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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A good year for Heritage despite difficult markets

After a promising start to the year markets suffered a mid-year slump on concerns over Greece, a slowdown in China and rising US interest rates and despite a partial recovery in the final quarter, the major equity market indices in the UK and US ended 2015 in negative territory, with bonds also suffering a difficult year.

We are pleased to report that despite this tricky background our largest fund, the Heritage Managed Portfolio Fund was able to produce a gain of 6.8% in 2015. Full details on our funds can be found as usual on page 3, as well as a more detailed analysis of their performance for the year on page 4.

Target returns for 2016

The US finally raised short-term interest rates in December 2015 by 0.25% to 0.50% after keeping them at historic lows for 7 years, but the UK did not increase rates as expected by the markets and they remain at 0.50%. Ten year bond yields fluctuated significantly during the past year, ending up 0.21% at 1.96% for the UK and up 0.11% at 2.28% in the US. Government bonds fell in value during the year as a result of rising yields, whilst the UK and US equity markets ended in negative territory as a result of the collapse in energy and commodity prices following the slowdown in China. Short interest rate futures are currently forecasting that, by the end of 2016, short-term rates may rise by 0.50% to 1.00% in both the UK and US, but the US central bank has indicated that it expects rates to rise by as much as 1.00% over the coming year.

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 currently seek to achieve this by investing in exchange traded funds which track the US equity market index. The risk of incurring significant losses will be hedged using derivatives to limit annual losses to around 5%, although this cannot be guaranteed. Based on the UK and US current annual inflation rates of close to zero and the central banks benchmark rate of 2%, our target net annual returns after fees and expenses are expected to be in the order of 3%-5% for our Sterling and US Dollar Absolute Return Funds.

It is anticipated that 2016 will again reward superior stock selection by avoiding those sectors which have depressed stock market indices, such as energy and commodities in 2015. The outlook for corporate earnings in 2016 is uncertain as much depends on the sustainability of the modest global recovery. Furthermore, the anticipated interest rate increases could unsettle equity markets and cause long-term yields to rise further. 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 1% 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 long-range target returns are for guidance only and that there is obviously no guarantee that they will be achieved over the coming year.

Market Commentary and Outlook

It was a decent final quarter to 2015 with all of the major equity markets registering reasonable gains. However, this was not enough to counteract the weakness in the previous two quarters and for the year as a whole the Global equity index lost just over 2%, with bond markets also suffering a difficult year.

One of the interesting features in equity markets recently has been the emergence of a small number of large US stocks that have done very well and without which the overall market would have done even worse. The core group consists of Facebook, Amazon, Google and Netflix, which have been dubbed the "Fangs" and extending the group to include Microsoft, Salesforce, Ebay, Starbucks and Priceline produces the "nifty nine" and both of these groups were up by over 60% in 2015.

This is reminiscent of the so called "nifty fifty" group which dominated the US market in the early 1970s and although it may just be a point of interest, there is also a slight concern that it is symptomatic of an ageing bull market where earnings growth generally is hard to find and investors are drawn to a small group of stocks that offer a more exciting story. Furthermore membership of this exclusive club of "winners" is no guarantee of long-term success and whilst the likes of Pfizer, Coca-Cola and Disney have continued to thrive over the long-term, others such as Kodak and Polaroid turned out to be disastrous investments.

United Kingdom

The FTSE 100 index has been the worst of the major equity indices in recent times and although it was up by 2.98% in the final quarter, for the full year it made a loss of 4.93% and it is the only major market to fall in both 2014 and 2015.

This poor performance might seem strange given that the domestic economy has been relatively healthy and that the political situation now looks reasonably stable following the UK general election in May. However, in reality the FTSE is quite an international index that has been dragged down by London listed global resources shares and the more domestically focused small cap index has actually had a rather better year.

Looking ahead to 2016 two of the major issues for investors are likely to be the timing and extent of any interest rate rises and the uncertainty and implications surrounding the promised referendum on the UK leaving the European Union.

United States

Despite a decent gain of 6.5% in the final quarter, the S&P 500 index failed to make it back into positive territory for the full year.

As described above, this performance would have been even worse had it not been for a small number of very strongly performing technology related stocks as the general market struggled to maintain earnings growth momentum and energy stocks had a particularly bad year.

The big news this quarter is that the Federal Reserve Bank has finally raised interest rates – the first increase since 2006. So far investors appear to have taken it in their stride and the key in 2016 will be how much further the Fed intends to go.

Europe

European markets had a good final quarter which pushed the full year return into positive territory despite the ongoing political and economic challenges that the Eurozone continues to face and unlike the UK and US where interest rate rises are on the agenda, the European Central Bank were still reducing rates in 2015.

Japan

As often seems to be the case Japan was not entirely in step with the other major developed markets this year and the Nikkei index was the best performing market for both the final quarter and the year overall with a gain of just over 9%.

Emerging Markets

With US interest rates rising, a slowdown in China and further weakening of the commodities cycle, emerging markets remain firmly out of favour with investors and the MSCI Emerging Markets index was down by 20% in 2015, making it three years in a row of negative returns.

Investment Statistics - 31/12/2015

Equity Markets	Q4 2015	2015	2014	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	4.34%	-2.07%	4.42%						
US (S&P 500)	6.47%	-0.73%	11.48%	19	2.6%	0.50%	2.28%	1.4739	1.0000
UK (FTSE 100)	2.98%	-4.93%	-2.71%	17	4.3%	0.50%	1.96%	1.0000	1.4739
Europe (STOXX 50)	4.96%	3.85%	1.20%	17	3.5%	0.05%	0.63%	1.3564	1.0860
Japan (Nikkei 225)	8.89%	9.07%	7.11%	18	1.8%	0.10%	0.27%	177.22	120.30

Total returns- including dividends

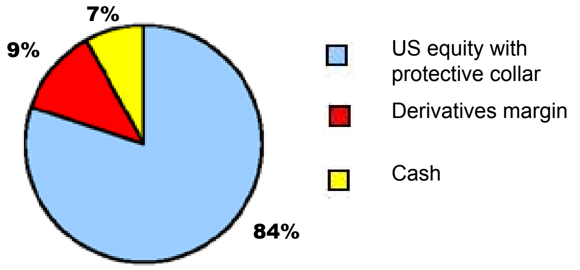
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 31st December 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 31 December 2015	£172.12	US$140.93	£248.21		
Return for quarter	3.29%	3.18%	3.21%	-0.01%	7.57%
Year 2015 return (net)	-0.23%	-0.47%	6.80%	0.06%	3.49%
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)	3.84%	2.25%	6.29%	2.19%	4.86%
Annual volatility	4.60%	4.83%	5.00%	0.05%	10.69%
Size of Fund (millions)	£12.0	U$10.9	£131.2		

Absolute Return Funds



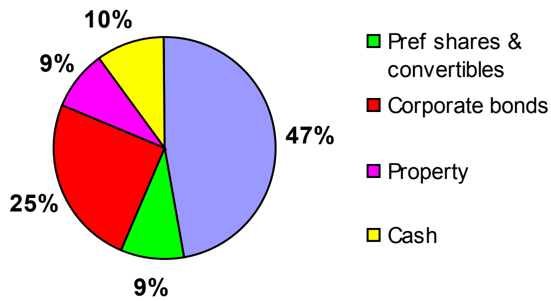
The Absolute Return Funds aim to protect investor's capital and generate annual returns significantly in excess of inflation by investing in liquid exchange traded funds which track developed equity market indices, with the risk of significant losses being hedged using derivatives.

The investment in core equity index funds, which track the S&P 500 largest US companies, represented 84% of the funds under management at the end of the year. These exchange traded funds lost 0.35% during a volatile year as a result of concerns about the slowdown in Chinese economic growth and the timing of the first US interest rate increase.

The exposure to the US equity market is hedged against significant annual losses in excess of approximately 5% by means of protective puts, whilst part of the upside exposure has been sold to generate income. These derivatives positions gained just over 1% for the year. Losses are limited to approximately 5% from current levels.

The Funds produced a disappointing return for the year as a result of the small loss incurred on the US equity index, but 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 multi-asset portfolio.

The Fund finished the year with a gain of 3.21% in the final quarter and for the full year the return was 6.80%, despite it being a poor year for major equity and bond markets.

Some of the main positive factors for our equity portfolio were minimal exposure to the poorly performing energy and commodities sectors combined with a decent performance from our largest sector exposure, insurance, where three take-overs and a number of special dividends helped bolster returns.

Our bond portfolio has had another decent year with the main driver of returns being the income yield of just over 6%, although we also received a boost to our capital this quarter from the conversion of our Electra bond holding and an early redemption of a corporate bond at a premium due to a take-over.

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.

Analysing the Absolute Returns Funds performance in 2015

2015 was the worst type of year for the current investment strategies followed by the Absolute Return Funds – a flat market. The Absolute Return Funds have their core of approximately 84% invested in exchange traded funds tracking the US equity market S&P 500 index, which tracks the top 500 companies in the US by market capitalisation. The downside risk of investing in these ETF funds is hedged by buying protective puts in order to limit losses to approximately 5%, although this cannot be guaranteed. The cost of this hedging is funded by selling options which limits the upside returns which the Funds can generate.

The Absolute Return Funds will, therefore, perform relatively well in years when equity markets perform strongly (as in 2014 when the Sterling Fund returned over 6% when the US equity market rose 11%) and in years when there are large market falls (as in 2008 when the Sterling Fund losses were limited to under 6% when the US equity market fell 39%). In years of rising markets, the returns will lag the index owing to the costs of hedging, but in falling markets losses should be limited to around 5%.

In 2015, the S&P 500 equity market index lost 0.70%, with its strong gains in consumer, healthcare and information technology dragged down by its exposure to energy and materials (ie commodities) stocks. The costs of hedging so tightly are high and the Absolute Return Funds incurred hedging costs of approximately 4% in buying protective put options to limit losses to approximately 5%, which was not required as the loss for the year on the S&P 500 equity market index was modest and less than 1%. Fortunately, however, the Funds did generate income of around 5% by selling options to cover the cost of these protective put options and management and administration fees. This left the Absolute Return Funds with small losses of less than 0.5% for the year after charges, which was just marginally better than the loss on the US equity index.

It can, therefore, be seen that the Absolute Return Funds are more suited to risk-averse investors who wish to limit their downside losses to approximately 5% (although this is not guaranteed) and who are prepared to accept a lower return equal to approximately half of the equity market return in order to achieve this.

... and the performance of the Managed Portfolio Fund

On the face of it 2015 did not provide a particularly favourable environment for the Heritage Managed Portfolio either, as both major equity and bond markets were unable to make positive progress over the year. However, fortunately we were able to produce a positive return of 6.8% to show that an active management approach can add value.

Firstly, our **bond strategy** meant that we were not too exposed to rising rates. Unlike very low yielding government bonds our portfolio of corporate bonds has a running yield of just over 6% which provides a decent base return before any changes in capital values are introduced. Furthermore, our bond selection also provides opportunities for capital appreciation with our Electra convertible bond producing particularly strong capital gains and the takeover of QED resulting in a compulsory early redemption of our bond holding at a premium to par of over 20%.

Avoiding the worst **sectors** has also been beneficial as the Fund has fairly minimal exposure to energy and commodities markets that have suffered a particularly torrid time and fortunately our largest sector exposure has been to insurance which has been a top performer.

Also, although as already noted the major blue chip indices had a negative 2015, it has been a decent year for **smaller companies**, an area where much of our active stock selection efforts are concentrated. Our performance this year has also benefitted from four of our holdings being subject to **take-overs** at significant premiums by larger competitors.

Finally, unlike many mixed asset funds we do not just focus on equities and bonds and our exposure to selected **property based investments** has also enhanced our performance this year.

Of course adopting an active approach in no way guarantees a better result, as our exposure to Asian markets which has been a drag this year demonstrates, and it must be recognised that timing and luck are also major influences over shorter periods such as a single year.

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%	1.5%	4.5%	4.5%
Balanced	50%	50%	6.0%	3.3%	5.1%	4.5%
Growth	0%	100%	7.0%	6.8%	6.3%	5.0%
Benchmarks:						
UK Inflation				0.1%	2.2%	0.1%
TR Global Equity Index (total return)				3.5%	4.9%	10.7%

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