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 Conduct Authority, providing a wide range of investment services to individuals, trusts, companies and pension funds.

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A good year for investors

2013 turned out to be a very good year overall for investors, with the major equity markets enjoying their best returns for a number of years as interest rates remained supportively low.

We are pleased to report that the Heritage Funds have also enjoyed a good year and that the 13.85% return generated by our Managed Portfolio Fund has helped to push it above the £100 million mark. Further details on our funds can be found as usual on page 3.

Target returns for 2014

To the surprise of many investors, 2013 turned out to be a spectacular year for equity markets with US and UK large cap stocks up by 29% and 14% respectively. The announcements by the US Federal Reserve about the proposed and actual tapering of monthly bond purchases failed to suppress equity markets as they were supported by confirmation that short-term interest rates will remain at historically low levels until economic growth is well established and unemployment levels have fallen significantly. However, 10 year bond yields rose significantly in the US during the year on the tapering announcements from 1.76% to 3.03%, and in the UK from 1.84% to 3.03%, resulting in significant losses on long-dated government bonds. Short interest rate futures are currently forecasting that short-term rates could rise by 0.50% to 1.00% in the UK, and by 0.25% to 0.50% in the US, by the end of 2014.

Our Sterling and US Dollar Absolute Return Funds will continue to focus on capital preservation and target net annual returns of 3% over inflation rates. The Funds will seek to achieve this by investing in a balanced portfolio of exchange traded funds which track developed equity market and investment grade bond market indices, using a top-down asset allocation approach. The downside risk will be managed using derivatives to limit annual losses to no more than 5%, although this cannot be guaranteed. Based on anticipated UK and US inflation rates during the year of around 2%, our target net annual returns after fees and expenses are expected to be in the order of 5% for our Sterling and US Dollar Absolute Return Funds.

Corporate earnings are expected to continue to grow in 2014 as the global economy recovers. The continuing expectation of low interest rates should be positive for equity markets, but rising long-term yields will prove a challenge for bonds. 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 further upside in equity markets and tightening of corporate bond spreads as global economies recover, whilst being well positioned to weather any market weakness on earnings disappointments.

Based on an expected average risk-free rate of around 0.75% plus a 5 to 6% risk premium, we believe that 6 to7% 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 2013

Market Commentary

With a strong final quarter, 2013 has turned out to be a vintage year for most equity investors. However, it is worth noting that due to the fact that the rise in share prices has outpaced the increase in corporate profits, valuations have become quite extended. This can be seen from the PE (price to earnings) ratios which have increased from an average of around 14 across the major markets a year ago to the current level of around 18.

Nevertheless, despite valuation concerns there are good reasons why share prices might continue to push higher for a while yet. A PE ratio of 18 may look expensive but when you consider that this implies an earnings yield of over 5%, shares still looks relatively good value compared to the alternatives with cash interest rates below 1% and bond yields of around 3%, even before you consider the potential for future earnings growth from shares.

Furthermore, once markets gain momentum they tend to overshoot on both the up and the down side and the past has shown that PE ratios can become extended for long periods before reverting to the mean.

Overall, whilst we need to remain grounded by our valuation yardsticks, it is also important to realise that in reality other factors play an important role in determining overall market movements.

United Kingdom

The UK market had a very good year with the FTSE 100 index closing up over 14% at around 6,750, which is within touching distance of its previous peaks reached at the turn of the century and again in 2007.

The current bull market has been broadly based with most sectors as well as small and mid caps enjoying a good year, although the one major blot on the landscape has been the resources sector which accounted for 8 out of the 10 worst performing shares in FTSE 100 index.

In November the OECD upgraded its forecasts for UK economic growth, at the same time as it tempered its forecasts for global growth. The improving strength of the UK economy has come as a major surprise to most commentators and talk has now turned to the risks associated with a possible housing bubble, which shows just how much domestically focussed sentiment has improved.

United States

The US market rounded off its best year since 1997 with the S&P 500 index closing up 29% at an all time high of 1,848.

Some of the biggest winners this year have been tech stocks with Google, Amazon, Adobe and Hewlett-Packard all up over 50% and Yahoo up over 100%. This helped the tech heavy Nasdaq index to rise over 30% in 2013, although interestingly it still remains well below the peak that it reached at the height of the technology bubble in 2000.

With markets still fixated on the monetary policy of central banks and in particular possible further tapering of bond purchases in the US, the focus in 2014 will now be squarely on Janet Yellen, who is due to become the US Federal Reserve Bank's first female chairman in February.

Europe

It has also been a good year for European stock markets and following the Cyprus debacle early in 2013 it was encouraging that there were no further crises. In fact there was finally some good news in December when Ireland was able to successfully exit its bailout.

Japan

In local currency terms Japan was comfortably the best performer in 2013 with the Nikkei 225 index up a massive 55%. Although the radical "Abenomics" reforms certainly appear to be working wonders domestically, returns for international investors have been tempered somewhat by the 20% depreciation of the Japanese Yen this year.

Emerging markets

Given all the positive action in the major developed markets in 2013 it was perhaps surprising that emerging markets, which are often seen as a geared play on major markets, not only underperformed but actually made losses, with the FTSE emerging index down 7%, with lower growth expectations and weakening currencies providing headwinds for investors.

Investment Statistics - 31/12/2013

Equity Markets	Q4 2013	2013	2012	2011	2010	2009
TR Global ($)	7.17%	22.10%	13.16%	-5.01%	12.47%	30.57%
TR UK	5.57%	21.73%	11.96%	-1.56%	13.05%	27.89%
TR US	10.15%	33.21%	16.04%	2.09%	15.08%	26.47%
TR Europe	7.71%	25.97%	20.86%	-5.93%	8.15%	29.97%
TR Japan	9.09%	53.98%	17.87%	-15.65%	-1.46%	21.05%

Total returns - including dividends

Other	UK	US	Europe	Japan
PE Ratio	12	19	15	21
Dividend Yield	3.9%	2.3%	3.3%	1.4%
Interest rates - base	0.50%	0.00-0.25%	0.25%	0.10%
Bond Yields - govt. 10 year	3.03%	3.03%	1.94%	0.74%
Exchange rates (vs GBP)	-	1.6556	1.2043	174.31
Exchange rates (vs USD)	1.6556	-	1.3745	105.30
Gold ($ per ozs)		1205		

Source: Thomson Reuters

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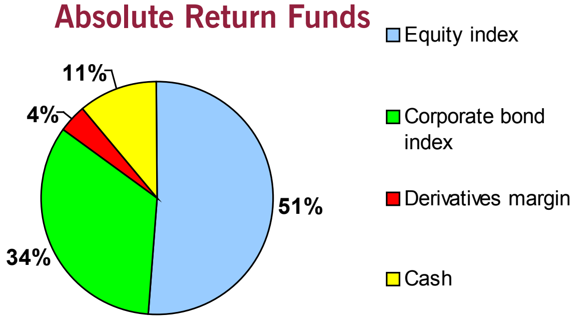
Heritage Investment Fund Limited

Review for the quarter ended 31st December 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 net annual return	Inflation +3% (ie 5%)		+6-7%		
Price at 31 December 2013	£162.45	US$134.31	£215.72		
Return for quarter (net)	2.04%	2.27%	4.48%	0.02%	4.76%
Year 2013 return (net)	4.67%	3.98%	13.85%	0.25%	19.85%
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)	3.98%	2.22%	6.14%	2.57%	4.51%
Annual volatility	2.0%	2.1%	5.8%	0.0%	11.4%
Size of Fund (millions)	£14.8	U$7.6	£106.6		

Absolute Return Funds



The Absolute Return Funds aim to protect investors capital and generate annual returns significantly in excess of inflation by following a top-down asset allocation strategy investing in a balanced portfolio of liquid exchange traded funds which track developed equity market and investment grade bond indices, with the risk of significant losses being hedged using derivatives.

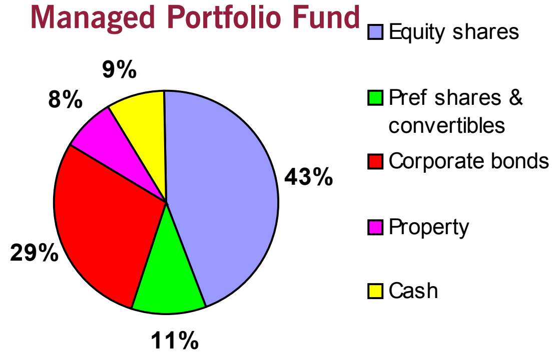
The core equity index funds which track the S&P 500 largest US companies gained 2.90% during the quarter. Developed equity markets continued their bull run supported by confirmation that central bank short-term interest rates will remain low.

The core UK and US corporate bond index funds lost -0.24% and -0.01% respectively for the quarter. The bond funds currently yield 2.7% (GBP) and 1.9% (USD) per annum gross to maturity and have average durations of 3.5 and 3.2 years respectively. Government bond yields rose during the quarter, but corporate bond spreads continued to contract.

The derivatives positions, hedging against falls in equity indices and government bonds in excess of -5% of funds under management, cost the Funds -0.53% for the quarter.

The Funds produced steady gains for the quarter, with limited downside risk of -5%, and their calendar year net returns are well in excess of inflation of approximately 2% per annum.

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 final quarter, with a gain of 4.48% helping to take the fund size above £100 million and produce a full year return of 13.85%.

Our share portfolio has continued to benefit from the strong run that global equities enjoyed this year and the majority of our holdings were up this quarter. Overall this year the best performers have tended to be small and mid cap stocks.

Our bonds have also continued to perform well, helped by our preference for higher yielding corporate bonds and convertibles over government debt.

The commercial property market has been showing signs of improvement and our property investments have benefiited from a combination of rising net asset values and a narrowing of discounts to NAV.

Overall, although valuations are no longer as compelling as they were, we believe that our portfolio of well diversified investments remains well positioned to generate decent returns for long-term investors.

This report is not an invitation to subscribe for shares in the Heritage Investment Funds and is for the information of investors only. Investors should be aware that past investment performance is not a guide to future performance, and that the value of investments may fall as well as rise. An investor may get back less than the original amount invested.

Target returns and savings versus investment explained

On page 1 of this newsletter we attempt to provide some guidance on target investment returns. However, it is important to realise that these figures are not really predictions for the year ahead and rather seek to provide an indication as to what can reasonably be expected on average for the various asset classes within the context of current market conditions.

It is this inherent uncertainty as to the expected returns which differentiates investing from saving. With a cash based savings product you generally know exactly what your return will be, whilst with investment you give up the certainty of low short term returns in order to have a chance of achieving higher returns over the longer run.

The actual historic returns of the Heritage Managed Portfolio Fund actually demonstrate this principle quite neatly. By taking on a sensible level of risk the fund has achieved a net average annual return of just over 6%, which is well above cash deposit rates. However, it is interesting to note that over the 13 individual calendar years since the inception of the fund, not once has the actual annual return fallen within the 3%-10% range around this average. In fact broadly speaking, the 6% average has been made up of 2 negative years, 3 flattish years and 8 double digit positive years.

So whilst the historic returns lend support to the 6% average target return that we suggest for long-term planning purposes, it also shows that this is actually a terrible guide over shorter periods and virtually useless if used as a prediction for the year ahead – which is precisely why we tend to avoid making short term predictions ourselves and are generally sceptical of those who do.

In conclusion then, whilst we have no real confidence as to what the returns for the Managed Portfolio Fund for the year ahead will be, experience tells us that by taking on a certain amount of sensible risk, the returns from longer term investment are likely to provide a superior result to the certainty of the rates offered by savings products. Furthermore, with base rates currently at historically low levels, the case for considering a cautious investment plan as an alternative to maintaining purely cash savings becomes quite compelling.

Widening of the investment parameters of the Absolute Return Funds

The Absolute Return Funds have, up to now, been restricted to investing their core funds (over 90%) in short-dated investment grade bonds. Since the credit crisis of 2008, bond yields have fallen to historically low levels and this limitation has restricted the Funds to earning around 0.5% per annum on the bulk of their funds, with almost all of the return being generated by taking hedged derivatives positions in equity index and bond futures using margin funds of less than 10% of the funds managed.

Permission has now been granted by the Guernsey regulatory authorities for the Funds to significantly widen their investment parameters and to invest in any equity or fixed income securities. The conservative investment objectives of the Funds will, however, not change and they will continue to focus on the protection of investors' capital and its enhancement ahead of inflation. The Funds will, in future, invest their core funds directly in exchange traded funds which track developed equity market and investment grade bond market indices, using a top-down asset allocation approach. These exchange traded funds are listed on the London Stock Exchange, and are liquid and transparent.

The Funds will target a higher return than previously and, for this reason, will not be as tightly hedged as in the past as this has limited the upside performance. The monthly returns of the Funds will, accordingly, be more volatile, but this should result in improved performance in the longer term.

The downside risk will continue to be managed using futures and options to limit annual losses to no more than 5%. However, investors should be aware that hedging is not an exact science and it is possible that annual losses may exceed this target percentage.

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	75%	25%	5.0%	6.9%	4.5%	2.6%
Balanced	50%	50%	6.0%	9.1%	5.1%	3.5%
Growth	0%	100%	7.0%	13.6%	6.1%	5.8%
Benchmarks:						
3 month interest rate				0.3%	2.6%	0.0%
TR Global Equity Index (total return)				19.9%	4.5%	11.4%

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