Heritage

Quarterly Newsletter & Investment Review

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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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Relief for investors as markets rally

Following the dramatic falls in March as a result of the coronavirus pandemic, investment markets have experienced a much welcome rally in the second quarter.

We are pleased to report that it has also been a good quarter for the Heritage funds with the Managed Portfolio Fund having its best quarter in over 10 years with a gain of 6.7% and the 4.6% return for USD Absolute Return Fund taking it into positive territory for the year-to-date. Further details and commentaries on our funds can be found as usual on pages 3 and 4.

Understanding recent market movements

An often heard comment on the rising stock market recently is along the lines of "how can the market be going up when the economy is in the midst of one of the worst slumps of all time?" Whilst as naturally cautious investors we have some sympathy with this view it is worth taking time to try and understand the reasons behind this.

Firstly, the complete panic at the initial onset of the coronavirus pandemic took markets into free fall, with all the major indices falling over 30% from their previous levels. Selling during this phase is rarely a good idea and is why we cautioned against it in our previous newsletter. As it became a bit clearer that whilst severe, the virus ultimately should be defeated or at least be manageable, the market was able to find a base and it is from low bases that impressive percentage gains can often be made.

Secondly, it is important to understand the difference between the economy and the stock market. Whilst economics predominantly deals with what is happening here and now the stock market is more forward looking and so is always anticipating what is expected to happen in future – in this case that things will ultimately recover. Furthermore there is another very real and important difference in the composition of the economy compared to the stock market. In simple terms the stock market has a higher weighting of the relative "winners" from the pandemic such as healthcare and IT (for example IT accounts for under 5% of the real economy GDP but over 25% of the US stock market value) whilst the economy has a heavier weighting to sectors that have been hit harder such as energy and property.

Finally, it's important to appreciate the significance of the response from governments and central banks. The unprecedented reliefs and support measures introduced by governments have gone a long way to preventing an outright economic collapse and financial crisis, whilst the lowering of interest rates has also had a significant stimulating effect on markets. The reason for this is that lower interest rates make future cashflows more valuable (conversely high discount rates make future cashflows less valuable), so whilst 2020 may well turn out to be a terrible year for both corporate profits and dividends this is outweighed by the increase in the value of all future cashflows arising from the lower discount rate now applied. A more simplistic way of viewing the impact of lower interest rates on the value of shares is that when cash deposit rates fall to virtually zero it makes holding cash unattractive and investments with even a low yield look attractive by comparison – a phenomenon often dubbed as "TINA (there is no alternative)".

Whilst it is possible to rationalise the current stock market recovery it is also important to not become complacent about the many risks that still exist. Overall we believe that a cautious approach and a well diversified portfolio should provide the best chance of balancing the need to navigate these risks with providing decent long term investment returns.

Market Commentary and Outlook

In our previous quarterly review we commented that "it is worth noting that stock markets tend to bottom out well before the economy itself starts to recover" and so it has proved, as all of the major markets have staged a strong recovery over the second quarter whilst the bad economic news continues to pile in.

The latest forecasts suggest that 2020 will see the deepest global recession since World War II, with a contraction of over 6% being more than twice as severe as the one associated with the 2008/9 global financial crisis.

The hope is that despite the severity of the downturn, the pandemic will be predominantly a one off hit impacting 2020, followed by a recovery once the virus is defeated by a vaccine or naturally subsides. The evidence for this is so far mixed, with encouraging news from the Far East which appears to have dealt with it quite well so far and European countries where cases have seen a steady decline from their peaks and lockdowns are now being lifted, to on the other hand a worrying upward trend in cases in the Americas and some emerging markets such as India.

United Kingdom

In the UK the FTSE 100 index had its best quarter since 2010 with a return of 8.8% although this still leaves it down by over 18% for the year-to-date.

The events of this year has resulted in some major changes to the shape of the top end of FTSE index with the likes of Royal Dutch Shell, BP and HSBC dropping from the top spots to be replaced by AstraZeneca and Unilever.

With the new Chancellor, Rishi Sunak, having announced back in March a huge relief package and an undertaking to do "whatever it takes" to help get the UK through the crisis, the scale of the bill for this is now becoming apparent with record borrowing of over £100bn in April and May alone taking total government debt to £1.95 trillion. Fortunately the cost of borrowing is at record low rates and the government was recently actually able to issue a tranche of gilts on a negative yield for the first time ever.

United States

As is often the case, the US market has been at the forefront of the global stock market rally and the S&P 500 index was the strongest of the major indices with its best quarter since 1998.

Given how the US has struggled to deal with the coronavirus pandemic, with by far the largest number of cases (currently 2.8m and rising) and deaths (over 130,000 so far) of any country on earth, it is perhaps a little surprising just how well its stock market has recovered. However, as explained in our article on page 1, there is a big difference between the health of the nation and economy in general and the stock market which is now dominated by the major technology stocks such as Amazon, Apple, Microsoft, Facebook and Alphabet (Google) which have emerged as relative winners from the current crisis.

Europe

In line with other major indices, the European market also had a good quarter with a gain of 9.5%.

The big recent corporate news in Europe has been the dramatic downfall of Wirecard. Over the past 30 years the German company had grown from fintech start-up to become a member of the Dax 30 blue chip index before plunging into insolvency at the end of June due to the uncovering of a massive multi-year fraud and the arrest of its chief executive.

Japan

The Nikkei 225 index has also enjoyed a strong rally with a gain of 17.8% over the quarter. One of the regular criticisms of Japanese companies over the years has been their ultra-cautious approach to balance sheet management, with a tendency to hoard cash and investments rather than gear up in the name of more "efficient" capital management as preferred in the West. However, the current crisis has demonstrated the merits of having a bullet proof balance sheet and will have only served to stiffen Japanese resolve to maintain their cautious approach.

Emerging Markets

Whilst COVID-19 originated in China, the experience of previous viruses such as SARS has meant that the Far Eastern countries have actually dealt with the current pandemic much better than other parts of the world and in fact the China A share and Korean KOSDAQ indices are now about the only two major global indices in positive territory for the year-to-date.

Investment Statistics - 30/06/2020

Equity Markets	Q2 2020	2020	2019	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
								vs GBP	vs USD
TR Global ($)	19.65%	-7.23%	26.29%						
US (S&P 500)	19.95%	-4.04%	28.88%	22	2.4%	0.25%	0.65%	1.2401	1.0000
UK (FTSE 100)	8.77%	-18.20%	12.10%	17	4.0%	0.10%	0.20%	1.0000	1.2401
Europe (STOXX 50)	9.47%	-12.17%	24.78%	19	3.3%	0.00%	-0.46%	1.1036	1.1231
Japan (Nikkei 225)	17.82%	-5.78%	18.20%	20	2.0%	-0.10%	0.03%	133.82	107.92

Total returns- including dividends

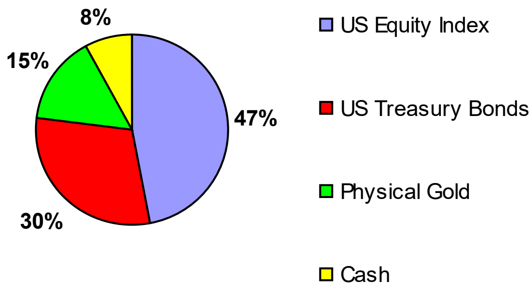
Source: Thomson Reuters

Heritage Investment Fund Limited

Review for the quarter ended 30th June 2020

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 June 2020	US$174.55	£294.52		
Return for quarter (net)	4.63%	6.69%	0.16%	0.25%
Year 2020 return (net)	3.93%	-12.46%	0.75%	0.65%
Year 2019 return (net)	11.37%	16.31%	1.79%	1.82%
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%
Compound annual return (from 1/01)	2.85%	5.73%	2.11%	2.11%
Annual volatility	4.46%	15.65%	0.21%	0.11%
Size of Fund (millions)	US$18.8	£170.0		

US Dollar Absolute Return



The US Dollar Absolute Return Fund aims to generate annual returns in excess of inflation and to protect investors' capital against significant double-digit 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.

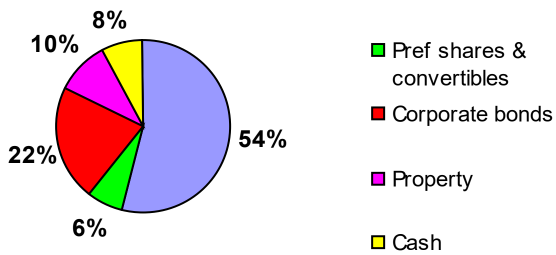
The US equity market position, which is held for growth, recovered most of its first quarter losses during the current quarter as deaths from the coronavirus pandemic declined and many business started to open again. The gains were partially reduced by losses on our managed derivatives positions.

The position in US Treasury Bonds, which is held for capital protection and as a hedge against equity market weakness, fell slightly in value during the quarter as yields remained little changed.

The physical gold position, which is held as a hedge against inflation and US Dollar weakness, rose significantly in value during the quarter as interest rates fell to historical lows.

The Fund gained 4.63% for the quarter and is up 3.93% for the year to date. The uncorrelated, diversified asset class exposure and the protective derivatives positions should help insulate the Fund against double digit losses during the current year in the event of future market falls.

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 the large falls caused by the coronavirus pandemic in the first quarter, markets have recovered strongly and the Fund was up by 6.69% over the second quarter, making it the strongest quarter for the Fund in over 10 years.

Whilst nearly all shares enjoyed an initial bounce in April, the price movements in May and June were more mixed as the impact of the Covid crisis on individual businesses became a little clearer. For example, our holding in Air Partner which initially suffered a huge fall in line with other aviation and travel stocks has subsequently doubled this quarter having announced record trading due to medical freight and repatriation charter flights. On the other hand property shares have continued to struggle over concerns that there will be a lower demand for commercial space in future as work and shopping patterns might be permanently altered.

Our portfolio of bonds and preference shares also had a positive quarter and looking forward has an attractive average yield of over 7%.

Although the outlook is currently very uncertain, we believe that our portfolio of investments remains well positioned to generate attractive returns for long-term investors, whilst our decent cash weighting should provide some protection against the risks of further market weakness and enable us to add to favoured investments at attractive prices.

Heritage coronavirus update

Despite the ongoing enforced closure of our London office due to the lockdown imposed to contain the coronavirus, we have been fortunate given the nature of our business that all of our team have been able to continue to work remotely. As we are sure clients will understand, we are still currently unable to conduct face to face meetings but remain available to deal with any investment trades, payments and queries etc. as usual via email and phone. Given the recent easing of the lockdown we are hopeful that we will be able to return to the office before too long.

The passive investment style of Heritage Absolute Return Fund

Passive investing is an investment strategy that generally tracks a broad market-weighted index, such as an equity or bond market index. By tracking an index, the investment portfolio provides extensive diversification among many securities, low turnover and transactions costs, and low management fees. Passive investors do not seek to profit from short-term price fluctuations or market timing, but rather to profit from long-term positive market returns over time.

Last year in the US, assets managed by passive equity funds outstripped assets managed by active funds for the first time. Over the prior decade, just 23% of active US equity funds managed to survive and outperform their passive peers.

Passive investing is usually achieved through holding index funds or exchange traded passive funds (ETF's). ETF's are quoted on recognised stock exchanges, can be traded throughout the day at tight spreads and are highly liquid. Previous criticisms about their liquidity and performance have proved to be illusionary during the recent equity and bond market crash caused by the coronavirus.

Our Heritage US Dollar Absolute Return Fund invests in ETF's that fully replicate all the underlying securities represented in the index, rather than just a sample of such securities. We add value by determining the optimal asset allocation between various asset classes which is the main driver of returns, rebalancing these allocations regularly and hedging against the risk of significant losses.

Since December 2014 when the US Dollar Absolute Return Fund investment mandate was broadened beyond bonds to include equities and other assets, it has provided solid risk-adjusted returns for investors over the last 1 year (8.62%), 3 years (16.08%) and 5 years (24.99%) which includes the severe market falls in the first half of this year. For Sterling-based investors, the returns have been even better due to the depreciation of Sterling against the US Dollar.

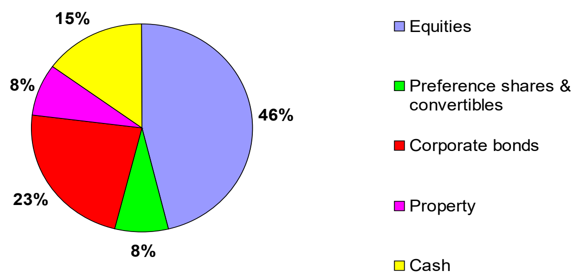
SVS Heritage Balanced Portfolio Fund

Price at 30/06/20	115.1p (launched at 100p 1/12/16)
Fund size	£23.03m
Fund type	OEIC, UCITS (UK domiciled)
Eligible for	ISAs, SIPPs, Funds at Lloyd's
Pricing and dealing	Daily
Minimum Investment	£10,000
Administrator/ACD	Smith & Williamson

Performance

Return	2020 Q2	2020 YTD	2019	2018	2017	Inception 01/12/16
SVS HBPF	7.27%	-12.34%	18.29%	-3.48%	12.30%	15.10%
UK CPI	0.25%	0.65%	1.82%	2.51%	2.72%	8.06%

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 the large falls caused by the coronavirus pandemic in the first quarter, markets have recovered strongly and the Fund was up by 7.27% over the second quarter, making it the strongest quarter for the Fund since inception. 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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