Quarterly

# Newsletter & Investment Review

Issue 20 | Combined news & investment review from Heritage | Quarter 4 2002


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**HeritageCapital Management Limited**
Heritage Capital Management Limited is an independent, specialist investment management company based in London and regulated by the Financial Services Authority, providing a wide range of investment services to individuals, trusts and companies.

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Heritage

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## 2002 - Another good year for Heritage

The past year has seen a continuation in the sharply contrasting fortunes of the Heritage Investment Fund compared to global equity markets generally. Whilst the World Index fell by over 20% in 2002 and is now almost 50% below the peak it reached three years ago, the Heritage Investment Fund on the other hand had another excellent year, which has helped it to achieve total investment growth of just over 20% over the past three years. The Fund has three types of sub-funds, covering the major asset classes of bonds, equities and hedge funds and is managed on a conservative basis in line with the Heritage investment philosophy, which places great emphasis on the preservation and enhancement of capital. The details of the individual sub-funds' performances and asset allocations can be found on page 3 and the suggested model portfolios, which enable an individual investor to match their objectives and risk profile to the appropriate combination of these funds can be found on the back page.

## Target returns for 2003

With the continuing substantial reductions in short-term interest rates over the past few years in the UK, US and Europe, supported by some of the lowest inflation statistics in decades, it is appropriate to again temper investors' return expectations for the year ahead. After 12 interest rate reductions during 2001 and 2002, the US Federal Funds rate currently stands at 1.25% per annum. With less drastic rate reductions, the present UK base rate has now remained at 4% per annum for the past 14 months, whilst the European Central Bank rate is currently 2.75% per annum.

Our Enhanced Bond and Diversified Hedge Funds target absolute returns, irrespective of the performance of equity markets. We seek to achieve a net margin over short-term bank deposit rates for these Funds, after management fees and costs. For our Enhanced Bond Fund, this margin is 1% over short-term bank deposit rates, which translates to a target net return of 4.9% per annum for Sterling and 2.3% per annum for US Dollars. These returns may appear modest, but they represent a substantial percentage increase over the rates that are currently available on secure investments and also still show a net real return over the rate of inflation. Our Diversified Hedge Funds, which carry greater (although moderate) risk, target a margin of 4% over short-term bank deposit rates, giving net return targets of 7.9% and 5.3% per annum for Sterling and US Dollars respectively.

Our Managed Portfolio Fund, which is a balanced fund comprising equities and fixed-income securities, targets the historical long-run return delivered by equities, but with substantially lower volatility. With the Sterling interest rate at an historical low of 4% and allowing for an equity risk premium of around 4-6%, the expected return of the Managed Portfolio Fund over the next 12 months is in the region of 8-10%. However, investors should not place too much reliance on such a short-term target due to the inherent volatility and uncertainty of equity returns.

Investors will appreciate that the above target returns are indicative only and that there is no guarantee that they will be achieved over the coming year. As you will be aware, past performance is no guarantee of future performance and the value of investments can fall as well as rise.

# Heritage Capital Management Limited

## *Review for the quarter ended 31 December 2002*

## Market Commentary

Global equity markets managed to stage a recovery in the final quarter of 2003 but this did not prevent the returns for the full year from being the worst for over 25 years. This year was also the third year of the current bear market which now ranks as one of the worst in stock market history.

The large fall this year can to a certain extent be explained by the continued unwinding of the late 1990s stock market bubble but there has also been plenty of additional bad news for investors. The slowdown in the global economy and in particular corporate investment, further terrorist attacks, the threat of war in the Middle East and the corporate governance and accounting scandals in the US have all impacted negatively on investor sentiment.

On a more positive note the market is of course a discounting mechanism and much of this bad news is already in today's prices. It is therefore quite possible that in the absence of further bad news, the market could continue its current rally into the New Year. In particular if the Iraq situation is dealt with swiftly and decisively within the next couple of months it is likely that the oil price will fall back and equity markets will recover strongly.

However, the strength and sustainability of an equity market recovery will depend on the extent to which the global economy, led by the US, is able to recover. Unfortunately, it seems unlikely that we will see the usual strong cyclical recovery which has followed previous recessions. This is because companies will find it hard enough to produce strong earnings growth in the current low inflation environment, without also having to cope with longer-term problems such as high debt burdens and substantial pension fund deficits.

### United Kingdom

In the UK the FTSE 100 index ended the year just below 4,000, a fall of over 24% to levels last seen in 1996.

Unlike the US and Europe, the UK has not cut interest rates which have remained at 4% all year. This is because the industrial slowdown has been offset by bouyant consumer spending associated with a boom in house prices. The biggest risk in the UK is therefore that there will be sharp slowdown in consumer confidence.

The UK's chancellor, Gordon Brown appears to have lost his reputation for "prudence" following his announcement of huge increases in government expenditure at a time of falling tax revenues (due to the weaker economy) which will result in a huge budget deficit. However, overall the UK economy still looks in reasonably good shape and it should at least continue to outperform mainland Europe.

### United States

Despite the fourth quarter rally the overall US market still ended the year down by approximately 23% with the technology biased NASDAQ index down by over 30%. It was also a bad year for the US dollar which had its worst performance since 1987, falling by nearly 10% on a trade weighted basis.

The already substantial interest rate cuts made in 2001 in the end did not prove sufficient to stimulate a recovery in investment spending (although consumers have been enjoying the benefits of low rates) and in November the Federal Reserve was forced to cut interest rates by a further half a point to just 1.25%, the lowest rate for over 40 years. However, with rates this low further cuts will have limited impact. The problem is that most companies are still struggling to reduce their large debt burdens (resulting from massive over-investment during the late 1990s) and are certainly not looking to take on additional debt to finance new investment, no matter how low interest rates fall.

### Europe

The European market was the weakest of all the major markets in 2003 falling by over 33%. The Euro on the other hand was the strongest major currency having broken decisively above parity with the US Dollar towards the end of the year.

The credibility of the ECB has to some extent been improved by their decision to reduce interest rates by half a percent and thus appear to be concentrating on assisting the weakening economy rather than being fixated on controlling inflation. However, rates are still too high for Europe's largest economy, Germany, which is an example of the problems caused by the Eurozone's "one size fits all" monetary policy. Furthermore, the Eurozone's "stability pact" which imposes limits on government budget deficits has been coming under strain and its credibility was certainly was not helped by the EC Commissioner calling it "stupid".

### Japan

Japan was the only major market which fell in the final quarter, although overall it managed to produce the best returns for the full year. The recent weakness has been due to the deteriorating economic indicators which show that the economy is yet again moving back into recession. The continued lack of progress by the Japanese government in tackling the underlying problems also continues to frustrate investors.

### Emerging markets

With limited prospects for the major mature economies, selected emerging markets such as the Far East offer an attractive combination of good growth prospects and attractive valuations as well as offering diversification benefits to the global investor.

## Investment Statistics - 30/09/02

| Equity Markets | Q4 2002 | 2002 | 2001 | 2000 |
|---|---|---|---|---|
| Global - FTSE World ($) | 7.54% | -20.60% | -16.20% | -14.05% |
| UK - FTSE 100 | 5.87% | -24.48% | -16.15% | -10.21% |
| US - S&P 500 | 7.92% | -23.37% | -13.04% | -9.31% |
| Europe - FTSE Eurotop 100 | 5.83% | -33.51% | -18.64% | -3.82% |
| Japan - Nikkei 225 | -8.57% | -18.63% | -23.52% | -27.19% |

*Source : Financial Times*

| Other | UK | US | Europe | Japan |
|---|---|---|---|---|
| Interest rates - base | 4.00% | 1.25% | 2.75% | 0.00% |
| Interest rates - 10 year | 4.44% | 3.75% | 4.15% | 0.79% |
| Exchange rates ( vs GBP ) | - | 1.6099 | 1.5342 | 191.047 |
| Exchange rates ( vs USD ) | 1.6099 | - | 1.0494 | 118.670 |
| Gold ( $ per ozs ) | | $ 343.250 | | |

*Source : Financial Times*

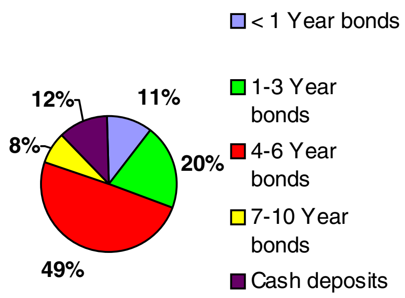
# Heritage Investment Fund Limited

*Performance for the quarter ended 31 December 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% | | 0% - 9% | | -9% - +12% | |
| Price at 31 December 2002 | £137.19 | US$125.14 | £112.76 | US$112.62 | £91.84 | MSCI Index |
| Return for quarter (net) | 1.39% | 0.97% | 1.97% | 1.38% | 4.08% | 5.22% |
| Year 2002 return (net) | 5.19% | 4.27% | 7.95% | 5.82% | -0.41% | -29.01% |
| 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 | 0.9% | 1.2% | 1.8% | 1.8% | 7.9% | 24.8% |
| Size of Fund (millions) | £25.8 | US$10.8 | £7.1 | US$4.0 | £5.5 | |

### Enhanced Bond Funds

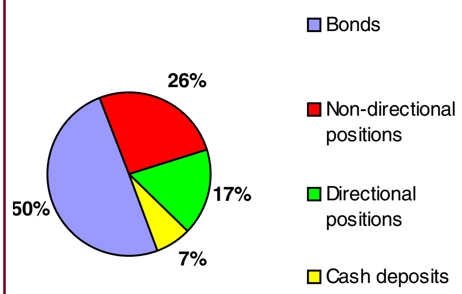



The Enhanced Bond Funds are invested in a diverse spread of high-quality investment grade bonds, with not more than 5% allocated to any one issuer. The Sterling and US Dollar bond portfolios currently yield 4.5% and 2.8% per annum gross to maturity, and both have average net hedged durations of less than 1 year.

Sterling and US Dollars bonds experienced a volatile quarter, showing substantial losses in October and November as investors switched their investments out of the security of investment grade bonds into equities. However, the fall in equity markets in December caused bond prices to recover and end the quarter with yields mostly unchanged. Our continued hedging of the interest rate exposure of the medium and longer duration bonds insulated the portfolios against most of this volatility.

Both Bond Funds had a solid quarter much in line with expectations, resulting in positive returns for the year a few percent in excess of those available on cash deposits.

### Diversified Hedge Funds

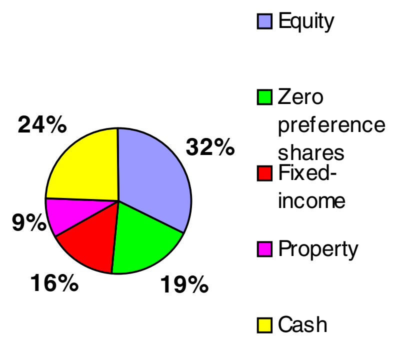



The Diversified Hedge Funds focus on absolute return investment strategies, which seek to generate consistent positive returns irrespective of market direction. We look to achieve these returns by exposure to interest rates, currencies and equity indices employing futures and options. The maximum gross 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.

Volatility fell substantially during the quarter, particularly in equity markets, making it difficult to profit from non-directional derivatives positions, which showed only modest gains. Our bearish directional equity index position did, however, contribute to returns in December as equity markets gave up part of the gains made in the previous two months.

Both Diversified Hedge Funds achieved their target returns for the quarter, and returned approximately 4% in excess of interest rates available on cash deposits for the year.

### 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 good quarter, helped by a recovery in equity markets, and the return for the full year was a small loss of just 0.41% compared to a fall of 29% for the MSCI World Index.

Our equity holdings have continued to benefit from avoiding exposure to the general markets in favour of individual stock selections and exposure to certain favoured sectors such as the strongly performing Lloyds insurers.

The zero dividend preference shares which we hold have an average cover of over 1.5 with a yield to maturity of well over 10%, and so should be capable of producing satisfactory returns even if markets do not recover.

Overall our conservative asset allocation has served us well and we are holding a high cash weighting which allows us the flexibility to take advantage of opportunities as and when they arise.

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

# Equity investment revisited

With equity markets suffering a savage bear market for the past three years, now is a good time review what has gone wrong and to remind ourselves of the fundamental theory of equity investment so that we can consider what might be expected in the future.

### The theory

Investment in a company's ordinary shares gives the shareholder a proportionate share of the ownership of the net assets of the company and any profits which are distributed by way of a dividend.

There are many methods of valuing shares, but ultimately for the long-term investor a share's value is the total of all future cash flows received in the form of dividends discounted to a present value.

Due to the uncertainty arising from the fluctuating fortunes of companies, investment in equities is riskier than cash or bonds. However, in the long-run equities in the form of a broadly diversified portfolio of shares should produce a higher return than cash and bonds to compensate for the additional risk - if they are valued sensibly.

### What went wrong

Unfortunately, equity investment based on this sound fundamental theory was forgotten in the late 1990's. The collective over confidence of investors led by the major financial institutions created a stock market bubble. The ever increasing prices of companies were justified by spurious new valuation techniques such as EBITDA and price to sales ratios. Even companies with no profits or sales achieved huge values based on the number of "clicks" on their web sites.

Of course like all bubbles it eventually burst and the unwinding of the excesses has been a painful lesson for those who thought that markets only went up.

### The conventional approach

The problem with the vast majority of actively managed equity funds (and index funds) is that they tend to be obsessed with not deviating significantly from their equity index benchmark - rather than considering whether their holdings can be justified by sound fundamentals. This means that ultimately they simply broadly track the overall market. This is fine during a long bull market but can lead to inappropriate risk being undertaken when the index is dominated by a number of significantly overvalued companies which these funds then feel compelled to invest in.

### The Heritage approach

We at Heritage on the other hand prefer to ignore the indices and simply assess individual equity investments on their own merits. We analyse a company's net assets, profits and dividends etc. to form an understanding of the business and a view on its prospects and intrinsic value. We then only make an investment if we believe that the current market price is below our estimate of the intrinsic value.

Heritage's equity based fund is the Managed Portfolio Fund and rather than always being fully invested in equities, individual shares are also constantly assessed relative to alternative assets such as bonds and cash, which we believe is a good discipline for equity investors.

Overall this approach has enabled us to largely avoid the huge falls that most equity funds have suffered in recent years.

### Looking forward

One thing we can be sure of is that equity indices will fluctuate in a largely unpredictable way and will continue at times to be driven by the irrational over-confidence or pessimism of the majority of investors.

A portfolio of shares and competing asset classes managed according to sound investment fundamentals will to a certain extent be impacted by the movements of the overall market but should avoid the huge swings that we have experienced in recent years. This could mean not fully participating in potentially higher returns in a strongly rising market but should help to avoid the risk of significant losses.

In the long-run such a portfolio should be capable of producing better returns than cash and bonds with a significantly lower risk than equity indices.

**Model risk-adjusted asset allocations for Heritage's mutual funds:**

| | Suggested asset allocation | | | | | Last 12 months | | |
|---|---|---|---|---|---|---|---|---|
| | Enhanced Bond Fund | Diversified Hedge Fund | Managed Portfolio Fund | Target returns £ | US $ | Actual return £ | US$ | Average volatility |
| Model portfolios: | | | | | | | | |
| Defensive | 100% | | | 5.0% | 2.3% | 5.2% | 4.3% | 0.9% |
| Cautious | 60% | 40% | | 6.0% | 3.5% | 6.3% | 4.9% | 1.0% |
| Balanced | 24% | 52% | 24% | 7.5% | 5.7% | 5.3% | 4.0% | 2.1% |
| Growth | | 40% | 60% | 9.0% | 8.1% | 2.9% | 2.1% | 4.8% |
| Benchmarks: | | | | | | | | |
| 3 month interest rate | | | | | | 3.9% | 1.3% | 0.0% |
| MSCI World Equity Index | | | | | | -29.0% | -21.5% | 24.8 |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