Heritage Managed Portfolio Fund

Heritage investment philosophy

Our investment style is generally conservative. Our clients' investments usually represent a substantial portion of their accumulated wealth and may often be pension or trust moneys which we seek to preserve and enhance.

We place great emphasis on building a well diversified portfolio, with an appropriate combination of the major investment asset classes, including shares, bonds, cash and property.

Heritage investment approach as applied to the Heritage Managed Portfolio Fund

The objective of the Heritage Managed Portfolio Fund is to generate long-term capital growth with a lower risk than that associated with the major stock market indices.

We recognise that good investment returns are only possible if a certain amount of risk is undertaken and that historically equities have offered a better alternative than bonds and cash to the long-term investor. However, we feel that it is important not to underestimate the considerable risks involved in equity investment and we therefore seek to manage and control this risk through diversification of equity risk, as well as investing in less risky alternatives such as fixed interest securities and property based investments. We also believe that this *conservative approach* is appropriate given the profile of a typical investor in the Fund and the serious approach that we take to the responsibility of managing wealth entrusted to us.

Our approach can also be described as *long term* as we believe that good investment ideas often take time to reach fruition and that a short term approach based on significant trading merely serves to add to the costs and reduce the expected returns. We do not profess to know which way the markets are going in the short term and are very sceptical of those who claim that they can. However, we do believe that a well researched investment purchased at a discount to the its intrinsic value (the expected future cash flows) will more often than not result in a satisfactory return if held for the longer term.

Flexibility and common sense are also important to our approach. We are distrustful of following particular investment styles or fashions and prefer to maintain a more flexible and pragmatic approach based on our own criteria of value. We also believe that investment management is not a pure science and we therefore use a combination of rigorous financial analysis and straightforward common sense.

Investment Approach – shares in companies

Our approach to equity investment 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 All-Share index. They then tend to be obsessed with not deviating significantly from this benchmark 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 equities (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 longer term. We analyse individual companies and only invest in those which meet our criteria - generally they will need to have a combination of attractive business fundamentals and reasonable valuations.

The detailed process for selecting companies to invest in, involves a very large number considerations but we always analyse the following aspects;

<u>1) Business</u>
Gaining an understanding of the business itself is vital. We therefore 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.
<u>2) Profitability and cash flow</u>
We prefer companies that have a proven record of profitability. We analyse the historical record, competitive strength, and profitability 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.
<u>3) Management</u>
The quality and integrity of the directors is paramount. We also have a preference for companies where senior management has a meaningful shareholding, so that their interests are aligned with fellow shareholders.
<u>4) Assets and liabilities</u>
An analysis of the balance sheet including an assessment of the assets and liabilities/financing is also required. We generally prefer companies with a conservative level of debt/gearing.
<u>5) Growth prospects and strategy</u>
Growth can be achieved in many different ways but we have a preference for companies that are able to grow their core business organically, rather than companies embarking on new ventures and acquisitions which often fail to deliver value to shareholders.
<u>6) Valuation</u>
The above analysis will help us to determine if the company meets the criteria in terms of quality of business but we will only proceed to making an investment if we are also satisfied with the valuation. We use a range of valuation techniques based on earnings (PE ratio in relation to earnings prospects), dividends (the dividend yield and present value of future dividend stream) and net assets (price to book value in relation to return on equity).

Investment approach - investment trusts

In addition to individual trading companies the Fund also invests in investment trusts, which are investment companies that are listed on a stock exchange and trade in exactly the same way as company shares. The main use for investment trusts in the Managed Portfolio Fund is to provide exposure to specialist sectors and geographical regions.

We recognise that we cannot spread our expertise across every sector and every country across the globe and so we use specialist investment trusts to gain exposure to areas that we feel offer good investment opportunities. Examples include our use of investment trusts to gain exposure to emerging markets and commodities. Investment trusts are also suitable vehicles for holding illiquid investments that we have an allocation to such as private equity and property.

Having identified specialist sectors or geographic regions that we would like the Fund to invest in, we will then choose suitable investment trusts with managers whose approach is similar to ours.

Investment approach – bonds and preference shares

In addition to equities and specialist funds, which can provide long-term capital growth, we also invest in a range of fixed income securities, including bonds and preference shares, which are generally considered to be less risky investments than shares and provide further level of diversification to the overall portfolio.

Corporate bonds - These securities rank above the ordinary shareholders and usually offer a fixed return consisting of regular interest payments and a repayment of capital at the redemption date. Corporate bonds offer a higher yield than cash or government bonds and a good spread of bonds can therefore enhance the level of income in a portfolio whilst also providing a good level of capital stability.

Convertibles – these are bonds that in addition to providing the usual interest payments, also offer the holder the option of converting the bond into shares of the issuing company as an alternative to the repayment of capital at redemption. This can provide the possibility of capital gains if the company does well, whilst still providing the additional security of a bond if the shares do not perform well.

Zero dividend preference shares - Zeros are the first ranking class of shares of certain investment trusts. As their name implies, they pay no dividend but are issued at a discount to their pre-determined redemption value and a yield to maturity can be calculated. Providing there are sufficient assets (cover) in the final portfolio the zero holders will be paid in full at maturity. They can therefore be described as fixed interest securities backed by equity portfolios. Although the image of splits and zeros was tarnished in the past by some poorly structured trusts, there are still a number of well managed trusts which offer attractive opportunities to investors with a good knowledge and understanding of the sector.

<u>Advantages of the Heritage Managed Portfolio Fund over typical larger funds</u>

Size - Whilst allowing individual investors to benefit from the fund structure, the Fund does not face the size related constraints of larger heavily marketed funds. This flexibility, which being able to deal in smaller amounts and smaller companies brings, is an important aspect of the Fund's competitive advantage. Furthermore, because the majority of investors in the Fund are individuals it does not need to take account of the differing and at times conflicting objectives of large institutional investors.

Independence - As we are not part of a large investment house we are free to select the best investments from a truly independent perspective rather than being restricted to in-house research and funds.

Fees - As we do not employ a large sales force or spend large amounts on advertising and marketing we do not need to charge initial fees to recover these costs as most larger retail funds do (typically they charge 5% up-front) and our annual management fees are also below average.

Management participation - We believe that investors should be cautious of funds that are managed by individuals who are not prepared to commit a significant proportion of their own wealth to the fund that they manage, as is often the case. Investors in Heritage's Funds on the other hand can take some comfort from the knowledge that the individual managers have aligned their own interests with those of the funds' investors by having the bulk of their family capital within the Heritage Funds.

Stability - A further advantage of having a manager with a personal interest in both the Fund and the management company is that it provides better stability. Too often, fund managers, who are simply employees of a large company, lack the commitment and loyalty to stay with a fund for more than a few years as they are easily tempted by better offers from rival firms leaving the investors with a considerable problem.