Quarterly Newsletter & Investment Review

Issue 14 Combined news & investment review from the Heritage Group Summer 2001

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Contacts

Roy Glew
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
Email roy@heritage-capital.co.uk
Responsible for advising Heritage Investment Fund Limited and providing other investment management services.

Graeme Olsen
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
Email graeme@heritage-capital.co.uk
Responsible for Heritage Capital Management Limited which provides a wide range of investment services.

Nigel Westgarth
Tel +44 (0) 1481 722066
Fax +44 (0) 1481 724308
Email nigel.westgarth@heritage.co.gg
Responsible for Heritage Trust Limited which provides trust and company formation and administration and general fiduciary services

www. heritage-capital.co.uk
www.heritage-trust.com

Coping with lower expected returns

This year has seen short-term interest rates on all the major international currencies fall by varying degrees in response to the global economic slowdown. In the US, where the Federal Reserve has a reputation for acting quickly, the Fed Funds rate has been reduced 6 times by a total of 2.75% since the beginning of the year, and now stands at 3.75% per annum. The reductions in the UK base rate have been less marked, but 3 cuts of .25% each have reduced the base rate to 5.25% per annum currently. The European Central Bank, with its narrow anti-inflationary mandate, has only reduced rates once this year by .25%, tending to largely ignore increasing signs of an economic slowdown.

Government bond yields have also fallen this year, although by not as much, as they tend to also factor in the potential outlook for inflation. Bond yields fell sharply through to the end of March, but increasing concerns about the possibility of rising inflation have caused yields to back up by between 0.3% to 0.6% in the last few months. US 5 year government bonds now yield 4.98% per annum, whilst UK and German 5 year government bonds yield 5.53% and 4.61% respectively.

Many investors have failed to adjust their return expectations in light of the interest rate reductions which have taken place in the US, UK and Europe over the past year and, more particularly, in the last 6 months. Some investors erroneously believe that it is still possible to earn virtually risk-free annual returns in the order of 7%. The reality is that they will have to reduce their expectations by 2% to 3%. The same holds true for expected future returns on hedge fund investments and equities. Low returns are the result of greater economic stability, as the dangers of inflation, depression, confiscatory taxation, political instability and war have receded.

The picture is, however, not as bleak for investors as it would first appear. All the returns referred to above are termed nominal returns and are inclusive of inflation expectations. The return that investors should rather be focusing on is the real return, which is the nominal return less inflation. With inflation currently running at between 2% and 3% per annum in the US, UK and Europe, short-term deposits and bonds still produce a positive real return after inflation. This means that investors' capital is still growing in real terms, albeit at a modest rate, and is not being eroded by the effects of inflation. There was a period in the UK in the mid 1970's when interest rates were in the order of 16% but, after adjusting for the high level of inflation, investors were actually earning a negative real rate of return on their funds.

The message for investors is that their return expectations must be tempered and that they must avoid being seduced by offers of high returns as these will, inevitably, carry the risk of loss. A case in point is high yield bonds, which can offer returns in the order of 8% per annum, but there is a very real risk of default with such bonds and a consequent loss of capital.

Good performance continues for Heritage Funds

We are pleased to report that despite the background of turbulent market conditions, all of the Heritage Investment Funds have generated positive returns for the year to date. The Enhanced Bond and Diversified Hedge Funds, which target steady absolute returns, have continued their run of positive quarterly returns, whilst the newer, more equity based Managed Portfolio Fund has done well to produce positive returns despite falls in all the major equity markets so far this year.

Heritage Capital Management Limited

Review for the quarter ended 30 June 2001

Market Commentary

The second quarter started well for global equity markets with a strong bounce in April. However, further negative sentiment in the wake of continuing profit warnings pushed most of the indices lower again resulting in all the major equity markets being in negative territory for the year to date.

The technology and telecoms sectors continue to be hardest hit. A large number of companies in these sectors have actually fallen in value by 90% or more and even former "blue chips" such as BT, Nortel Networks and Marconi are currently trading at a fraction of last year's peak values. Although the so called "old economy" stocks have so far held up relatively well, there have been very few sectors that are making any absolute progress in the face of a global economic slowdown.

In the **UK,** the FTSE 100 narrowly avoided a sixth consecutive quarterly loss by posting a small gain of less than 0.2% for the quarter which leaves it down nearly 10% for the year to date. The FTSE is struggling to break through the 6,000 barrier, a level that it first reached way back in April 1998. The anticipated re-election of a Labour Government has had little impact on the equity markets although the currency markets appear to be adjusting to the increased possibility of Sterling entering the Euro.

Interest rate expectations have recently changed very swiftly with the previous consensus that rates would continue to fall throughout the rest of the year replaced by expectations that the next move may be upwards, based on fears of a pick-up in inflation and continuing robust domestic consumer demand.

The **US** market was the strongest of the major markets, registering a 5.9% gain for the quarter, although it still remains down by 6.7% for the year to date. Companies continue to issue profit warnings at an alarming rate as the excesses of the technology bubble continue to unwind.

The US Dollar continues to be surprisingly strong considering that interest rates have fallen from 6.5% at the start of the year to their present level of just 3.75% with the prospects of further cuts to come.

Europe, too registered a gain for the quarter but remains well down (10.2%) for the year to date. The European Central Bank finally cut interest rates by 0.25% to 4.50% but they appear to be struggling to establish much credibility with the markets as reflected by the continuing slide in the Euro.

In **Japan** the Nikkei 225 index at one point recovered by a healthy 23% from its March lows on optimism that the new Prime Minister, Junichiro Koizumi, would be able to finally bring about the necessary and long overdue reforms. However, subsequent falls have left the market down both for the quarter and the year to date.

Most **emerging markets** have continued to hold up surprising well considering current weakness in the more established major markets.

Investment Statistics - 30 / 6 /01

Equity Markets	Q2 2001	2001 ytd	2000	1999
Global - MSCI World ($)	2.22%	-11.17%	-14.05%	23.56%
UK - FTSE 100	0.16%	-9.32%	-10.21%	17.81%
US - S&P 500	5.85%	-6.69%	-9.31%	20.74%
Europe - FTSE Eurotop 100	1.56%	-10.21%	-3.82%	33.46%
Japan - Nikkei 225	-0.24%	-5.92%	-27.19%	36.79%
Emerging Mkts - MSCI EM ($)	2.44%	-3.31%	-30.00%	66.18%

Source : Micropal

Other	UK	US	Europe	Japan
Interest rates - base	5.25%	3.75%	4.50%	0.00%
Interest rates - 10 year	5.33%	5.40%	5.09%	1.15%
Exchange rates (vs GBP)	-	1.4064	1.6613	175.4
Exchange rates (vs USD)	1.4064	-	0.8466	124.72
Gold ($ per ozs)		270.0		

Source : FT

The Future of Sterling

Sterling as a currency has had a remarkably strong run over the past 5 years. Viewed on a trade-weighted basis, it is not far off its all-time high. It has been seen by investors as an alternative to the mighty US Dollar, the world's reserve currency, and insulated from the troubles of the Euro. During this period, Sterling has often been aligned with the fortunes of the US Dollar because of the strong investment and trade links between the UK and the US. Surprisingly, only 43% of UK trade is with European Union countries, the majority being with the US and the rest of the world.

There are many factors which can affect the strength of a currency. The interest rate differential between currencies is often a significant factor which leads investors to favour higher yielding currencies. This has been a major factor in Sterling's favour since the mid-1990's as Sterling rates have mostly exceeded those of the US Dollar and European currencies. In recent years, however, the flow of capital appears to have assumed more significance in determining the relative values of the major currencies. The US economic miracle has attracted significant investment into that country, boosting the strength of the US Dollar, particularly at the expense of the Euro. Trade surpluses and deficits should also impact upon the value of a currency, but latterly these appear to have had little influence.

Sterling currently has an additional factor weighing upon it and that is the pressure to join the single European currency, the Euro, at some future date. The UK government has indicated that it will not proceed to recommend entry into the Euro until its so-called 5 economic tests, based on convergence with the Euro zone economy, have been met. It has, further, committed itself to holding a referendum to ascertain the views of the British public before going ahead. Indications are that this referendum may be held in the next 2 years, but the weakness of the Euro since its introduction concerns many in the UK.

UK manufacturers have long complained that the high value of Sterling makes UK goods expensive on the international markets and that UK export markets are suffering. Many foreign companies with manufacturing operations in the UK are increasingly struggling with the high UK cost base. It would appear that the value of Sterling will have to fall if the UK is to remain internationally competitive. It has been speculated that Sterling will have to depreciate by between 10% and 15% before joining the Euro to be competitive in Europe. Although Sterling has weakened by approximately 6% against the US Dollar this year, it shows no signs yet of falling against the Euro. This may be because the market does not expect Sterling to join the single European currency for some time yet.

Heritage Capital Management Limited is regulated by the Personal Investment Authority for Investment Business. Investors should be aware that past investment performance is not necessarily 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.

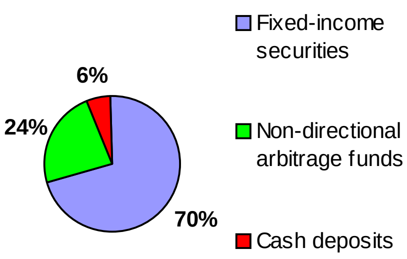
Heritage Investment Fund Limited

Performance for the quarter ended 30 June 2001

Performance

	Enhanced Bond Funds		Diversified Hedge Funds		Managed Portfolio Fund
Risk profile	Low		Moderate		High / Moderate
Minimum investment horizon	1 year		3 years+		3 - 5 years+
Target annual return	Bank deposits + 3%		Bank deposits + 5%		10%+
Typical range of returns	5% - 8%		4% - 10%		-5% - +20%
Price at 30 June 2001	£127.50	US$118.45	£100.49	US$103.10	£100.70
Return for 2nd Quarter (net)	1.46%	1.70%	1.61%	1.09%	4.05%
Year to date return (net)	3.15%	3.73%	2.77%	2.08%	1.34%
Year 2000 return (net)	9.59%	9.66%	6.53%	6.89%	-0.6% (1 month)
Annual volatility	0.9%	0.8%	3.0%	2.9%	9.7%
Size of Fund (millions)	£20.2	US$11.6	£3.6	US$2.5	£3.8

Enhanced Bond Funds

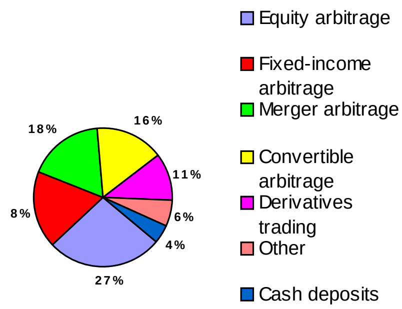


The core of our Enhanced Bond Funds is invested in a diverse spread of high-quality, short-dated AAA/AA bonds, with around 5% allocated to each issuer. The Sterling and US Dollar bond portfolios currently yield 5.7% and 4.4% per annum to maturity, and have net average durations of 1.0 and 1.2 years respectively. This return is augmented, where considered appropriate, by limited exposure to interest rates, currencies and markets using derivative instruments.

We seek to further enhance the return of the Funds by modest exposure to a portfolio of 8 investment funds following non-directional arbitrage strategies, which have a low correlation to equity and bond market movements. Each holding is restricted to approximately 3% to limit specific risk. These holdings will be reduced in the months ahead to reduce the risk profile of the portfolio.

Both Enhanced Bond Funds continue to produce positive monthly returns for the current year, despite the volatile market conditions, and are 1% to 2% ahead of cash deposit rates for the 6 month period.

Diversified Hedge Funds

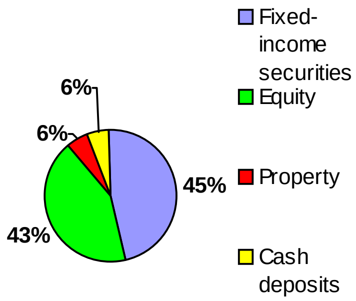


The Diversified Hedge Funds are predominantly focused around non-directional arbitrage strategies, which have the potential to perform irrespective of the direction of equity and bond markets. Individual fund holdings are limited to approximately 10%.

The Funds are currently invested with 11 managers following non-directional arbitrage strategies, which returned a below-par 1.5% for the quarter. The returns were depressed by losses incurred on merger arbitrage in June due to the failure of the General Electric/Honeywell proposed merger. The additional 3 managers employing directional strategies returned only 1.0% for the quarter, with derivatives trading experiencing a difficult month in June.

Both Diversified Hedge Funds continue to produce positive quarterly returns. However, the volatile market conditions and the weight of money flowing into hedge funds, have made it more difficult for managers to achieve the consistent monthly returns we have seen in past years.

Managed Portfolio Fund



The Managed Portfolio Fund had a good quarter, appreciating by 4.1%. The fund is now back in positive territory for the year-to-date compared to the FTSE 100 which is down by 9.3% and the World Index which is down 11.1% (-5.2% in sterling terms).

The fund's direct UK equity exposure is concentrated on 15 holdings with all but 3 of these showing a gain for the quarter.

The performance of the international funds during the quarter was also generally positive with the US, Japan and other/emerging markets all up.
Our European blue chip fund was down, although there was a positive contribution from the smaller cap fund.

In the fixed interest part of the portfolio, the Zero Dividend Preference shares continue to provide consistently positive returns and the convertible bond holdings also had a good quarter, although sterling eurobonds struggled.

The detailed composition of the Fund portfolios is available to investors upon request.

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 necessarily 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.

Advantages of a fund based investment portfolio

Originally investment funds were set up to allow the not-so-wealthy to "pool" their funds in order to allow access to a professionally managed and well diversified spread of investments which would not otherwise be available cost effectively on an individual basis.

This logic still applies today, but other considerations such as simplicity of administration, costs and tax planning advantages now mean that even the wealthiest of private clients will often choose a fund based approach in preference to direct investment.

The main advantages of investing through a fund can be summarised as follows ;

Diversification – A fund allows an individual investor to obtain exposure to a wide range of investments through a single holding. Additionally, many asset classes such as unquoted / private equities, high yield bonds and hedge funds are not easily accessible to an individual private investor. However, these illiquid holdings can usually be held through a liquid pooled fund.

Management – Investment decisions can be taken purely on the basis of the investment merits, rather than being complicated by tax related concerns as a fund is not liable to taxes such as capital gains tax which apply to individuals. This ability to separate tax considerations from investment decisions is a considerable advantage in today's fast changing markets. Also, the fund's portfolio will receive the full time attention of a suitably qualified professional manager, whereas an individual portfolio will quite often only be reviewed and managed on an occasional or ad-hoc basis. Furthermore, in the case of a fund where the manager has his own wealth invested in the fund the investor can take further comfort from the fact that the manager is happy to "eat his own cooking".

Tax planning – Holding a portfolio of investments within a single fund can also produce a simpler and more flexible and efficient framework from a tax planning point of view. For example, a non-distributing ("roll-up") fund can be held for a number of years or even indefinitely without giving rise to any tax liability. This allows the investment to compound tax free for many years as well as providing the investor with the ability to plan to only pay tax at a future time and date which suits him (e.g. when he becomes a lower rate tax payer or becomes non-resident etc.).

Administration - A further benefit, which should not be underestimated, is the reduction in record keeping, administration and calculations required to keep track of many individual holdings, trades, dividends and interest etc. This is particularly true with today's ever more complex self-assessment tax regimes, where even experienced investors will normally require the services of a tax accountant in order to ensure that CGT records and computations are correct if a portfolio of individual holdings is actively managed.

Costs – The economies of scale which are available to a pooled fund give rise to cost advantages which are not available to individual portfolios. For example dealing within the fund should be at institutional rates rather than the higher rates usually charged to individual investors.

Heritage approach
We continue to offer both an individual portfolio management service and our own fund based service for our investment clients. However, we believe that the funds approach offers the best solution for the majority of clients who require a discretionary service and that the individual portfolio approach is only really suitable for non-discretionary / advisory clients.

OECD forced to ease pressure on tax havens

The Organisation for Economic Co-operation and Development (OECD) has recently been forced onto the back foot in its battle against offshore tax havens which began in 1998 at the instigation of France. Its harmful tax competition initiative which gave 35 tax havens a deadline of 31 July 2001 to co-operate or face sanctions has been criticised firstly by US Treasury Secretary Paul O'Neill and more recently by a group of 200 leading economists led by the Nobel Prize winner Milton Friedman. Friedman wrote to President Bush saying " We urge you to reject the OECD's so-called harmful tax competition initiative. Tax competition is a liberalising force in the world economy and should be celebrated rather than persecuted. It forces governments to be more fiscally responsive lest they drive economic activity to lower tax environments." Many commentators now feel that this effectively leaves the OECD's initiative "dead in the water".

A Guide to areas of responsibility

We at Heritage pride ourselves on our personal and friendly approach to servicing clients' needs. We thought that it may be helpful to clients if we set out the primary areas of responsibility within our organisation. The objective in doing this is to direct clients to the person responsible for a particular area of the business, so ensuring that the matter is dealt with efficiently and timeously. Having said this, the principals of our business, Roy, Graeme and Nigel, are always available to clients and can be approached on any matter.

Roy - Responsible for advising Heritage's Enhanced Bond and Diversified Hedge Funds, asset allocation, and general investment advice especially bonds, hedge funds and currencies.

Graeme - Responsible for advising Heritage's Managed Portfolio Fund, investment executions, and general investment advice especially equities and investment funds

Nigel - Responsible for managing Heritage Trust Limited in Guernsey, and advice on establishing international trusts and companies. Please note that Nigel's e-mail has recently changed to nigel.westgarth@heritage.co.gg.

Rayman - Responsible for client accounting and portfolio valuations, investment executions, and confirming.

Sally - Responsible for client banking and transactions statements, deposits, payments and transfers of funds

Heritage group

London Office 40 Broadway, London SW1H 0BT
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

Guernsey Office Polygon Hall, PO Box 135, Le Marchant Street, St. Peter Port, Guernsey GY1 4EL Tel: +44 (0) 1481 722066 Fax: +44 (0) 1481 724308
General Email: htl@heritage.co.gg **Website** www.heritage-trust.com

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