Heritage

Quarterly Newsletter & Investment Review

Issue 62 Quarterly news & investment review from Heritage Quarter 2 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 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 200.69, and we remain fully committed to this tried and tested approach.

Heritage Capital Management Limited

Review for the quarter ended 30th June 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	Q2 2013	2012	2011	2010	2009	2008
TR Global ($)	5.99%	13.16%	-5.01%	12.47%	30.57%	30.57%
TR UK	10.80%	11.96%	-1.56%	13.05%	27.89%	27.89%
TR US	10.96%	16.04%	2.09%	15.08%	26.47%	26.47%
TR Europe	3.04%	20.86%	-5.93%	8.15%	29.97%	29.97%
TR Japan	21.76%	17.87%	-15.65%	-1.46%	21.05%	21.05%

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		

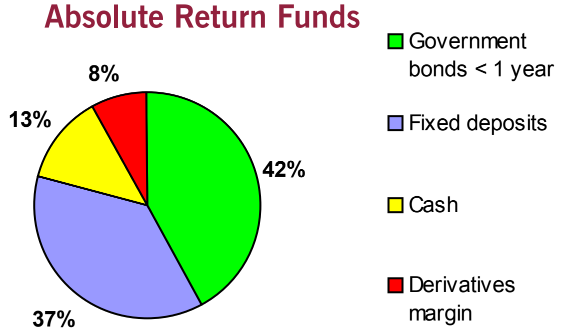
Source: Thomson Reuters

Heritage Investment Fund Limited

Review for the quarter ended 30th June 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 over bank deposit rate	+4%		+6-7%		
Price at 31 March 2012	£158.36	US$130.79	£200.69		
Return for quarter & 2013 return ytd	2.04%	1.25%	5.92%	0.06%	13.31%
	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%
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



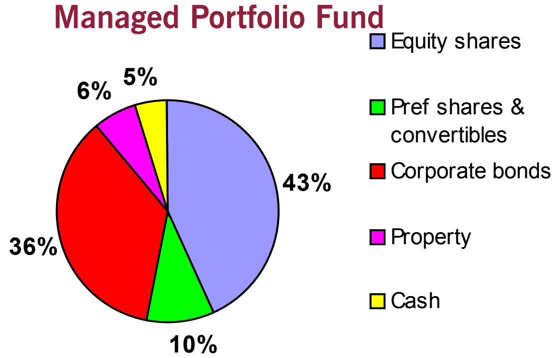
The Absolute Return Funds aim to protect investors capital and generate modest annual returns in excess of inflation by following a macro investment strategy using equity index and other financial derivatives. As these positions require limited margin outlay, most of the funds are invested in short-dated 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 diversification benefits fo the Heritage Investment Funds

Heritage manages two distinct classes of investment funds, each with different return objectives and risk profiles – the Absolute Return Funds (£ and US$) and the Managed Portfolio Fund (£).

The Absolute Return Funds have the following attributes:

- the primary objective is the preservation of investors' capital and its modest enhancement ahead of inflation, in order to preserve its value in real terms.
- they aim to achieve this objective over a 12 month period
- decisions are based on top-down macro economic fundamentals
- Core investments are restricted to liquid, investment grade fixed income securities only
- they use derivatives to obtain equity and bond market exposure, and can take both long and short positions
- their core bond portfolios are diversified, but derivatives positions are concentrated on equity and bond market indices
- derivatives positions are primarily in the US market for liquidity and transparency
- downside risk is always hedged, with losses limited to a maximum of 5%, which restricts upside gains
- any foreign currency exposure is normally hedged back into the denominated currency of the Fund

The Managed Portfolio Fund has the following attributes:

- its primary objective is to target the long-term returns associated with equity investment, but with lower risk
- it also invests in fixed income securities including investment grade, high yield and convertible bonds as well as property related investments
- it has a longer time horizon of up to 5 years
- decisions are based on bottom-up, value-based security analysis
- it does not use derivatives or take short positions
- it holds a very well diversified spread of individual equities and bonds as well as some specialist investment trusts
- individual securities are primarily listed in the UK or issued by UK companies
- potential downside losses are not hedged
- any foreign currency exposure is not normally hedged

Investors can cater for their own personal return/risk preferences by combining different percentages invested in each of the Absolute Return and Managed Portfolio Funds. The model asset allocation table below gives an indication of the target and actual returns that can be achieved by varying the percentages invested in each type of Fund. We would be happy to assist investors in determining their optimal asset allocation between our Funds using our proprietary asset allocation model.

Zero dividened preference shares - Update on Taxation

Until recently, there had been concerns that Zero Dividend Preference shares issued by investment trusts would be caught up in the HMRC's new rules that seek to charge income tax on disguised interest with effect from 6 April 2013. However, following lobbying by the Association of Investment Companies (AIC), changes have been made in the final version of the Finance Bill to exclude certain shares listed on a regulated market from the disguised interest provisions. The effect of these changes is that existing EU listed ZDPs should be grandfathered and new ZDPs issued after that date should be excluded, so long as the holder is genuinely exposed to investment risk, and the return is essentially not guaranteed.

We had always felt that existing ZDPs should not have been affected, but at one stage there appeared to be a significant possibility that future ZDP issuance would be impacted. This outcome is good news for investors in ZDPs as their returns should continue to be assessed under Capital Gains Tax (28% for a higher rate taxpayer plus £10,900 annual exemption) versus a top rate of income tax of 45%.

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 (total return)				14.7%	4.3%	9.4%

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