Heritage

Quarterly Newsletter & Investment Review

Issue 103 Quarterly news & investment review from Heritage Quarter 3 2023

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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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Inflation is finally falling but investors kept waiting on interest rates

Whilst the data is now showing hard evidence that inflation has passed its peak and is falling in all of the major economies, investors have so far been kept waiting by central banks for signs that interest rates may have also reached a peak and will follow suit. However, the current thinking is that rates may well now stay higher for longer. In the short term this has acted as a drag on markets but as we explain in the article below it can hopefully result in better long term returns.

Despite the generally weaker global markets over the summer, the Heritage funds have produced another small positive performance this quarter. As usual further details for the Heritage Managed Portfolio Fund can be found on page 3 and the SVS Heritage Balanced Portfolio Fund on page 4.

"Spotlight On" - Investing with higher interest rates

Up until last year savers and investors had become accustomed to a world in which interest rates were virtually zero. In response to the great financial crisis in 2008 central banks slashed interest rates. In the UK and other major economies the base rate remained below 1% for well over a decade, from early 2009 right up until May 2022. Since then, in response to the inflation shock created by the war in Ukraine, base rates have risen steadily to their current rate of 5.25%. Whilst this has no doubt come as a shock to many, it is worth remembering that for the decade before the financial crisis interest rates moved in a cyclical pattern in a band between 3.5% and 6.0%, so the current situation may be viewed more of a return to the long delayed normal rather than something temporary or exceptional.

There is no denying that for nearly all investors this adjustment back to higher interest rates has been a painful experience. The basic laws of finance mean that higher inflation and interest rates reduce the expected value of future cash flows and so the prices of all financial investments have to fall to provide higher yields. This effect is felt particularly acutely by long dated investments and some of the worst returns last year were suffered by supposedly "safe" government bonds. For example the price of the UK government 4.25% gilt maturing in 2039 fell by over 30% in 2022. Equities also suffered from the same effect and the World Index was down by just under 20%, and it was a similar story for property and other alternatives such as infrastructure investments.

So far 2023 has been a fairly frustrating year as inflation remained stubbornly high and investors realised that there would not be a swift return to the previous ultra-low interest rates from the previous decade. However, the key now is what the future holds for investors and fortunately things are starting to look more attractive.

With a risk free rate of over 5% today capital should be deployed far more efficiently and productively than in a world of zero interest rates. With a sensible cost of capital, only the better quality businesses and projects should receive investment and there will be less zombie companies limping on for years and money thrown at marginal and speculative ventures, which were a feature of the strange zero interest rate environment. Overall this should result in a healthier financial system and economy and higher returns for those with capital to invest.

With this potentially more positive general outlook for investors we thought it would be helpful to also take a closer look at the impact on the various asset classes, as well as providing some specific examples of how we are managing things within our portfolios.

Continued on page 4

Heritage Capital Management Limited

Review for the quarter ended 30th September 2023

Market Commentary and Outlook

Global equity markets had a difficult third quarter declining by 3.2%. The main headwind has been the realisation that interest rates have not yet peaked and that they may also have to stay higher for longer than previously anticipated.

However, as we point out in our main article this is not a bad thing. In fact ending the long period of near zero rates is akin to the economy finally being released from intensive care and sustainably higher interest rates are associated with a more robust economy. Higher rates can also help to deliver better returns across the board and it is notable that investment returns were generally much better in the 1990s when interest rates and economic growth were higher than in the 2010s which were associated with low rates, sluggish economic growth and lower returns.

The other major benefit of higher rates is that bonds now offer not just a decent return but also genuine diversification. In the previous zero interest rate world bonds offered virtually no returns and were exposed to rising rates. However from today's starting point of 5% rates, if the economy performs well and rates stay high then bonds will continue to produce good returns but crucially if the economy slows and central banks are forced to lower rates, then bonds will come into their own as a hedge, as falling rates mean higher bond prices.

This means that conservative investors such as ourselves once again have a very useful tool in our box and with this in mind we have recently been increasing the bond weightings within our portfolios.

United Kingdom

The FTSE 100 index was the only one of the major markets in positive territory this quarter with a small gain of 1%.

There has also been some slightly better news from the UK on the economic front. Revised official figures now show that the UK recovered faster than previously reported from its pandemic slowdown and rather than lagging other G7 economies the rebound has in fact been much stronger than previously thought and better than many others including the Eurozone's largest economy, Germany.

The main negative continues to be that inflation is not yet fully under control and is not being helped by ongoing wage pressure and strikes. The Bank of England has therefore continued to raise interest rates from 3.5% at the start of the year to the current level of 5.25%. However, more recently there has been some slightly more encouraging news on inflation and previous expectations that rates would need to keep rising to 6% now look overly pessimistic.

United States

The US market was weaker over the summer with the S&P 500 declining by 3.7% although a strong start to the year means that it is still nicely up for the year-to-date.

The US market has been driven this year by a very narrow band of tech giants which have been christened the Magnificent Seven, consisting of Apple, Microsoft, Alphabet (Google), Amazon, Nvidia, Tesla and Meta (Facebook). As these big seven stocks that dominate the market trade on well above average PE ratios it does leave the US more exposed to a correction than other markets that are on more reasonable valuations.

Having increased interest rates 10 times in a row since March 2022, the Federal Reserve voted for a pause in June but followed this with another rise in July to take the rate to 5.5%.

Europe

European markets were the weakest of the major markets this quarter, declining by just over 5%. Inflation is currently also of major concern across Europe and the European Central Bank has continued to raise interest rates from 4.0% to 4.5%.

Previously the French luxury goods group, LVMH, was Europe's largest listed stock but the recent meteoric rise of Danish pharmaceutical company, Novo Nordisk, has taken it to the top spot, thanks to the excitement over its weight loss wonder drug, Wegovy.

Japan

The very strong run up in the Japanese market earlier in the year came to a halt this quarter with a 4% decline and the excitement over the possibility of the Nikkei finally passing its previous high from 1989 has abated for now.

Emerging markets

Emerging markets have generally continued to struggle this year. The highlight of the recent BRICS summit in South Africa was the agreement to admit six new member countries: Argentina, Ethiopia, Iran, Saudi Arabia and the United Arab Emirates, who will join the group in January 2024.

Investment Statistics - 30/09/2023

Equity Markets	Q3 2023	2023 YTD	2022	2021	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates	
									vs GBP	vs USD
TR Global ($)	-3.19%	9.89%	-17.91%	18.84%						
US (S&P 500)	-3.65%	11.68%	-19.92%	26.89%	22	2.1%	5.25%	4.57%	1.2197	1.0000
UK (FTSE 100)	1.02%	2.10%	0.91%	14.30%	11	3.9%	5.50%	4.44%	1.0000	1.2197
Europe (STOXX 50)	-5.10%	10.04%	-11.74%	20.99%	12	3.4%	4.50%	2.84%	1.1536	1.0570
Japan (Nikkei 225)	-4.01%	22.09%	-9.37%	4.91%	17	1.9%	-0.10%	0.77%	182.20	149.35

Total returns- including dividends

Source: Refinitiv

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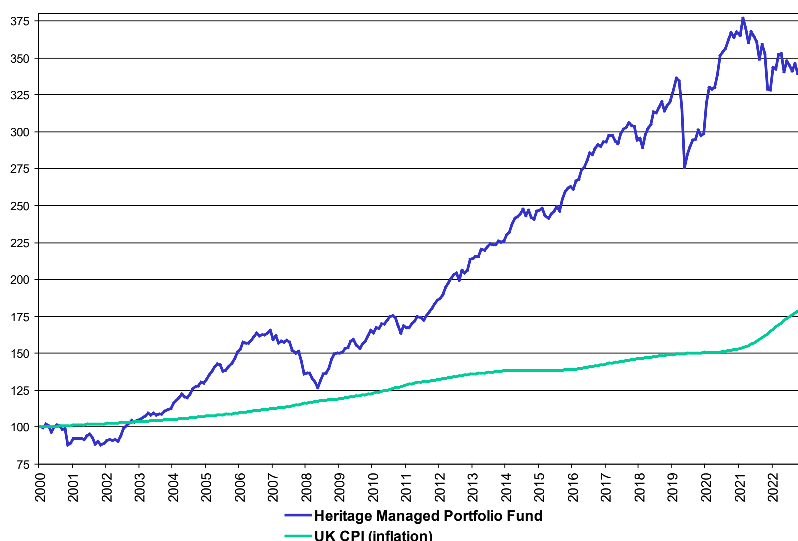
Heritage Managed Portfolio Fund

Review for the quarter ended 30th September 2023

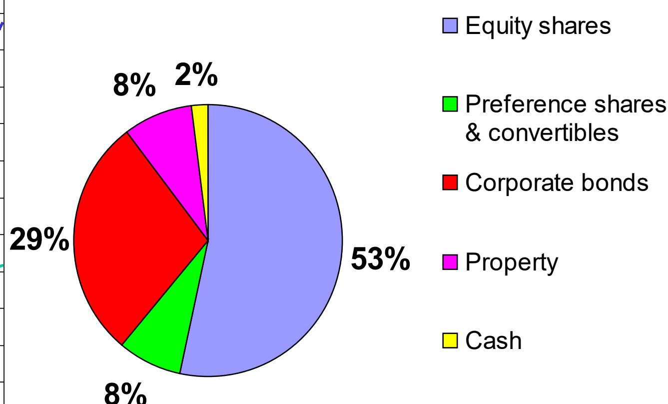
Performance	Managed Portfolio Fund	Inflation (UK)
Return for the quarter (net)	0.48%	1.79%
Year 2023 year to date (net)	0.19%	6.86%
Year 2022 return (net)	-9.14%	8.97%
Year 2021 return (net)	14.07%	2.20%
Year 2020 return (net)	-1.87%	0.93%
Year 2019 return (net)	16.31%	1.82%
Year 2018 return (net)	-2.76%	2.51%
Year 2017 return (net)	11.50%	2.72%
Year 2016 return (net)	7.48%	0.68%
Compound annual return since 2001	5.67%	2.46%

Fund information	
Price at 30th September 2023	£342.80
Fund size	£180.2 million
Fund domicile	Guernsey
Fund status	Non-distributor ("roll-up")
Subscriptions/redemptions	Monthly dealing
Further Information	www.heritage-capital.co.uk
Risk	**Annual Volatility**
Managed Portfolio Fund	7.6%
TR World Index	13.8%

Price Performance



Asset Allocation



Commentary

The Managed Portfolio Fund seeks to generate attractive long-term investment returns at a lower risk than that associated with pure equity market investment through active management of a well diversified multi-asset portfolio.

Despite the negative return for global equity markets this quarter the Fund gained 0.48%, taking the overall year-to-date return into positive territory.

Within our share portfolio there were notable positive contributions from System1, Bellway, Shell, Standard Chartered and our largest holding Computacenter, which all gained over 10%. Of our specialist equity funds, ICG Enterprise Trust, AVI Global Trust, HgCapital and Caledonia Investments all made positive progress despite the generally weaker markets. On the other hand our property based holdings have continued to find things more difficult as values have continued falling due to higher interest rates.

Whilst high inflation and the transition to higher interest rates have also made it a tough period for fixed income investments, the prospective returns are now looking particularly attractive and our bond portfolio currently has a running income yield of over 7%. Furthermore the yield to redemption is over 9%, as many bonds are now trading below par and we can expect a capital gain as well as a high income yield if the bonds are held to maturity. We have therefore been increasing the weighting of our bonds by topping up existing holdings as well as finding new bonds to buy.

Although the near term outlook remains uncertain, we believe that our portfolio of well diversified investments is well positioned to generate attractive returns for long-term investors.

This report is not an invitation to subscribe for shares in the Heritage Investment Funds and is for the information of investors only. Investors should be aware that past investment performance is not a guide to future performance, and that the value of investments may fall as well as rise. An investor may get back less than the original amount invested.

"Spotlight On"- Investing with higher interest rates - continued

Firstly, the outlook for ***bonds and fixed interest securities*** generally is much more positive today. Up until last year the choice for investors was particularly unappealing, consisting of either lending money to governments or investment grade companies at close to zero percent, or taking on more risk with less secure corporate borrowers to generate slightly higher but still fairly paltry returns. Today we can buy high quality bonds on yields of over 5% as well as a range of higher yielding bonds, in many cases offering double digit percentage returns.

We have therefore recently been actively buying bonds for our funds as these can now generate attractive returns with a lower risk than equities. For example we have bought several shorter dated bonds from quality issuers such as Rolls-Royce, M&S, Whitbread, Burberry, Hiscox and Lloyd's of London on yields of around 6-8% and with a bit more research and analysis we have been finding and buying bonds on even more attractive yields.

Property and property shares (known as REITS or real e
investment trusts) have also been heavily impacted by hi
interest rates and inflation. Whilst in the long run propert
a real asset, should act as a good inflation hedge, in the
term the focus has been on falling property values. Fortun
most REITS have fixed their debt at low rates and the inc
from rents has been increasing with many leases having st
inflation linkage. Lower prices mean higher yields and a
example of this is one of our old favourites, Primary H
Properties, which has increased its dividend for over 20 y
and is now on a yield of over 7%.

When it comes to ***equities*** the impact of higher interest rates is slightly less explicit, but in general higher rates tends to favour higher yielding "value" shares over "growth" shares, where the expected cashflows are more heavily loaded into the future and hence worth less discounted at today's higher rates.

Overall then, despite the challenging period that we have been through adjusting to a higher interest rate environment, we see the outlook for future returns being much more positive. Having said that as conservative investors we are always mindful of the risks involved and also therefore have an eye towards mitigating these. For bonds this means a focus on shorter dated bonds which would be less exposed if interest rates rise further. For property companies we prefer those with long and secure leases with rent rises linked to inflation and for equities we have a preference for companies with solid balance sheets and tried and tested business models that reward shareholders with growing dividends.

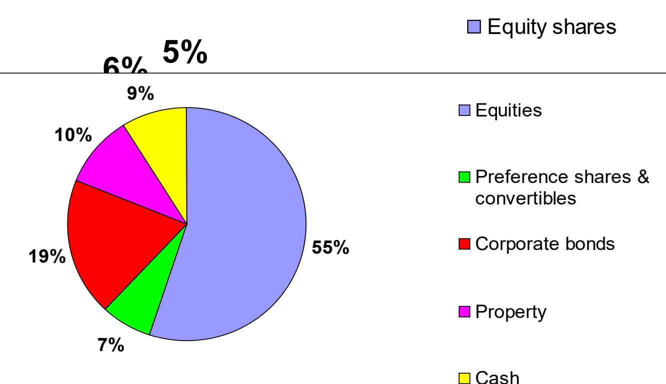
SVS Heritage Balanced Portfolio Fund

Price at 30/09/23	1.362p (launched at 100p 1/12/16)
Fund size	£32.1 million
Fund type	OEIC, UCITS (UK domiciled)
Eligible for	ISAs, SIPPs, Funds at Lloyd's
Pricing and dealing	Daily
Minimum Investment	£10,000
Administrator/ACD	Evelyn Partners

Performance

Return	2023 Q3	2023 YTD	2022	2021	2020	Inception 01/12/16
SVS HBPF	0.81%	-0.15%	-8.27%	15.00%	-1.52%	36.20%
UK CPI	1.79%	6.86%	8.97%	2.20%	0.93%	28.95%

Asset allocation



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 investment returns at a lower risk than that associated with pure equity market investment through active management of a well diversified multi-asset portfolio.

The Fund made a positive return of 0.81% this quarter and the more detailed comments on the Heritage Managed Portfolio Fund 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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