Heritage

Quarterly Newsletter & Investment Review

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In this issue

Heritage Capital Management Limited

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

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Solid progress

Equity markets picked up a bit in the second quarter with all of the major indices making positive progress, although the weak start to the year means that the FTSE 100 index has not quite made it back into positive territory for the year-to-date. Contrary to almost all expectations, 2014 has so far been a good year for bonds with yields falling against a backdrop of subdued inflation.

We are pleased to report that the Heritage Funds have continued their solid progress this year, with both the Absolute Return Funds and Managed Portfolio Fund having another positive quarter. Further details on our funds can be found as usual on page 3.

Stewardship versus salesmanship

When it comes to assessing investment funds the vast majority of investors and advisers tend to look at past performance. This is not without good reason as despite the oft reminded regulatory warning that "past performance is not a guarantee of future results", actual historic results do provide just about the only purely objective guide to a fund.

However, clearly it is important to also consider other more subjective factors, which is why leading fund research companies, such as Morningstar, have come up with alternative methodologies to pure performance analysis, based on what they call "stewardship". Stewardship involves taking a responsible and careful approach to the management of assets entrusted by clients and can be contrasted with salesmanship, which unfortunately is all too common in the financial industry.

Fortunately, fund managers who are more interested in asset gathering can be fairly easily spotted, as they appear to spend more time and effort on attracting new funds to earn fees on rather than looking after their existing clients and investments. In addition to heavy marketing and sales expenditure (ultimately paid for by their clients) they have a tendency to launch flavour of the month, "me-too" funds, which usually turn out to be at the top of the market.

Managers who eschew the salesman approach in favour of good stewardship are harder to spot as they tend to quietly go about their business, but there are certain traits to look out for. These include, how long investment managers stay with a company and manage a particular fund, how much money the manger has personally invested in the fund alongside clients and reasonable fees, with no attempt to extract initial or exit fees or lock clients into funds for set terms.

Hopefully, with a core team that has been together for 18 years and owner managers who invest the bulk of their own family wealth in the Heritage funds it should be clear which camp we believe that we fall into. Finally, whilst it is possible to analyse stewardship as a separate issue from historic performance we also believe that in the long run the two are in fact related, with good stewardship ultimately being rewarded by good performance.

Market Commentary and Outlook

The following market commentary and outlook for the major Western economies of the US, UK and Europe is largely based on market consensus views. However, it should not be relied upon when making investment decisions as it is represents current market views which may well change and not necessarily prove to be correct in the future.

Interest rates and inflation:

During the quarter, the US and UK central banks maintained their short-term interest rates at historical lows of 0.25% and 0.50% per annum respectively to underpin their economic recoveries as inflation held at or below their annualised targets of 2%, whilst the EU reduced its benchmark refinancing rate further from 0.25% to 0.15% to combat low inflation and high unemployment. The EU also became the first major central bank to levy a negative interest rate of -0.10% on its deposits to increase credit to the economy.

The market consensus for the path of future short-term interest rates, which can be derived from short interest rate futures, currently indicates that, by the end of 2014, the UK may be the first major economy to raise short-term interest rates by 0.25% to 0.75% on recent strong GDP growth and falling unemployment, but that US and EU rates will most probably remain at their current lows of 0.25% and 0.15% respectively. By the end of 2015, the market expects US and UK short-term interest rates to be around 1.00% and 1.75% per annum, whilst by the end of 2016 they may be as high as 2.00% and 2.50% respectively.

Both the US and UK central banks have indicated that future rate increases will be in small increments (most likely 0.25%), whilst the Bank of England has commented that markets are underestimating the likely pace of future interest rate increases. In contrast, the futures markets do not expect the EU to start increasing interest rates until 2016 and then only to a modest 0.25%.

Bond yields and spreads:

Contrary to expectations, US and UK 10 year government bond yields have both fallen from levels of around 3% at the beginning of this year, despite the US tapering its bond buying programme, and are currently 2.52% and 2.67% respectively. In the EU, 10 year German government bond yields have similarly fallen from almost 2% at the beginning of the year to 1.25%. One reason is that inflation has been subdued and is holding below or close to the target rate in all three economies of 2% per annum and this lack of pricing pressure has kept short-term interest rates and bond yields low.

Credit spreads on 5 year investment grade US Dollar and Euro denominated corporate bonds over government bonds are just off their historical lows at 0.58% and 0.62% respectively, having fallen from highs of over 2% at the end of 2008, and currently do not offer much compensation for the additional risk of holding corporate bonds. With short-term interest rates expected to starting rising later this year, the market outlook is for a less steep, higher yield curve.

Government and corporate bonds carry significant downside risk at these low yields and credit spreads, and their future performance is asymmetrically skewed with limited upside, but substantial downside should yields rise and credit spreads widen. Liquidity may also be a concern with bond dealers having substantially reduced their inventories to meet bank capital adequacy requirements.

Equity valuations:

US, UK and European large cap equity indices advanced by between 2% and 5% this quarter, with the US and UK indices being just off their all-time highs, supported by low interest rates and a modest overall improvement in earnings.

Based on its trailing price to earnings (PE) ratio of 18.7, the US S&P 500 equity index looks fully valued when compared with its average over the past 25 years of 19. The price to book (ie net asset value) ratio of the S&P 500 index of 2.6 is also close to its long term average of 2.7, again supporting the view that the US equity market may be fully valued. With the US constituting over 50% of the world equity index, it has a major impact on the performance of other equity markets.

The current trailing PE ratios of the UK FTSE 100 and the Euro STOXX 50 equity indices are 15.8 and 16.4 respectively, and their price to book ratios are 1.9 and 1.6, which makes these equity markets not quite as expensive as the US equity market. At these levels equity markets may be vulnerable to any external shocks such as future interest rate increases and major geopolitical events. This does not mean that the bull market is necessarily coming to an end, but that the risks of investing in equities at this late stage of the bull market are high.

Investment Statistics - 30/06/2014

Equity Markets	Q2 2014	YTD 2014	2013	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global (£)	2.40%	3.13%	19.85%						
US (S&P 500)	4.69%	6.05%	29.60%	19	2.3%	0.25%	2.52%	1.7106	1.0000
UK (FTSE 100)	2.21%	-0.08%	14.43%	16	3.9%	0.50%	2.67%	1.0000	1.7106
Europe (STOXX 50)	2.11%	3.84%	17.95%	16	3.5%	0.15%	1.25%	1.2494	1.3692
Japan (Nikkei 225)	2.25%	-6.93%	56.72%	19	1.6%	0.10%	0.55%	173.34	101.33

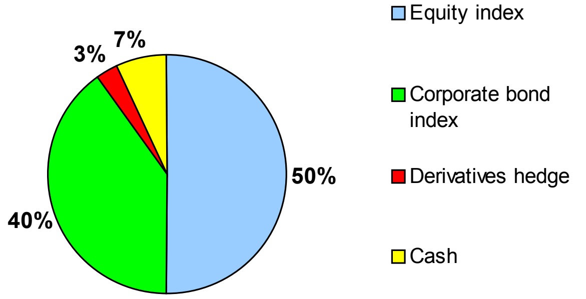
Source: Thomson Reuters

Heritage Investment Fund Limited

Review for the quarter ended 30th June 2014

Performance	Absolute Return Funds		Managed Portfolio Fund	Inflation (UK)	TR Global World Index (£ total return)
Risk profile	Moderate		High /Moderate		
Minimum investment horizon	3 years +		5 years +		
Target net annual return	Inflation plus 2-3% (ie 4-5%)		6-7%		
Price at 30 June 2014	£166.54	US$138.65	£223.60		
Return for quarter	2.08%	2.29%	1.75%	0.41%	2.40%
Year 2014 return (net)	2.52%	3.23%	3.65%	0.89%	3.13%
Year 2013 return (net)	4.67%	3.98%	13.85%	2.61%	19.85%
Year 2012 return (net)	1.28%	1.95%	13.27%	2.87%	7.93%
Year 2011 return (net)	-2.22%	-2.28%	0.06%	4.55%	-4.50%
Year 2010 return (net)	2.80%	2.06%	10.78%	3.35%	16.49%
Year 2009 return (net)	4.25%	1.26%	10.32%	2.19%	17.86%
Compound annual return (from 1/01)	4.02%	2.37%	6.19%	2.36%	4.57%
Annual volatility	2.60%	2.65%	4.89%	0.09%	9.72%
Size of Fund (millions)	£14.0	U$8.0	£110.8		

Absolute Return Funds



The Absolute Return Funds aim to protect investors capital and generate annual returns significantly in excess of inflation by following a top-down asset allocation strategy investing in a balanced portfolio of liquid exchange traded funds which track developed equity market and investment grade bond indices, with the risk of significant losses being hedged using derivatives.

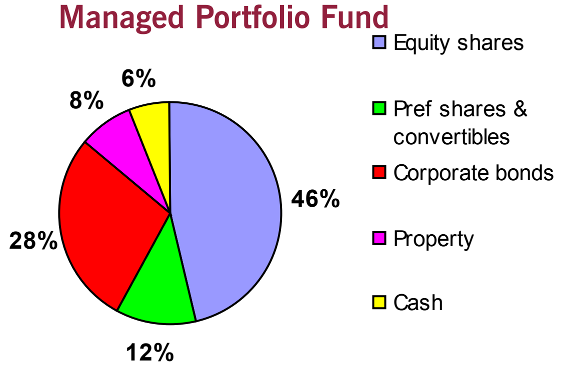
The core equity index funds, which track the S&P 500 largest US companies, contributed 2.72% during the quarter on the back of US equity market gains of 4.69% supported by benign economic data and an accommodative interest rate policy.

The core UK and US investment-grade corporate bond index funds returned 0.29% and 0.47% respectively for the quarter. The bond funds currently yield an average of 2.87% (GBP) and 2.26% (USD) per annum gross to maturity and have average durations of 5.0 and 4.6 years respectively.

The derivatives positions, hedging against losses in excess of -5% on a calendar year basis, cost a net -0.83% for the quarter.

The Funds produced a solid gain for the quarter, and are well positioned to generate returns in excess of inflation in the medium term, with limited downside risk.

Managed Portfolio Fund



The Managed Portfolio Fund seeks to generate long-term capital growth at a lower risk than that associated with pure equity market investment through active management of a well diversified portfolio.

The Fund has built on its good start to the year with a solid second quarter return of 1.75% and for the year-to-date the Fund is now up by 3.65%, which is ahead of the 3.13% total return for the £ World Index.

Our share portfolio gave an overall positive contribution this quarter as markets rose, although a few of our better small cap performers from earlier this year slipped back.

Our corporate bond portfolio had another good quarter as interest rates remain low and credit spreads continue to narrow, to the extent that we are now selectively taking profits on certain bonds where prices have risen to a level where yields are no longer as attractive.

Our property investments also continue to perform well as commercial property markets recover and net asset values rise.

Overall, we believe that our portfolio of well diversified investments remains well positioned to generate decent returns for long-term investors, whilst our relatively defensive positioning should provide some protection against any setbacks.

Convertible bonds

Much of the focus and commentary on our Funds tends to be around the major asset classes of equities and bonds, so we thought that it might be interesting to highlight a fairly niche area of the market that we also invest in through our Managed Portfolio Funds - convertible bonds.

Convertible bonds are occasionally issued by listed companies as an alternative source of finance to equity share capital or pure debt. From the investors point of view they offer an interesting hybrid security which exhibit some of the properties of both bonds and shares.

The easiest way to explain how they work is to look at a specific example. In 2009 the LSE listed utility investment company, Ecofin Water & Power Opportunities raised £80m via a convertible bond. The terms of the bond were a par value of £100, a coupon of 6% and an option to convert the bond into equity shares at any time during the 7 year life of the bond up until maturity in 2016. The conversion price was set at 172.6p which represented a 25% premium to the share price at the time of the issue.

Having looked at this issue in detail we decided that it made a potentially good investment for the Heritage Managed Portfolio for the following reasons. Interest rates at the time were just 0.5% (and still are today), making cash returns very unattractive and whilst some corporate bond yields were similar to the 6% coupon on the Ecofin convertible they often had a large amount of company specific risk, whereas Ecofin had a diversified portfolio of investments in global utility companies and the cover on the bond was excellent at over 4 times. Therefore, viewed purely as a straight bond the issue held quite an attraction with a decent yield and capital protection, but the additional benefit for the holder of the convertible bond was the option to convert their investment into shares if things went well.

We therefore participated in the placing and continue to hold the convertible bond which has been paying a steady 6% coupon for the past 5 years. The performance of Ecofin shares was fairly disappointing in the early years and the convertible bond traded at just over par for most of the time as it remained a solid bond but did not appear to offer much upside from the conversion option.

However, earlier this year the performance picked up considerably with the net asset value of the ordinary shares rising to their current level of over 200p. Although this improvement has dramatically increased the prospects for a profitable conversion of the bonds into shares, the convertible bond's price has not yet fully factored this in and we have therefore recently topped up our holding further.

The Ecofin convertible bond still has 2 years to go before it matures and overall we are fairly confident that it will have made a sound and profitable investment for our Fund.

We have also found a small number of similar convertible bonds within this niche area, which we believe offer potentially attractive returns for a limited amount of risk and act as a good example of how the unconstrained approach of our Managed Portfolio Fund is an advantage over most funds that tend to focus purely on equities or bonds.

Upgraded Heritage website

We are pleased to report that we have recently completed a major upgrade of our web site. The site has been improved to provide enhanced access via a range of modern devices including mobile phones and tablets, as well as good old fashioned computers.

In addition to being able to access our quarterly newsletter and investment reviews, you can also find more regular monthly updates of our Fund prices and commentary.

The site also contains a wealth of information on our team, our investment approach, the services we offer, our Funds, useful downloads on specific topics and archived publications, our contact details and how to find us if you would like to come and see us in person.

We hope that you find the new site at the same address, www.heritage-capital.co.uk, useful and please do feel free to provide us with any feedback that you may have.

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

	Suggested Asset Allocation		Target returns	Last 12 months Actual return	Compound annual return since 1/1/01	Average volatility
	Absolute Return Fund	Managed Portfolio Fund				
Model Portfolios:			£	£	£	
Cautious	75%	25%	5.0%	7.1%	4.6%	2.8%
Balanced	50%	50%	6.0%	8.7%	5.1%	3.3%
Growth	0%	100%	7.0%	11.9%	6.2%	4.9%
Benchmarks:						
UK Inflation				2.1%	2.4%	0.1%
TR Global Equity Index (total return)				9.0%	4.6%	9.7%

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