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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A volatile start to the year

It was a very volatile start to the year for equity markets with the FTSE 100 index plunging below 5,600 at its low point in February, a fall of over 20% from its peak in April last year putting it into bear market territory. Thankfully, markets have subsequently rallied and the net result for the year-to-date is no longer looking so bad.

The Heritage Funds ended the first quarter slightly down, although the swings in their prices were not as severe as those for the overall markets due to their relatively defensive positioning. Full details on our funds including the current asset allocation and commentary on performance can be found as usual on page 3.

Taking a long term view pays dividends

It is interesting to note how often we are asked about our thoughts on what will happen to financial markets in the near future or year ahead. This focus on the short term is encouraged both by the media which thrives on the news that the drives current markets and the investment banks and brokers that profit from anything that stimulates more active trading activity.

Whilst this focus on the short term is understandable in a modern society in which we are constantly bombarded by 24-hour news and social media, we believe that it is at odds with the needs of most investors including the individuals, pension funds and trusts that we count as our clients for whom taking a much longer term view is more appropriate.

Of course taking a long-term view does not mean completely ignoring whatever is happening at the moment and simply hoping that things will turn out alright in the end. It is crucial to be able to pick out the key factors that provide relevant investment signals as opposed to the large amount of unnecessary and unhelpful "noise". Differentiating between the noise and what is important to the ultimate prospects for a business allows investors to assess whether current price movements are likely to be temporary or not and helps avoid making snap decisions based on irrelevant facts or chasing the latest fads.

The other important thing that long-term investors need to bear in mind is that although it is the sharp short term movements in prices and capital values that grab all the headlines, the bulk of the long run returns actually come from the income generated from the dividends on the shares, interest on the bonds and rental income from the properties and the reinvestment and the compounding of these returns. Overall, the ability to focus on what drives returns means that rather than being a cause for over enthusiasm when prices rapidly rise or being alarmed and fearful when prices fall, the long-term investor is able to constantly undertake a rational analysis of valuations. This approach has the added benefit of resulting in a much lower turnover and avoids the additional cost burden that results from higher frequency trading.

However, clients are not always supported in taking a more sensible long-term view as fund mangers and company directors are themselves all too often susceptible to short term pressures. At Heritage we do our best to overcome these dangers by building a stable owner managed business and taking a long-term view not only with the management approach that we ourselves take, but also within the companies that we look to invest in.

Market Commentary and Outlook

It was a very volatile start to the year for global equity markets with the worst January in many years followed by a further plunge in mid February taking many indices into bear market territory. However, without any particularly convincing rationale for these large movements down, markets have subsequently managed to stabilise and rally to end the first quarter looking in more reasonable shape.

In theory a major fall in the oil price should provide a large positive stimulus for the global economy, so it was perhaps surprising that falling prices last year were greeted with something closer to despair rather than celebration by financial markets. It seems that the speed and the scale of the plunge was to blame as it put a severe strain on energy companies, which in turn impacted financial markets due to concerns over potential serious losses for the lending banks, bond holders and investors. Furthermore, the sovereign wealth funds of the major oil nations which had been prolific buyers of bonds and equities for many years suddenly faced the prospect of having their finances squeezed and even becoming net sellers, putting further pressure on markets.

However, the hope is that with oil prices having at least found a floor this year, markets can now move on from the initial dislocation fears and focus on the potential positive impact on the wider economy for energy costs that are substantially lower than had previously looked like the norm.

United Kingdom

Despite a terrible start to the year which saw the FTSE 100 index down by over 11% at one point in February when it fell below 5,600, the UK market was able to recover to end the first quarter down by just over 1%.

In fact it is now the currency rather than the stock market which is causing more concern in the UK due to the uncertainty surrounding the upcoming EU referendum and a potential so-called Brexit. Whilst both the Leave and Remain campaigns are making headlines by presenting quite extreme views of the potential consequences either way, the reality is that in the long run most people and companies will find a way to continue to go about their business whichever way the vote goes, although there is certainly the potential for much uncertainty and disruption in the short term.

United States

Whilst the US suffered a very poor start to the year in common with all of the major markets it was the only one that actually managed to crawl back into positive territory for the year-to-date.

A major victim of the market volatility this quarter has been the IPO market with a total of 21 companies having to cancel or postpone planned listings and only 9 managing to successfully float, with the total capital raised being the lowest since the end of the financial crisis in Q1 2009.

Since the Federal Reserve Bank finally raised interest rates in December – the first increase since 2006 – much attention has been paid to when the next rise would be but weaker markets and recent comments by the Fed chief, Janet Yellen, have now dampened expectations of further rate rises for the remainder of the year.

Europe

Despite a late rally European markets had a very poor quarter overall losing over 8%. Although the immediate reaction of the market to the Brussels terrorist attacks was not severe the spread of similar activity is a concern as is the issue of uncontrolled mass immigration and the possible impact on European markets if the UK votes to leave the EU.

Japan

Japan was the worst performing major market this quarter with a fall of nearly 12% for the Nikkei index as fears over the negative impact of a stronger Yen, a slowdown in China and doubts over the flagship Abenomics policies weighed heavily on the Japanese equity market.

Emerging Markets

Following a long period of underperformance, emerging markets finally managed to stage a bit of a recovery this quarter. In part this was due to a very sharp rally in commodities from the extreme lows reached towards the end of 2015 and it will be interesting to see if this turnaround in relative fortunes can be sustained.

Investment Statistics - 31/03/2016

Equity Markets	Q1 2016	2015	2014	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	0.11%	-2.07%	4.42%						
US (S&P 500)	0.77%	-0.73%	11.48%	19	2.5%	0.50%	1.78%	1.4362	1.0000
UK (FTSE 100)	-1.08%	-4.93%	-2.71%	18	4.5%	0.50%	1.42%	1.0000	1.4362
Europe (STOXX 50)	-8.04%	3.85%	1.20%	15	4.2%	0.05%	0.16%	1.2614	1.1378
Japan (Nikkei 225)	-11.95%	9.07%	7.11%	17	1.9%	0.10%	-0.04%	161.64	112.56

Total returns- including dividends

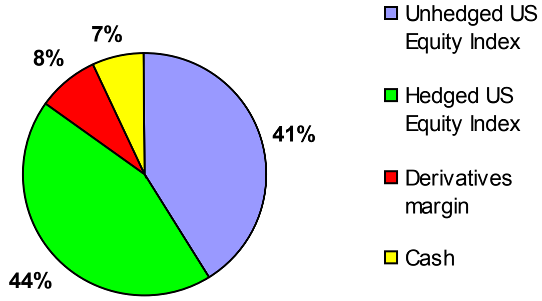
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 31st March 2016

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 3-4%)		6-7%		
Price at 31 March 2016	£170.63	US$139.83	£244.88		
Return for quarter & 2016 ytd (net)	-0.87%	-0.78%	-1.34%	0.04%	4.10%
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)	3.72%	2.16%	6.09%	2.16%	4.96%
Annual volatility	6.63%	6.65%	5.27%	0.04%	11.07%
Size of Fund (millions)	£10.6	U$10.5	£134.5		

Absolute Return Funds



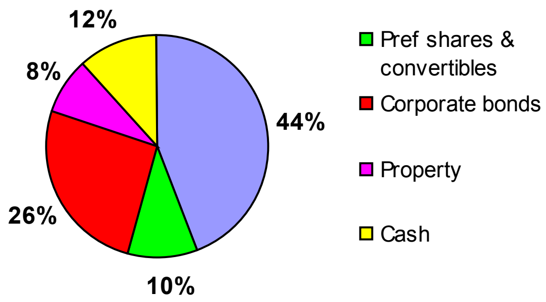
The Absolute Return Funds aim to protect investors capital and generate annual returns in excess of inflation by investing in liquid exchange traded funds which track developed equity market indices, with the risk of significant losses being hedged using derivatives.

The investment in core equity index funds, which track the S&P 500 largest US companies, was 85% at the end of the quarter. These exchange traded funds gained 0.3% for the quarter during a very volatile period for US equities, which were down 13% at one point, due to concerns over the slowdown in economic growth in the US and the tightening of US monetary policy. The continuing strength of the US Dollar has adversely affected the foreign earnings of US multinational companies.

Currently, 44% of the exposure to the US equity market is hedged against significant losses by writing covered call options, where the upside has been sold to protect against falls in the equity market and to generate income. These derivatives positions lost a net 1.0% for the quarter.

The Funds survived a very volatile start to the year with moderate losses, and 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. After a very volatile start to the year markets have subsequently stabilised and overall the Fund was down by 1.3% for the first quarter.

Equity markets took a severe plunge in February with the FTSE 100 index falling to below 5,600 before recovering sharply to end the quarter only slightly down, and our share portfolio followed a similar course.

The volatility in equity markets also had a negative impact on credit markets with spreads widening and bond prices falling which allowed us to pick up some additional bonds on attractive yields.

Whilst our property companies have continued to perform well, reporting increased asset values and dividends, their share prices have recently fallen back with most now trading at discounts to their underlying net asset values.

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.

A haven from Brexit concerns?

At present, the polls are showing that support for remaining in the EU or leaving it are fairly evenly balanced. There is much uncertainty about the implications for the UK should Britain vote to leave the EU. Of particular concern is what impact a vote to leave the EU may have on the UK economy and currency. Sterling has already weakened by 5% over the past six months and many investment houses are forecasting that it may have further to fall.

The US Dollar and US equity market may provide a haven for Sterling investors who are concerned about the impact on their UK investments should Britain vote to leave the EU. Although global equity markets have had a difficult quarter as economic growth has slowed and corporate profits have come under pressure, the US equity market is probably best placed to weather the storm of this slowdown as they have a well diversified spread of multinational companies with access to global markets.

The sector allocation and performance for the year to date of the various sectors of the US S&P 500 equity market index are as follows:

	Allocation	Performance
Information technology & telecoms	23%	4%
Financials	15%	-7%
Healthcare	15%	-6%
Consumer discretionary	13%	0%
Industrials	10%	4%
Consumer staples	11%	4%
Energy	7%	3%
Materials	3%	3%
Utilities	3%	15%

When it comes to equity investment, the general consensus is that it is best not to hedge any foreign currency exposure back into one's home currency, as equities returns tend to be self-adjusting. In other words, when equity markets are weak, this is often because their currency is strong, and vice versa. The US equity market has weakened as its currency has strengthened and its significant foreign earnings of over 50% have translated into less US Dollars for US multinational companies.

Our US Dollar Absolute Return Fund offers an alternative for investors who wish to diversify a portion of their investments away from Sterling and the UK economy. It invests the core of its funds in a very large and liquid exchange traded fund tracking the top 500 US companies. A large percentage of this equity exposure is hedged using derivatives to limit downside losses in the event of significant market falls. Although this Fund has lost 0.8% for the quarter, for investors whose home currency is Sterling, the gain of 2.6% in the US Dollar against Sterling over the quarter has outweighed this loss, and they would have made a net gain of 1.8% in Sterling terms over the past three months.

Strengthening the Heritage team

Whilst the core team at Heritage that has been built up over the last 20 years remains largely unchanged, we are pleased to report a couple of recent positive developments which will strengthen our team.

Firstly, congratulations are in order to Jemma Glew, who recently added the CISI level 6 certificate in Private Client Investment Advice and Management to her qualifications.

We are also pleased to announce that Len Gayler and John Tappenden have joined Heritage. Len and John bring a wealth of experience in managing listed investment companies from their previous home at Cayenne Asset Management.

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%	-0.9%	4.3%	6.0%
Balanced	50%	50%	6.0%	-0.2%	4.9%	5.6%
Growth	0%	100%	7.0%	1.1%	6.1%	5.3%
Benchmarks:						
UK Inflation				0.0%	2.2%	0.0%
TR Global Equity Index (total return)				-1.5%	5.0%	11.1%

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