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 Services Authority, providing a wide range of investment services to individuals, trusts, companies and pension funds.

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A tougher quarter for investors

Following an encouraging start to the year, investors have become increasingly worried about the implications of the sovereign debt crisis and the risks to the global economy resulting in sharp falls for all of the major stock markets this quarter.

Against this background, the Heritage Funds have held up relatively well and further details on the performance and strategies for the funds can be found as usual on page 3.

The benefits of regulation

One of the results of the recent financial crisis is an increasing focus on regulation within the banking and financial services industry. Whilst, there is a tendency amongst those working within the industry to bemoan the seemingly ever increasing amount of regulation and red tape that needs to be dealt with, there are also undoubtedly a number of positive aspects to regulation and our clients should take comfort from the fact their investments are being handled by an organisation and individuals operating within this environment.

Qualified individuals – in addition to the company itself being regulated, those individuals with responsibility for the management and administration of client investments are personally registered with the Financial Services Authority (FSA) and must obtain benchmark investment qualifications and then maintain a programme of continuing professional development.

Compliance procedures – regulated firms need to comply with a number of rules and regulations. Important aspects are; client cash and investments must be segregated from company funds in specially designated client accounts, regular reconciliations of client cash and investments to banking and custodian accounts must be performed, and the appointment of a Compliance Officer who has responsibility for ensuring that all the correct systems and procedures are properly followed.

Financial strength – for those investment managers, such as ourselves, who are authorised to manage investments and hold client cash there are also strict capital adequacy rules. This requirement to have a strong balance sheet is designed to ensure that the company has stability and can continue to operate and manage investments without running into financial difficulty.

Audit – as well as regular quarterly returns to the FSA, our business is also subject to an annual independent regulatory audit of both our accounts and our compliance systems and procedures.

Professional Indemnity Insurance – this is a mandatory requirement for all regulated firms and provides an additional level of assurance to investors in the unlikely event of problems arising due to negligent errors, omissions or fraud.

Finally, as part of the FSA's ongoing monitoring of regulated firms, Heritage Capital Management was subject to an assessment visit in April 2010 and we are pleased to report that our regulators conclusion was "…that customers can be confident that they are dealing with a firm where the fair treatment of customers is central to its culture."

Heritage Capital Management Limited

Review for the quarter ended 30th June 2010

Market Commentary

The strong recovery that global stock markets had enjoyed over the previous twelve months came to an abrupt end this quarter with all of the major indices suffering a sharp setback. Although it is not altogether surprising that markets should suffer a correction after a good run there are a number of serious concerns that are occupying investors at present.

In particular, governments across the developed world are being forced into introducing severe austerity measures in order to deal with the unprecedented build up of debt on their balance sheets as a result of years of overspending compounded by recent global recession and the need to bail out the banks and alleviate the credit crisis.

Whilst this harsh medicine is necessary it will have a number of nasty side effects, including weaker economic growth and a generally more challenging environment for corporate profits, allied to higher unemployment and possible civil unrest as the public sector cuts take effect.

United Kingdom

The FTSE 100 index had its worst quarter since 2002, falling below 5,000 to end down by 12.5%.

As well as general market weakness, the FTSE was also severely impacted by the halving in BP's share price as a result of its disastrous oil spill off the US coast. BP had previously been the largest company in the index and in addition to the falling share price, the suspension of its dividend is a major blow to income investors as BP accounted for around 12% of the total dividend income of the UK market.

The new Con-Lib coalition government presented its "Emergency" Budget on 22nd June which sets out the measures that it believes are necessary to deal with the huge debt burden inherited as result of years of profligacy under the previous Labour regime. Although there is a risk that such austerity will stifle economic recovery, it should at least allow the UK to avoid the risk of a Greek style debt crisis and Sterling has subsequently strengthened against the US Dollar and Euro.

United States

The US market was down by 11.4% this quarter. The major negative contributions came from financial stocks, which are suffering due to the uncertainty over the proposed regulatory overhaul and energy stocks where the long run cost implications for the oil sector as a result of the BP oil spill are being digested.

The recent nervousness of markets was highlighted by the strange "flash crash" in May where the S&P index fell 7% in 15 minutes and the defensive blue chip stock, Proctor & Gamble, fell nearly 47% for no apparent reason, before substantially recovering. Although computer trading was suspected, the exact cause is still not known and new "circuit breakers" are being tested to help prevent a recurrence.

Europe

With a fall of 6.9%, European markets lost less than the other major markets this quarter, although once the fall in the value of the Euro is taken into account international investors have not done any better in Europe than elsewhere.

The major risk for Europe is that despite its €750bn financial support package, the sovereign debt crisis spreads beyond Greece to other vulnerable Eurozone members such as Spain, which has already had its credit rating downgraded. In addition to this the economy continues to struggle and unemployment has risen above 10%.

Japan

The Nikkei index was down by a massive 15.4% in the second quarter with the ongoing turmoil in Japanese politics not helping as Naoto Kan became their fifth different prime minister in the past three years, although despite this there was at least some reasonably encouraging data on the economy and a number of major corporate earnings upgrades.

Emerging markets

It was generally also a poor quarter for emerging markets. However, worrying events such as increasing tension in Korea and political turmoil in Thailand were at least balanced by some encouraging economic news as recent growth was considered robust enough to justify interest rate rises in some countries such as Brazil and Malaysia.

Investment Statistics - 30/06/2010

Equity Markets	Q2 2010	2010 ytd	2009	2008	2007	2006
Global - MSCI World ($)	-12.24%	-9.49%	30.57%	-40.30%	7.09%	17.95%
UK - FTSE 100	-12.50%	-7.19%	27.89%	-27.93%	3.80%	10.71%
US - S&P 500	-11.41%	-6.64%	26.47%	-36.91%	3.53%	13.62%
Europe - FTSE Eurotop 100	-6.89%	-3.92%	29.97%	-40.57%	2.41%	12.41%
Japan - Nikkei 225	-15.35%	-10.38%	21.05%	-41.03%	11.13%	6.92%

Other	UK	US	Europe	Japan
PE Ratio	13	15	13	31
Dividend Yield	3.8%	2.1%	4.0%	1.7%
Interest rates - base	0.50%	0.00%	1.00%	0.10%
Bond Yields - govt. 10 year	3.36%	2.93%	2.58%	1.29%
Exchange rates (vs GBP)	-	1.4945	1.2215	132.15
Exchange rates (vs USD)	1.4945	-	1.2238	88.43
Gold ($ per ozs)		1242		

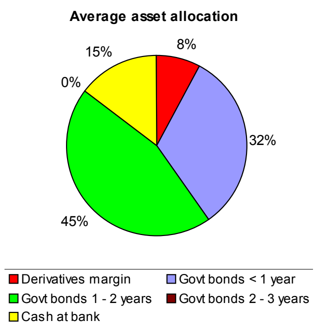
Source: Bloomberg/FT

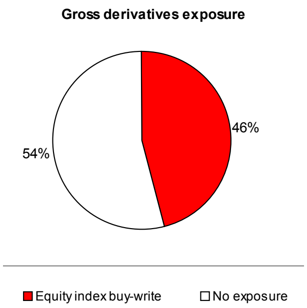
Heritage Investment Fund Limited

Review for the quarter ended 30th June 2010

Performance	Absolute Return Funds			Managed Portfolio Fund	Cash Deposits (£)	MSCI World Index (£)
Risk profile	Moderate			High /Moderate		
Minimum investment horizon	3 years +			5 years +		
Target return over bank deposit rate	+2.5%			+5%		
Price at 30 June 2010	£151.96	US$125.48	€97.77	£153.26		
Return for quarter (net)	-0.61%	-0.85%	0.15%	-3.07%	0.06%	-11.11%
Return for year to date 2010 (net)	-0.32%	-1.22%	0.74%	1.56%	0.13%	-2.32%
Year 2009 return (net)	4.25%	1.26%	6.50%	10.32%	0.13%	17.86%
Year 2008 return (net)	-5.81%	-12.95%	-8.87%	-15.66%	4.20%	-18.86%
Year 2007 return (net)	7.14%	6.09%		2.74%	4.62%	8.24%
Year 2006 return (net)	6.79%	7.41%		16.79%	3.23%	6.01%
Year 2005 return (net)	6.24%	3.72%		14.28%	3.17%	22.69%
Compound annual return (from 1/01)	4.75%	2.31%	-0.93%	4.67%	3.44%	-1.68%
Annual volatility	2.9%	3.4%	2.5%	6.6%	0.0%	18.0%
Size of Fund (millions)	£37.2	U$21.0	€5.7	£34.8		

Absolute Return Funds





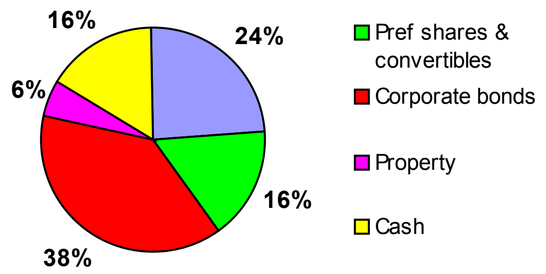
The Absolute Return Funds aim to generate positive returns significantly in excess of cash deposits over time by limited exposure to derivative products, mainly based on underlying equity market indices. As these positions require limited margin outlay, most of the funds are invested in short-dated government bonds to provide income.

The historically low bond yields currently make it extremely difficult to generate positive returns after expenses. The core government bond portfolios and cash deposits currently yield a low 0.65% (GBP), 0.35% (USD) and 0.75% (EUR) per annum gross to maturity and have average durations of 1.1, 1.1 and 0 years respectively.

The US equity market fell during the quarter by 12%. Our long futures, short call options derivatives positions in equity market indices only lost a net 0.95% for the quarter, with the loss on our futures exposure being reduced by a gain from the sale of options.

Our hedged derivatives strategies held up well against the severe equity market falls during the quarter, although the returns for the year to date have been disappointing. However, the Funds are relatively defensively positioned going forward and well placed to generate positive returns in excess of cash deposits when markets stabilise.

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 portfolio.

The sharp fall in equity markets impacted the Fund's performance this quarter, although our conservative portfolio held up relatively well with a fall of 3.1% compared to an 11.1% loss for the MSCI £ World Index. For the year-to-date the Fund is still up by 1.56%, despite a loss for the index.

With all of the major equity markets below their levels at the start of the year it has been difficult to find areas or sectors that have been able to make progress and our equities have not been immune, although we did receive a decent boost from a take-over offer for one of our top 5 holdings.

Corporate bonds also suffered a difficult quarter as the flight to safety pushed prices for higher yielding bonds lower. The running/income yield on our bond portfolio is now a healthy 7.24%, with scope for capital appreciation if held to redemption.

The fall in markets has enabled us to selectively add to some of our existing holdings and introduce a couple of new positions at attractive prices, although overall we are continuing to maintain a defensive portfolio.

The sovereign debt crisis

Having just about recovered from the severe credit crisis of 2008, it appears that another major crisis may be looming in the over-indebtedness of developed countries. Government debt levels increased sharply during the credit crisis as US, UK and European governments supported failing financial institutions and provided stimulus to their slowing economies. Global sovereign debt jumped from 62% of world GDP in 1997 to 85% in 2009 and, over the same period, the average fiscal deficit in the G20 countries rose from 1% of GDP to 7.9%. These trends were much more pronounced in advanced Western countries due to greater output declines, a more severe banking crisis, and highly developed social safety nets. With only a modest economic recovery predicted for this year, government debt will continue to rise as a share of GDP, although the rate of increase will slow as tax revenues improve, government expenditure is cut and governments derive returns from their capitalisation of troubled banks.

Increasing the supply of government bonds generally pushes yields up, raising the cost of borrowing throughout the economy. However, the most important determinant of government bond yields is investor confidence in the country's governance. Despite surging debt levels, indicators suggest that investors have not lost confidence in the major economies of, for example, the US, UK and Germany. The credit default swap levels for the US, UK and Germany are currently 26, 82 and 46 basis points respectively, compared with Greece at 815 basis points. Confidence in some of the other Euro zone economies is, however, wavering with spreads over German government bonds widening dramatically in Greece and increasing in Spain, Portugal, Italy and Ireland. These latter countries do not have the option of devaluing their currency to deflate their way out of the sovereign debt crisis.

We are monitoring the sovereign debt crisis carefully at Heritage as our Absolute Return Funds have significant exposure to US, UK and German government debt. This debt is short-dated and comprises a range of maturities up to 2 years, and is held to provide income and liquidity for the Funds. The debt issued by the US, UK and German governments is currently rated AAA by all the rating agencies, although the UK is on negative outlook with one of the agencies. Although the US and UK are running high budget deficits as a percentage of GDP at 9.3% and 12.6% respectively, their levels of total debt to GDP of 84% and 62%, although significant, are well below that of other G20 countries like Japan, Greece and Italy. In addition, the average maturity profile of UK government debt at around 14 years is one of the longest, compared with the US and Germany, both at around 4 years, which will require refinancing sooner. Much will depend on the active measures taken by governments to bring their debt down to more manageable levels by a combination of significant cuts in government expenditure and tax increases.

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	71%	29%	4.0%	7.7%	4.7%	3.3%
Balanced	43%	57%	5.0%	9.5%	4.7%	4.4%
Growth	14%	86%	6.0%	11.4%	4.7%	5.8%
Benchmarks:						
3 month interest rate				0.9%	4.1%	0.0%
5 yr Government bonds (total return)				0.9%	-0.6%	2.4%
MSCI World Equity Index (total return)				22.0%	-1.7%	18.0%

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