Heritage

Quarterly Newsletter & Investment Review

Issue 74 Quarterly news & investment review from Heritage Quarter 2 2016

In this issue

EU Referendum result shocks market

With a strong consensus that the "remain" team would win the EU referendum, the result on 24th June came as a huge shock to markets which had not been pricing in a "leave" scenario.

We are pleased to report that markets have subsequently stabilised and that both the Heritage Managed Portfolio Fund and the Absolute Return funds actually produced positive returns for the quarter. Full details including the current asset allocation and a commentary on performance can be found as usual on page 3.

The investment implications of Brexit

As we all know, financial markets hate uncertainty, so in the run up to June 23rd everyone was looking forward to getting the EU Referendum out of the way so that markets could move on with more clarity. Well it didn't quite work out like that! Virtually everyone from pollsters, to betting markets, to political and financial commentators were caught out by the result which came as a major shock and has caused turmoil in global currency and stock markets. Furthermore, far from clarifying things the vote to leave the EU has simply raised a host of new questions and concerns and the UK has been left with a political vacuum with no clear picture of who will be leading the country into what will be an extremely testing and complex period.

As investors we need to try and understand what is happening and assess the possible outcomes and implications. Firstly, there is no doubt that markets have had a severe jolt - Sterling has fallen from 1.50 against the US Dollar on the evening of the referendum to under 1.35 and global stock markets immediately plummeted in reaction to the result.

However, when you look beyond the initial headlines and dig a bit deeper it is not all bad news for investors. For example the FTSE 100 index, which is predominantly made up of global international companies that happen to be listed in London, has subsequently rallied sharply due to the realisation that neither the UK nor the EU are that important to their operations and a weaker pound will actually lead to improved reported profitability. On the other hand domestically focussed companies have come under severe pressure as the process of pricing in a possible economic slowdown has occurred in a matter of days rather than being a more usual gradual adjustment.

It is also interesting to note how weak European markets have been as the implications are potentially worse for our continental neighbours whose politicians may risk harming trade by shooting the deserter in order to discourage other members who may also be tempted to leave the EU. However, ultimately sense should prevail and businesses and individuals will continue with mutually beneficial trade, whilst the UK as a major independent trading nation should find new opportunities as well as continuing to benefit from key advantages such as language, a well respected legal system, London as a leading global financial city in a central time zone and established links with a multitude of countries including those of the Commonwealth.

Finally, with interest rates now looking set to stay even lower for even longer the need for putting together a well chosen and diversified portfolio of assets including dividend paying shares to generate an income and provide the potential for growth has never been more important.

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.

Contacts - directors

Graeme Olsen
Graeme is responsible for client portfolios and advising the Heritage Managed Portfolio Fund.
graeme@heritage-capital.co.uk

Roy Glew
Roy is responsible for advising the Heritage Absolute Return Funds.
roy@heritage-capital.co.uk

www. heritage-capital.co.uk
Tel +44 (0) 20 7799 2110
Fax +44 (0) 20 7222 1599
Broadway House, Tothill Street,
London SW1H 9NQ

Market Commentary and Outlook

The relatively benign looking return of 1.16% for the TR Global Index for the second quarter certainly does not tell the full story, as the major global equity indices have suffered a very volatile ride and there has been an enormous divergence between and even within markets which has been further complicated by large currency moves, as our usual analysis by region below explains.

However, although it is equity markets that generally tend to grab the headlines there have also been some extraordinary developments in bond markets recently. The two year UK gilt has now entered unchartered territory by trading on a negative yield for the first time and the UK is far from being the only country in this unusual position with the likes of Germany, Switzerland, Austria, the Netherlands and Japan all having negative yielding bonds. In fact it is estimated that more than $12 trillion of global government debt is now trading on negative yields and even those longer dated bonds left trading on positive yields offer derisory returns.

The situation has major implications as institutional investors such as pension funds rely heavily on gilts to match their liabilities and provide a long-term income stream to enable payments to pensioners. Also, banks will find it hard to earn a reasonable interest margin in a world of negative rates, but perhaps most worrying of all is for how long will investors be willing to continue to finance governments for no return and what the consequences would be if they lost their appetite for such meagre fare?

United Kingdom

Despite a negative first quarter and another plunge down below 6,000 after the shock Brexit result, the FTSE 100 index rallied strongly in the final week of June to end the quarter with a gain of just over 5.3%.

However, this is primarily a currency effect as the weaker pound helps push the sterling share prices of the multinationals listed in London higher. Furthermore, due to their size the global mega caps such as AstraZeneca, Glaxo, Shell, BP, Vodafone, Diageo and Unilever which dominate the FTSE give a skewed impression of what is happening with the majority of UK shares and the mid cap FTSE 250, Small Cap and AIM indices are in fact all now in negative territory for the year-to-date.

There is no doubt that the UK now faces a very challenging period but on the plus side the Bank of England looks set to cut interest rates and provide additional stimulus for the economy, the Chancellor is now hinting at lower corporation tax rates and interestingly directors' buying of their own listed shares was at an all time high in the week after the referendum, all of which provide hope that most of the more dire predictions about a Brexit scenario should be avoided.

United States

Although the US has not been totally immune from the effects of Brexit, as the initial sharp fall in reaction to the result showed, it has at least provided a relatively good haven and the S&P 500 index managed to creep back into positive territory for the quarter and the year-to-date by the end of June.

In fact the relatively subdued net impact for the US (and indeed the global market which is still dominated by the US) is probably a fair reflection as the exact extent to which the UK and Europe remain connected is dwarfed by the global forces that will drive economies and markets in the long-run.

Europe

European markets have taken the Brexit result particularly badly with the German DAX and French CAC indices falling sharply as the risks of an economic slowdown and potential political contagion are factored in and the STOXX 50 index of leading continental European shares is down by just over 12.3% this year.

Japan

Strangely, although it is on the other side of the world and may have hoped to avoid the volatility plaguing western markets, Japan was actually the worst performing major market this quarter with a fall of over 7% and the Nikkei index is now down by over 18% for the year-to-date. However, it should be noted that currencies have again been an important factor and whilst the FTSE returns have been helped by the weak pound, conversely the Nikkei has been hampered by a very strong Japanese yen this year.

Emerging Markets

Emerging markets are finally having a better year relative to developed markets and recently they have also benefitted from being relatively unaffected by Brexit related concerns - and sterling based investors have had an additional boost from the currency effect.

Investment Statistics - 30/06/2016

Equity Markets	Q2 2016	2016	2015	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	1.16%	1.27%	-2.07%						
US (S&P 500)	1.90%	2.69%	-0.73%	20	2.5%	0.50%	1.49%	1.3311	1.0000
UK (FTSE 100)	5.33%	4.20%	-4.93%	21	4.2%	0.50%	0.90%	1.0000	1.3311
Europe (STOXX 50)	-4.67%	-12.33%	3.85%	15	4.3%	0.05%	-0.13%	1.1984	1.1104
Japan (Nikkei 225)	-7.06%	-18.17%	9.07%	16	2.1%	0.10%	-0.23%	137.35	103.25

Total returns- including dividends

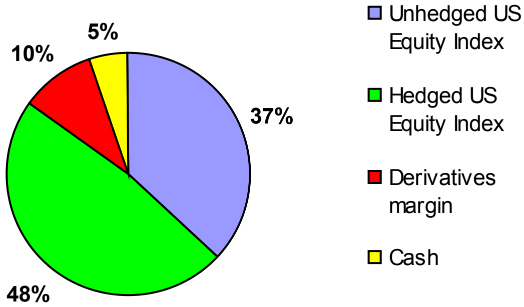
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 30th June 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 30 June 2016	£170.90	US$140.34	£246.22		
Return for quarter (net)	0.16%	0.36%	0.55%	0.09%	9.15%
Year 2016 return to date (net)	-0.71%	-0.42%	-0.80%	0.16%	12.14%
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%
Compound annual return (from 1/01)	3.67%	2.14%	6.03%	2.13%	5.47%
Annual volatility	6.68%	6.73%	5.00%	0.06%	12.43%
Size of Fund (millions)	£10.4	U$7.7	£140.3		

Absolute Return Funds



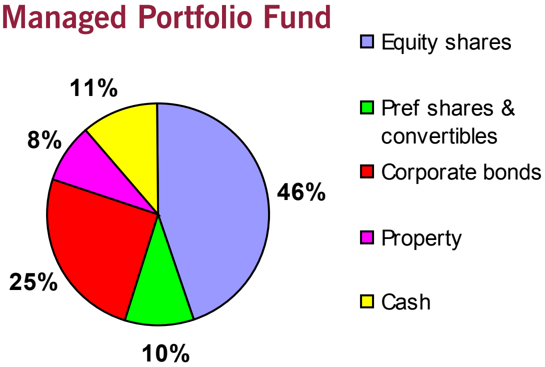
The Absolute Return Funds aim to protect investor's capital and generate annual returns in excess of inflation by investing in liquid exchange traded funds which track developed equity market indices, with the risk of significant losses being hedged using derivatives.

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 1.15% for the quarter as the US equity market continued it's recovery on improving economic data, but it has been unsettled by the decision of the UK to leave the EU. The gains in the S&P 500 index came from a recovery in energy, health care, real estate and utility stocks, whilst technology stocks lost ground over the quarter.

Currently, 48% 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 0.49% for the quarter.

The Funds generated modest gains during a volatile period for US equities which were constrained by losses incurred on hedging portion of the downside risk, 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 had a positive quarter with an overall gain of 0.55%, although a weak finish due to the surprise EU Referendum result pushed the year-to-date return back into negative territory.

There has recently been an unusually high divergence amongst the constituents of our share portfolio – whilst our smaller companies and domestically focussed stocks reacted very badly to the shock Brexit vote, our global multinational shares such as Unilever benefit from a weaker pound and actually closed the quarter at a new all time high.

The current uncertainty has seen the spreads on our higher yielding corporate bonds and preference shares widen and our property holdings which had been performing well in the run up to the Referendum reacted very badly to the result and most are now trading on big discounts to their net asset values.

Overall, we continue to 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 at times of heightened uncertainty.

The impact of Brexit on markets and our Heritage funds

The UK's referendum decision to leave the EU will lead to significant structural and financial implications for the UK, and has inevitably spilt over into global markets as concern grows over economic growth and the future of the EU. The current volatility in the equity and currency markets is expected to continue until there is some clarity on who will lead the governing party in the UK, what form the UK's exit from the EU will take, and what trade agreements the UK is able to negotiate.

After an initial fall of over 8% after the referendum result, the UK FTSE 100 equity market index has recovered remarkably well and, at the quarter end, was trading almost 3% higher than the day before the vote. This has been driven by the fact that almost 80% of the revenue of the large-cap FTSE 100 companies is derived from overseas. The weaker Pound, which has fallen 10% and 8% against the US Dollar and Euro respectively during the last week of June, will result in increased Sterling revenue for those companies. The more domestically focused companies making up the mid-cap FTSE 250 have not fared as well and the index is down 6% in the past week on concerns about the outlook for UK economic growth. However, the EU accounts for approximately 44% of UK exports of goods and services and the depreciation of Sterling against the European currencies should make such exports more competitive.

The futures markets are indicating that the UK short-term interest rate may be reduced by 0.25% to 0.25% per annum before the end of the year to stimulate economic growth and that it will be held at this low level until the end of 2018. This should help support equity and bond valuations. The UK 10 year government bond yield has fallen from almost 2% at the beginning of the year to an historic low of 0.9% per annum, although the economic uncertainty has caused corporate bond spreads to widen. One concern is that the weakness of Sterling will make imports more expensive and most likely cause inflation to rise.

The Absolute Return Funds invest in the US S&P 500 equity index. The top 500 US companies only derive 3% of their revenue from the UK and the UK's decision to leave the EU should have little impact on their revenue. However, the uncertainty generated by Brexit, and its wider implications, has unsettled global equity markets and contributed to concerns over economic growth.The resulting tighter financial conditions may delay any further interest rate increases by the US Federal Reserve. Although these Funds have 85% exposure to the US equity market index, 48% of this exposure is currently hedged against market falls. Despite showing a small loss of 0.4% for the year to date in US Dollars, a UK investor in our US Dollar Absolute Return Fund would have shown a gain of 10% in Sterling terms, given the devaluation of the Pound over this period.

The Managed Portfolio Fund holds a well diversified spread of equities, fixed income securities, property and was also holding over 10% in cash prior to the Brexit shock leaving it well positioned to take advantage of buying opportunities that may arise during this market adjustment. One of the main reasons for the success of the Fund over the years has been sensible and conservative asset allocation and taking a long-term view and whilst some managers believe that they can confidently predict the future and as a result end up doing spectacularly well or badly, we prefer to take the view that markets are inherently unpredictable and that focusing on putting together a collection of sensible investments that will provide decent returns under a wide range of scenarios is a better way to safeguard our capital.

Successful investment is a long-term process and investors would be well advised to sit tight and do nothing as previous market declines have shown that the worst thing that one can do is panic, sell-out at the bottom and miss out on any recovery. Market reaction is often overdone and it is important to ride out this period of uncertainty and volatility.

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%	0.7%	4.3%	6.1%
Balanced	50%	50%	6.0%	0.9%	4.9%	5.6%
Growth	0%	100%	7.0%	1.3%	6.0%	5.0%
Benchmarks:						
UK Inflation				0.1%	2.1%	0.1%
TR Global Equity Index (total return)				13.2%	5.5%	12.4%

Heritage Capital Management Limited
Broadway House, Tothill Street, London SW1H 9NQ
Tel: +44 (0) 20 7799 2110 Fax: +44 (0) 20 7222 1599
General email: info@heritage-capital.co.uk
Website www.heritage-capital.co.uk