Quarterly
Newsletter & Investment Review

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Investment strategies in an uncertain world

Although recent events have created a great deal of turbulence and uncertainty for global financial markets, the basic principles of sound investment remain intact. In this Newsletter we focus on two aspects of investment which have tended to have been overlooked in recent years, namely bonds (page 1 below) and the importance of dividends (page 4). We also provide our usual market commentary (page 2) and updates on how our own Funds (page 3) are coping against this difficult background.

Bonds - perhaps boring, but safe!

Fixed-income investments (commonly referred to as bonds) are regarded by many as inferior investments to the more exciting potential of equities. Bonds are debt instruments issued by governments and corporations to finance their operations and, in their most common form, pay a fixed rate of interest and are redeemable at a specified date. Bonds are issued in many currencies and carry differing levels of risk depending on the creditworthiness of the issuer. In the event of the liquidation of a company, bondholders are paid out ahead of equity shareholders. Our Enhanced Bond Funds only invest in the top two tiers (ie AAA and AA) of investment grade bonds, where there has never been a bond default. Liquidity is an often-overlooked investment criteria, and investment grade bonds are highly marketable. All the bonds held by our Enhanced Bond Funds could be sold and converted to cash on the same day.

The values of bonds fluctuate according to the expected levels of interest rates and inflation. The prices of longer-dated bonds are more sensitive to changes in interest rates and inflation than bonds with shorter maturities. For our Enhanced Bond Funds, we have a policy of not attempting to forecast the likely direction of interest rates as getting it wrong can lead to losses. Instead, we focus on maximising the annual return on the bonds, hedging out any interest rate or currency risks as far as possible. This means that our Enhanced Bond Funds can produce positive returns in excess of bank deposits when interest rates are rising (the values of bonds move inversely to interest rates), as well as when they are falling.

Although the returns generated by our Enhanced Bond Funds may appear modest when compared with the returns on equities in past bull years, they are superior to bank deposits. One of the most important aspects of successful investment is to avoid losses and to generate steady positive returns. When losses are incurred on an investment portfolio, the arithmetic works against you. If your portfolio falls by 20%, for example, it will have to appreciate by 25% to get back to its original value! The power of compounding consistent returns is also significant and should not be underestimated, as a steady return of 7% per annum will double the value of your capital in 10 years.

Although investment in bonds may appear straightforward, there are many different types of bonds (ie straight, convertibles, zeros, high-yield) and exposures (ie duration, currency, credit, diversification, liquidity, volatility) that need to be professionally managed. We believe that our Enhanced Bond Funds are able to fulfil this role and deliver consistent, secure, positive returns in excess of bank deposit rates in all market environments.

Heritage Capital Management Limited

Review for the quarter ended 30 September 2001

Market Commentary

The events of September 11th have been both devastating and widespread and the knock-on effects have already begun to be felt by economies and industries across the world. Apart from those sectors most obviously affected, such as the travel and insurance industries, the slowdown in the already faltering global economy has been accelerated as consumer confidence deteriorates. Significant job losses will continue as companies cut costs in an attempt to protect profits that were already under pressure.

Of course much of this bad news is already priced into the markets and the declines in equity indices across the world now make this one of the most severe bear markets in history, with most major indices down over 30% from their peaks. However, a look at historical PE ratios and dividend yields shows that despite the recent market falls, equities could retreat a lot further before they reach levels seen in previous bear markets. Apart from this already bleak background, the continuing deterioration of investor confidence continues to be a problem. Whilst investor optimism allowed markets to climb to unrealistically high levels during the rampant bull market and technology boom of the late 1990's, the subsequent falls since then have gradually been eroding confidence in equities. Sentiment has now deteriorated further following this latest disaster led plunge which may well cause a permanent increase in the equity risk premium and the evaporation of the so called "peace dividend".

On the bright side, central banks across the world have been quick to react to the threat of a global recession, cutting interest rates sharply, and equities now look quite attractive relative to bonds. Also, any recovery next year could be quite marked as it seems inevitable that many companies will take the opportunity to "clear the decks" of all bad news in the final quarter of 2001giving a lower base for more of a "V-shaped" recovery for earnings in 2002.

Investment Statistics - 30/9/01

Equity Markets	Q3 2001	2001 ytd	2000	1999
Global - FTSE World ($)	-15.31%	-23.25%	-14.05%	23.56%
UK - FTSE 100	-13.10%	-21.20%	-10.21%	17.81%
US - S&P 500	-14.98%	-21.16%	-9.31%	20.74%
Europe - FTSE Eurotop 100	-18.24%	-26.59%	-3.82%	33.46%
Japan - Nikkei 225	-24.63%	-29.10%	-27.19%	36.79%

Source : Financial Times

Other	UK	US	Europe	Japan
Interest rates - base	4.75%	3.00%	3.75%	0.00%
Interest rates - 10 year	4.94%	4.63%	4.80%	1.36%
Exchange rates (vs GBP)	-	1.4697	1.6138	175.08
Exchange rates (vs USD)	1.4697	-	0.9217	119.13
Gold ($ per ozs)		291.0		

Source : Financial Times

United Kingdom

Despite falling a further 13.1% during the third quarter to leave it down over 21% for the year to date, the FTSE 100 has held up slightly better than other international equity indices and domestic small caps (which are down 32% year to date). This was partly due to a sharp 10% rally in the last week of the quarter from a low of just 4433, a level not seen since early 1997.

United States

The technology shares rout has now spread to the broader market and the S&P 500 ended the quarter hovering around 1,000, a fall of over 33% from its high of over 1,500 last year. The Nasdaq index continues to fare even worse and has now fallen below 1,500 compared to its all time high of over 5,000, representing a decline of 70%.

Europe

European markets have been particularly disappointing, falling even faster than the US and UK. Although there does appear to be a reasonable case for suggesting that European equities now offer good value to long-term investors caution is still required as the earnings base continues to deteriorate.

Japan

Japan provides a very worrying scenario of what can happen to a market that fails to recover from the collapse of an earlier boom. The Nikkei 225 index has now fallen below 10,000 making new 17 year lows and it remains way off its 1989 peak of over 39,000.

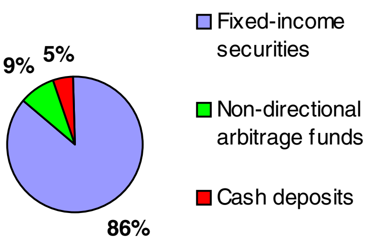
Heritage Investment Fund Limited

Performance for the quarter ended 30 September 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 + 2%		Bank deposits + 5%		10%+
Typical range of returns	4% - 7%		3% - 9%		-5% - +15%
Price at 30 September 2001	£129.66	US$120.01	£102.11	US$104.52	£87.65
Return for Quarter (net)	1.73%	1.36%	1.75%	1.52%	-12.96%
Year 2001 to date return (net)	4.89%	5.10%	4.43%	3.49%	-11.79%
Year 2000 return (net)	9.59%	9.66%	6.53%	6.89%	-0.6% (1 month)
Annual volatility	1.0%	1.0%	2.1%	2.1%	14.9%
Size of Fund (millions)	£24.5	US$12.4	£3.5	US$2.9	£3.4

Enhanced Bond Funds



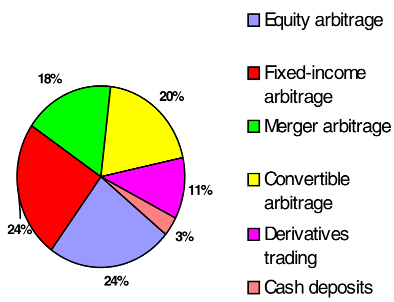
The core of our Enhanced Bond Funds is invested in a diverse spread of high-quality AAA/AA bonds, with not more than 5% allocated to any one issuer. The Sterling and US Dollar bond portfolios currently yield 4.9% and 3.6% per annum to maturity, and have net durations of 0.7 and 0.9 years respectively.

Our investments in third-party arbitrage funds are being liquidated, to reduce the risk profile of the portfolio, and should be completed by the end of October. These funds are being reinvested in high quality bonds as they are received.

Our disciplined approach to hedging all duration and currency risks meant that we did not benefit from the reduction in interest rates in the latter part of September, but our high quality bond portfolio was unaffected by a widening of corporate bond credit spreads.

Both Enhanced Bond Funds continue to produce positive monthly returns for the current year, well ahead of cash deposit rates.

Diversified Hedge Funds

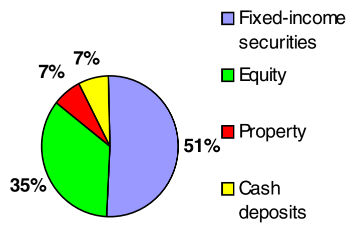


The Diversified Hedge Funds are focused on non-directional arbitrage strategies, which have the potential to perform irrespective of the direction of equity and bond markets. Individual fund holdings are limited to approximately 15%.

The Funds are currently invested with 12 managers. Arbitrage strategies made little progress during September as spreads widened dramatically in the aftermath of the attacks in the US. In particular, merger arbitrage and fixed-income arbitrage strategies suffered losses of up to 2%. Derivatives trading generated almost 2% for the month, benefiting from market volatility, whilst well-hedged convertible bond arbitrage showed gains of over 1%.

The Diversified Hedge Funds demonstrated the resilience of their arbitrage strategies during the quarter to produce positive returns. Returns for the year to date, although modest, remain positive and ahead of cash, despite the severe losses suffered by equity markets.

Managed Portfolio Fund



The Fund had a poor quarter as it was unable to avoid the impact of the September 11th US terrorist attacks. However, the defensive positioning and good relative performance for the first 8 months of the year have restricted losses to only around half as much as the FTSE 100 and World Indices for the year to date.

Apart from the impact of the general market weakness, the following factors contributed to the Fund's losses ;
- Exposure to generally defensive sectors such as travel and insurance which were severely impacted by the terrorist attacks
- The relative underperformance of smaller cap stocks (the UK Small Cap Index was down over 21% in September)
- Widening of discounts on investment trusts
- Rising yields on fixed interest securities as spreads over government bonds widened sharply in a "flight to quality".

However, many of the portfolio holdings now offer very good value and a high level of cash should provide opportunities going forward.

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

The importance of dividends

Returns from investing in equities come from two sources; capital growth and income. Capital growth was the major contributor to the high total returns enjoyed by equity investors in the 1980s and 1990s and during this period, to many investors, dividend income became almost a trivial irrelevance.

This period of exceptional capital growth is increasingly looking like an anomaly as investors realise that consistent capital gains cannot be taken for granted. In fact longer term historical statistics for equity returns in the UK show that since 1920 the average total return per annum has been 12.1% made up of 6.9% capital gain and 5.2% dividend income. Clearly dividends have been a very major component of total returns.

We are now entering an era of lower inflation, lower interest rates and lower nominal returns, an environment not dissimilar to long periods earlier this century where income was an important part of overall equity returns.

Apart from the possible return of the importance of dividends to their historical norms, we believe that the current uncertainty in global equity markets provides another good reason for considering companies that pay a good dividend yield. In times of uncertainty, we are very wary of optimistic projections of future sales and earnings growth which are used to justify the high PE ratios and low or non-existent dividend yields of so called "growth" companies. In our Managed Portfolio Fund we therefore tend to prefer the stability and security of established, profitable companies who have a proven business model. These companies are capable of generating cash to provide a secure dividend which is well covered by current earnings and has good prospects of growing at a modest rate in future.

The current market weakness has produced a growing number of stocks that have a dividend yield which is above the current yields available on cash deposits and government bonds, but are still capable of providing positive earnings and dividend growth. We will therefore continue to focus on these types of companies that provide an attractive combination of safety and growth.

Reminder of redemption terms for Heritage Investment Fund

We thought that it might be useful to remind investors of the terms for the redemption of shares in our Enhanced Bond, Diversified Hedge and Managed Portfolio Funds, which are set out in the Explanatory Memorandum of Heritage Investment Fund. We would like investors to adhere to these terms as closely as possible, as premature redemptions may force us to liquidate investments at an inopportune time, thereby possibly adversely affecting the performance of the Funds.

Redemptions only take place at the end of each month for all Funds and the proceeds are paid out within 15 business days of the month-end, once the Funds have been priced. In practice, we try to accommodate those investors only making partial redemptions by paying them out on the first business day after the month-end. However, the notice to be given for an intended share redemption varies according to the type of Fund:

- For our Enhanced Bond Funds, written notice must be received by us by the last business day of the month
- For our Diversified Hedge and Managed Portfolio Funds, written notice must be received 35 days prior to the month-end on which it is intended that the shares be redeemed.

Where investors require funds urgently for some unexpected reason, we will try to accommodate them if possible by seeing if we can transfer their shares to a new investor subscribing for shares in the particular Fund.

Investors are also permitted to switch investments between our funds. This is normally done at no charge to the investor, but if an investor switches more than once in a calendar year, additional switches will attract initial charges.

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