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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Greek exit fears reverse gains

Following a good start to the year, markets plunged at the end of the second quarter due to fears surrounding the possible exit of Greece from the Eurozone, more or less wiping out the gains made for the year-to-date.

We are pleased to report that despite this setback our largest fund, the Heritage Managed Portfolio Fund, was able to generate a small gain in the second quarter and is now up by 4.6% for the year-to-date. Full details on our funds can be found as usual on page 3.

The limitations of a benchmark index

One criticism that is often levelled at fund managers is that they focus too much on their performance relative to a benchmark index rather than actually making money or at least avoiding losing money for their clients. They tend to think of risk as the danger of underperforming an index such as the FTSE 100 and fear of straying too far from their benchmark means that even if they do not like a particular large company they tend to still own it in an "underweight" position. The result is that most major funds broadly follow whatever the overall market is doing and the worst offenders are often referred to as "closet index trackers". To be fair to fund managers a number of institutional clients take benchmarking and relative performance very seriously, however, in the real world private clients do not have much sympathy with a manger who tries to tell them that he has performed well in a year when the market is down 30% but they have "only" lost 20%.

As a regulated fund the Heritage Managed Portfolio Fund is obliged to have a benchmark and this happens to be the World Equity Index. However, when constructing the portfolio we take no account of what is in the World Index and focus solely on putting together a well diversified collection of what we believe are good investments for the long-term. Also, although the official benchmark is a pure equity index our fund holds other asset classes such as bonds and property which helps reduce the overall volatility and the tactical use of these allows us to reduce the risk of making a loss during periods of equity market weakness – as demonstrated in recent years such as 2011 and 2014 when the FTSE 100 Index was down whilst the Managed Portfolio Fund was able to make positive returns.

So if benchmark equity indices are of limited use to private clients what else might be helpful in assessing how well their investment manager is performing? Helpfully, the Financial Times recently published the results of a survey of nearly 40 of the UK's largest wealth managers and the performance of their "balanced portfolios". A summary of the results are shown below and we have added those for our own version, the Heritage Managed Portfolio Fund.

Average % performance of balanced portfolio

Wealth Manager	Over 1 year	3 years	5 years
Average	4.8	27.4	38.4
Best	7.5	33.5	47.8
Worst	-2.5	19.7	25.6
Heritage MPF	7.7	38.4	54.0

Source: FT Survey results to end 2014

Heritage Capital Management Limited

Review for the quarter ended 30th June 2015

Market Commentary and Outlook

Up until mid June it looked like it would be a reasonable quarter for global equity markets but a late setback triggered by a deepening of the Greek debt crisis pushed most of the major markets into negative territory.

One of the notable features for markets this year has been a resurgence in merger and acquisition activity to levels not seen since the previous peak in 2007 before the financial crisis. Low interest rates and improving confidence among CEOs has led to an increasing number of deals being done recently with estimates for the value of such deals topping $1.3 trillion in the second quarter of this year.

In common with many aspects of financial markets M & A activity tends to be cyclical as the level of deals escalates as more companies join the bandwagon and managers fear missing out on being part of the action. The justifications this time around are that the deals so far at least have been mainly driven by sensible consolidation within industry sectors, such as the $78bn merger of Time Warner and Charter Communications, whereas in 2007 the major deals tended to be private equity led leveraged buyouts.

United Kingdom

Having finally managed to break the 7,000 barrier earlier this year the recent fall took the FTSE 100 index back to 6,521 at the end of June, just below where it started 2015 and a loss of 3.5% for the second quarter.

The big news for the UK this quarter was the surprisingly decisive result of the general election in May. A majority Conservative government is widely seen as a positive for UK businesses and although the FTSE 100 index has fallen back since the election, this has been more to do with general international market weakness and in fact domestically focussed businesses and small cap stocks have actually been doing quite well and sterling has strengthened against most other currencies.

As mentioned above, M&A activity is on the rise and one of the biggest examples was in the UK where Royal Dutch Shell is set to take-over BG for just under £50bn.

United States

The S&P 500 index has also recently fallen back to around the level that it started the year.

The recent news from Greece has even impacted US markets showing just how interconnected global markets are these days and closer to home there are now also developing concerns from Puerto Rico, which is facing a financial crisis and its governor has stated that it will be unable to repay $70bn of municipal debt.

The main domestic focus for US investors continues to be on the timing and extent of interest rate rises that the Federal Reserve Bank have indicated will be likely later this year, although recent weaker economic statistics could mean that these are once again pushed back.

Europe

Not surprisingly, European markets have also fallen sharply recently although thanks to a very strong first quarter they generally remain in positive territory for the year-to-date.

Despite Greece accounting for just 1.8% of the value of Eurozone economy and the likelihood of it being unable to meet its liabilities being well known to all for some time, the ongoing crisis has proved that it still has the ability to destabilise international markets. This is because although the amounts involved are reasonably manageable by its European partners, there are fears that the wider political implications still provide an existential threat to the Euro itself, particularly if it were to spread to other struggling members of the Eurozone.

Japan

Japan was the one bright spot for world markets in the second quarter with the Nikkei index gaining a further 5% to add to the 10% gain made in the first quarter as there are signs that Shinzo Abe's package of pro growth and inflation reforms will have the desired result. However, one of the side effects has been a weakening of the Japanese yen which has mitigated any gains for foreign investors.

Emerging Markets

Whilst most emerging markets have continued to suffer a relatively poor period recently there has been an incredible bubble inflating in China's domestic equity market. The Shanghai Composite Index has more than doubled within the last year but this type of activity invariably proves to be unsustainable and a 25% fall in the past few weeks shows that this particular party could now be coming to an abrupt end.

Investment Statistics - 30/6/2015

Equity Markets	Q2 2015	2015	2014	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	0.69%	3.43%	4.42%						
US (S&P 500)	-0.23%	0.20%	11.48%	19	2.4%	0.25%	2.34%	1.5710	1.0000
UK (FTSE 100)	-3.72%	-0.69%	-2.71%	16	4.2%	0.50%	2.03%	1.0000	1.5710
Europe (STOXX 50)	-7.39%	8.83%	1.20%	17	3.5%	0.05%	0.77%	1.4099	1.1135
Japan (Nikkei 225)	5.36%	15.96%	7.11%	21	1.5%	0.10%	0.45%	192.35	122.49

Total returns- including dividends

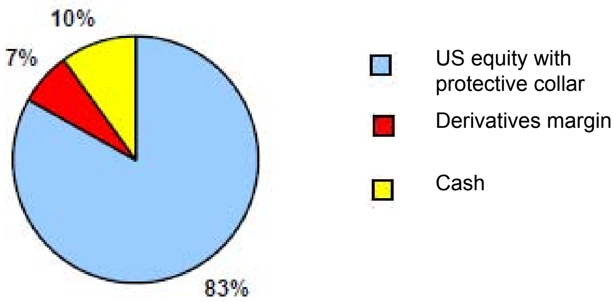
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 30th June 2015

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 30 June 2015	£170.02	US$139.65	£243.18		
Return for quarter	-1.87%	-1.37%	0.36%	0.00%	-5.02%
Year 2015 return (net)	-1.45%	-1.37%	4.63%	0.02%	2.55%
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%
Compound annual return (from 1/01)	3.89%	2.26%	6.37%	2.26%	4.96%
Annual volatility	3.27%	3.09%	3.90%	0.23%	8.81%
Size of Fund (millions)	£12.7	U$10.2	£124.2		

Absolute Return Funds



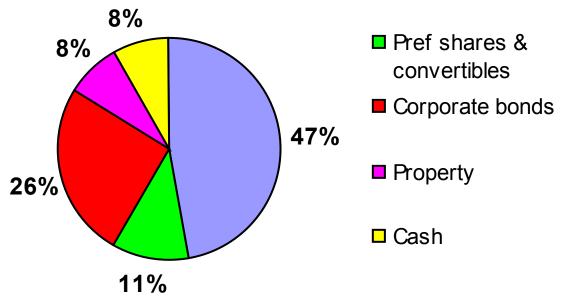
The Absolute Return Funds aim to protect investors capital and generate annual returns significantly in excess of inflation by investing in liquid exchange traded funds which track developed equity market indices, with the risk of significant losses being hedged using derivatives.

The investment in core equity index funds, which track the S&P 500 largest US companies, was increased to 83% during the quarter. These exchange traded funds lost 0.50% for the quarter on the back of a volatile period for equities. During the quarter, we sold the balance of the core UK and US investment-grade corporate bond index funds as we are of the opinion that the risks are skewed to the downside.

The exposure to the US equity market is hedged against significant losses by means of protective puts, whilst the upside exposure has been sold to generate income. These derivatives positions contributed a net 0.58% for the quarter. Losses are limited to approximately 6% from current levels.

The Funds have had a disappointing quarter largely due to volatile equity markets and a strong US Dollar, but are nevertheless 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 managed to continue its run of positive quarterly returns with a small gain of 0.36% and for the year-to-date is now up by 4.63% compared to the MSCI £ World Index which was down 5.02% this quarter and is now up 2.55% for the year-to-date.

A number of our domestic equity holdings received a boost from the unexpectedly positive UK general election result, although our larger caps and international equities had a poorer quarter due to the general market weakness as a result of the Greek crisis. We also received the take-over proceeds for three of our holdings this quarter which has increased our cash weighting.

Bonds prices were generally a bit weaker this quarter due to expectations that interest rates will finally start rising but with a healthy average running income yield of around 6% they continue to offer a decent total return.

Overall, we believe that our portfolio of investments remains well positioned to generate attractive returns for long-term investors, whilst our relatively defensive positioning and diversification should continue to provide some protection against market setbacks.

When will interest rates rise?

Having been through a lengthy period of below normal interest rates, which have boosted the valuations of most asset classes, the UK and US monetary authorities have both indicated that they wish to see rates gradually return to more normal levels provided that this is supported by favourable economic conditions.

At the beginning of 2015, short interest rate futures (which can be regarded as the market consensus) were forecasting that UK and US interest rates would rise by 0.25% to 0.75% in the UK and by 0.75% to 1.00% in the US by the end of this year.

However, six months on, the market view has changed considerably and the outlook is much more dovish, particularly in the US, with the US Dollar weakening as a result. This is because inflation has fallen well below the target rate of 2% per annum due to falling energy prices, weak GDP growth in the first quarter and strong currencies which have put pressure on exports.

Short interest rate futures are currently implying that interest rates will increase by only 0.25% to 0.75% and 0.50% in both the UK and US respectively this year. The recent Federal Open Market Committee statement, however, maintained their forecast that there would be two interest rate increases of 0.25% each this year, in contrast to the one quarter point rise implied by the futures markets.

Looking further ahead, the futures markets are implying further interest rates rises of 0.50% and 0.75% in the UK and US respectively in 2016 and another 0.50% in both countries in 2017. Again, the US Federal Reserve is forecasting more aggressive increases in interest rates of 1.00% next year. Time will tell who is correct, although the markets have a better record of being right!

In contrast, 10 year government bond yields have risen significantly in anticipation of rising interest rates in the coming years and look set to possibly move higher. In the UK bond yields have risen by 0.28% from 1.75% to 2.03% and in the US yields have increased by 0.17% from 2.17% to 2.34%. These increases in bond yields have resulted in significant volatility and losses for government and investment-grade corporate bonds this year. Equity markets will also be impacted by these rising yields as borrowing costs increase, and the road ahead could be volatile and uncertain.

How our bond holdings could be effected by higher rates

As investment managers we need to be aware of the potential impact of rising interest rates on our bond holdings.

For much of their history, the Absolute Return Funds have tended to hold a large proportion of their capital in government and investment grade corporate bonds. However, in recent months this exposure to bonds has been reduced and has now been completely eliminated.

The Managed Portfolio Fund on the other hand does still hold various bonds, although the weighting has been falling in recent times. Furthermore it is important to understand the nature of the bonds that the fund does still hold.

Firstly, there is no exposure at all to low yielding government bonds as it is these (particularly the long dated ones) that are most exposed to rising interest rates. The majority of the bonds held are higher yielding corporate bonds and the performance of these is not just related to interest rate moves but also the underlying strength of the issuing company. Fortunately, there is a tendency for these factors to offset each other to a certain extent, as interest rates tend to only rise as the economy strengthens which is positive for the credit quality of higher yielding issues and spreads tighten in response.

Also, a number of our holdings are already either floating rate notes that will actually benefit from higher coupons if interest rates rise, or they are securities that will switch from fixed rate to floating rate in the next few years.

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%	3.8%	4.5%	2.5%
Balanced	50%	50%	6.0%	5.4%	5.1%	2.4%
Growth	0%	100%	7.0%	8.8%	6.4%	3.9%
Benchmarks:						
UK Inflation				0.7%	2.3%	0.2%
TR Global Equity Index (total return)				10.4%	5.0%	8.8%

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