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.

Contacts - directors

Graeme Olsen
Graeme is responsible for client portfolios and advising the Heritage Managed Portfolio Fund.
graeme@heritage-capital.co.uk

Roy Glew
Roy is responsible for advising the Heritage Absolute Return Funds.
roy@heritage-capital.co.uk

www. heritage-capital.co.uk
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
Broadway House, Tothill Street,
London SW1H 9NQ

A mixed bag

Equity markets were mixed this quarter, with the UK market falling whilst most international markets made positive progress.

Of the Heritage Funds, the Managed Portfolio Fund has done well to post three positive quarters so far this year and all of our funds remain comfortably up for the year-to-date, in contrast to the FTSE 100 index which has recently fallen back into negative territory. Full details on our funds can be found as usual on page 3.

Understanding investment risk

Most people are fairly comfortable with the concept of investment returns and have some understanding of how invested capital can produce returns through income and capital gains. However, whilst most are also aware that the flipside to returns is risk, an understanding of what is meant by risk and its implications is generally less well appreciated and even amongst professional investors there is much debate as to how risk should be defined, measured and avoided or embraced.

The most commonly used measure of investment risk is “volatility” which gives an indication of the variability of returns of an investment. By looking at the price history of a particular investment one can calculate the fluctuation (or standard deviation) from the average returns to get a measure of its volatility or risk. On this scale a bank deposit or very short term bond would exhibit virtually zero volatility, whilst the annual volatility of an equity index might typically be around 10% and an individual company share much higher still at over 20%. Whilst volatility is a useful measure and does give some indication of the riskiness of an investment, in reality there is a lot more to understanding risk than this purely mathematical and historic measure.

Another simpler definition of investment risk is the danger of a permanent loss of capital. Although perhaps less scientific, this definition has the advantage of requiring an investor to consider a range of risks that are not necessarily picked up by historic volatility measures. Examples include businesses that employ excessive gearing or a risky strategy that works for a while until they get caught out (Northern Rock and Lehman), investing in a dying industry (HMV selling albums on the high street) or businesses that become decimated by new competition (Kodak cameras), fraudulent management (Enron and Madoff) or simply paying far too much for a business which fails to live up to expectations (technology, media and telecoms stocks in 1999 and many “growth” companies).

Cautious investors may choose to avoid these type of risks by sticking to Government bonds and savings accounts but often they do not fully appreciate that this simply exposes them to one of the biggest risks to the real value of their capital in the long run – inflation.

Overall investment risk is a complex subject but it is also clear that some level of risk is required for a long-term investment plan and so rather than simply avoiding it, the key to successful investment is to properly understand and manage the risks.

Market Commentary and Outlook

Overall it has been a mixed quarter for investors, with UK market weakness contrasting with reasonable progress in international markets.

A positive aspect for the global economy has been the recent fall in the oil price to below $100 per barrel. This is because the lower oil price feeds through to lower production and transport costs to businesses and ultimately consumers, which has an effect equivalent to a tax cut. This benefit is meaningful for most countries but even more so in the US which has one of the highest oil consumption per capita rates and where the effect has not been mitigated by a weaker currency as the Dollar is enjoying a strong run this year.

Whilst this is good news for the global economy, unfortunately for investors the linkage to share prices is neither strong nor automatic at the best of times, and today we find ourselves in the odd position where the fear of rising interest rates is such that signs of economic recovery, which would normally be a good thing for markets, is more likely to cause a fall in share prices, as investors react to the prospect of an end to supportively low base rates.

United Kingdom

The UK has been the weakest of the major markets so far this year and the recent fall has been across the board, with the FTSE 100, Mid Cap 250, Small Cap and AIM indices all down for the quarter and now in negative territory for the year-to-date.

Part of the recent weakness can be explained by the political uncertainty surrounding the Scottish Referendum, although things could have become a lot worse if the result had gone the other way. With an economic recovery that looks increasingly robust compared to its struggling Eurozone neighbours and the lowest PE ratio and highest dividend yield of the major markets, it is possible that the UK stock market now offers reasonable relative value.

United States

The US has been the strongest of the major markets this year and whilst the S&P 500 index has recently retreated from its all time high of just over 2,000 it remains well up for the year-to-date. Although it is really a Chinese company, the successful IPO of Alibaba in New York which raised a record $25bn, is a demonstration of the current buoyant mood in markets and in total over $40bn was raised in IPOs this quarter.

The economy has also been looking stronger, boosted by lower oil prices as mentioned above and it is the US itself which has been partly responsible for an increase in the oil supply, with the discovery of vast shale oil reserves resulting in US production recently rising above that of Saudi Arabia and it is now expected that the US will become energy self sufficient within the next decade.

Europe

European markets have generally enjoyed a reasonable quarter despite very little positive news on the economic front. In fact in contrast to the situation in the UK and US where economic growth and employment have been improving, the European Central Bank President, Mario Draghi, was forced to cut interest rates to a record low of just 0.05% in September and the focus is now on what additional measures he may take to help the Eurozone's ailing economy.

Japan

The Japanese Nikkei 225 index was actually the strongest of the major markets this quarter, although it remains in negative territory for the year-to-date and a weaker Yen has further exacerbated the loss for unhedged international investors.

Emerging Markets

Up until recently emerging markets had been staging a reasonable recovery after a poor start to the year but a plunge of around 10% in September has brought the rally to an abrupt end.

Whilst emerging markets generally still offer superior growth opportunities, events this year such as Argentina's debt default, the conflict in Russia/Ukraine and most recently the protests in Hong Kong all serve as a reminder of the additional risks associated with emerging market investment.

Investment Statistics - 30/09/2014

Equity Markets	Q3 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 (£)	3.02%	6.24%	19.85%						
US (S&P 500)	0.62%	6.70%	29.60%	19	2.3%	0.25%	2.40%	1.6214	1.0000
UK (FTSE 100)	-1.80%	-1.87%	14.43%	15	3.9%	0.50%	2.36%	1.0000	1.6214
Europe (STOXX 50)	1.76%	5.07%	17.95%	16	3.8%	0.05%	0.91%	1.2835	1.2632
Japan (Nikkei 225)	6.67%	-0.72%	56.72%	19	1.5%	0.10%	0.53%	177.78	109.66

Total returns- including dividends

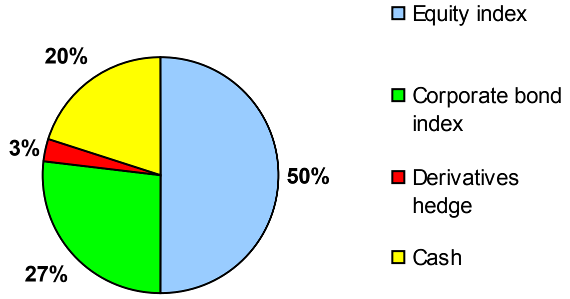
Source: Thomson Reuters

Heritage Investment Fund Limited

Review for the quarter ended 30th September 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 September 2014	£166.28	US$137.49	£225.32		
Return for quarter	-0.16%	-0.84%	0.77%	0.44%	3.02%
Year 2014 return (net)	2.36%	2.37%	4.45%	1.33%	6.24%
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)	3.94%	2.27%	6.14%	2.36%	4.72%
Annual volatility	2.77%	3.02%	3.89%	0.09%	7.77%
Size of Fund (millions)	£15.8	U$7.9	£111.5		

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.

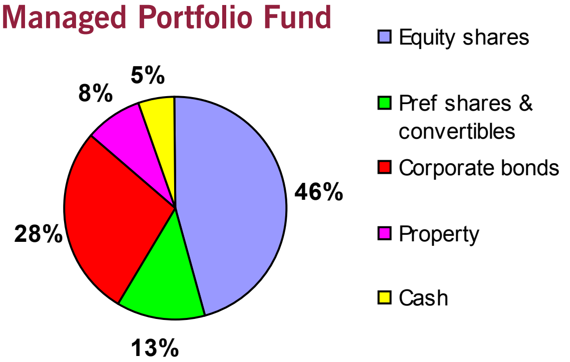
The core equity index funds, which track the S&P 500 largest US companies, gained 0.95% during the quarter despite volatile equity markets, caused by concerns that interest rates will rise sooner than expected and geopolitical events.

The core UK and US investment-grade corporate bond index funds returned 0.26% and -0.11% respectively for the quarter. The bond funds currently yield an average of 2.79% (GBP) and 2.47% (USD) per annum gross to maturity and have average durations of 5.8 and 5.4 years respectively.

The derivatives hedging positions cost a disappointing net 1.14% for the quarter, as the Funds were tightly hedged when equity markets fell and subsequently recovered during the quarter. Losses are presently limited to approximately 4% from current levels.

The Funds produced a small loss for the quarter, but are still 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 had another positive quarter with a gain of 0.77% and for the year-to-date is now up by 4.45%.

Our equity holdings had a mixed quarter with roughly equal numbers of gainers and losers. With an average dividend yield of over 4% and PE ratio of under 13 our share portfolio remains attractively valued compared to the overall market.

Our bond portfolio has performed steadily and currently yields around 6%, and our preference shares and convertibles also had a good quarter as we participated in a couple of new issues which began trading at a premium.

Our commercial property investments have also continued their good run, providing an attractive combination of rising capital values and a decent income yield.

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.

Exchange Traded Funds

Exchange Traded Funds (ETFs) are the fastest growing financial instrument in the asset-management industry. ETFs are investment funds which track an index, commodity or bundle of securities and are traded on recognised stock exchanges. ETFs can hold a variety of securities, such as shares and bonds, as well as cash, forwards, futures and swaps.

The reasons behind the success in the growth of ETFs are that the investor can obtain diversification, they have low expense ratios, they are tax efficient and they have tight spreads between buying and selling prices which is a positive indicator of market liquidity. ETFs are a more recent development in the asset management industry, with the first ETF, which was a domestic equity investment fund tracking the S&P 500, being introduced in 1993.

Typically ETFs track an index through full replication whereby the investment fund will replicate the index by holding exactly the same securities as those in the index in exactly the same proportions. This requires constant rebalancing of the investment portfolio to ensure constant full replication of the index. This provides security and transparency. We, at Heritage, avoid investing in ETFs which employ synthetic replication using derivatives to mimic the return on an index instead of holding the actual securities in the index. We also do not invest in ETFs which use leverage, sampling, track less liquid markets with consequent pricing issues, or ones that are active and opaque as we believe all of these approaches lead to less transparency and increased risk. The transparent passive ETFs which we use enable us to easily and effectively hedge the downside risk using derivatives.

In keeping with its conservative, hedged approach, the Heritage Absolute Return Funds (HARFs) currently hold only two types of ETF that invest in physical securities managed by Blackrock, the world's largest asset manager. The equity ETF tracks the S&P 500 largest 500 companies listed on the US stock exchange and holds all 500 shares in the index weighted by market capitalisation. The US equity market constitutes approximately 50% of the world index.

The Sterling and US Dollar bond ETFs track bond indices comprised of the most liquid investment grade corporate bonds issued by large cap companies. These bond ETFs hold well diversified portfolios of hundreds of bonds, with the exposure to the largest issuer being only 1.2%. Each of these ETFs have over a billion US Dollars or Pounds Sterling invested in them. They trade on the London Stock Exchange like normal shares, and are highly liquid with narrow spreads, making trading and pricing easy and transparent.

A new addition to the Heritage team - Jemma Glew

This year we have been pleased to welcome a new member to the Heritage team, Jemma Glew. Following an excellent educational record, culminating in a double honours degree in Accounting and Finance from Bristol University, Jemma went on to qualify as a Chartered Accountant with Moore Stephens. Since joining Heritage Jemma has now also obtained her Investment Management Certificate and continues to work towards further professional qualifications, as well as gaining valuable practical experience by assisting in a variety of areas within Heritage.

As a reminder, the full Heritage team now consists of;

Graeme Olsen & Roy Glew – the directors and owners of the business, responsible for managing the investments.

Sally Hobbs – responsible for the administration of client cash as well as a wide variety of other general office management duties. Sally has been a valuable member of the Heritage team since 1996.

Rayman Wong – in addition to being our company accountant, Rayman holds the Investment Management Certificate and is responsible for our investment administration. Rayman joined the Heritage team in 1997.

Clare Thompson - Clare joined Heritage in 2010 and her responsibilities include a wide range of investment and general administration activities.

Jemma Glew – the newest member of our team.

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%	4.3%	4.4%	2.7%
Balanced	50%	50%	6.0%	4.7%	5.0%	2.9%
Growth	0%	100%	7.0%	5.6%	6.1%	3.9%
Benchmarks:						
UK Inflation				1.7%	2.4%	0.1%
TR Global Equity Index (total return)				6.2%	4.7%	7.8%

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Tel: +44 (0) 20 7799 2110 Fax: +44 (0) 20 7222 1599
General email: info@heritage-capital.co.uk
Website www.heritage-capital.co.uk