Heritage

Quarterly Newsletter & Investment Review

Issue 84 Quarterly news & investment review from Heritage Quarter 4 2018

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.

Contacts - directors

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

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

Jemma Spencer
jemma@heritage-capital.co.uk
Jemma is responsible for compliance oversight and assisting with the management of the Heritage funds.

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

Weak final quarter rounds off a disappointing year for investors

2018 ended on a particularly weak note with all of the major markets down by over 10% in the final quarter and even the previously more resilient US market falling by 14%. Overall this year has been the worst for investors since the financial crisis ten years ago, with the UK market down by 12.5% and the Global index off by just under 10%.

The Heritage Funds did at least manage to hold up relatively well with the Managed Portfolio Fund down by just 2.76% in 2018. Further details on the Managed Fund and our US Dollar Absolute Return Fund can be found on page 3 and on our newer UK regulated fund, the SVS Heritage Balanced Portfolio Fund on page 4.

Keep it simple - why complex products are best avoided when it comes to investment

The past year has acted as a reminder that positive returns for investors are by no means guaranteed and following a poor year such as 2018 we thought it would be useful to provide a reminder of some basic principles for investors that may at least help improve their chances of obtaining a satisfactory result from their investments.

As investment managers we are often asked what we think of some new investment product that is being promoted. There is a vast range of different products on offer these days, from insurance linked bonds and other complex tax driven schemes to so-called "guaranteed" structured products that are often linked to one or more indices.

There are usually a few common features behind all of these products. Firstly on the plus side, and highlighted prominently in the promotional material, will be a seemingly attractive headline rate of return. However, in our experience these products also contain a number of other features which the banks or insurance companies and their network of salesmen are less keen to point out including;

Complexity – Although the sales material will highlight the attractive potential returns, actually understanding what you are investing in is much harder. Also, the small print often reveals that so called "guarantees" only apply to either the capital or income, whilst the risks to the other are conveniently ignored.

Poor value – You can be sure that the product is not offering a free lunch and that on top of the cost of the product itself, the high marketing costs will also be built in either via initial charges or ongoing hidden charges.

Illiquidity – Unlike a simple investment fund, investment products usually have a set lifetime with restrictions on cashing in your investment or penalties for early redemption.

Marketing rather than investment driven – As these products invariably originate from the marketing department and will be promoted via a sales campaign, they are often plagued by the tendency to launch right at the top of the market (think technology stocks in 2000, property backed debt structures in 2007 and cryptocurrencies a year ago).

Finally, the very fact that a product is being sold and actively promoted should be a warning sign. As with most things in life, if someone appears very keen to sell you something you will probably find that he will have more to gain from the sale than you will benefit from the purchase. In our experience good investments are more likely to be found by hunting for value in areas that are currently out of fashion with the large financial institutions, and that simple investment funds are better than complex products.

Heritage Capital Management Limited

Review for the quarter ended 31st December 2018

Market Commentary and Outlook

2018 has ended up being a very poor year for investors as a result of a particularly weak final quarter with the World Index down by 12.7%. For the full year there were significant losses for all of the major equity indices and fixed interest markets also had a bad year due to a combination of rising interest rates and widening credit spreads.

In fact one of the themes this year has been that there were precious few areas of the market that helped investors to protect their portfolios.

In most years there tends to be a mix of positive and negative performances from the various sectors of the equity market but this year there were falls virtually across the board, from Telecoms and Technology with falls of over 20%, Consumer Goods, Financials and Industrials all down over 10% as well as smaller falls for Utilities, Consumer Services and Resources, leaving Healthcare alone as the only sector to avoid losses over the last year.

One of the only positive thoughts as we round up 2018 is that unlike some we did at least ignore the temptation to diversify out of mainstream assets by "investing" in cryptocurrencies, as this was the year that the bubble finally burst with the price of Bitcoin falling by around 80%.

Looking forward to 2019, it appears that most of the known risks such as rising interest rates, the withdrawal of quantitative easing, possible trade wars, Brexit and other general global political uncertainties are now fairly well priced into markets, hopefully at least leaving scope for some slightly more positive themes to emerge in the year ahead.

United Kingdom

Perhaps surprisingly given the ongoing uncertainty surrounding Brexit, the UK was actually the strongest of the major markets in the final quarter, although a loss of 10.4% still made for a very poor end to the year and resulted in an overall loss for 2018 of 12.5%.

As mentioned above, virtually all sectors suffered losses this year and it wasn't just confined to the large caps that dominate the FTSE 100 index, as mid and small caps were down by around 15% and the junior AIM market lost over 17%. Retailers have had a particularly bad year with the likes of House of Fraser, Wine Rack, Maplin, Toys R Us, Evans Cycles and Poundworld all entering administration and even ecommerce retailers were not immune, with the previously high flying online clothing specialist, ASOS, ending the year down by over 60% following a profit warning in December.

United States

The US market had been holding up relatively well compared to other markets for most of 2018 but that all changed in the final quarter. In fact if it hadn't been for a sharp bounce in the final week of December the US would have ended in bear market territory, down by 20% from its record high just a few months ago.

In December the Federal Reserve bank once again increased interest rates by a further 0.25% and at 2.5% US Dollar rates are now significantly higher than the UK at 0.75%, Europe at 0% and Japan where rates are still negative. Up until recently equity markets have taken these US rate rises in their stride and as a sign of more robust economic growth in America. However, there has recently been a change in sentiment and the worry now is that the Fed may press ahead with the further increases that it has signalled for 2019, despite signs that economic growth may have started to falter.

Europe

Europe was the worst performing major developed market in 2018 with a fall of 11.7% in the final quarter taking the overall loss for the year to 14.3%.

Although the Euro interest rate remains at zero, the European Central Bank has now declared that it will stop expanding its QE (quantitative easing) programme under which it has bought over €2.6 trillion of bonds since 2015, giving investors cause for concern over the removal of an important supportive policy whilst Eurozone economic growth remains so fragile.

Japan

The Japanese market has mirrored the US this year, by turning a fairly robust position at the end of quarter 3 into a horror show in the final quarter with a loss of 17% for the Nikkei index. The full year loss of 12.1% was the first since 2011, bringing an end to a decent run for what has often been a volatile and difficult market for investors.

Emerging Markets

Emerging markets have also had a poor year but unlike the major markets which left their worst until the final quarter, they have actually had a relatively decent end to the year. However, as always the averages can obscure differing underlying stories as epitomised by the contrast this year between China where the A Share index was down 30% and Brazil's Bovespa Index which gained nearly 20%.

Investment Statistics - 31/12/2018

Equity Markets	Q4 2018	2018	2017	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	-12.66%	-9.61%	24.62%						
US (S&P 500)	-13.97%	-6.24%	19.42%	18	2.7%	2.50%	2.69%	1.2760	1.0000
UK (FTSE 100)	-10.41%	-12.48%	7.63%	11	4.8%	0.75%	1.27%	1.0000	1.2760
Europe (STOXX 50)	-11.70%	-14.34%	6.49%	13	4.0%	0.00%	0.25%	1.1121	1.1469
Japan (Nikkei 225)	-17.02%	-12.08%	19.10%	13	2.1%	-0.10%	0.00%	139.82	109.56

Total returns- including dividends

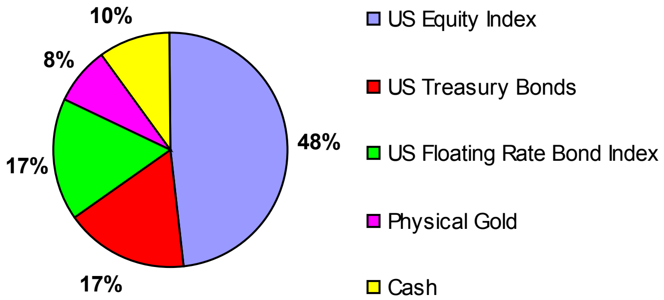
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 31st December 2018

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 30 December 2018	US$150.80	£289.25		
Return for quarter (net)	-7.41%	-4.69%	0.58%	-10.81%
Year 2018 return (net)	-5.42%	-2.76%	2.49%	-4.26%
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%
Compound annual return (from 1/01)	2.25%	6.12%	2.14%	6.04%
Annual volatility	6.91%	5.03%	0.09%	12.16%
Size of Fund (millions)	U$15.3	£177.2		

US Dollar Absolute Return Fund



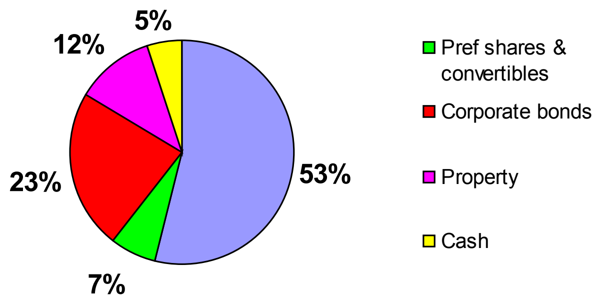
The US Dollar Absolute Return Fund aims to protect investors' capital against double-digit annual losses using derivatives and generate annual returns in excess of inflation by investing in liquid, diversified exchange traded funds (ETFs) which track US equity, bond and gold indices, whose returns are normally uncorrelated in order to reduce losses and volatility.

US equities experienced a severe fall in the final quarter of 2018 as a result of an expected slowdown in economic growth in 2019, US-China trade tensions, rising US interest rates and a strong US Dollar. The equity exposure of the Fund was hedged so as not to lose more than 5% of the funds under management in 2018 and losses were contained to this level by the protective put options.

Small losses were also incurred on the investment in corporate bonds, which were sold earlier in the year as yields rose and spreads widened, and the gold holding. Funds were switched into floating rate bonds, whose yields increase as US interest rates are raised and, more recently, into US Treasury Bonds for capital protection and as a hedge against further equity market falls.

The Fund incurred a disappointing loss of 5.42% for the year, its worst since 2008. Expectations are that market volatility will continue in 2019 and the downside protection of the Fund has been tightened to limit the annual loss to around 3%, although this will limit the upside to the target of around 5% per annum.

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.

Although the Fund was down by 2.76% in 2018 it has held up reasonably well against a background of very weak global markets, particularly towards the end of the year with all of the major markets down by over 10% in the final quarter.

Most holdings in our share portfolio were impacted by this year's general market weakness, although there were some notable positive performances including the large defensive healthcare stocks, AstraZeneca and GlaxoSmithKline and a few small caps such as Bloomsbury Publishing and T Clarke that enjoyed strong trading results. A bidding war resulting in a take-over of our holding in Sky also provided a welcome boost as did a couple of profitable private equity exits.

Our property holdings also had a more difficult year as did our bonds, although the lower prices mean that our bond portfolio now has an attractive yield to redemption of just under 6% and a running yield of over 6.5%.

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 should continue to provide some protection against the risks of any further general market weakness.

Hallmarq - an example of a private equity investment

In our Quarter 1 2018 newsletter we described why and how we invest a portion of our Heritage Managed Portfolio Fund directly into private equity and as a follow up we thought it would be helpful to actually run through an example of how this can work in practice.

Hallmarq Veterinary Imaging Ltd was established in 2000 with the aim of becoming the pre-eminent supplier of MRI diagnostic services to the global veterinary industry. The company's initial focus was on the equine market where there is a need for MRI imaging of horses' legs. A unique standing MRI scanner was developed for this application as horses have a relatively high risk of anaesthetic death, so a MRI scanner that avoids this risk has clear advantages.

We first invested in Hallmarq in 2011 by which time the company had developed to a point where it had almost reached profitability and required further investment to fully capture the opportunity and grow the business internationally. Our investment was via a £250k 3 year 4.25% convertible loan note which meant that we were able to convert our loan into shares at a price of £6 in 2014 when we had evidence of how the company had successfully progressed.

Over the next few years, from its base near Guildford in Surrey, Hallmarq continued to grow and by 2016 it had nearly 100 horse MRI scanners installed worldwide with recurring annual revenues of over £5m and profits of over £1m. It had also by now developed new scanning products for the large and growing companion animal market (cats and dogs).

However, some of the very early investors were growing impatient at the lack of an exit via a sale or stock market listing and this provided us an opportunity to invest a further £220k at share price of £11 through a private trade in June 2017.

Finally in December 2018, Hallmarq was successfully sold to a private equity group (August Equity) with a good background within the veterinary market, at a share price of £19.35, with our share of the proceeds of just under £1.2m enabling us to crystallise significant profits on our investment.

Of course not all private equity investments work out this well and so it is important to have a high quality pipeline of opportunities and a rigorous screening process to reduce the risks. In this regard we are fortunate to have built up a good network of contacts (including our friends at LGB Investments who introduced us to Hallmarq) and we hope to be able to report on further successful investments in the future.

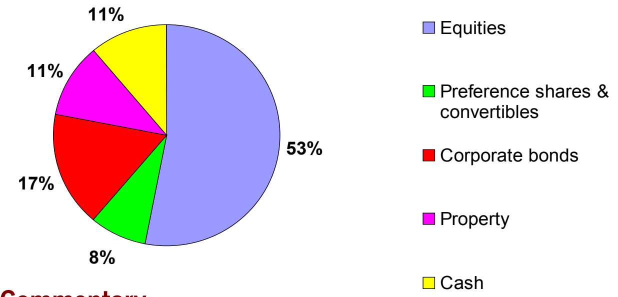
SVS Heritage Balanced Portfolio Fund

Price at 31/12/18	111.0p (launched at 100p 1/12/16)
Fund size	£16.8m
Fund type	OEIC, UCITS (UK domiciled)
Eligible for	ISAs, SIPPs, Funds at Lloyd's
Pricing and dealing	Daily
Minimum Investment	£10,000
Management fee	1% per annum
Administrator/ACD	Smith & Williamson

Performance

Total Return to 31/12/18	2018	2017
Heritage Balanced Portfolio Fund A Accumulation	-3.48%	12.30%
Thomson Reuters UK Index	-12.98%	8.53%

Asset allocation



Commentary

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) – i.e. 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 held up relatively well in 2018 with a decline of 3.5% compared to the TR UK Total Return Index which lost 13.0%. The more detailed comments on the HMPF performance on page 3 of this newsletter also apply to the SVS Heritage Balanced Portfolio Fund.

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.

Heritage

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