Heritage Quarterly Newsletter & Investment Review

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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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China's slowdown impacts markets

Concerns over a slowdown in China, which has for many years been the major contributor to global growth, resulted in the worst quarter since 2011 for global equity markets. In the UK the FTSE 100 index was down by around 7% and all of the world's major markets have now fallen into negative territory for the year-to-date.

Although the Heritage Funds were not immune to the market turmoil the Heritage Managed Portfolio Fund was down by just 1.1% this quarter and is up by 3.5% for the year-to-date. Full details on our funds can be found as usual on page 3.

The advantages of multi-asset fund approach

Most investment management groups offer a large number of funds to their clients, reflecting the very wide range of asset classes that are available. In addition to the major asset classes of shares, bonds and property it has been increasingly possible to gain exposure to more specialist areas such as private equity, convertibles, infrastructure, commodities and hedge funds to name but a few.

Whilst having a sensible level of diversification across different asset classes provides diversification and helps to reduce risk, most individuals who are not investment professionals feel ill equipped to weigh up the relative merits and risks associated with such a diverse range of asset classes against an ever changing economic backdrop, and this is why we believe that an actively managed multi-asset fund can provide a useful solution for most peoples needs.

With a managed fund, these key asset allocation decisions are made by an investment professional, taking into account factors such as historical returns, interest rates, bond and property yields, economic statistics and forecasts and share valuation measures including PE ratios and dividend yields. Furthermore, as all the activity takes place within the fund itself, there is no need for the client to be constantly making or approving switches between investments which also helps to keep things simple and paperwork and administration to a minimum.

This approach makes a managed multi-asset fund suitable as a core holding and in fact many people find it the most appropriate home for most of, or even their entire portfolio. In addition to this it can also be used by more sophisticated investors as part of a core/satellite approach - where a core holding in a managed fund is supplemented with other specialist funds of their choice in order to tailor their overall portfolio.

There are a number of factors that we consider go into making a good managed fund. These include taking a long-term approach without any constraints on the range of possible investments or placing an undue emphasis on risky equities, independence so that investments are chosen purely on merit, substantial participation by the fund manager to demonstrate commitment and alignment of interests, and keeping costs to a minimum. Clients will hopefully recognise these factors as the key ingredients of our own Heritage Managed Portfolio Fund.

Heritage Capital Management Limited

Review for the quarter ended 30th September 2015

Market Commentary and Outlook

This quarter has been the worst for global markets since 2011 as rising concerns over a Chinese slowdown were further exacerbated by worsening corporate earnings and nervous investors fretting over US monetary policy. The World Index fell by 9.65 % in the third quarter and all of the global major markets are now down for the year-to-date.

The Chinese slowdown is having a particularly nasty impact on the resources sector. The scale of the over investment during the boom years is becoming increasingly clear and one telling statistic is that the current level of Chinese excess steel production is greater than the entire European Union capacity. The down cycle is now in full swing and the current combination of falling commodity prices and reducing volumes is a massive problem for both global resources companies and emerging markets generally, as these countries tend to be net producers rather than importers of natural resources and commodities.

On a more positive note these deflationary pressures provide cheaper energy and raw material costs for global consumers which ultimately should lead to an upturn in economic growth – and so the cycle continues.

United Kingdom

Having finally managed to briefly break through the 7,000 barrier earlier this year the FTSE 100 index fell as low as 5,900 in the recent turmoil before ending the quarter and the year-to-date down by over 7% at 6,062.

Interestingly the more domestically focussed FTSE 250 index of mid caps and the FTSE small cap index have both performed better than the FTSE 100 index which has been hindered by its exposure to a number of large global resources stocks. The worst of these has been the highly geared commodities group, Glencore, which has seen its value fall by 70% this year whilst miners such as Anglo American, Rio Tinto and BHP Billiton are all down more than a quarter and oil giants Royal Dutch Shell and BP also well down.

The Monetary Policy Committee has once again voted to maintain base rates at just 0.5% and with growth and inflation looking muted the likelihood is that it will now be 2016 at the earliest before rates will rise.

United States

The S&P 500 index also had its worst quarter since 2011, falling by 6.94% to close at 1,920.

A major concern has been corporate earnings growth which had already disappointingly been falling earlier this year and is now in danger of turning negative due to a combination of the recent severe weakness for energy companies and international groups being hurt by the strong US Dollar.

Another worry is the timing and extent of interest rate rises. The Federal Reserve Bank had previously indicated that it might finally start to raise rates in September but once again this has been delayed and with the recent weakening of economic numbers it could well be next year before action is finally taken.

Europe

European markets were down by over 9% this quarter and although the focus has for now at least moved on from the Greek crisis, the European economy remains fragile and unlike their US and UK central bank counterparts the ECB is not even considering interest rate rises for now.

The big corporate story in Europe was the extraordinary admission from Volkswagen in September that it had been cheating emissions tests on its diesel vehicles. Not surprisingly given the uncertainty surrounding how much this could end up costing the group, the share price has reacted very badly with a fall of 50% this quarter.

Japan

Although Japan was the worst of the major developed markets this quarter with the Nikkei index falling 14%, it remains as the best performer for the year-to-date due to its good first half of the year.

Emerging Markets

Whilst developed markets have had a bad quarter emerging markets have been hit even harder and the FTSE BRIC index of Brazil, Russia, India and China was down by 20%.

Furthermore, international investors in emerging markets have suffered even bigger losses once the weakening currencies are taken into account with the Brazilian Real in particular losing around a third of its value so far this year against the US Dollar.

Investment Statistics - 30/9/2015

Equity Markets	Q3 2015	2015	2014	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	-9.65%	-6.55%	4.42%						
US (S&P 500)	-6.94%	-6.74%	11.48%	18	2.7%	0.25%	2.04%	1.5129	1.0000
UK (FTSE 100)	-7.04%	-7.68%	-2.71%	15	4.6%	0.50%	1.77%	1.0000	1.5129
Europe (STOXX 50)	-9.45%	-1.45%	1.20%	15	3.8%	0.05%	0.59%	1.3531	1.1176
Japan (Nikkei 225)	-14.07%	-0.36%	7.11%	17	1.7%	0.10%	0.35%	181.31	119.84

Total returns- including dividends

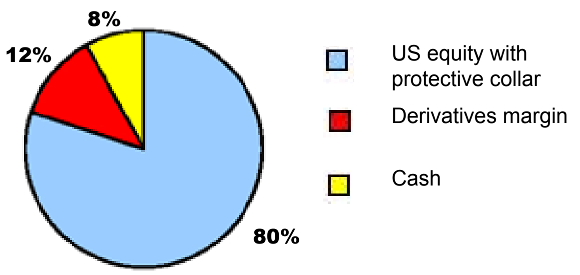
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 30th September 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 September 2015	£166.63	US$136.59	£240.49		
Return for quarter	-1.99%	-2.19%	-1.11%	0.00%	-6.18%
Year 2015 year to date return (net)	-3.41%	-3.53%	3.47%	0.02%	-3.79%
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)	3.68%	2.07%	6.18%	2.22%	4.43%
Annual volatility	4.34%	4.08%	4.92%	0.16%	10.10%
Size of Fund (millions)	£12.2	U$10.0	£124.75		

Absolute Return Funds



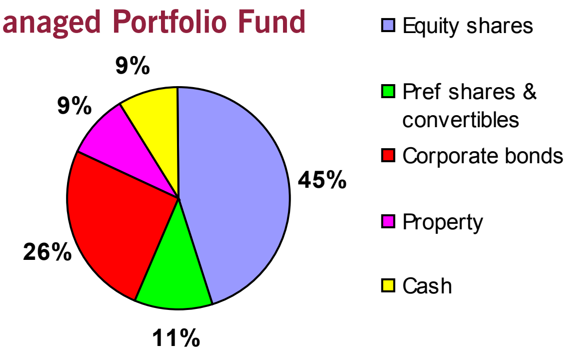
The Absolute Return Funds aim to protect investors capital and generate annual returns significantly in excess of inflation by investing in liquid exchange traded funds which track developed equity market indices, with the risk of significant losses being hedged using derivatives.

The investment in core equity index funds, which track the S&P 500 largest US companies, was 80% at the end of the quarter. These exchange traded funds lost 5.88% for the quarter during an extremely volatile period for equities due to concerns over the slowdown in economic growth in China and the uncertainty over when the US will begin tightening monetary policy. The increasingly strong US Dollar has also adversely affected the foreign earnings of US multinational companies.

The exposure to the US equity market is hedged against significant losses in excess of approximately 5% annually by means of protective puts, whilst part of the upside exposure has been sold to generate income. These derivatives positions contributed a net gain of 4.04% for the quarter. Losses are limited to approximately 1.3% from current levels.

The Funds had a disappointing quarter as a result of the 7% fall in the value of US equities, 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 multi-asset portfolio.

The Fund was down by 1.11% this quarter with the World Index down 6.18%, whilst for the year-to-date the fund is now up by 3.47% compared to a loss of 3.79% for the index.

Although the severe market weakness inevitably impacted most of our shareholdings, it is interesting to note that some shares can still buck the trend and this quarter there were positive contributions from a over a quarter of our individual equities with our largest holding, a small cap insurance company, actually gaining over 20% and take-over bids for two of our other holdings resulting in share price increases of over 35%.

Our corporate bonds and property holdings have held up fairly well although a few preference shares were hit by the impact of the new UK dividend tax.

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

How to deal with the new UK dividend tax

The UK 2015 Summer Budget detailed a new dividend tax which will take effect on the 6th April 2016 and looks to be one of the UK Government's biggest revenue raisers in 18 years, expected to raise £6.8 billion over the next five years. The announcement states that the first £5,000 of dividend income will be tax free and that amounts above this will be taxed at 7.5% within the basic rate band of taxable income up to £32,000, 32.5% within the higher rate band of taxable income between £32,000 and £150,000, and 38.1% within the additional rate band of taxable income over £150,000. There will be no tax deducted at source and, consequently, there will be no notional grossing up and netting down. Dividend income will still be eligible for the personal allowance (currently £10,600).

At present, as dividends are paid out of company profits that have already suffered corporation tax, basic rate taxpayers pay no further tax on their dividend income, higher rate taxpayers pay an effective rate of 25% and additional rate taxpayers pay an effective rate of 30.56%. Therefore, taxpayers are currently paying less tax on dividend income than they would do on earned income.

Taxpayers who receive more than £5,000 in dividend income per annum and who have already used up their personal allowance will pay significantly more tax under the new dividend tax regime. One way to avoid the new dividend tax is to transfer your dividend paying shares into an ISA but, with the current ISA limit of £15,240, it would take several years to transfer large shareholdings into an ISA, and in addition ISAs are subject to a multitude of complex and regularly changing regulations.

Fortunately, an offshore gross roll-up fund such as the Heritage Funds could provide the answer. A roll-up fund automatically retains dividend income and capital gains within the fund without the deduction of tax. These returns produce an increase in the net asset value and price of the fund and subsequently re-investment enables returns to compound tax free within the fund itself. On an ongoing annual basis there is no need for the individual investor in the fund to account for or pay any tax. When you require access to your funds you simply sell sufficient shares to raise the required amount. Although a tax charge is triggered at this point, you do not pay tax on the full amount sold but just on the top-slice of it that represents growth, with the balance representing a return on capital.

Investors looking to avoid the impact of the new UK dividend tax and still have access to their funds would do well to consider an offshore gross roll-up fund - and with no initial charges or exit fees the Heritage Funds offer an unusually simple and efficient alternative. Please note that Heritage is an investment manager and not a financial or tax advisor, so if you require any advice as to the suitability of the Heritage Funds and how they might fit into an overall financial plan, you should seek appropriate financial advice – which we are happy to arrange through an association we have with a well established regulated advisor.

Investing in property - an update

A couple of years ago, in our Q2 2013 newsletter, we included an article on investing in property as we felt that there was an attractive opportunity in commercial property to provide a decent income in an environment of low interest rates as well as the potential for a recovery in capital values.

As an example we highlighted a listed property fund that we had been buying within our Heritage Managed Portfolio Fund, Picton Property, which provided a well diversified spread of over 60 offices, shops and industrial properties providing a net yield of around 7%, and as property was out of favour with most investors at the time we were able to build our position at a discount to the underlying net asset value.

We are pleased to report that subsequent progress has been excellent. As commercial property markets have recovered and the fund's debt has been refinanced at more attractive interest rates, Picton's net asset value has increased from 49p to the current level of 70p. In addition the shares no longer trade a discount to NAV so the share price gains have been even stronger and finally we have also received a very healthy income yield over the period.

Although future returns are unlikely to be as strong as those recently delivered we still believe solid tangible assets such as property that have the potential to grow both the income and capital can play a useful role in a diversified portfolio for long-term investors.

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%	1.8%	4.3%	4.3%
Balanced	50%	50%	6.0%	3.5%	4.9%	4.3%
Growth	0%	100%	7.0%	6.7%	6.2%	4.9%
Benchmarks:						
UK Inflation				0.3%	2.2%	0.2%
TR Global Equity Index (total return)				0.5%	4.4%	10.1%

Heritage

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