Heritage

Quarterly Newsletter & Investment Review

Issue 80 Quarterly news & investment review from Heritage Quarter 4 2017

In this issue

Heritage Capital Management Limited

Heritage Capital Management Ltd 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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2017 has been another good year

2017 has been another good year for investors with all of the major markets making positive progress, including here in the UK where the FTSE 100 index finished the year at a new all-time high of 7,688, up 7.6% since the start of the year.

We are pleased to report that it has also been a year of strong returns for the Heritage funds with our largest fund, the Heritage Managed Portfolio Fund up by 11.5%. This run of positive annual returns now extends back nearly a decade to the end of the financial crisis, during which time a combination of good returns and net inflows has enabled the fund to grow from £30m to its current size of over £180 million. The US Dollar Absolute Return Fund also did well with the strongly performing US equity market helping it to achieve its highest ever annual return of 10.8%.

In addition to these well established Guernsey funds our newest fund, the SVS Heritage Balanced Portfolio, has made a very encouraging start. Since it was launched 13 months ago on 1st December 2016 it has generated a return of 15%. As expected this is very similar to the performance of its bigger brother, the Heritage Managed Portfolio Fund, as the new fund was established as a UK domiciled and regulated version of the HMPF to allow a wider range of investors, including ISAs, to access the investment strategy.

Further details of our Guernsey funds including the current asset allocation and a commentary on performance can be found as usual on page 3 and we now also include information on our new UK regulated fund on page 4.

The importance of MiFID II for investors

The EU's long-awaited regulatory reforms, known as MiFID (which stands for Markets in Financial Instruments Directive) II, are set to become effective from 3 January 2018. They are designed to provide greater protection for investors and make the trading of all asset classes (eg equities, bonds, exchange traded funds, derivatives) more transparent and efficient. The new rules cover the entire financial services industry, including investment management firms such as Heritage.

Significantly more information will have to be reported timeously by brokers and investment managers in respect of each transaction in securities. Investments managers will have to ensure that all investments that they purchase or sell for clients are appropriate, and that best execution has been achieved for clients. To ensure that no conflicts of interest arise, investment managers will have to pay for any research they use to make investment decisions and not accept any gifts, benefits or inducements from third parties. They will also have to clarify in more detail their costs and charges, and break down these costs in currency and percentages on an ex-anti and ex-post basis.

Heritage has published policy statements on its website that incorporate the new MiFID II regulations covering appropriateness, best execution, investment fees, inducements and complaints. It would be appreciated if all clients would familiarise themselves with these new terms of business which will be operative from 3 January 2018. We are in the process of sending out our revised Client Agreements to every client and it would be most helpful if these could be signed and returned to us as soon as possible.

Heritage Capital Management Limited

Review for the quarter ended 31st December 2017

Market Commentary and Outlook

It has been another good year for global markets with all of the major equity indices making positive progress and many registering record new highs.

Although most market commentaries understandably tend to focus on the major developed equity markets investors can no longer afford to ignore the growing influence of emerging markets. Due to their faster growing populations and higher economic growth trends, emerging markets account for an increasing share of the global investment universe.

Within emerging markets one region that stands out as being of particular interest to investors is Asia. The region has grown rapidly in recent years and now accounts for over half of the global population and 24% of global GDP. However, with the region's weighting in the equity world index still under 10% there is certainly scope for Asian stock market growth. Also, valuations look attractive relative to developed markets on a range of measures from PE ratios and dividend yields to price to book value ratios, whilst earnings are forecast to grow strongly.

Furthermore Asia is evolving from being predominantly a cheap manufacturing base for developed markets with a move up the value chain, as demonstrated by the huge increase in innovation measures such as research and development expenditure as a percentage of GDP and the number of patents filed. Productivity is also on the rise as the region has embraced automation. For long-term investors we would argue that it is more important to have some exposure to these powerful emerging trends that will shape the world in the coming decades, rather than fixating on short term political and economic noise closer to home.

United Kingdom

The FTSE 100 index ended the year at a new all-time high of 7,688 with the final quarter gain of 4.3% taking the full year return to 7.6%.

Whilst the UK market's return may seem pedestrian compared to the US, once you factor in the fact that sterling gained nearly 10% against the US Dollar in 2017, the underlying performances are not too dissimilar. Part of the reason for the stronger pound this year is that interest rates are finally on the rise with the move in November to 0.5% being the first time that the MPC has increased rates in more than ten years.

Although the large majority of UK shares performed well in 2017 there were some notable laggards including utility stocks. The reason for this was an unexpected and unwelcome move towards a more interventionist approach by the current Conservative government and a background danger of even worse to come from the possibility of a Corbyn led Labour government – a prospect that many investors find far more concerning than Brexit.

United States

The US market has continued its impressive run with the S&P 500 hitting new highs and appreciating by over 6% in the final quarter to end the year with a 19.4% gain.

To a large extent the index has been driven by America's giant technology groups and it is interesting to note that the largest five US listed companies are now all tech based and that the share price gains for this group consisting of Apple, Alphabet (Google), Microsoft, Amazon and Facebook were all greater than 35% in 2017.

After such a strong run the major concern for investors is that the US market is now starting to look very expensive and the current PE ratio of 24 is certainly well above the long term average. However, the bulls would argue that earnings are growing strongly and with a huge boost still to come from President Trump's tax reforms and global economic growth ticking along nicely the market could continue to trend upwards.

Europe

Europe was the only major market to fall back in the final quarter with the 2.5% decline also relegating the region to the bottom of the pack for the full year.

The recent weakness is partly due to the political uncertainty in Germany where following the inconclusive election in September, Angela Merkel has still not been able to form a coalition government.

Japan

The Japanese market finished the year very strongly with a fourth quarter gain of 11.8%, signalling a resounding vote of confidence in Shinzo Abe's victory in the snap election he called in October.

Emerging Markets

Following a poor relative run against the major markets in recent years emerging markets came back strongly in 2017 with the FTSE Emerging index gain of 28% well ahead of the overall returns for developed markets.

Investment Statistics - 31/12/2017

Equity Markets	Q4 2017	2017	2016	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	5.88%	24.62%	8.49%						
US (S&P 500)	6.12%	19.42%	9.54%	24	2.2%	1.50%	2.41%	1.3515	1.0000
UK (FTSE 100)	4.27%	7.63%	14.43%	21	3.7%	0.50%	1.19%	1.0000	1.3515
Europe (STOXX 50)	-2.53%	6.49%	0.70%	16	3.4%	0.00%	0.42%	1.1252	1.1998
Japan (Nikkei 225)	11.83%	19.10%	0.42%	19	1.6%	-0.10%	0.05%	152.14	112.69

Total returns- including dividends

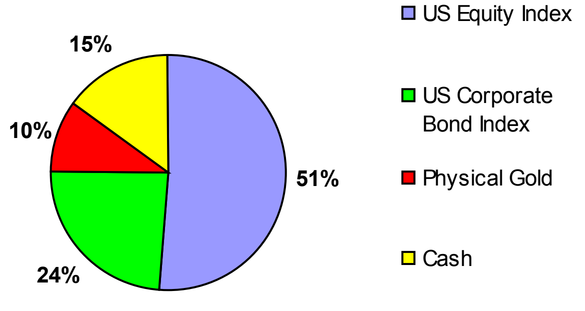
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 31st December 2017

Performance	**US Dollar Absolute Return Fund**	**Managed Portfolio Fund**	**Inflation (US)**	**TR Global World Index (£ total return)**
Risk profile	Low	Medium		
Minimum investment horizon	3 years +	5 years +		
Target net annual return	5%	6-7%		
Price at 31 December 2017	US$159.44	£297.45		
Return for quarter (net)	3.79%	2.56%	0.53%	5.10%
Year 2017 return (net)	10.83%	11.50%	2.14%	13.78%
Year 2016 return (net)	2.08%	7.48%	1.16%	29.59%
Year 2015 return (net)	-0.47%	6.80%	0.08%	3.49%
Year 2014 return (net)	5.42%	7.74%	1.65%	10.99%
Year 2013 return (net)	3.98%	13.85%	1.49%	19.85%
Year 2012 return (net)	1.95%	13.27%	2.10%	7.93%
Compound annual return (from 1/01)	2.72%	6.66%	2.12%	6.68%
Annual volatility	3.05%	3.02%	0.09%	6.09%
Size of Fund (millions)	U$12.1	£184.2		

US Dollar Absolute Return Fund



The US Dollar Absolute Return Fund aims to protect investors' capital and generate annual returns in excess of inflation by investing in liquid, well-diversified exchange traded funds (ETF) which track US equity, corporate bond and gold indices, whose returns are uncorrelated in order to reduce losses and volatility. Downside risk is managed using derivatives to limit losses.

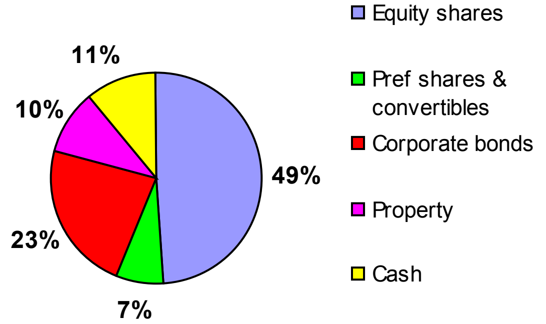
The Fund has 51% invested in an equity index ETF for growth, which tracks the S&P 500 largest US companies and yields 1.45% per annum, which gained 9.14% for the year after hedging.

The Fund also has 24% invested in a US investment-grade corporate bond ETF, yielding 3.25% per annum, both for income and as a hedge against equity market weakness, which gained 1.69% for the year after hedging.

The Fund has a further 10% invested in a physical gold ETF, as a hedge against inflation and US Dollar weakness, which gained 1.01% for the year.

The Fund produced a positive return of 3.79% for the quarter and is up 10.83% for the year. It is well positioned to generate future returns significantly in excess of inflation over the medium term.

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 has had a good year in 2017 with a gain of 2.56% in the final quarter taking the full year return to 11.50%.

Equity markets have enjoyed a strong year and there were excellent gains of over 25% for a number of our shares including Intermediate Capital, Greggs, Computacenter, Bellway, Air Partner, Beazley, Clarke, Victrex and Unilever and double digit gains from some of our specialist funds such as Dunedin Enterprise, Worldwide Healthcare and Utilico Emerging Markets.

Our property investments also performed well with particularly strong gains of over 25% from TR Property and Hansteen and we also realised good profits on a direct investment in 12 properties in Wokingham acquired at a discount from a major housebuilder.

Our portfolio of fixed interest securities has also had another decent year and continues to provide a running yield of over 6%.

Looking ahead, 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 any major market setbacks.

Our approach to fixed income investing

In addition to investing in equities and property the Heritage Managed Portfolio Fund invests in fixed income securities, also known as bonds. With equity markets currently enjoying a prolonged period of excellent growth and bond yields still at very low levels it might be tempting to simply ignore bonds. However, we believe that there is still a place for carefully selected bonds in a portfolio as they can provide benefits in terms of security of income, risk management and diversification. Generally bonds are less risky than equities but it is important to understand that there are many different types of fixed interest securities, each with their own characteristics.

Government bonds

In theory sovereign bonds are the most secure type of bond, as gilts (as they are termed in the UK) are backed by the government. In our view lending money to governments that are running huge deficits for long periods at the current low rates does not make an attractive investment and therefore we currently have no exposure to government bonds.

Corporate bonds

These securities, issued by large companies, rank above the ordinary shareholders and usually offer a fixed return consisting of regular interest payments and a repayment of capital at the redemption date. Corporate bonds offer a higher yield than cash or government bonds. Following the credit crisis we were able to buy a number of good quality investment grade corporate bonds on attractive yields although our exposure to this area has subsequently fallen as the bonds have matured or we have taken profits as prices have risen.

Floating rate bonds

Most conventional bonds pay a fixed coupon making them vulnerable to rising interest rates. However, it is also possible for bonds to pay variable coupons which reset periodically. A decent proportion of the bonds that we currently hold are either floating rate notes or are bonds that will switch from a fixed to a floating rate at a future date, which will benefit from any increase in interest rates from their current low levels.

Convertible bonds

These are bonds that in addition to providing the usual interest payments, also offer the holder the option of converting the bond into shares of the issuing company as an alternative to the repayment of capital at redemption. This can provide the possibility of capital gains if the company does well, whilst still providing the additional security of a bond if the shares do not perform. We have in the past made some excellent gains from such convertibles and we currently hold a small number with good upside potential.

Preference shares

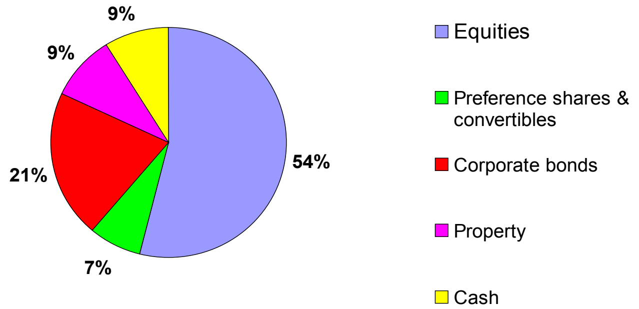
Preference shares are actually more like bonds as they rank ahead of the ordinary shareholders and pay a fixed rate. There are still some attractively valued pref shares available and our highest yielder is currently 8.5%. Also, there are still a few split capital investment trusts which offer attractive opportunities to investors with a good understanding of the zero dividend preference share sector.

Overall our fixed interest holdings offer an average running yield of over 6% and a slightly lower yield to maturity, which we believe offers the potential to provide decent returns, particularly when blended together as part of a well balanced portfolio.

SVS Heritage Balanced Portfolio Fund - summary of key features

Price at 31/12/17	115.0p (launched at 100p 1/12/16)
Fund size	£14.8m
Fund type	OEIC, UCITS (UK domiciled)
Eligible for	ISAs, SIPPs, Funds at Lloyd's
Sedol code	BDQPPL5
Pricing and dealing	Daily
Minimum Investment	£10,000
Management fee	1% per annum
Administrator/ACD	Smith & Williamson

Asset allocation



Commentary and performance

The approach adopted by the Fund is in line with the existing larger offshore version of the fund (the Guernsey regulated Heritage Managed Portfolio Fund). The Fund has continued its positive start with a gain of 2.59% this quarter taking the full year return for 2017 to 12.3%.

Further details and the full fact sheet for the fund can be found on our web site at www.heritage-capital.co.uk.

The information set out above does not constitute an offer to subscribe to shares, which may only be purchased after reading the full Prospectus/Key Investor Information Document (KIID). The Prospectus and KIID can be found at www.heritage-capital.co.uk.

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