start of the year, such as a Greek exit and disorderly breakup of the Eurozone, did not materialize.

We are pleased to report that the Heritage Funds have also done well, with the Managed Portfolio Fund having a particularly strong year, gaining over 13% despite its relatively defensive positioning. Further details on the performance and strategies for our funds can be found as usual on page 3.

Target Returns 2013

With weak equity markets in the second and fourth quarters, 2012 has proved to be another volatile year for equities. US corporate earnings only grew by around 4% this year, and the markets have also had to contend with the ongoing Eurozone sovereign debt crisis, the slowdown in emerging markets and, more recently, the uncertainty over the resolution of the US fiscal cliff issues. However, equity and bond markets remained well supported by historically low interest rates and yield-seeking investors during 2012. Interest rates have remained at historical lows during the year and futures are currently forecasting that short-term rates in the UK and US will remain at their current levels in 2013.

Our Absolute Return Funds will continue to focus on capital preservation and target modest net annual returns of 3% over short-term interest rates. The Funds will seek to achieve this by investing in a core of short-dated government bonds for income and security, supplemented by positions in equity index and other derivatives to generate income, with losses limited to no more than 5%. Based on anticipated average central bank interest rates during the year of 0.5% to 0.0% for the UK and US, our target net annual returns are expected to be in the order of 3% for our Sterling and US Dollar Absolute Return Funds. However, equity markets, and consequently Fund returns, are expected to be volatile as a result of the unresolved geopolitical risks that exist.

Although equity markets will be vulnerable to the above geopolitical risks overshadowing the markets, corporate earnings are expected to be better in 2013 than last year and the continuing expectation of low interest rates should be positive for both equity and bond markets. Returns for the year ahead are, as always, difficult to predict, but we would expect that the well-diversified equity and corporate bond portfolio of the Managed Portfolio Fund should be favourably placed to benefit from any upside in markets generally, whilst being well positioned to weather any weakness on earnings disappointments. Based on an expected average risk-free rate of around 0.5% plus a 5 to 6% risk premium, 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 2012

Market Commentary

2012 has turned out to be quite a good year for investors, as despite the ongoing uncertainties surrounding the Eurozone and the lack of any meaningful economic recovery, we have managed to avoid the worst case scenarios that were providing much cause for concern at the start of the year.

In particular the European Central Bank's decision to make a meaningful intervention in order to support the struggling peripheral nations has taken away much of the risk of a disorderly break up of the Euro in the short-term.

The other major factor supporting markets has been the continuation of ultra low interest rates which has made assets offering higher yields, such as equities and corporate bonds, look relatively more attractive , thereby helping to push prices higher.

However, in a normal healthy economy this type of ultra loose monetary policy would be highly inflationary which highlights just how fragile the underlying situation is, but for now the deflationary forces arising from weak demand is helping to keep things in balance for the time being. These competing forces of inflation and deflation are a source of much debate between economists and market commentators. Rather than falling definitively into either of these camps, we feel that it is important to remain flexible, as even if it were possible to know how things will eventually unfold, predicting the exact timing is near enough impossible.

United Kingdom

Although the UK ended the year as the laggard amongst the major markets it still managed a good performance, with a double digit total return for 2012 and with a PE ratio of just 11 the UK currently looks relatively attractive on valuation grounds.

The overall performance of the UK market has been held back by some of the biggest stocks, including a number of FTSE 100 mining companies that were well down this year. On the other hand, after a weak year in 2011, smaller companies enjoyed a strong recovery with the FTSE Small Cap Index enjoying a remarkable rise of over 30% in 2012.

United States

Although the US market was unable to make further progress in the final quarter due to concerns regarding the political impasse over the so called "fiscal cliff" (a package of tax rises and spending cuts with the potential to create a US recession), it was overall a good year with the S&P 500 index gaining over 16%.

With newly re-elected Democratic President Obama largely winning the battle over tax rises, attention in the US is now turning to the debt ceiling, where an agreement is required to raise the limit from the current $16.4 trillion, with the Republicans determined to force through significant spending cuts as part of the solution.

Europe

Although Europe started the year as the region that most investors were concerned about, contrarian investors would have been well rewarded this year as Europe turned out to be the best performing major market as the Eurozone held together.

Despite this strong run European equities are still reasonably cheap on a PE of 13 and a dividend yield of 4.2%, although clearly the major financial and political problems remain largely unresolved. Furthermore, with important elections taking place in Germany and Italy later this year, 2013 could be another volatile year for European markets.

Japan

Following a long period of being outperformed by the other major markets, Japan finally sprang to life in the fourth quarter with a gain of 16.5%, boosted by hopes that the return of Shinzo Abe as prime minister will help to provide a much needed fiscal and monetary stimulus to the Japanese economy.

Emerging markets

After struggling to make progress for much of 2012, emerging markets finished the year with a strong final quarter, although as ever the average performance does not tell the whole story for such a diverse set of markets, with returns ranging (in Sterling terms) from a 287% gain for Venezuela to a 40% loss for the Ukraine.

Investment Statistics - 31/12/2012

Equity Markets	Q4 2012	2012	2011	2010	2009	2008
TR Global	1.88%	13.16%	-5.01%	12.47%	30.57%	-40.30%
TR UK	3.66%	11.96%	-1.56%	13.05%	27.89%	-27.93%
TR US	-0.02%	16.04%	2.09%	15.08%	26.47%	-36.91%
TR Europe	7.16%	20.86%	-5.93%	8.15%	29.97%	-40.57%
TR Japan	16.49%	17.87%	-15.65%	-1.46%	21.05%	-41.03%

Total returns - including dividends

Other	UK	US	Europe	Japan
PE Ratio	11	15	13	18
Dividend Yield	4.2%	2.6%	4.2%	2.0%
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)	-	1.6253	1.2316	140.83
Exchange rates (vs USD)	1.6253	-	1.3197	86.74
Gold ($ per ozs)		1674		

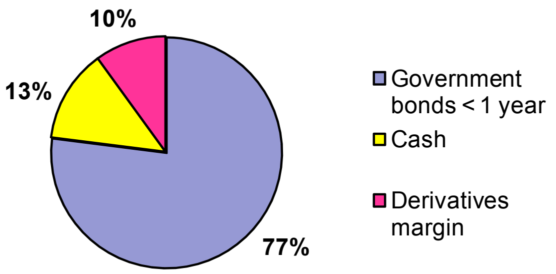
Source: Thomson Reuters

Heritage Investment Fund Limited

Review for the quarter ended 31st December 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 31 December 2012	£155.20	US$129.17	£189.47		
Return for quarter (net)	-1.51%	-1.49%	3.18%	0.06%	1.16%
Year 2012 return year to date	1.28%	1.95%	13.27%	0.25%	7.93%
Year 2011 return (net)	-2.22%	-2.28%	0.06%	0.25%	-4.50%
Year 2010 return (net)	2.80%	2.06%	10.78%	0.25%	16.49%
Year 2009 return (net)	4.25%	1.26%	10.32%	0.13%	17.86%
Year 2008 return (net)	-5.81%	-12.95%	-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)	3.93%	2.07%	5.53%	2.76%	3.31%
Annual volatility	3.0%	3.5%	2.9%	0.0%	6.9%
Size of Fund (millions)	£16.7	U$10.6	£78.0		

Absolute Return Funds



The Absolute Return Funds aim to protect investors capital and generate modest annual returns in excess of short-term interest rates by following a macro investment strategy using equity index and other financial 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 0.37% (GBP) and 0.15% (USD) per annum gross to maturity and have short average durations of 0.4 and 0.6 years respectively. These short-dated bonds are held for security and liquidity, but currently disappointingly produce negligible income.

The Funds derivatives exposure unfortunately incurred losses during the quarter due to market volatility caused by uncertainty over the US fiscal cliff negotiations. At the year end, the derivatives exposure comprised gross equity index positions equivalent to 88% of the funds under management, but this exposure is well protected by option collars limiting any further losses in the Funds to a total of 3.7%.

The Funds incurred disappointing losses for the quarter, but nevertheless generated net positive returns for the year in excess of short-term interest rates.

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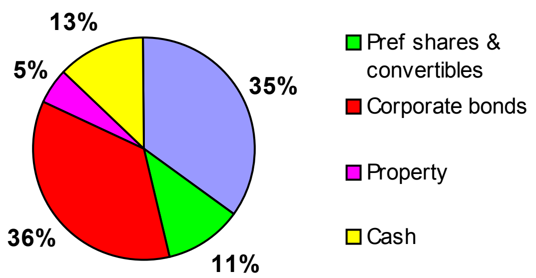
Managed Portfolio Fund



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 ended 2012 well with a 3.18% gain in the final quarter. For the full year the Fund was up by 13.27% versus 7.93% for the World index.

Our portfolio of equity shares had a good year overall, with most of the best gains coming from smaller companies which outperformed the larger caps and we also benefitted from a couple of take-overs in the first half of the year. We have also recently benefitted from an increase in our Asian holdings which have been performing well.

Despite the reasonable contribution from our equities, the main driver of the Fund's good performance in 2012 has been our fixed interest securities, where a combination of rising prices and an attractive income yield of around 7% has produced a double digit total return for our corporate bond portfolio and our preference shares and convertibles have also performed well.

Whilst it is pleasing to outperform the World Index in a fairly strong year for markets generally, investors should also take comfort in the fact that the Fund remains conservatively managed, as political and economic risks continue to be of major concern.

"Top-down" versus "bottom-up" investing

Investment styles and approaches can be classified in many different ways and one of the major distinctions often made is that between a macro or "top-down" approach, in contrast to a micro or "bottom-up" approach.

Macro investors focus on the factors that drive overall markets and economies, such as monetary and fiscal policies, and study economic variables such as GDP growth, balance of trade and employment statistics. These "top-down" investors are generally traders, often using index funds or derivative strategies to profit from their market views.

The "bottom-up" approach on the other hand lends itself well to taking a long-term view, as it sees short term market movements as mere background noise to be largely ignored in favour of a careful analysis of the merits and prospects of individual companies.

The macro approach

The Heritage Absolute Return Funds are a good example of the macro approach in action as the following current outline strategy demonstrates;

With a weighting of approximately 50% in the world equity index, the US equity market has a significant influence on other global equity markets. The Absolute Return Funds generate their income by selling covered call options on the US S&P500 equity index and use portion of these funds to buy protective puts to limit losses to less than 5%. The latest consensus analysts forecasts for 2013 are for earnings on the S&P500 to grow by 5% which, although just ahead of forecast nominal GDP growth, may be optimistic given the ongoing US debt and fiscal issues, the financial problems in the Eurozone and the slowdown in China. Based on the current PE ratio of almost 15, the index could rise to around 1460, an increase of 5%. Should the PE ratio increase to its long-term average of over 16, the S&P500 index could rise by as much as 15% in 2013 to around 1600.

The micro approach

The Heritage Managed Portfolio Fund provides a good demonstration of the contrasting "bottom-up" approach in action.

By way of example, a share that we have held for many years is a small specialist retailer, Majestic Wine. In deciding to make an investment in Majestic we largely ignored any consideration of the overall economy and politics and instead carried out a thorough analysis of the individual company itself.

Traditional wine retailers found on the high street such as Threshers and Oddbins have been struggling as the large supermarkets such as Tesco have become increasingly dominant. Majestic has managed to buck this trend with a niche format that has proven to be very successful. Its strategy has been to base itself in slightly out of town locations, which has the dual advantage over high street competitors of lower rents and on-site customer parking. Furthermore, by ensuring that its staff are well trained and knowledgeable (all staff have to take a higher certificate in wine) it is able to offer a much better service than the supermarkets to discerning wine drinkers. This winning formula has enabled it to double the number of stores it operates from under 100 back in 2001, when we first invested in Majestic, to around 200 stores today. Importantly it has achieved this growth completely organically and with virtually no debt, as the roll-out has been self funding from retained profits. Also, with a strong balance sheet, good cash flows and rising profits Majestic has been able to increase its dividend payments to shareholders from under 2p per share in 2001 to the current level of 15.6p.

Of course not all stock selections work out as planned and so in addition to patience, this approach requires investment in a number of well researched companies to provide sufficient diversification.

Conclusion

Although both of these approaches are valid there are periods when conditions will favour one style over the other. For instance the current environment has been particularly challenging for macro funds as market movements are being driven more by political rather than economic factors, whilst on the other hand, fortunately a number of the individual "bottom-up" investments made within the Heritage Managed Portfolio Fund over the years have recently been bearing fruit.

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%	7.3%	4.7%	2.5%
Balanced	30%	70%	6.0%	9.7%	5.0%	2.6%
Growth	0%	100%	7.0%	13.3%	5.5%	2.9%
Benchmarks:						
3 month interest rate				0.3%	2.8%	0.0%
MSCI World Equity Index (total return)				7.9%	3.3%	6.9%

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