Heritage

Quarterly Newsletter & Investment Review

Issue 85 Quarterly news & investment review from Heritage Quarter 1 2019

## 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

## A good start to 2019

After a poor end to 2018 there has been a welcome sharp recovery in global markets over the first quarter of 2019.

The Heritage funds have benefitted from this recovery, with the Managed Portfolio Fund up by 5.48% over the quarter. Further details on the Managed Fund and our US Dollar Absolute Return Fund can be found on page 3 and on our UK regulated fund, the SVS Heritage Balanced Portfolio Fund on page 4.

## The small company advantage

The amount of data available to investors these days is absolutely vast and in particular data on past performance of different individual shares, funds, sectors, indices and markets globally can be overwhelming, with much of it of limited practical use. However, we believe that there are some key findings from past performance data that are of particular interest as they show a tendency for an enduring advantage for a small number of investment strategies.

One of these is the tendency for a value strategy to outperform growth (i.e. more attractively valued shares tend to do better than those that have already been bid up to loftier valuations by overly optimistic buyers). Another is that smaller companies tend to do better than very large ones. We have dealt with the value versus growth approach in previous newsletters and this time we look at the small company effect in a bit more detail.

Firstly the evidence. According to the long running annual study of small caps by Dimson, Marsh and Simpson of the London Business School, £1 invested in large caps in 1955 would be worth just over £1,225 today, which sounds very impressive until you consider that the same amount invested in small caps would now be worth £8,200. Furthermore this effect is something that can be observed across all of the major and emerging markets as the following returns for the past 10 years demonstrate (based on MSCI indices to 2/2019);

| | UK | USA | Japan | Europe | Emerging markets |
|---|---|---|---|---|---|
| **Large companies** | 156% | 351% | 134% | 159% | 190% |
| **Small companies** | 359% | 441% | 202% | 320% | 228% |

Whilst the performance data is very clear, the reasons are of course open to interpretation, but it looks likely that certain factors are at play. Firstly, small companies are often ignored by the large fund management groups. As a result fewer analysts follow and research small caps which creates opportunities for those prepared to do their research to uncover unrecognised growth and any hidden gems. Also, it is easier for sales and profits to increase significantly off a smaller base – whilst the old adage that “elephants don’t gallop” explains why it’s much harder for most larger companies to do grow rapidly. In fact in an attempt to keep growing, large companies often end up making take-over bids for smaller companies at a large premium to the current share price which can provide a further boost for shareholders of the smaller company target.

At Heritage we are pleased to say that investing in smaller companies has been an important part of our strategy and success over the years and hopefully will continue to be so for many years to come.

## Market Commentary and Outlook

In our previous quarterly review, following the very weak end to 2018, we commented that many of the known risks such as rising interest rates, the withdrawal of quantitative easing, possible trade wars and Brexit were fairly well priced into markets, hopefully leaving scope for some slightly more positive themes to emerge in 2019. Whilst it would be fair to say that nothing positive has yet to emerge from the ongoing Brexit saga, the risks of rising interest rates and trade wars have fortunately abated somewhat, helping global markets to rally strongly and record their strongest first quarter for a number of years.

Whilst markets can be impacted by all sorts of geopolitical events it is a useful reminder that whilst they do not dominate the headlines to the same extent, it is interest rates that are perhaps the most important underlying factor driving investment markets. It is no coincidence that the strong rally that we have seen this year coincides with a marked change in approach by the US Federal Reserve bank.  After raising rates throughout 2018 and indicating that it expected to continue with further rises in 2019, it now appears to have softened its stance and is talking about being very "patient" in evaluating its next move.

Markets have also had support from lower longer bond yields. The table below shows the 10 year government bond yields for the major markets, all of which are lower than where they were at the start of the year. It is also worth remembering just how low all these yields are compared to the long run history and that European and Japanese 10 year yields are now actually negative.

Given the important part that interest rates have played in both the overall long bull market run since the 2008 financial crisis and even the short term rally that investors have enjoyed so far this year, we think that smart investors will be looking beyond the current political noise and keeping an eye on what really matters.

### United Kingdom

The UK market was up just over 8% in the first quarter. Whilst this was a few points below the other major western markets the stronger pound has meant that returns were actually very similar when measured in a common currency.

The UK market is still being avoided by many international investors because of the ongoing political uncertainty surrounding Brexit. Analysts estimate that a valuation gap of approximately 25% currently exists on the UK index when benchmarked against other developed market indices and whilst it may still be too early to expect this gap to close any time soon, this anomaly does present the possibility of an interesting long term value opportunity.

### United States

The US market has enjoyed its best start to a year since 1998 with the S&P 500 index up just over 13% in the first quarter, almost completely reversing the dramatic 14% plunge in the final quarter of 2018.

With companies having all reported their 2018 earnings, attention is turning to the 2019 Q1 results and here the signs are less encouraging. Analysts are now forecasting the first decline for a few years as the boost to last year's earnings from corporate tax cuts provides a tougher comparison and the US has recently had to endure the longest ever government shutdown and some very severe cold weather.

### Europe

European markets also enjoyed a strong start to the year with the 11.7% gain exactly mirroring the fall in the final quarter last year.

Looking ahead Europe may find it tough to make further significant progress this year as Germany appears to be very close to slipping into recession and with interest rates already at zero there is limited scope for the ECB to provide that much in the way of helpful stimulus.

The big corporate news is that Germany's largest bank, Deutsche Bank is in merger talks with its main rival Commerzbank, backed by the government that holds a 15% stake in the latter and making this a very important deal for German and European banking, business and politics.

### Japan

Whilst a positive return of just under 6% for Japan's Nikkei index sounds decent enough it is only a partial recovery of the previous quarter's dramatic17% fall and the Japanese market has also so far lagged the other major markets this year.

### Emerging Markets

Emerging markets have also enjoyed a good start to the year, led by Chinese equities which were up by 20% in the first quarter thanks to easing trade tensions and expectations that the government's fiscal and monetary policy will become more supportive. The recent news that MSCI will be increasing the weighting of Chinese stocks in its emerging market indices will also help as large index tracking funds will be compelled to buy.

## Investment Statistics - 31/03/2019

| Equity Markets | Q1 2019 | 2018 | 2017 | PE Ratio | Dividend Yield | Central Bank Interest Rates | 10 yr Gvnmt Bond Yields | Exchange Rates vs GBP | Exchange Rates vs USD |
|---|---|---|---|---|---|---|---|---|---|
| TR Global ($) | 11.81% | -9.61% | 24.62% | | | | | | |
| US (S&P 500) | 13.07% | -6.24% | 19.42% | 20 | 2.5% | 2.50% | 2.41% | 1.3033 | 1.0000 |
| UK (FTSE 100) | 8.19% | -12.48% | 7.63% | 15 | 4.6% | 0.75% | 1.00% | 1.0000 | 1.3033 |
| Europe (STOXX 50) | 11.67% | -14.34% | 6.49% | 16 | 3.7% | 0.00% | -0.07% | 1.1612 | 1.1216 |
| Japan (Nikkei 225) | 5.95% | -12.08% | 19.10% | 15 | 2.0% | -0.10% | -0.09% | 144.47 | 110.84 |

*Total returns- including dividends*

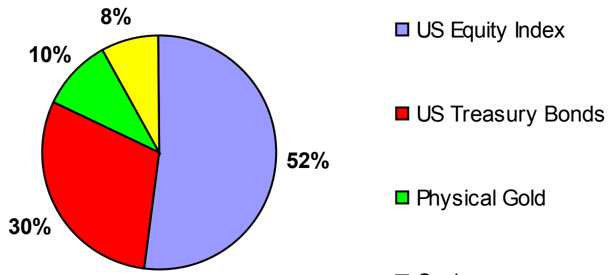
*Source: Thomson Reuters and the Financial Times*

# Heritage Investment Fund Limited

## Review for the quarter ended 31st March 2019

| 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 March 2019 | US$156.58 | £305.09 | | |
| Return for quarter & 2019 ytd (net) | 3.83% | 5.48% | 0.42% | 9.46% |
| 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) | 2.43% | 6.34% | 2.13% | 6.49% |
| Annual volatility | 6.47% | 5.95% | 0.14% | 12.72% |
| Size of Fund (millions) | U$13.2 | £184.8 | | |

### US Dollar Absolute Return Fund




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

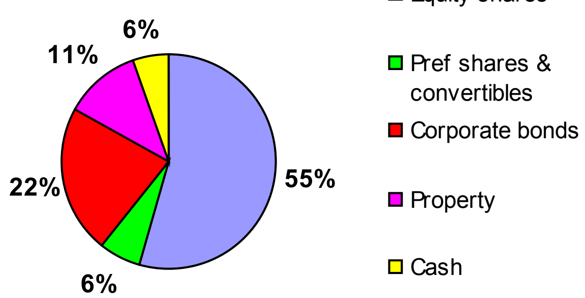
The US equity market exposure, held for growth, continued its strong rally this year as a result of dovish Federal Reserve comments on the future path of interest rates and hopes of a satisfactory resolution to the US-China trade dispute.

The position in US Treasury Bonds, which is held for capital protection and as a hedge against equity market weakness, rose in value during the quarter as yields fell on concerns over slowing economic growth.

The physical gold position, which is held as a hedge against inflation and US Dollar weakness, increased slightly in value over the quarter being restrained by a strong US Dollar.

The Fund gained 3.83% for the first quarter. The return was significantly reduced by losses on hedging, but these currently limit the downside risk of the Fund to an annual loss to around 3.5%.

### 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 made a strong start to the year with a return of 5.48% as global stock markets have rallied sharply after a weak 2018.

There were a number of strong performances within our equity portfolio in response to positive reported results, most notably from Greggs and T Clarke which were both up over 40% for the quarter and we received a further boost from a take-over approach for our holding in Dairy Crest.

Our property holdings also had a good start to the year with Primary Health Properties trading particularly strongly and we decided to take some profits on this position.

Our corporate bonds had a steady quarter and are currently providing a yield to redemption of 5.6% and a running income yield of 7%.

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 general market weakness later this year.

## The potential impact of Brexit on investments

No one knows what the outcome of Brexit will be, but it is important to be aware of the possible impact the various options may have on the future performance of Sterling, equities and bonds. Markets dislike uncertainty and the recent volatility reflects concerns over what the future holds for the UK economy. With the government still unable to agree on what form Brexit should take, the only thing we can be certain of is that the market volatility will continue for some time.

With no deal all but ruled out by the UK Parliament, a soft Brexit or no Brexit at all would most likely result in a relief rally, with Sterling recovering strongly against the other major currencies. The strengthening currency should keep inflation under control and the Bank of England will probably allow interest rates to normalise as the economy recovers. Any resulting rise in government bond yields would be negative for bonds. Domestically focused stocks should rally as international investors reverse their underweight positions in UK equities, but UK multinational companies with foreign earnings could suffer on a strengthening of Sterling.

On the other hand, in the event of a hard Brexit or leaving the EU with no deal at all, it is likely that Sterling would fall further in value, although a lot of bad news is probably already factored into Sterling's value. A fall in Sterling would be likely to result in a rise in inflation, but the Bank of England would probably look through this and focus instead on the downside risks to the economy by following an accommodative monetary policy and cutting interest rates. Government bonds could be seen as a safe haven with yields falling. The domestic equity market could also suffer as a result of concerns over the future for the UK economy, but companies with foreign earnings would benefit from a weaker currency.

Diversification among a wide range of asset classes is the best approach to ensure portfolio resilience and to weather this period of uncertainty over the outcome of Brexit. Well structured portfolios holding a mix of equities, bonds, property and cash, like our Heritage Managed and Balanced Portfolio Funds, should be well placed to cope with any market volatility. It is important to take a long term view when investing, not to overreact to short term noise, and to remain invested so as not to miss investment opportunities.

Brexit is unlikely to have a significant impact on markets outside the EU and, for investors looking to diversify outside of the UK, our Heritage US Dollar Absolute Return Fund may be an option as it holds hedged US equities, US government bonds and gold.

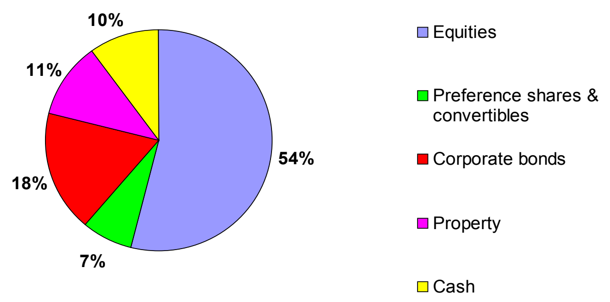
## SVS Heritage Balanced Portfolio Fund

| | |
|---|---|
| Price at 31/03/19 | 117.7p (launched at 100p 1/12/16) |
| Fund size | £18.15m |
| 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 31/03/19 | 2019 ytd | 2018 | 2017 |
|---|---|---|---|
| Heritage Balanced Portfolio Fund A Accumulation | 6.04% | -3.48% | 12.30% |
| Thomson Reuters UK Index | 8.20% | -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 has made a strong start to the year with a return of 6.04% in the first quarter as global stock markets have rallied sharply after a weak 2018. 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