Quarterly
Newsletter & Investment Review

Issue 19 | Combined news & investment review from Heritage | Quarter 3 2002

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Heritage

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Markets go from bad to worse

It has been another very poor quarter for equity markets and many major indices are now only worth around 50% of their values at the peaks, a couple of years ago. Fortunately, most Heritage clients who invest in our funds have managed to get through this difficult period with their capital intact. In this issue we attempt to explain a couple of the factors that we believe have made important contributions to how this has been achieved. The article below highlights the advantages of smaller, independent investment managers such as Heritage and on page 4 we explain the importance of asset allocation.

Bigger is not necessarily better

During the bull market of the 1990s a perception built up that bigger was better. Large cap stocks outperformed smaller companies and global investment banks dominated the investment management industry. However, we believe that the tide is turning, as this recent quote from a leading financial publication followed by a summary of the important differences illustrate;

"There is a strong future for small companies. An individual working for his or her own company will focus solely on investment, without endless committee and marketing responsibilities. The incentives for boutique fund managers are much more aligned to those of their investors."

Independence - At Heritage we are not part of a large investment house and are free to select the best investments from a truly independent perspective. There are often conflicting pressures within larger organisations with analysts often publicly recommending stocks to clients despite having serious concerns over the same companies in private.

Personal service - With more lucrative fees on offer from large corporate clients, most multinational investment institutions now allocate less experienced staff to individual private clients. We, on the other hand, continue to build our business around the concept of long-standing relationships and a high level personal service.

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, as is so often the case with large retail funds. Investors in Heritage's funds can take some comfort from the knowledge that we do "eat our cooking".

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 and investment advisors who are simply employees of a large company lack the commitment and loyalty to stay with a company for more than a few years as they are easily tempted by better offers from rival companies.

Size -Heritage is large enough to benefit from the economies of scale resulting from the pooling of our clients' assets, but not too large as to suffer from the constraints of larger, unwieldy funds. This flexibility is an important aspect of our competitive advantage.

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.

Overall, we believe that the benefits outlined above mean that smaller investment companies such as Heritage offer clients the more attractive alternative, with the prospect of a better service, superior performance and lower fees.

Market Commentary

Global equity markets had their worst quarter since the 1987 stock market "crash". Coming on top of the already substantial falls, which have been suffered over the last few years, many major markets are now down by 50% or more from their peaks, making the current bear market one of the worst in history.

At present there is plenty to give investors further cause for concern, with the weakness in the economy and company earnings, the threat of war in the Middle East and the ongoing corporate governance and accounting scandals in the US.

The question now for investors is just how long can this bear market continue and how low can prices go? Comparisons with the aftermath of the other major stock market bubble of recent decades, Japan in the late 1980's, are not encouraging. Here, the onset of deflation has led to a bear market that is now in its 12th year, with still no sign of a sustainable recovery. Fortunately, there are important differences between Japan and the major western markets but this worst case scenario is now something that investors need to bear in mind as a possibility.

United Kingdom

In the UK the FTSE 100 index has now fallen back below 4,000 to levels last seen in 1996.

At least there does appear to be some cause for optimism for investors as the UK economy is so far holding up rather better than most. Strong consumer and government spending are supportive and although the rate of increase in house prices is unsustainable it is unlikely that these will collapse without a sharp increase in interest rates or unemployment – neither of which appear likely.

Also, valuations do appear more reasonable now with an average PE ratio of 17 and a dividend yield of 3.75% - just below the base rate of 4%.

United States

The US market is now down by nearly 30% for the year-to-date having already fallen substantially in the previous two years. One might therefore be tempted to conclude that at least shares must now be offering good value to long term investors. Unfortunately the evidence for this is far from compelling as the PE ratio still remains above the long-term average and the dividend yield is just 1.6%.

The inability of the economy to show any strong signs of a recovery continues to give cause for concern and despite interest rates being as low as 1.75% there is now the possibility that the Federal Reserve may actually need to cut rates further.

Europe

The European market is having a truly terrible year and was once again the worst performer of all the major markets this quarter, with the Eurotop 100 index falling by over 24%.

A major problem for Europe at the moment is the weakness of its largest economy, Germany. The recent re-election of Gerhard Schroeder, by a slim majority and relying on a coalition with the Green party, has done nothing to help the prospects of much needed economic liberalisation. The equity markets are also likely to suffer from a mismatch between supply and demand with a deluge of upcoming rights issues from sectors in distress such as insurers and telecoms, at a time of weak demand for equities.

Japan

Although Japan has so far this year been the best performing major market, this says more about the weakness of other markets than it does about Japan. Despite a brief cyclical rally the economy now looks likely to slip back into recession again in 2003. The government continues to try and intervene to support the stock market, with the latest attempt being the Bank of Japan's decision to buy shares from the ailing banks, but the radical reforms required seem as elusive as ever.

Emerging Markets

Emerging markets have actually done slightly better than the major markets so far this year and undoubtedly do offer some diversification benefits. However, with investors discovering that there is far more risk involved in major markets than most had imagined, it is unlikely that many will be tempted to invest heavily in emerging markets at present.

Investment Statistics - 30/09/02

Equity Markets	Q3 2002	2002 ytd	2001	2000
Global - FTSE World ($)	-18.70%	-26.17%	-16.20%	-14.05%
UK - FTSE 100	-20.07%	-28.67%	-16.15%	-10.21%
US - S&P 500	-17.63%	-28.99%	-13.04%	-9.31%
Europe - FTSE Eurotop 100	-24.28%	-37.17%	-18.64%	-3.82%
Japan - Nikkei 225	-11.66%	-11.00%	-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	4.44%	3.65%	4.34%	1.18%
Exchange rates (vs GBP)	-	1.5726	1.5913	191.45
Exchange rates (vs USD)	1.5726	-	0.9883	121.74
Gold ($ per ozs)		323.60		

Source : Financial Times

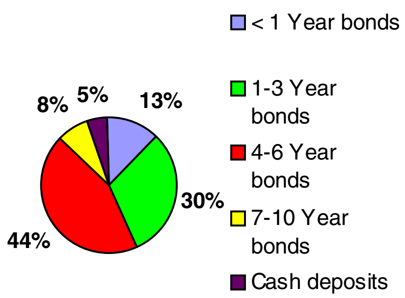
Heritage Investment Fund Limited

Performance for the quarter ended 30 September 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 + 1%		Bank deposits + 4%		10%+	
Typical range of returns	3% - 6%		1% - 9%		-6% - +12%	
Price at 30 September 2002	£135.31	US$123.94	£110.60	US$111.11	£88.24	MSCI Index
Return for Quarter (net)	1.81%	1.85%	2.34%	2.10%	-4.91%	-20.42%
Year to date return (net)	3.75%	3.27%	5.88%	4.40%	-4.31%	-32.53%
Year 2001 return (net)	5.51%	5.11%	6.83%	5.38%	-7.19%	-15.11%
Year 2000 return (net)	9.59%	9.66%	6.53%	6.89%	-0.64%(1 mth)	-7.11%
Annual volatility	1.0%	1.4%	2.6%	1.9%	8.6%	22.9%
Size of Fund (millions)	£25.5	US$11.0	£5.5	US$3.3	£4.6	

Enhanced Bond Funds

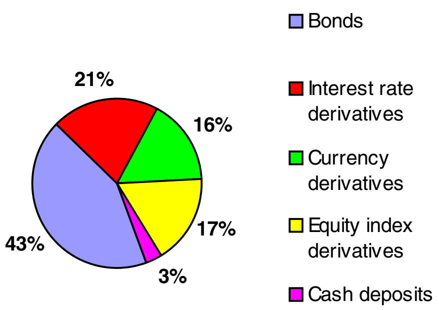


The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds, with not more than 5% allocated to any one issuer. The Sterling and US Dollar bond portfolios currently yield 4.3% and 3.0% per annum gross to maturity, and both have average net hedged durations of less than 1 year.

Despite the continuing global economic weakness and threat of war against Iraq, we continue to substantially hedge the interest rate exposure of our longer duration bonds. Current bond yields are very low by historical standards and we are concerned that bond prices could fall significantly on any signs of an economic upturn or resolution of the Iraqi conflict. Accordingly, the Funds have only benefited to a limited extent from the resulting appreciation in our bond portfolios, as a large portion of these gains has been offset by corresponding losses incurred on the hedges.

Both Bond Funds produced good positive returns for the quarter and are ahead of cash deposits for the year to date.

Diversified Hedge Funds

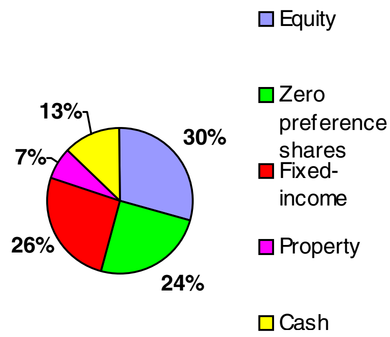


The Diversified Hedge Funds focus on absolute return investment strategies, which seek to generate consistent positive returns irrespective of market direction. We look to achieve these returns by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross exposure of these derivatives positions is limited to the total funds under management. As these positions require limited margin outlay, the balance of funds is invested in short-dated investment grade bonds to provide underlying income for the Funds.

The quarter proved to be a volatile one for derivatives markets. Our limited directional derivatives trades, which had made little contribution during the months of July and August, showed positive results in September as equity markets fell and investors sought sanctuary in bonds. Our core non-directional positions continued to generate modest positive returns.

Both Funds generated pleasing positive returns for the quarter and are in line with our target returns for the year to date.

Managed Portfolio Fund



The Managed Portfolio Fund seeks to generate long term capital growth at a lower risk than pure equity alternatives.

The Fund had a difficult quarter as equity markets fell sharply. However, the fund has held up relatively well due to its defensive positioning and has produced a small positive return over the last 12 months compared to a fall of approximately 24% for the World Index.

Unsurprisingly, our equity and zero dividend preference shares have suffered this quarter as a result of the severe market weakness. However, overall losses were limited by focusing on "value" stocks and by reducing our exposure to the less well covered zeros after the brief summer rally in August.

The bonds had a good quarter as yields fell in response to continuing economic weakness.

With our cash position now over 10%, the Fund is reasonably well positioned to take advantage of any good quality bargains that may arise as a result of any further indiscriminate panic selling.

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

The importance of asset allocation in maximising returns

Asset allocation is the process of determining the proportion of funds which should be invested in cash, bonds, hedge funds and equities in order to position a portfolio to generate an investor's expected return over the longer term, commensurate with the amount of risk that investor is prepared to accept. Various studies have found that more than 90% of an investment portfolio's performance is derived from asset allocation.

Every investor has a different return objective and attitude to risk, and his/her preferred asset allocation will be unique. Although we tailor portfolios to match the individual objectives of our investment clients, we also run four asset allocation models to assist clients in understanding the potential risks and returns of various asset allocation strategies. Our cash management facility and range of mutual funds (ie Enhanced Bond, Diversified Hedge and Managed Portfolio Funds) cover all the typical investment classes and should enable an investor to establish his/her preferred asset mix.

Heritage prides itself on being an independent investment manager that does not follow the herd. When you invest in any of Heritage's mutual funds, you are investing directly in the underlying securities and not in a fund that invests in other mutual funds, with consequent additional layers of charges. In keeping with our conservative approach to investment where the protection of capital is paramount, our mutual funds do not use any leverage or borrowings, so their exposures never exceed the assets under management. We do not engage in any financial engineering to attempt to provide capital guarantees which lock-in investors' funds and reduce returns as a result of additional costs. All the securities held by our mutual funds are highly tradable, easily independently priced and the portfolios could all be liquidated on a single day if necessary. This enables us to allow the timely redemption of funds at the end of each month, if required by an investor.

The target net annual return, after management fees and expenses, of our Heritage Sterling-based mutual funds, together with the actual net return and volatility over the last 12 months are as shown in Table 1.

Based upon the information in Table 1 and the historical correlation between the returns of our various mutual funds, we set out in Table 2 four Sterling-based asset allocation models with varying return expectations and levels of risk (as indicated by volatility) as a guide for investors.

From Table 2, it can be seen that conservative investors seeking higher returns than those generated by our Enhanced Bond Fund, should seriously consider allocating a proportion of their funds to our Diversified Hedge Fund (and even our Managed Portfolio Fund) as the increase in risk, as indicated by the volatility figure, does not increase significantly. Bond yields are currently historically low and the opportunities for generating future capital gains from bonds are limited. Even the most adventurous investor, following our growth asset allocation recommendation to target higher returns, would not have lost money over the past 12 months; a period when the MSCI World Equity Index fell 26% in Sterling terms.

We strongly recommend that investors review with us their asset allocation between our various mutual funds in order to maximise their future returns in keeping with their level of risk aversion.

	Cash deposits	**Enhanced Bond Fund**	**Diversified Hedge Fund**	**Managed Portfolio Fund**
Target annual return (net)	3.0%	5.0%	7.5%	10.0%
Actual return last 12 months (net)	3.0%	4.4%	8.3%	0.7%
Actual volatility last 12 months	0.0%	1.0%	2.6%	8.6%

Table 1.

	Target return	**Last 12 months return**	**Last 12 months volatility**	**Enhanced Bond Fund**	**Diversified Hedge Fund**	**Managed Portfolio Fund**
Model portfolios:						
Defensive	5.0%	4.4%	1.0%	100%		
Cautious	6.0%	5.9%	1.5%	60%	40%	
Balanced	7.5%	5.5%	2.7%	24%	52%	24%
Growth	9.0%	3.7%	5.4%		40%	60%

Table 2.

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