Heritage

Quarterly Newsletter & Investment Review

Issue 61 Quarterly news & investment review from Heritage Quarter 1 2013

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 flying start to the year

Investment markets have had one of their strongest ever starts to the year, with first quarter returns generally on par with what would be considered a decent gain for a full year.

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.

A different approach to equity investment

As most clients will be aware, our approach to investing in shares is quite different to the average equity fund. The starting point for most funds is their "benchmark", which is usually an equity index such as the FTSE 100 index and the inevitable result of such an approach is that the fund ends up looking and performing very much like the index itself.

At Heritage on the other hand we prefer to ignore the indices and simply assess individual investments on their own merits. Our starting point is that it is only worth investing in shares (which are inherently riskier assets than cash or bonds) if they offer the prospect of generating a positive return ahead of the risk free rate over the long-term. Our detailed process for selecting companies to invest in involves a large number of considerations but these are some of the key aspects;

1) Business
Gaining an understanding of the business itself is vital. We have a preference for companies with a simple business model and a proven product or service where future earnings can therefore be predicted with a reasonable degree of accuracy.

2) Profitability, cash flow and dividends
We prefer companies that have a proven record of profitability. We analyse the historical record, competitive strength, and ratios such as margins and return on capital. Companies should have the ability to generate cash and to pay decent dividends, as this is the ultimate test of profitability.

3) Management
The quality and integrity of the directors is paramount and we also have a preference for companies where senior management have meaningful shareholdings, so that their interests are aligned with fellow investors.

4) Assets and liabilities
An analysis of the balance sheet including an assessment of the assets and liabilities is also required. We prefer companies with a conservative level of debt as high levels of gearing can greatly increase the investment risk.

5) Growth prospects and strategy
Our preference is for companies that are able to grow their core business organically, rather than embarking on new ventures and acquisitions which often fail to deliver value to shareholders.

6) Valuation
The above analysis will help us to determine the quality of a business but we will only make an investment if we are also satisfied with the valuation. We use a range of valuation techniques based on earnings (such as the PE ratio), dividend yields and net asset value.

Whilst most of the major indices have failed to make much progress from the peaks that they reached over a decade ago, our focus on fundamental value has helped the price of our Heritage Managed Portfolio Fund to double from 100 when launched in December 2000 to its current level of 200.69, and we remain fully committed to this tried and tested approach.

Heritage Capital Management Limited

Review for the quarter ended 31st March 2013

Market Commentary

Following a good year in 2012, markets have produced a further surge upwards at the start of this year with many of the major indices having one of their best ever first quarters.

Usually when markets are rising rapidly it is the riskier and more cyclical stocks that lead the way as equity investors chase the higher beta stocks. However, one of the interesting features of the current rally is that it has been the traditionally more defensive sectors that have led the market higher. For example, sectors such as household goods, food producers, beverages, pharmaceuticals & healthcare have all risen by more than 10% so far this year, whilst more cyclical sectors such as auto makers and industrials have lagged behind and the mining sector which is often at the forefront of market rallies is actually down for the year-to-date. Furthermore, emerging markets which are usually considered to be a geared play on global markets, are currently being outperformed by the major developed markets.

This unusual behaviour is most likely to be yet another feature of the huge distortions currently in financial markets created by central banks determination to push interest rates to artificially low levels. This forces investors who were previously content with low risk cash or bonds to take on more risk in their quest to maintain a reasonable yield and naturally their first port of call is the traditionally safer areas of the equity market such as defensive stocks in developed markets, rather than cyclical sectors and emerging markets.

United Kingdom

Given that the UK market has had its best first quarter in well over a decade one might reasonably assume that all is well with the UK economy, however in fact this is far from being the case.

Firstly, the ratings agency, Moody's, downgraded UK government debt from its long-held AAA rating in February and when the Chancellor, George Osborne, delivered his budget in March it was apparent that despite much talk of austerity the reality is that the national debt continues to increase to ever more worrying and unsustainable levels. Fortunately, most of the UK's companies are rather better managed than the country itself and encouragingly for investors corporate earnings and balance sheets remain in generally good shape.

United States

The US market has led the current global rally with the S&P 500 index finally surpassing its pre-credit crisis high at the end of March. Good corporate earnings growth and the Federal Reserve's ongoing bond-buying programme have provided support to drive the market higher and investors have also taken comfort at a number of increasingly positive economic indicators.

However, the big question is what will happen when the Fed begins to reduce the pace of its monthly bond purchases, which is likely to happen later this year, and how the markets would cope with a rise in interest rates if economic growth continues to improve.

Europe

Europe was the weakest of the major markets this quarter and it is not difficult to see why. The Italian election in February demonstrated just how unhappy voters in Europe are with their leaders, as the outgoing centrist Prime Minister, Mario Monti, received less than half the votes that comedian Beppe Grillo registered as part of a widespread protest vote and in March things then took a dramatic turn for the worse with the crisis in Cyprus, which despite its small size in relation to the overall Eurozone has set a number of very worrying precedents.

Japan

The sharp turnaround in the Japanese market gained further momentum in the first quarter of 2013, and the return of Shinzo Abe as prime minister has even giving rise to a new branch of economics dubbed "Abenomics", although despite encouraging signs it is too early to declare his range of radical policies, including specific inflation targeting, successful yet.

Emerging markets

As mentioned above, emerging markets have generally underperformed so far this year and heightened tensions in Korea and fears that Argentina could be heading towards yet another debt default are not helpful for sentiment.

Investment Statistics - 31/3/2013

Equity Markets	Q1 2013	2012	2011	2010	2009	2008
TR Global ($)	5.99%	13.16%	-5.01%	12.47%	30.57%	-40.30%
TR UK	10.80%	11.96%	-1.56%	13.05%	27.89%	-27.93%
TR US	10.96%	16.04%	2.09%	15.08%	26.47%	-36.91%
TR Europe	3.04%	20.86%	-5.93%	8.15%	29.97%	-40.57%
TR Japan	21.76%	17.87%	-15.65%	-1.46%	21.05%	-41.03%

Total returns - including dividends

Other	UK	US	Europe	Japan
PE Ratio	13	17	14	20
Dividend Yield	4.0%	2.4%	3.8%	1.7%
Interest rates - base	0.50%	0.00-0.25%	0.75%	0.10%
Bond Yields - govt. 10 year	1.77%	1.85%	1.28%	0.56%
Exchange rates (vs GBP)	-	1.5194	1.1856	143.17
Exchange rates (vs USD)	1.5194	-	1.2816	94.19
Gold ($ per ozs)		1597		

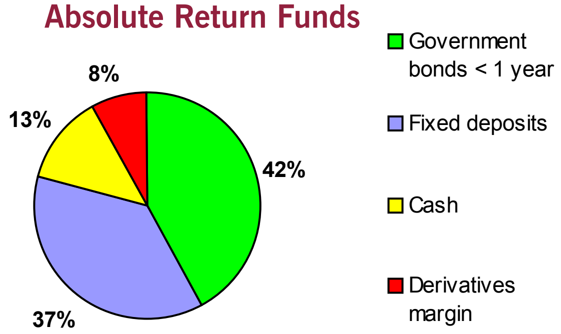
Source: Thomson Reuters

Heritage Investment Fund Limited

Review for the quarter ended 31st March 2013

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	4%		6-7%		
Price at 31 March 2013	£158.36	US$130.79	£200.69		
Return for quarter & 2013 ytd (net)	2.04%	1.25%	5.92%	0.06%	13.31%
Year 2012 return (net)	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)	4.01%	2.13%	5.91%	2.71%	4.30%
Annual volatility	2.7%	3.0%	3.3%	0.0%	9.4%
Size of Fund (millions)	£14.5	U$13.3	£86.4		

Absolute Return Funds



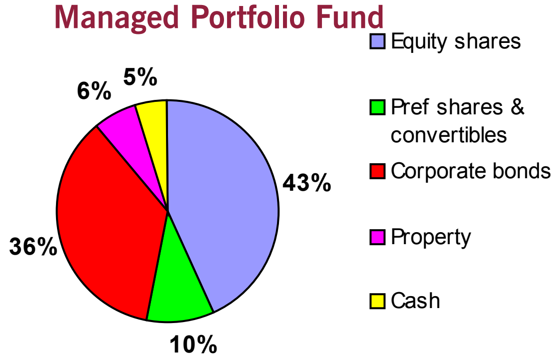
The Absolute Return Funds aim to protect investors capital and generate modest annual returns in excess of inflation by following a macro investment strategy using equity index and other financial derivatives. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds and fixed deposits to provide capital protection, liquidity and income.

The core UK and US government bond portfolios, which constitute 79% of the funds under management, currently yield an historically low 0.32% (GBP) and 0.19% (USD) per annum gross to maturity and have short average durations of 0.3 and 0.3 years respectively. These short-dated bonds are held for security and liquidity, but currently disappointingly produce negligible income.

The Funds' equity index derivatives exposure generated reasonable net gains during the quarter on the back of a strong equity market, but was constrained by tight hedges against losses after the strong start to the year. At the quarter end, the derivatives exposure comprised gross equity index positions equivalent to 100% of the funds under management. This exposure is well hedged by option collars limiting any losses in the Funds to a total of 2.6%.

The Funds generated steady positive returns for the quarter and are well positioned to continue to produce positive annual returns in excess of inflation, with limited downside risk.

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 continued its good run with a gain of 5.92% in the first quarter, as markets generally have made a very strong start to the year.

The majority of our equity holdings made positive contributions this quarter with a number rising more than 10%. We have continued to add to our positions in favoured individual stocks and sectors including insurance, where the risks are not that highly correlated to the general economic cycle and strong earnings are supporting generous dividend yields.

Having built a portfolio of attractively valued bonds in recent years, the focus is now on finding opportunities to switch from bonds where the prices have risen into more attractive higher yielding bonds, without taking excessive additional risk.

The property sector had not really been attracting much attention compared to equities and bonds recently and we think it is quite possible that investors will at some point come to recognise the benefits of holding income producing tangible assets that provide a long-term inflation hedge and recently we have begun increasing our property exposure.

The outlook for UK interest rates

UK interest rates are at an all-time low in an attempt to stimulate economic growth. These low interest rates, coupled with contracting bond spreads, have had the effect of driving returns in the bond and equity markets as investors hungry for yield have pushed prices ever higher.

The economic outlook in the UK is currently so gloomy that the futures markets are only forecasting the bank rate to rise by 0.25% from its current level of 0.50% per annum early in 2016. With negative growth of -0.30% for the 4th quarter of 2012 and the outlook for the 1st quarter of this year not looking promising, it is possible that the UK may fall back into recession for the third time in recent years. With economic activity very fragile and limited, it is likely that the Bank of England may opt for more quantitative easing to inject more liquidity into the banking system.

Although the Bank of England are sticking with their 2% annual inflation target, they have signalled that growth needs to be boosted. It is, therefore, likely that they will not be too concerned with rising inflation, which currently stands at 2.8% per annum, and that this will have little impact on the outlook for short-term interest rates. There is even a possibility that rates could be reduced further down to 0.25% per annum or even zero, to try and stimulate the economy. This would most likely have the effect of weakening Sterling on the foreign exchange markets, further fuelling inflation.

This is a very difficult time for investors as low interest rates and higher inflation lead to negative real returns, eroding the real value of their capital. The anticipated prolonged period of low interest rates, however, bodes well for our Managed Portfolio Fund with its well-diversified portfolio of higher yielding corporate bonds and equities, but makes it more challenging for our Absolute Return Funds with their core of low-yielding government bonds and fixed deposits.

Restatement of benchmark for the Absolute Return Funds

The dual 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 3.0 to 3.5% per annum for Sterling and US Dollars.

With central banks more focused on stimulating growth by keeping interest rates low and less concerned about inflation, it is more appropriate to measure the performance of the Absolute Return Funds against the more demanding target of current inflation plus a margin. Accordingly, we shall in future measure their performance against the consumer price index (year-on-year) plus a margin of 2.0% which, with inflation running at 2.6% and 2.0% in the UK and US respectively, equates to target net annual returns of 4.6% and 4.0% for the Sterling and US Dollar Funds.

We aim to meet the other objective of capital protection by investing the core of the funds under management (ie in excess of 90%) in short-dated UK and US government bonds and cash deposits for security and liquidity. Furthermore, the downside risk of the derivatives exposure to US equity market indices is hedged by buying protective puts so that aggregate losses are limited to less than 5% of the funds under management.

Wealth Management and our partners

Although Heritage Capital Management itself specialises in investment management, a number of our clients also use us as the focal point for their overall wealth management, dealing with the creation and management of tax efficient structures such as pensions, offshore trusts and companies and other aspects of their overall financial planning. This inevitably involves input from our established professional partners, including HFL in Guernsey specialising in offshore structuring and Carlton Asset Management in Surrey who are able to provide a comprehensive financial planning service. As a reminder we remain available, together with our trusted partners to help clients with their overall wealth management, so please do not hesitate to contact us should you feel that you may benefit from a more comprehensive financial review.

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%	8.0%	4.9%	2.5%
Balanced	25%	75%	6.0%	11.4%	5.4%	2.7%
Growth	0%	100%	7.0%	14.9%	5.9%	3.3%
Benchmarks:						
3 month interest rate				0.3%	2.7%	0.0%
TR Global Equity Index				14.7%	4.3%	9.4%

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