Heritage

Quarterly Newsletter & Investment Review

Issue 68 Quarterly news & investment review from Heritage Quarter 4 2014

In this issue

- Page 2
  Market commentary, outlook and investment statistics
  The latest performance, news and our outlook for the major international markets.

- Page 3
  Heritage Investment Fund Limited
  Performance, commentary and asset allocation for the Heritage Absolute Return and Managed Portfolio Funds.

- Page 4
  - Gaining exposure to the US equity market via the Absolute Return Funds …
  - And individually selected shares via the Managed Portfolio Fund

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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A solid year for the Heritage Funds

Equity markets were mixed this year, with our home UK market falling whilst many international markets, led by the US, made positive progress.

We are pleased to report that despite this tricky background the Heritage Funds all produced solid positive returns, with the Managed Portfolio Fund leading the way this year with a gain of 7.74%. Full details on our funds can be found as usual on page 3.

Target returns for 2015

The big surprise in 2014 was that UK and US interest rates did not rise as expected and remained at levels of 0.5% and 0.25% respectively. Ten year bond yields also unexpectedly fell significantly from around 3.0% at the beginning of 2014 to 1.8% in the UK and 2.2% in the US, due to muted wage growth and falling inflation. Bonds had one of their best performances in recent years, whilst equities were mixed, with the US market supported by growing evidence that their economy is improving. Short interest rate futures are currently forecasting that, by the end of 2015, short-term rates could rise by 0.25% to 0.75% in the UK, and by 0.75% to 1.00% in the US, which is lower than central banks are currently indicating. The consensus is that, unlike 2014, it is highly likely that rates will rise in the second half of 2015 and that this could result in equity market volatility and a flattening of the yield curve.

Our Sterling and US Dollar Absolute Return Funds will continue to focus on capital preservation and target net annual returns of 3% over inflation rates. The Funds seek to achieve this by investing in a balanced portfolio of exchange traded funds which track US equity market and UK or US investment grade corporate bond market indices. The risk of incurring significant losses will be hedged using derivatives but, due to the high cost of hedging, annual losses will now be limited to around 10% (previously 5%), although this cannot be guaranteed. Based on the UK and US central bank benchmark annual inflation rates of 2.0%, our target net annual returns after fees and expenses are expected to be in the order of 5% for our Sterling and US Dollar Absolute Return Funds.

Corporate earnings are expected to continue to grow in 2015 as the global economy recovers. However, the anticipated interest rate increases could unsettle equity markets and cause long-term yields to rise. Returns for the year ahead are, as always, difficult to predict, but we would expect that the well-diversified equity and corporate bond portfolio of the Managed Portfolio Fund should be favourably placed to benefit from any further upside in equity markets and tightening of corporate bond spreads as global economies recover, whilst being well positioned to weather any market weakness on earnings disappointments. Based on an expected risk-free rate of around 0.75% plus a 5-6% equity risk premium, we believe that 6-7% would be a reasonable annual average target return for long-term planning purposes.

Investors will appreciate that the above target returns are for guidance purposes only and that there is obviously no guarantee that they will be achieved over the coming year.

Heritage Capital Management Limited

Review for the quarter ended 31st December 2014

Market Commentary and Outlook

Overall it was a mixed year for investors, with weakness in our local UK stock market contrasting with the reasonable progress made in international markets led by the US.

Although it is useful to analyse markets from a regional perspective, as we do as usual below, often there is a greater divergence at the industrial sector level and for investors, an ability to understand the contrasting fortunes of the various sectors within stock markets can be just as important as those at the geographical and political level.

This was certainly the case in 2014 where the resources sector had a particularly torrid time. The collapse in the oil price, which has halved this year to under $60 per barrel, as new supply has outstripped demand, has had a well publicised impact on the energy sector and it has been a similar story for the prices of metals such as iron ore and the adverse effect that this has had on the major mining companies.

By contrast the healthcare sector has had a stellar year with pharmaceutical companies benefitting from some remarkably successful new blockbuster drugs such as Gilead Sciences's Solvadi treatment for Hepatitis C and biotechnology companies making encouraging progress in their immunotherapy programmes to tackle cancer.
As we featured in our Q3 2013 newsletter, the Heritage Managed Portfolio Fund uses a listed fund, the Worldwide Healthcare Trust, to obtain exposure to this specialist area and this was one of the strongest performers in 2014 with a return of just under 40%.

United Kingdom

The UK stock market had a disappointing year with the FTSE 100 index down by 2.7% and the junior AIM market of smaller companies having an even worse year with a 20% decline.

Part of the reason for this weakness can be explained by an understanding of the sectoral influences that we mention above, as the FTSE 100 and AIM indices were weighed down by their high exposure to resources companies that have chosen to list in London, whilst the more domestically focussed FTSE 250 index of mid caps at least managed to break even for the year, as the UK economy itself has been reasonably robust compared to its European neighbours.

United States

The US was comfortably the strongest of the major markets this year with the S&P 500 index gaining 11.5% as it reached new all time highs of over 2,000.

The US economy has also been looking stronger than the other major trading blocks around the globe, and as the recovery gains momentum, 2015 could finally be the year that interest rates are raised from the "emergency" level of virtually zero that have been in place since the financial crisis in 2008. The big question for investors will be how will markets react to this?

Europe

It was a fairly subdued year for European markets with a small gain of 1.2% for the full year, although things could have been a lot worse given that the list of troubles for the Eurozone remains worryingly long. Germany appears to have stalled, France is struggling under an unpopular socialist government, Italy remains mired in recession and peripheral countries like Greece are still limping along hoping to avoid any further crises. Furthermore with looming deflation added to the negative impact from EU sanctions on Russia, the ECB may finally decide the time has come to unleash its version of quantitative easing to try and stimulate the ailing economy.

Japan

Japan was the strongest of the major markets in the final quarter as investors remain hopeful that the re-election of Shinzo Abe as prime minister will ultimately enable his package of pro growth and inflation reforms to have the desired effect.

Emerging Markets

It has been another disappointing year for investors in emerging markets with Russia being the biggest loser, down by nearly 50% in 2015 due to a perfect storm of collapsing oil prices and economic sanctions resulting from its political interference in the Ukraine.

Investment Statistics - 31/12/2014

Equity Markets	Q4 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 (£)	4.47%	10.99%	19.85%						
US (S&P 500)	4.42%	11.48%	29.60%	19	2.3%	0.25%	2.17%	1.5575	1.0000
UK (FTSE 100)	-0.86%	-2.71%	14.43%	18	4.0%	0.50%	1.76%	1.0000	1.5575
Europe (STOXX 50)	-2.46%	1.20%	17.95%	15	3.6%	0.05%	0.50%	1.2874	1.2099
Japan (Nikkei 225)	7.90%	7.11%	56.72%	20	1.5%	0.10%	0.33%	186.53	119.70

Total returns- including dividends

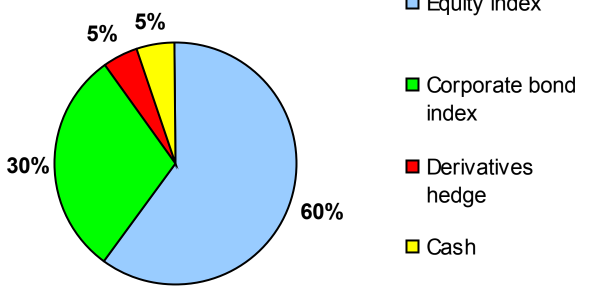
Source: Thomson Reuters

Heritage Investment Fund Limited

Review for the quarter ended 31st December 2014

Performance	Absolute Return Funds		Managed Portfolio Fund	Inflation (UK)	TR Global World Index (£ total return)
Risk profile	Low		Medium		
Minimum investment horizon	3 years +		5 years +		
Target net annual return	Inflation plus 2-3% (ie 4-5%)		6-7%		
Price at 31 December 2014	£172.52	US$141.60	£232.42		
Return for quarter	3.75%	2.98%	3.15%	0.33%	4.47%
Year 2014 return (net)	6.20%	5.42%	7.74%	1.67%	10.99%
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)	4.14%	2.44%	6.26%	2.35%	4.96%
Annual volatility	3.57%	3.33%	3.10%	0.08%	7.50%
Size of Fund (millions)	£14.6	U$8.0	£115.6		

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.

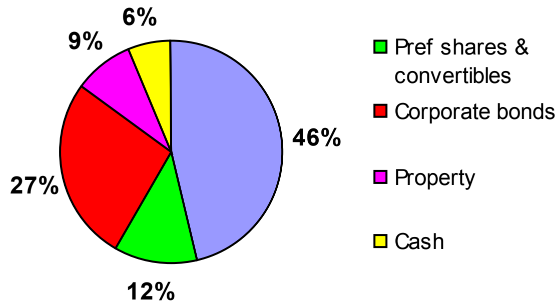
The core equity index funds, which track the S&P 500 largest US companies, contributed 2.77% on the back of a strong quarter for the US equity market, supported by improving corporate profits, collapsing oil prices and falling inflation.

The core UK and US investment-grade corporate bond index funds contributed 1.00% and 0.35% respectively for the quarter. The bond funds currently yield an average of 3.41% (GBP) and 3.15% (USD) per annum gross to maturity and have average durations of 9.1 and 8.1 years respectively.

The derivatives positions, hedging against significant losses, contributed a net 0.10% for the quarter. Losses are limited to approximately 11% from current levels.

The Funds produced significant gains for the quarter and are well positioned to generate returns substantially 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 completed 2014 with another positive quarterly return of 3.15%, taking the return for the full year to 7.74%.

In contrast to the poor performance of the overall UK equity market, our share portfolio has had a decent year with a number of individual holdings gaining over 20% and the final quarter return was helped by a take-over approach for one of our insurance holdings which also boosted our other companies in the sector.

Our corporate bond portfolio has generated another year of good returns for the Fund and the current yield of 5-6% still provides a decent pick-up over the current low rates available on cash and government bonds.

It was also another good year for our commercial property investments which continue to provide 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 market setbacks.

Gaining exposure to the US Equity Market via the Absolute Return Funds...

The US equity market is the leading global equity market, and currently constitutes 58% of the world equity index. With many of the world's largest multinational companies operating globally, US equities exert a significant influence over the performance of other equity markets.

The leading US equity index is the S&P 500 which is comprised of the most widely held 500 US companies, weighted by market capitalisation. The S&P 500 provides extensive diversification across all sectors of the US economy covering technology, financials, health care, consumer, industry, energy and utilities, which reduces volatility and eliminates the specific risk associated with investing in a limited number of individual companies. The index contains many multinational companies, which provides significant exposure to international markets. By investing in the S&P 500 equity index, one is taking a view on the US and, to a lesser extent, the global economy, rather than on the performance of individual companies.

The forecasted GDP growth for the US in 2015 is 3%, which is the strongest GDP growth forecast among the developed economies. The current historical price-earnings ratio (PE ratio) of the S&P 500 index is 18.8 and, based on the consensus projected earnings for 2015, the expected PE ratio for 2015 is forecast to be around 17.5. Compared with the average PE ratio since 2001 of 19, the US equity market would appear to be fairly valued. However, with a current earnings yield of 5.3% on the S&P 500 index, compared with a yield of 2.2% on the U.S. 10 year government bond, and with US interest rates forecast to rise around mid 2015, we favour equities over bonds for the year ahead.

The Heritage Absolute Return Funds (HARFs) currently have 60% exposure to the US equity market. This exposure is achieved by investing in low-cost exchange traded funds (ETFs) quoted on the London Stock Exchange, that hold all 500 shares which make up the S&P 500 index in proportion to their market capitalisation. By investing in these ETFs, the HARFs receive the total return on the S&P 500, made up of the price change of and the dividends paid by the 500 companies constituting the index. The HARFs also have 30% invested in investment grade corporate bond ETFs to reduce the overall volatility of the Funds, as their performance is generally negatively correlated with that of equities. The remaining 10% is held in cash for liquidity. The HARFs also hedge against significant annual losses in excess of 10% using derivatives, although this is not guaranteed.

With a 60:40 ratio of equities to bonds/cash, the HARFs should be well positioned to benefit from the expected strong US economic growth in 2015 and to weather any adverse affects arising from the anticipated increase in interest rates.

..and individually selected shares via the Managed Portfolio Fund

Whilst the Absolute Return Funds provide broad exposure to the world's largest equity market, the Heritage Managed Portfolio Fund provides its equity exposure via predominantly UK listed individual shares, that are selected for a combination of their attractive valuations and growth prospects. Although the overall UK market had a poor run in 2014 with the FTSE 100 and small cap indices both down for the year, our portfolio of selected shares performed rather better, helping the Managed Portfolio Fund to generate a positive return of 7.7%.

Notable winners this year were quite varied and included smaller companies such as the retail bakery Greggs which was up over 70%, transport group Go-Ahead which won a major rail franchise and Bellway which has benefitted from the current strong housing market. Large cap holdings that also appreciated by over 20% included Associated British Foods whose Primark retail division continues to thrive and the pharmaceutical group with an improving pipeline, AstraZeneca.

Of course not all our share selections do this well and 2014's laggards included resources stocks and supermarkets. However, we are pleased to have demonstrated that over time our long-term, value based stock picking approach has provided significantly better returns than the overall UK market.

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%	6.6%	4.7%	3.3%
Balanced	50%	50%	6.0%	7.0%	5.2%	3.2%
Growth	0%	100%	7.0%	7.7%	6.3%	3.1%
Benchmarks:						
UK Inflation				1.7%	2.3%	0.1%
TR Global Equity Index (total return)				11.0%	5.0%	7.5%

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