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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Some good news despite a lacklustre start

After an excellent run last year, markets have found the going a bit tougher so far in 2014, just about creeping back into positive territory after a very weak start.

However, despite this uninspiring start to the year for markets generally, we do have some good news to report. Firstly, the Heritage Funds have had a positive first quarter (further details on our funds can be found as usual on page 3) and secondly, the surprise announcements in the recent Budget that have some far reaching and positive implications for pension and ISA investors (which are outlined further on page 4).

Value investing rewards the brave and the patient

Most Heritage clients will be familiar with the fact that we adopt a value based investment approach and how this has helped the Heritage Managed Portfolio Fund to significantly outperform the overall market over the long term.

Furthermore, various studies of investment returns have also shown that value stocks do outperform growth stocks in the long run and so inevitably this raises questions as to why this is and how it is possible for a value based approach such as ours to continue to work.

One theory that is popular with academics is that value investing should produce superior returns as cheap companies are generally lowly valued due to the fact that they are generally of poorer quality and face higher risks. In an efficient market you would therefore expect that these shares should produce higher returns as the reward for taking on the higher risk. This value strategy is therefore one for brave investors who buy shares when they are out of favour and might also consider themselves to be contrarians.

A second theory is based on the study of behavioural finance, which suggests that humans have a natural tendency to go for stocks with an exciting growth story attached to them and overlook more boring companies that plod along year after year, producing more predictable profits and dividends. The implication is that due to this bias, markets are not efficient as most investors systematically overvalue growth stocks, which allows the patient value investor to benefit from this effect over the long term.

The drawbacks to these two theories when put into practice and used in isolation, is that the brave approach produces quite volatile returns and can suffer badly when overall markets turn negative, whilst the patient approach can underperform for long periods in strong bull markets. Fortunately, as pointed out in a recent study, the net result is that the two approaches can be highly complimentary and when used together can help to produce superior long-term returns whilst also reducing the overall risk and volatility to a level that most investors find acceptable.

We believe that the combined value approach that we adopt at Heritage is an example of one of the keys that has enabled us to produce favourable returns, with a lower risk when compared to the overall market and should continue to stand us in good stead well into the future.

Heritage Capital Management Limited

Review for the quarter ended 31st March 2014

Market Commentary

Although markets ended the first quarter of 2014 virtually flat this does not tell the full story. In January the major indices all fell quite sharply before staging a good recovery as an encouraging "earnings season" (where companies report their annual results in February and early March) provided a welcome boost, allowing the World Index to creep back into positive territory by the quarter end.

Also, within the overall market there has been divergence at the sector level as technology and biotech stocks, which were among the biggest winners last year, bucked the market by starting 2014 strongly. However, more recently there have been signs that some of the froth is being taken out of these overheated sectors as they have subsequently suffered quite a sharp pullback and it was interesting to see that King Digital, the maker of the latest fad in mobile gaming, Candy Crush, fell well below its IPO price on its first day of trading in March and is currently down by around 20%.

Although King is currently very profitable and is still valued at over $5.7bn, there must be huge doubts over the sustainability of its earnings given its reliance on a single and potentially ephemeral product and as we believe that it is the durability and quality of a companies profits which determines its ultimate value to long-term investors, we would not be surprised to see it and other similar companies trading at much lower levels in future.

United Kingdom

The UK market was unable to fully recover from a weak January and ended the first quarter down by 0.8%.

More encouragingly for the overall health of the UK quoted market there were a number of decent sized IPOs this quarter, including retailers AO World, Pets at Home, boohoo.com and Poundland as well as the insurance company, Brit.

The UK economic recovery that started last year has continued into 2014, with the rising level of activity in the housing market being the major driving force. The key to a more balanced recovery will be an increase in lending to businesses for investment and the decision to refocus the Funding for Lending scheme away from the housing market to concentrate on lending to smaller companies could provide some help in this regard.

United States

Despite a poor month in January the US market has rebounded well, ending the first quarter up 1.95% with the S&P 500 index recently entering record territory.

The US Federal Reserve Bank's first female chairman, Janet Yellen seems to have made a decent start, although the real test will be how well the challenge of restoring monetary policy to normal is managed, as quantitative easing is tapered down and interest rates are finally raised above their historically low levels.

Europe

Europe had the best start to the year of the major markets with a gain of just over 3%, as it enjoys some respite from the crisis that threatened the very future of the Euro itself.

For now at least markets are focussed again on more mundane matters, such as whether the European Central Bank will tweak interest rates and whether the recent appointments of Manuel Valls and Matteo Renzi as France and Italy's new Prime Ministers will have a positive impact on their struggling economies.

Japan

After a stellar performance in 2013 the Japanese market has suffered a sharp setback with a loss of nearly 7% in the first quarter of 2014. Much of the current nervousness of the market is due to the increase of sales tax from 5% to 8% from the 1st of April, with investors still scarred by the bad reaction to the introduction of this tax back in 1997.

Emerging markets

Emerging markets were the laggards last year and 2014 has not got off to a good start either with the recent intervention by Russia in Ukraine and yet another devaluation of its currency by Argentina being the most recent examples of how political uncertainty in emerging markets can adversely impact investor sentiment.

Investment Statistics - 31/03/2014

Equity Markets	Q1 2014	2014	2013	2012	2011	2010
TR Global ($)	1.37%	1.37%	22.10%	13.16%	-5.01%	12.47%
TR UK	-0.80%	-0.80%	21.73%	11.96%	-1.56%	13.05%
TR US	1.95%	1.95%	33.21%	16.04%	2.09%	15.08%
TR Europe	3.11%	3.11%	25.97%	20.86%	-5.93%	8.15%
TR Japan	-6.67%	-6.67%	53.98%	17.87%	-15.65%	-1.46%

Total returns - including dividends

Other	UK	US	Europe	Japan
PE Ratio	12	18	14	14
Dividend Yield	3.8%	2.3%	3.3%	1.8%
Interest rates - base	0.50%	0.00-0.25%	0.25%	0.10%
Bond Yields - govt. 10 year	2.74%	2.72%	1.57%	0.65%
Exchange rates (vs GBP)	-	1.6662	1.2098	171.92
Exchange rates (vs USD)	1.6662	-	1.3770	103.19
Gold ($ per ozs)		1284		

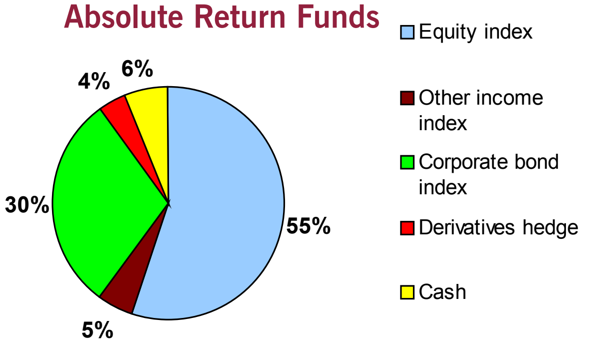
Source: Thomson Reuters

Heritage Investment Fund Limited

Review for the quarter ended 31st March 2014

Performance	Absolute Return Funds		Managed Portfolio Fund	Inflation (UK)	TR Global World Index (£ total return)
Risk profile	Moderate		High /Moderate		
Minimum investment horizon	3 years +		5 years +		
Target net annual return	Inflation plus 2-3% (ie 4-5%)		6-7%		
Price at 31 March 2014	£163.14	US$135.55	£219.76		
Return for quarter & 2014 ytd (net)	0.42%	0.92%	1.87%	0.48%	0.71%
Year 2013 return (net)	4.67%	3.98%	13.85%	2.61%	19.85%
Year 2012 return (net)	1.28%	1.95%	13.27%	2.87%	7.93%
Year 2011 return (net)	-2.22%	-2.28%	0.06%	4.55%	-4.50%
Year 2010 return (net)	2.80%	2.06%	10.78%	3.35%	16.49%
Year 2009 return (net)	4.25%	1.26%	10.32%	2.19%	17.86%
Year 2008 return (net)	-5.81%	-12.95%	-15.66%	4.20%	-18.86%
Compound annual return (from 1/01)	3.94%	2.22%	6.17%	2.39%	4.48%
Annual volatility	2.7%	2.8%	5.8%	0.2%	9.9%
Size of Fund (millions)	£14.0	U$7.9	£108.6		

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.

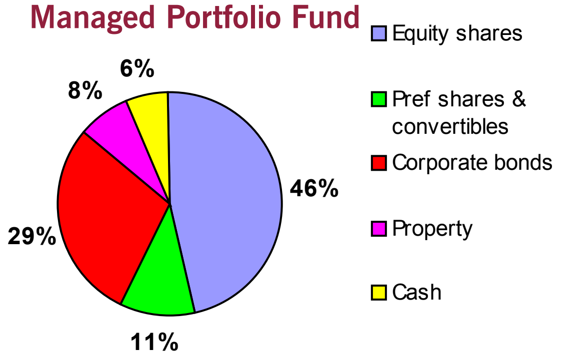
The core equity index funds, which track the S&P 500 largest US companies, contributed 0.70% during the quarter on the back of US equity market gains of 1.28%. The small other index fund position in listed real estate companies contributed 0.08%.

The core UK and US investment-grade corporate bond index funds returned 0.20% and 0.50% respectively for the quarter. The bond funds currently yield 2.6% (GBP) and 1.9% (USD) per annum gross to maturity and have average durations of 3.9 and 3.4 years respectively.

The derivatives positions, hedging against falls in equity indices in excess of -5% of funds under management, cost -0.43% for the quarter.

The Funds produced a modest gain for the quarter, but are well positioned to generate returns in excess of inflation in the medium term, 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 had a good start to the year, avoiding the market losses in January and producing a return of 1.89% in the first quarter compared to a total return of 0.71% for the £ World Index.

Of our equities the best performers this quarter included media, healthcare and transport holdings, whilst the laggards included banks, food retailers and emerging markets.

Our corporate bond portfolio has continued to perform well and although yields on our bonds are no longer as high as they were, the average yield of around 6% is still attractive compared to government bonds and cash, whilst the overall risk is lower than for our share holdings.

Our property investments also had another good quarter, as some of our larger property holdings reported strong growth in their net asset values.

Overall, we believe that our portfolio of well diversified investments remains well positioned to generate decent returns for long-term investors, whilst our relatively defensive positioning should provide some protection against any setbacks.

Low-risk investment strategy of the Absolute Return Fund explained

The low-risk investment approach of the Absolute Funds is based on top-down asset allocation, which is regarded as the most important determinant of investment performance and is based on the principal that different asset classes perform differently in different market and economic conditions.

This diversification reduces the overall risk of the portfolio. The asset allocation of our Absolute Funds includes the traditional assets classes of equities, bonds and cash, but has also been extended to include property and derivatives. The benchmark asset allocation of the Absolute Funds is 50% equities, 40% bonds and 10% cash, but our present target allocations are overweight equities (55%) and property (5%), underweight bonds (30%) with 10% in cash, as interest rates are expected to increase in the future which is negative for bonds.

The Absolute Funds invest in each asset class on a passive basis by investing in exchange traded funds which track broad equity, bond and other market indices, which eliminates the specific risk associated with investing in individual securities. These exchange traded funds are listed on the London Stock Exchange, and are liquid and transparent. The core equity index fund tracks the total return of the S&P 500 equity market index, which is comprised of the top 500 US companies, many of which are amongst the largest global companies and market their goods and services worldwide. The bond market index funds track the performance of short and medium duration, investment grade corporate bonds in the respective Fund currencies, with one fund hedging out the interest rate risk.

The equity market risk of the Absolute Funds is managed by buying protective put options on the S&P 500 equity index to limit any annual losses of the Funds to around 5%, although this is not guaranteed as hedging is not an exact science. The current cost of this hedging is approximately 2% per annum, which reduces the overall net return, but this is considered a premium worth paying as we are now 5 years into the current bull market with the S&P 500 equity index up 150%.

The asset allocation of the Absolute Return Funds is reviewed and rebalanced monthly against our target asset allocation, with overweight positions that have outperformed being reduced and underweight positions that have underperformed being increased. The revised investment strategy of the Absolute Funds was only implemented during the last quarter of 2013 after the approval of the regulator of the Funds but, if it had been followed over the past 5 years, it would have returned an average of just over 6% per annum after hedging and expenses.

Good news for pension and ISA investors

Most budgets are a bit of a non-event for investors, with the usual minor tinkering of allowances often combined with some additional rules that increase an already complex system. Therefore, the recent UK budget in March delivered quite a shock as the Chancellor, George Osborne, announced a package of fundamental and far reaching changes that have the potential to transform the landscape for investors.

The biggest changes will be for pensions, where the current rules effectively push the vast majority of people into ultimately buying an annuity from an insurance company. However, from next year the rules will be changed to allow pensioners the freedom to use their pension pot as an ongoing investment vehicle, with the flexibility to draw down both income and capital as they choose.

Furthermore, at a time when most tax breaks and allowances are being held back in real terms, the ISA (Individual Savings Account) allowance will be increased to £15,000 from the previous limits of £11,520 for investors and just £5,760 for cash savers. As this is an annual allowance a typical husband and wife that make full use of it will be able to build up a tax free investment portfolio of over a £100,000 in just a few years and assuming a reasonable return of 6% per annum, a total of £1m would be reached within 20 years.

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%	4.6%	4.5%	3.0%
Balanced	50%	50%	6.0%	6.3%	5.1%	3.8%
Growth	0%	100%	7.0%	9.5%	6.2%	4.7%
Benchmarks:						
3 month interest rate				2.4%	2.4%	0.1%
TR Global Equity Index (total return)				6.5%	4.5%	9.9%

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