Heritage

Quarterly Newsletter & Investment Review

Issue 87 Quarterly news & investment review from Heritage Quarter 3 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.

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Market struggles to make futher progress

Markets have been a bit more subdued over the summer, although following a very strong first half of the year they remain well up for the year-to-date.

The Heritage funds all generated small positive returns this quarter, building on the good first half and our Managed Portfolio Fund is now up by 9.79% for the year-to-date. Further details can be found on page 3 for our Managed Fund and our US Dollar Absolute Return Fund and on page 4 for the SVS Heritage Balanced Portfolio Fund.

How alternative investments can help to enhance returns and reduce risk

Much of our focus and commentary quite naturally centres around equity shares and bonds as the two major investment asset classes. However, at Heritage we are also cognisant of the fact that there are a number of other alternatives that can provide interesting opportunities to enhance returns and diversify investment risk, and with so many uncertainties currently facing equities and bonds, these alternative asset classes continue to play an important role in our investment strategies. Below is a brief summary of the ones that we think are of interest.

Property – Investing in real estate is perhaps the best known alternative to equities and bonds, as most people will have owned their own property and as a tangible asset it is relatively simple to understand. Our focus is on commercial property where the rental yields are more attractive than for residential and we currently prefer industrial and office property over retail which faces a structural challenge from online shopping. We also have exposure to specialist primary healthcare property which benefits from very secure, long leases.

Private equity – Many of the world's best companies, both large and small, are owned privately. Furthermore they are free to take a genuinely long-term approach, away from the spotlight and obsession on quarterly earnings forecasts and day-to-day share price movements. Our long established network of contacts means that we often come across interesting opportunities to take stakes in private companies and there are also a few specialist private equity funds that we invest in, often at a discount to their underlying net asset value.

Preference shares and convertibles – These are hybrid investments that have properties of both equities and bonds. Carefully selected preference shares and convertibles can be used to enhance the returns available from straight bonds whilst offering better security of capital than ordinary shares.

Gold – Gold is one of the oldest stores of value known to man and despite the fact that it has no yield and there are holding costs it can offer valuable diversification benefits, particularly in turbulent times.

Infrastructure – Investments in infrastructure assets including electricity and water networks, roads, railways and ports can provide attractive and reliable long-term cash flows which are not subject to the same economic, operational and management risks that face a typical private enterprise, although they are subject to regulatory and political oversight.

Renewable energy assets – This is a relatively more recent asset class, with the main focus currently being on wind turbines and solar panels which can be accessed via a specialist listed investment companies.

Others – The list of other possible alternative asset classes is fairly extensive and whilst we do not consider a number of them to be suitable for our funds (e.g. commodities, art, fine wines, Bitcoins etc.) we are always on the lookout for interesting new additions and over the past year these have included an investment in a specialist aircraft leasing fund and the acquisition of some forestry/timber assets.

Heritage Capital Management Limited

Review for the quarter ended 30th September 2019

Market Commentary and Outlook

Having dealt with various alternatives for investors to equities and bonds on page 1, we now return to our comments on the major mainstream investment markets. Despite a more subdued performance this quarter it is still looking like a good year so far thanks to the excellent returns for equity markets in the first half and bonds have also done well in 2019, as yields have fallen.

Despite starting the year on already seemingly low yields of 2.69% (US), 1.27% (UK), 0.25% (Euro) and 0% (Japan), 10 year government bond yields have fallen even further to 1.68% (US), 0.49% (UK), -0.49% (Euro) and -0.15% (Japan). This means that investors buying government bonds today are virtually guaranteed to make a loss in real terms (i.e. after inflation) if they hold these bonds to maturity. Historically government bonds have been sought after by investors for their supposedly risk free returns but today investors are faced with the rather less appetising prospect of return free risk.

By contrast, the dividend yields on stock markets are currently 2.4% (US), 4.5% (UK), 3.5% (Europe) and 2.4% (Japan) and although nothing is guaranteed, the chances are that overall dividends will continue to show some growth over the long term.

Therefore, whilst recognising the risks and short term volatility inherent within equity markets, the overall balance of risk versus reward leads us to a clear preference for equities over government bonds when taking a long term, 10 year view.

United Kingdom

The UK was the weakest of the major markets this quarter with a small decline of 0.23% leaving it up by just over 10% for the year-to-date, which could be worse considering the level of uncertainty that continues to surround the political scene.

On the one hand not a lot seems to change, as three years after the Brexit vote the UK has still not left the European Union. On the other hand, since then we have had many twists and turns with two prime ministers resigning and the latest incumbent, Boris Johnson, also making wholesale changes to his cabinet including Sajid Javid as the new Chancellor. All eyes are now on what happens on the supposed exit date of 31st October and whether there will be yet another general election. However, from an investment point of view we continue to see much the same story as ever, as well managed companies with good products and services continue to adapt and make profits and pay dividends whilst weaker companies struggle and seek to blame their performance on external factors.

United States

Following the best first half year for the S&P 500 index for over 20 years the third quarter returns were a bit more muted for the US market.

The big news on US Dollar interest rates is that the long but shallow upwards cycle that has seen rates rise from just 0.25% in 2008 to 2.50% earlier this year has now peaked out, with the Federal Reserve Bank lowering rates by 0.25% in both July and September.

Europe

With another positive quarter European markets have continued to enjoy a good run with the 2019 year-to-date gain now outweighing the sizeable fall of over 14% last year.

As noted in the table below and further commented elsewhere, German government bonds are currently trading on negative yields and Germany took advantage of this in August to issue the first 30 year government bond with a 0% coupon, and in a further sign of how fragile the Eurozone economy remains, the ECB president Mario Draghi recently announced the re-instatement of its Quantitative Easing programme.

Japan

Despite a reasonable gain of 2.26% this quarter, Japan remains the laggard of the major equity markets this year and going into the final quarter it will be interesting to see whether it is the potential boost from hosting the Rugby World Cup or the dampening effect of a sales tax increase from 8% to 10% that has the greater impact on the Japanese economy.

Emerging Markets

Emerging markets returns have lagged the major developed markets so far this year and were down around 5% this quarter. Whilst emerging markets still offer good prospects of long-term growth, there was a very sharp reminder of the risks involved when investors took fright at a surprise election result in Argentina in August, resulting in a 37% plunge in the stock market in tandem with a 30% fall in the Argentine peso in a single day.

Investment Statistics - 30/09/2019

Equity Markets	Q3 2019	2019	2018	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	3.68%	15.94%	-9.61%						
US (S&P 500)	1.19%	18.74%	-6.24%	21	2.4%	2.00%	1.68%	1.2287	1.0000
UK (FTSE 100)	-0.23%	10.11%	-12.48%	15	4.5%	0.75%	0.49%	1.0000	1.2287
Europe (STOXX 50)	2.76%	18.93%	-14.34%	18	3.5%	0.00%	-0.49%	1.1272	1.0898
Japan (Nikkei 225)	2.26%	8.70%	-12.08%	13	2.4%	-0.10%	-0.15%	132.81	108.06

Total returns- including dividends

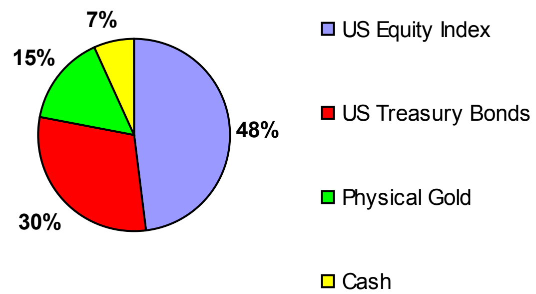
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 30th September 2019

Performance	US Dollar Absolute Return Fund	Managed Portfolio Fund	Inflation (US)	Inflation (UK)
Risk profile	Low	Medium		
Minimum investment horizon	3 years +	5 years +		
Target net annual return	5%	6-7%		
Price at 30 September 2019	US$162.92	£317.58		
Return for quarter (net)	1.39%	0.24%	0.43%	0.46%
Year 2019 return to date (net)	8.04%	9.79%	1.31%	1.44%
Year 2018 return (net)	-5.42%	-2.76%	2.49%	2.51%
Year 2017 return (net)	10.83%	11.50%	2.14%	2.72%
Year 2016 return (net)	2.08%	7.48%	1.16%	0.68%
Year 2015 return (net)	-0.47%	6.80%	0.08%	0.04%
Year 2014 return (net)	5.42%	7.74%	1.65%	1.47%
Compound annual return (from 1/01)	2.58%	6.39%	2.13%	2.14%
Annual volatility	6.76%	6.53%	0.08%	0.06%
Size of Fund (millions)	U$16.4	£190.6		

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.

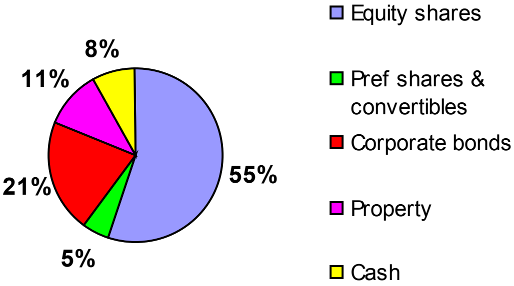
The US equity market position, held for growth, had a volatile, but positive, quarter as the ongoing trade dispute between the US and China remained unresolved and added to concerns it could impact economic growth.

The position in US Treasury Bonds, which is held for capital protection and as a hedge against equity market weakness, rose overall during the quarter as longer term yields fell as investors sought safety in government bonds.

The physical gold position, which is held as a hedge against inflation and US Dollar weakness, also rose overall in value for the quarter as investors switched to haven assets for capital protection.

The Fund gained 1.39% for the quarter and is up 8.04% for the year to date. The performance has been reduced by losses on hedging, but the maximum loss that the Fund can incur for the current calendar year is limited to low single digits.

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.

Following a very strong first half year the Fund had a more muted gain of 0.24% in the third quarter, leaving it up by healthy 9.79% for the year to-date.

It was a mixed quarter for our equities with a broadly even split between positive contributors and detractors. The two largest gains of around 40% each were for the pub group Greene King and niche insurance services company Charles Taylor, both of whom received take-over bids, demonstrating the underlying inherent value that strategic long-term buyers are finding in the currently Brexit depressed UK stock market.

Of our property holdings, the best performer was Assura in the defensive healthcare sector, whilst more economically sensitive commercial property funds gave back some of the gains made in the first half year. The prices of our bonds were also mixed but we continue to capture the current attractive income yield of 6.8%.

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.

Negative Bond Yields

Approximately thirty percent of investment grade bonds are currently on negative yields, which means that if an investor holds them to maturity they are guaranteed to make a loss. If an investor buys a bond for more than its face value, and if the total amount of interest the bond pays over its remaining lifetime is less than the premium the investor paid for the bond, the bond has a negative yield and the investor will make a loss if they hold it to maturity.

It makes no financial sense for an investor to tie their money up in debt that will pay back less in interest and capital if held until maturity than they originally invested. On the other hand, a Danish bank which is offering to pay its customers 0.5% to take out a 10 year mortgage may sound attractive to the borrower, but these distortions can have a negative impact on financial institutions and the economy.

Concerns about a global economic slowdown, or possible recession, and the continuing unresolved US – China trade dispute, have driven the prices of government bonds ever higher as investors have sought sanctuary by moving from highly-valued equities into the perceived safety of government and investment-grade bonds. This, in turn, has resulted in falling government bond yields, which in some countries like Germany and Japan have turned negative across a range of maturities. The fall in bond yields has been exacerbated by the enormous asset purchase schemes introduced by central banks to prevent a worldwide economic slump after the 2008 financial crisis.

In some countries like the US, Germany and Japan longer-term bond yields have fallen below short-term interest rates, resulting in an inverted yield curve. In the past, this has been quite a reliable indicator of an impending slowdown or recession. Large investors such as pension funds, insurance companies and financial institutions have been willing to pay a premium to buy bonds and take a loss because they need the safety and liquidity that government and high-quality corporate bonds provide. Other more speculative investors buy negative-yielding bonds in the expectation that rates will become more negative and that they can sell out at a profit.

The US, and to a lesser extent the UK, are some of the few major economies where government bond yields are still positive across the yield curve. Whilst US bond yields are historically low, they are currently yielding more than other developed markets and continue to offer some protection against equity market weakness. However, with the US reducing interest rates and the EU looking to restart their bond-buying programme to try and stimulate economic growth, the challenges presented by negative bond yields could intensify as bond yields fall further.

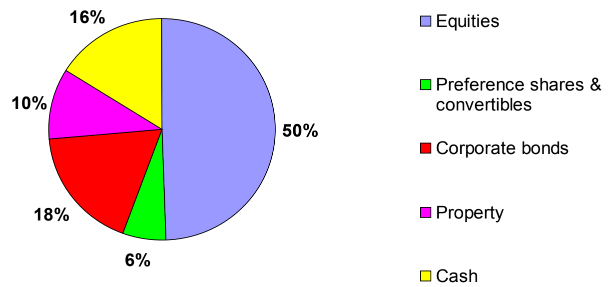
SVS Heritage Balanced Portfolio Fund

Price at 30/09/19	122.8p (launched at 100p 1/12/16)
Fund size	£21.6m
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 30/09/19	Q3 2019	2019 ytd	2018	2017
Heritage Balanced Portfolio Fund A Accumulation	0.33%	10.63%	-3.48%	12.30%
UK Consumer Price Index	0.46%	1.44%	2.51%	2.72%

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.

Following a very strong first half year the Fund had a more muted gain of 0.33% in the third quarter, leaving it up by healthy 10.63% for the year-to-date. 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.

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