Quarterly Newsletter & Investment Review

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Heritage

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Heritage funds steady as markets plunge

We are pleased to report that all three of Heritage's fund classes have managed to produce positive returns for both the current quarter and the year to date. This is quite an achievement considering the turmoil in global markets with most of the major equity indices falling by more than 10% during the quarter. Our conservative approach, based on the principle of capital preservation and enhancement, has helped our clients to weather the storm and further details of how these results have been achieved can be found on page 3.

Currency allocations

Calling the direction and timing of currency movements is notoriously difficult as there are so many factors that influence foreign exchange rates, including the flow of funds, current account balances, interest rates, fiscal policy, government intervention, etc. Indeed, an academic study found that the forward rate was a more consistent predictor of the likely future exchange rate than so-called expert currency forecasters! Currencies have a tendency to become over or under valued for long periods of time, before suddenly undergoing significant corrections. Of course, with the benefit of hindsight, it is always easy to see that a particular currency was out of line and should have been switched into an alternative.

For the above reasons, we at Heritage do not make currency decisions on behalf of our investment clients. We are more than happy to provide clients with our views on the major currencies, but we prefer clients to make the final decision themselves, as the impact of an incorrect currency call can be very significant and overshadow the underlying investment returns. Many clients use the currency of the country to which they have the strongest ties as their investment currency, either because they (or their children) live or own property there or are, perhaps, frequent visitors. Another approach for investors with significant capital is to diversify their currency risk by allocating their investments over two or three of the major currencies (eg Sterling, US Dollars and/or Euro) and altering the weightings from time to time to reflect their current views. Both our Enhanced Bond and Diversified Hedge Funds have separate classes denominated in Sterling and US Dollars, whilst our Managed Portfolio Fund is multicurrency although the price is reported in Sterling terms. Although we do not presently manage any Euro-denominated mutual funds, clients wishing to invest in Euros can be accommodated by purchasing Euro-denominated bonds or other securities. Alternatively, clients may wish to leave their underlying investments intact in the original currency and alter their currency exposure by means of forward currency contracts.

Heritage Capital Management Limited
Review for the quarter ended 30 June 2002

Market Commentary

Having traded in a narrow range for the first quarter of 2002, global equity markets plunged decisively lower in the second quarter leaving the US, UK and European markets all suffering double digit percentage losses.

Despite signs of a mild recovery in the world's major economies generally, there is no doubt that the corporate sector is still having a tough time. Company earnings continue to fall as it becomes apparent that many of the anticipated productivity gains from the so-called "new economy" either by-passed the companies and were passed on to the benefit of the consumer or were quite simply illusory.

Following two and a half years of falling equity markets and the recent stream of seemingly endless examples of corporate greed and corruption, it is perhaps not surprising that investors have started to lose their enthusiasm for equities. It is therefore quite possible that valuations, as measured by PE ratios and dividend yields, which remain quite high by historic standards will continue to unwind. This means that even if reported earnings do recover, investors will in future no longer be prepared to pay such high multiples for them, which will make it very difficult indeed for the markets to make significant progress from here.

Despite all the gloom it is probably worth remembering that new bull markets are often born in times of maximum pessimism. However, only the bravest of investors are likely to want to commit their entire portfolios to equity markets at present and we continue to prefer a cautious investment approach, incorporating other asset classes such as bonds, cash, alternative/hedging strategies and property.

United Kingdom

In the UK the FTSE 100 index had one of its worst ever quarters, falling by nearly 12%. The current market weakness is being compounded by life assurance companies who are being forced to sell equities into a falling market to maintain their regulated asset base. This selling pressure could continue as other institutional investors such as company pension funds are also belatedly discovering that maintaining a high equity exposure is too risky and are cutting their weightings in favour of bonds.

Despite the equity bear market, there has been no slowdown in the booming residential property market and with a large number of individuals now trying to cash in on this by gearing up in the "buy-to-let" market there are some concerns that we may heading down the familiar boom to bust path.

United States

The overall US market fell by nearly 14% during the quarter with the technology based Nasdaq index, which is now down 25% this year, leading the falls.

The integrity of corporate America has been dealt a severe blow by the stream of scandals which started with Enron. Since then further irregularities have come to light at Global Crossing, Tyco, Worldcom and Xerox with no one knowing just where it will end. There is no doubt that this has shattered the perception of the US as a model of good corporate governance and it will take some time before credibility and trust can be restored.

The once mighty US Dollar is also showing signs of weakness and has so far fallen by nearly 10% on a trade weighted basis so far this year, and with disillusioned foreign investors repatriating their funds and a huge current account deficit there could be worse to come.

Europe

The European market was the worst performer of all the major markets, with the Eurotop 100 index falling by just over 17%.

The one bright spot for European investors has been the resurgence of the Euro, which has now almost regained parity with the US Dollar, although this could well be more down to dollar weakness rather than any great confidence in the Euro itself.

Japan

Although Japan fell by 3.7% this quarter it is the only major market to still be in positive territory for the year to date as it enjoyed a brief cyclical rally against the background of a long secular downtrend.

Emerging Markets

Emerging markets have generally done better than the major markets so far this year with the FTSE All World Emerging Markets index up 4.4%. However, there has been a huge divergence around this average with the best performer being Indonesia which was up 63% in Dollar terms whilst Argentina on the other hand suffered a 65% fall.

Investment Statistics - 30/06/02

Equity Markets	Q2 2002	2002 ytd	2001	2000
Global - FTSE World ($)	-9.42%	-9.30%	-16.20%	-14.05%
UK - FTSE 100	-11.67%	-10.75%	-16.15%	-10.21%
US - S&P 500	-13.73%	-13.78%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	-17.11%	-17.02%	-18.64%	-3.82%
Japan - Nikkei 225	-3.66%	0.75%	-23.52%	-27.19%

Source : Financial Times

Other	UK	US	Europe	Japan
Interest rates - base	4.00%	1.75%	3.25%	0.00%
Interest rates - 10 year	5.13%	4.93%	4.98%	1.31%
Exchange rates (vs GBP)	-	1.5243	1.5434	182.697
Exchange rates (vs USD)	1.5243	-	0.9876	119.86
Gold ($ per ozs)		317.75		

Source : Financial Times

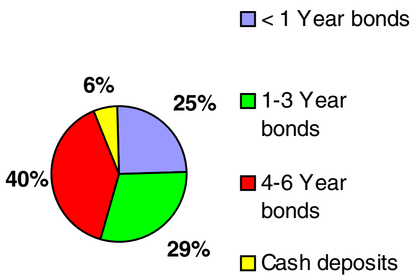
Heritage Investment Fund Limited

Performance for the quarter ended 30 June 2002

Performance

	Enhanced Bond Funds		Diversified Hedge Funds		Managed Portfolio Fund	
Risk profile	Low		Moderate		High / Moderate	
Minimum investment horizon	1 year +		3 years+		5 years+	
Target annual return	Bank deposits + 2%		Bank deposits + 5%		10%+	
Typical range of returns	3% - 6%		2% - 9%		-5% - +15%	
Price at 30 June 2002	£132.90	US$121.69	£108.05	US$108.80	£92.80	MSCI Index
Return for Quarter (net)	0.84%	0.54%	1.27%	0.76%	1.01%	-16.77%
Year to date return (net)	1.90%	1.39%	3.44%	2.23%	0.63%	-15.21%
Year 2001 return (net)	5.56%	5.16%	7.03%	5.64%	-7.19%	-15.11%
Year 2000 return (net)	9.59%	9.66%	6.53%	6.89%	-0.6% (1 mth)-	7.11%
Annual volatility	1.1%	1.4%	2.5%	1.9%	13.6%	19.5%
Size of Fund (millions)	£26.0	US$12.7	£4.3	US$3.1	£4.8	

Enhanced Bond Funds

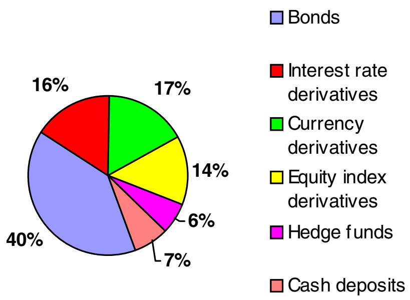


The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds, with not more than 5% allocated to any one issuer. The Sterling and US Dollar bond portfolios currently yield 4.9% and 3.8% per annum gross to maturity, and have average durations of 2.3 and 2.9 years respectively.

Based upon tentative signs of recovery in the US, we have continued to hedge the interest rate exposure of our longer duration bonds. However, the revelation of further accounting irregularities at US corporates and the resulting equity market weakness, has caused a flight to the safety of fixed-income securities, pushing up bond prices. The resulting appreciation in our bond portfolios has, to a large extent, unfortunately been offset by corresponding losses incurred on our hedges.

Both Bond Funds produced positive returns for the quarter much in line with cash deposits, which has resulted in them lagging behind our target returns for the year to date.

Diversified Hedge Funds

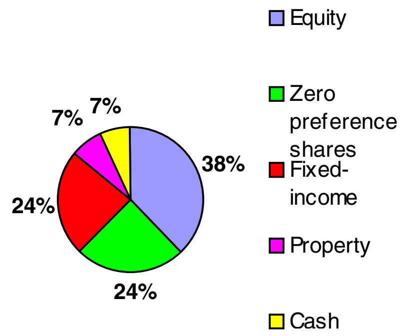


The Diversified Hedge Funds focus on non-directional investment strategies, employing proprietary methods using derivatives and by limited investment with third party managers. The derivatives strategies cover interest rates, currencies and equity indices, and the gross exposure is limited to the total funds under management. As these positions require limited margin outlay, the balance of funds is invested in high-quality investment grade bonds to provide underlying income for the Funds.

The derivatives positions generated positive returns in the first two months of the quarter, but incurred small losses on equity market index exposure in June as a result of the unexpected increase in the volatility of these markets. The modest exposure to a number of experienced derivatives trading funds performed well during the quarter, taking advantage of the volatile market conditions.

Both Diversified Hedge Funds generated positive returns for the quarter ahead of cash deposits, but short of our target returns. However, given the significant falls in equity markets this quarter, the Funds continue to perform well ahead of cash deposits.

Managed Portfolio Fund



The Managed Portfolio Fund did well to show a gain of 1.0% for the quarter against a background of severe equity market weakness, with the MSCI World Index down by 16.8%.

The fund's direct equity holdings remain concentrated on profitable companies on attractive valuations, with an average dividend yield of approximately 4% and a PE ratio of under 15.
The zero preference shares, which are a hybrid between equities and bonds, had a reasonable quarter overall and currently have an average yield of 9.9% with cover of 1.6 times and a duration of 2.4 years.
Commercial property continues to offer a good combination of attractive income yield and potential for capital growth and we have added to the fund's exposure this quarter.

In terms of portfolio strategy, we continue to maintain a fairly defensive asset allocation, with just over 30% of the fund currently held in investment grade bonds and cash, and prefer to seek to add value via the selection of attractive individual investments, rather than general market exposure.

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

Composition of our Diversified Hedge Funds

Our Diversified Hedge Funds focus on a range of non-directional investment strategies that have the potential to generate consistent positive returns in all market conditions. We manage both Sterling and US Dollar versions of these Funds, where all foreign currency exposure is hedged back into the denominated currency of the Fund. Although our Diversified Hedge Funds were originally structured as Funds of other underlying hedge funds, a few years ago we became increasingly concerned about the lack of transparency and risks of investing in these third party funds, and have substantially reduced our exposure to these funds. For over a year now, our investment in other hedge funds has been restricted to only a few derivatives trading funds which, together, constitute approximately 10% of our Funds' total investments.

Since last year, we have increasingly focused our efforts on managing the investments of our Diversified Hedge Funds entirely ourselves based upon our own proprietary approach. Our investment strategy employs futures and options to take positions in interest rate markets, major currencies and equity market indices, based upon on our views on the likely future direction of such securities and their expected volatility. As the use of these derivative instruments requires the depositing of limited margin, the majority of the funds under management are invested in a spread of high-quality investment grade bonds, to generate the core income for the Funds. All our derivatives positions are placed with recognised derivatives exchanges in the US, UK and Europe, which are highly liquid with transparent pricing. We do not employ any leverage in generating our returns and the total gross exposure to the securities underlying our derivatives positions is limited to the total funds under management in the respective Fund.

Our Diversified Hedge Funds aim to produce net annual returns of approximately 5% in excess of cash deposits in both bull and bear markets by employing a diversified investment mix of fixed-income securities, derivatives positions in interest rates, currencies and equity indices, and limited investment in third party hedge funds

Split capital investment trusts

One of the results of the weakness of the equity markets has been to expose the major faults within many poorly structured split capital investment trusts.

The basic idea of the split capital investment trust is a sound one as it allows the objectives of two or three different classes of shareholders to be met by a single underlying portfolio of investments. For example, a fairly simple trust could be created with £100m of assets consisting of £60m of ordinary shares and £40m of zero dividend preference shares. The trust would have a set life of 10 years and the £100m would be invested in a portfolio of diversified equities. The zero holders receive nothing during the life of the trust but are entitled to receive say £80m at the wind up date. As the starting capital is £100m and the portfolio should hopefully at least show some growth over 10 years this should be a fairly low risk investment providing a doubling of the investment over 10 years or an annual yield to maturity of 7.2%. During the life of the trust the ordinary shareholders receive all the income of the trust and at the wind up date they also receive whatever capital is left after repaying the zero holders their £80m. This provides a riskier, geared investment as, if the portfolio performs poorly and in fact declines by 20% to £80m at the wind up date the ordinary shareholders receive nothing as all the capital is required to repay the zero holders. Of course the gearing also works in their favour if the portfolio performs well, which was the normal situation during the long bull market.

The above example was fairly typical up until a few years ago, but then as often happens, the promoters of what started out as a basically good idea became greedy and pushed the idea too far. The first major problem was that in order to create even more gearing, bank debt was added to the capital structure. It is probably not a coincidence that this also had the effect of boosting the total gross assets of the trust which therefore increased the management fees to the fund managers and resulted in additional income being generated to bankers and advisors. Of course this additional gearing was considered an excellent enhancement to split trusts whilst we remained in a bull market. Capital structures were also further complicated by the addition of other share classes such as income shareholders who were as the name suggests entitled to the portfolio's income. The second major problem arose due to the fact that a number of the promoters of split capital trusts created a so called "magic circle" of trusts all supporting each others new fund launches by investing in each others trusts rather than simply investing directly in equities or bonds.

The result of these activities meant that the trusts became an accident waiting to happen once the equity bull market ended. Once the bear market set in the gearing caused the net assets of the trusts to fall much faster and further than the markets themselves. In order to reduce this spiralling gearing and prevent breaching of banking covenants, trusts were forced to sell assets to raise cash and repay debt. However, as many splits had invested in each other the selling pressure on the already troubled split capital trusts became unbearable and a full-scale crisis ensued. The worst affected trusts have seen the ordinary shareholders completely wiped out and even the supposedly low risk zeros have suffered huge falls as the asset cover has been decimated.

Fortunately, we at Heritage have always concentrated on the zero shares of well managed trusts without high gearing or cross holdings and have therefore managed to navigate the split capital crisis relatively unscathed. We believe that these holdings will continue to be solid investments in future and that this whole episode is a good example of how clients can benefit from having their investments professionally managed by an independent expert.

Heritage

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