Heritage

Quarterly Newsletter & Investment Review

Issue 63 Quarterly news & investment review from Heritage Quarter 3 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 Conduct Authority, providing a wide range of investment services to individuals, trusts, companies and pension funds.

Contacts - directors

Graeme Olsen
Graeme is responsible for client portfolios and advising the Heritage Managed Portfolio Fund.
graeme@heritage-capital.co.uk

Roy Glew
Roy is responsible for advising the Heritage Absolute Return Funds.
roy@heritage-capital.co.uk

www. heritage-capital.co.uk
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
Broadway House, Tothill Street,
London SW1H 9NQ

Relief rally pushes markets higher

Markets generally had a good third quarter, as investors were relieved that the much anticipated "tapering" of the US Federal Reserve Bank stimulus that derailed markets earlier this year has been delayed for now.

We are pleased to report that the Heritage Funds have also enjoyed a good quarter and that our Managed Portfolio Fund in particular is now well up for the year-to-date. Further details on our funds can be found as usual on page 3.

Why the UK is a good home for global investors

A question that we are often asked is "what percentage of your equity exposure is in the UK and how much is international?". Although this sounds like quite a simple question the answer is actually a little bit more complicated.

This is due to the fact that London has firmly established itself as the world's foremost major international financial hub. In fact a recent global survey once again confirmed that it ranks above rivals including New York, Hong Kong, Tokyo, Frankfurt and Singapore. The reasons for this are partly historical (as an open, developed market with good corporate governance and a strong legal and regulatory framework), and partly geographical (sitting in the European time zone, whilst straddling the US and the fast growing markets of the Far East). It also helps that English is the main international business language.

London is therefore not just a home for domestic UK companies, but is seen as an ideal base for a wide range of global multinational groups and an interesting analysis of the total turnover of all UK listed companies reveals the following breakdown ;

Emerging Markets	- 32%
UK	- 31%
Europe ex-UK	- 17%
USA	- 17%
Other	- 3%

Some good examples of global companies listed in London include ;
Unilever - with a portfolio of over 400 consumer goods brands including Wall's and Ben & Jerry's ice-creams, Dove soap and Lipton tea, emerging markets now generate over half of all its earnings.
HSBC – The biggest UK listed company is probably also the strongest global banking brand.
Diageo – Originally known as Guinness, the world's leading premium drinks business now owns the number one brands in vodka (Smirnoff), whisky (Johnny Walker) and liqueur (Baileys).
Resources companies – although the UK itself is not particularly rich in natural resources, it is home to a number of mining and oil giants such as BHP Billiton, Glencore Xstrata, Rio Tinto, BP and Royal Dutch Shell.

Overall, the establishment of London as an attractive domicile for global businesses has resulted in the UK stock market providing perhaps the best range of investment options for international investors, which is why it plays such a major role in our investment activities here at Heritage.

Heritage Capital Management Limited

Review for the quarter ended 30th September 2013

Market Commentary

After a mid year wobble markets have resumed their upward progress with a solid third quarter, with relief that the stimulus provided by central banks will not be taken away prematurely being the main driver.

As the actions of central banks continues to dominate markets it is worth recapping on what has been happening. In the US, the Federal Reserve Bank has been providing a massive stimulus by keeping interest rates at virtually zero since the global financial crisis began in 2008, as well as maintaining a quantitative easing programme whereby it currently buys $85bn of bonds every month. Recognising that the eventual transition back to normality could be problematical after spooking the markets at its mere mention in May, the Fed has now started to issue more detailed thoughts on the path of interest rates and how QE will be tapered. In the UK the new Governor of the Bank of England, Mark Carney, has also made it clear that his big new idea is "forward guidance" and that rates should stay lower for longer.

However, the problem with trying to provide too much clarity is that it could undermine the central banks' credibility, particularly when they introduce factors into the equation such as unemployment that they have little control over or even the ability to forecast with any accuracy.

United Kingdom

Although the UK market has slightly lagged the other major markets this quarter, it has still produced a strong double digit return for the year-to-date and the recent strength of the pound has been an added boost for international investors.

The biggest corporate news this quarter was the announcement that Vodafone is to sell its 45% stake in Verizon Wireless of the US to Verizon Communications in a deal worth $130bn. This makes it the second most valuable M&A deal on record – the biggest also involved Vodafone when it took over Mannesmann of Germany in 1999. Also noteworthy this quarter was the Lloyds Bank share price returning to the level at which the government bailed it out, prompting the de-nationalisation process to begin.

There was more good news for the UK's Chancellor of the Exchequer, George Osborne, who had until recently been much maligned for sticking to his austerity programme, as he appears to have now won the political debate, thanks to the recent encouraging return to growth of the UK economy. However, it is early days for the recovery and a measure of caution is still required.

United States

The US market has continued its excellent year with the S&P 500 index touching record highs above 1,700 as the economy continues to show encouraging signs of sustainable growth. However, whilst it might seem a bit perverse, if economic growth becomes too robust it will not necessarily be good news for markets, due to the associated fear of faster tapering of quantitative easing and rising interest rates.

In addition to Verizon buying out Vodafone as mentioned above, a further show of American corporate strength was Microsoft's recent purchase of the mobile phone unit of the once mighty Nokia of Finland.

Europe

Unusually in recent times, Europe was actually the best performing major market this quarter.

Although the ongoing antics of the Italian politicians provides an interesting sideshow, the bigger news this quarter was the emphatic re-election of the Eurozone's most important politician, Angela Merkel in Germany, as this at least provides a certain level of stability where the continent's real economic power lies.

Japan

After a decent third quarter, Japan is the best performing major market for the year-to-date, led by the exporters who appear to have been the initial major beneficiaries of "Abenomics" and a weaker Yen, together with the banks which remain highly geared to any domestic recovery.

Emerging markets

In contrast to the major developed markets which have all been enjoying a decent year, emerging markets are still in negative territory and for international investors the losses have been exacerbated by weakening local currencies.

Investment Statistics - 30/9/2013

Equity Markets	Q3 2013	2013 ytd	2012	2011	2010	2009
TR Global ($)	7.44%	13.94%	13.16%	-5.01%	12.47%	30.57%
TR UK	5.68%	15.30%	11.96%	-1.56%	13.05%	27.89%
TR US	6.10%	20.93%	16.04%	2.09%	15.08%	26.47%
TR Europe	13.54%	16.96%	20.86%	-5.93%	8.15%	29.97%
TR Japan	6.12%	41.15%	17.87%	-15.65%	-1.46%	21.05%

Total returns - including dividends

Other	UK	US	Europe	Japan
PE Ratio	13	17	15	20
Dividend Yield	4.1%	2.4%	3.8%	1.5%
Interest rates - base	0.50%	0.00-0.25%	0.50%	0.10%
Bond Yields - govt. 10 year	2.72%	2.62%	1.78%	0.69%
Exchange rates (vs GBP)	-	1.6186	1.1966	158.94
Exchange rates (vs USD)	1.6186	-	1.3526	98.21
Gold ($ per ozs)		1328		

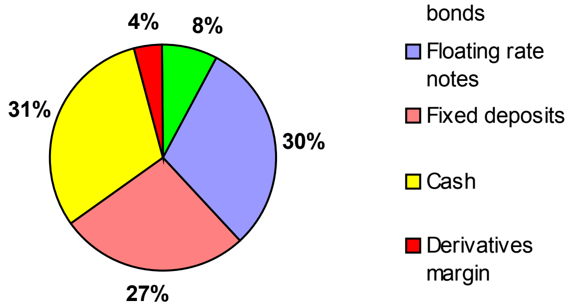
Source: Thomson Reuters

Heritage Investment Fund Limited

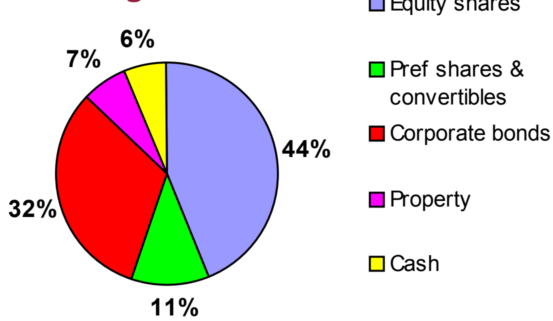
Review for the quarter ended 30th September 2013

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 30 September 2013	£159.20	US$131.33	£206.47		
Return for quarter (net)	0.86%	0.96%	3.35%	0.06%	0.92%
Year 2013 return year to date (net)	2.58%	1.67%	8.97%	0.19%	14.41%
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)	3.90%	2.08%	5.90%	2.62%	4.22%
Annual volatility	2.6%	2.5%	5.2%	0.0%	10.8%
Size of Fund (millions)	£14.1	U$10.9	£96.3		

Absolute Return Funds



Managed Portfolio Fund



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, floating rate notes and fixed deposits to provide capital protection, liquidity and income.

The core UK and US bonds and fixed deposits, which constitute 65% of the funds under management, currently yield an historically low 0.53% (GBP) and 0.33% (USD) per annum gross to maturity and have short average durations of 0.7 and 1.2 years respectively. Long government bond yields continued to rise during the quarter, but reversed this trend when the expected tapering in the US quantitative easing programme was postponed last month.

The Funds' US equity index and Treasury bond derivatives collars made modest gains for the quarter on the back of a rising equity market and bond yields, but were constrained by significant volatility in the second half. This derivatives exposure is well hedged by protective puts limiting any losses in the Funds to a total of -1.1%.

The Funds produced modest gains for the quarter in excess of inflation, with limited downside risk.

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 third quarter, with a gain of 3.35% and for the year-to-date the Fund is now up by 8.97%.

The recent strong rally by global markets has benefitted our overall share portfolio with small cap stocks doing particularly well. In fact 8 of our smaller company holdings enjoyed share price rises of over 10% this quarter, whilst our larger companies generally lagged behind.

Corporate bonds had a reasonable quarter and with a yield of around 7% our portfolio of bonds continues to generate a healthy level of income for the Fund.

Our property investments also had another good quarter as sentiment towards the property market continues to show a marked improvement so far this year.

Overall we believe that our portfolio of well diversified investments remains well positioned to protect the real value of capital as well as generating decent returns for long-term investors.

Is the bull market in bonds over?

It appears that we are at the end of one of the greatest bull markets in bonds, in which we have had 32 years of declining yields. Government and investment-grade corporate bond yields have declined from their peak in the hyper-inflationary period of the early 1980's and appear to have passed their low point. In 1981, the yield on US 10 year government bonds was 15.8% per annum and this fell to a low of 1.4% in July 2012. The 10 year yield has since backed up and is currently 2.6% per annum.

The US Federal Reserve has distorted the fixed income market with their quantitative easing programme, which has kept long-term interest rates artificially low by purchasing bonds to keep their prices artificially high. Last quarter, they announced that they are considering winding down their bond buying programme, now that unemployment is falling and the housing market is rebounding. The timing of this tapering of quantitative easing is uncertain, but will be a critical event for the bond markets and could commence later this year or early in 2014. Without government support, bonds will trade more on their own fundamental merits, and yields will likely move up. It looks like we could be in for a period of sub-par returns for bonds, where the risks outweigh the potential rewards.

It is advisable to consider reducing your exposure to long-term government and investment-grade corporate bonds by moving into shorter maturities. The longer the average maturity (ie duration) of your bond portfolio, the more sensitive it will be to rising yields. In our Absolute Return Funds, for some time now (perhaps prematurely) we have restricted our core government bond holdings to shorter maturities. We have also recently added floating rate notes, were the interest rate is reset every 3 months to a margin over LIBOR.

However, you should not abandon bonds completely as they provide a better return than many money market funds. Bonds also provide useful diversification in an investment portfolio as their prices tend to move inversely to equities and reduce volatility. High-yield bonds, which are held by our Managed Portfolio Fund, are less affected by changes in interest rates and are more dependent on the profitability of the issuing company and this Fund also holds a number of floating rate notes and bonds that will switch from a fixed rate to a floating rate if not called at a future date.

Of course, a run of weak economic date or an unforeseen crisis, like major military conflict or a return of the European debt crisis, could cause a flight to quality into bonds as they are perceived as a haven in troubled times.

Overall, the likely end to the bond bull market does not mean that all bonds should be avoided but a it does highlight the need for a combination of caution and specialist management.

London listed specialist funds

On page 1 of this newsletter we highlighted the attractions of the UK stockmarket for international investors and apart from multinational operating companies with global exposure, the London Stock Exchange is also home to a number of specialist listed funds. These investment trusts, as they are known, allow investors to obtain exposure to areas of the market that require a particular expertise, with the benefit of the liquidity and transparency of a listed company.

A good example is a trust that we hold in the Heritage Managed Portfolio Fund called the Worldwide Healthcare Trust. As the name implies it invests in the healthcare sector on a global basis and the trust's holdings can be broken down into a number of sub-sectors including pharmaceuticals, biotechnology, generics, medical devices and other healthcare related services. Clearly this requires very specialist knowledge and the managers of the trust, OrbiMed, have a team of over 30 experienced professionals with expertise in science, medicine, finance and law and a number of them also sit on the boards of investee companies.

Since the trust was formed in 1995 the investment returns have been excellent and £100 invested at launch would be worth over £1,000 today, significantly ahead of the general market and the sector benchmark.

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%	6.7%	4.9%	3.4%
Balanced	25%	75%	6.0%	9.6%	5.4%	4.3%
Growth	0%	100%	7.0%	12.4%	5.9%	5.2%
Benchmarks:						
3 month interest rate				0.3%	2.6%	0.0%
TR Global Equity Index (total return)				15.8%	4.2%	10.8%

Heritage Capital Management Limited
Broadway House, Tothill Street, London SW1H 9NQ
Tel: +44 (0) 20 7799 2110 Fax: +44 (0) 20 7222 1599
General email: info@heritage-capital.co.uk
Website www.heritage-capital.co.uk