# HERALD INVESTMENT TRUST plc

## REPORT & ACCOUNTS

31 December 2008

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**THIS DOCUMENT IS IMPORTANT AND REQUIRES YOUR IMMEDIATE ATTENTION. If you are in any doubt as to the action you should take you should consult your stockbroker, bank manager, solicitor, accountant or other independent financial advisor authorised under the Financial Services and Markets Act 2000 immediately.**

**If you have sold or otherwise transferred all of your ordinary shares in Herald Investment Trust plc, please forward this document and the accompanying form of proxy as soon as possible to the purchaser or transferee or to the stockbroker, bank or other agent through whom the sale or transfer was or is being effected for delivery to the purchaser or transferee.**

# COMPANY SUMMARY

| COMPANY DATA AT 31 DECEMBER 2008 | | |
|---|---|---|
| **Total assets†** | **Shareholders' funds** | **Market capitalisation** |
| **£276m** | **£211m** | **£153m** |

†Before deduction of bank loans and derivative financial instruments

| | |
|---|---|
| Policy and Objective | Herald's objective is to achieve capital appreciation through investments in smaller quoted companies, in the areas of telecommunications, multimedia and technology (TMT). Investments may be made across the world. The business activities of investee companies will include information technology, broadcasting, printing and publishing and the supply of equipment and services to these companies.<br>The Company's investment policy is contained within the Business Review on page 22. |
| Benchmark | The portfolio benchmark against which performance is measured is 2/3 Hoare Govett Smaller Companies Index plus AIM (capital gains ex. investment companies) and 1/3 Russell 2000 (small cap) Technology Index (in sterling terms).<br>Though we consider this benchmark to provide a reasonable base for measuring the Trust's performance, the portfolio is not modelled on it and outcomes may diverge widely. |
| Management Details | Herald Investment Management Limited ('HIML') is the appointed investment manager to the Company. The management contract can be terminated at twelve months' notice. Administration of the Company and its investments is contracted by HIML to Baillie Gifford & Co, who also act as Company Secretary. |
| Capital Structure | The Company's share capital consists of 83,408,123 Ordinary shares of 25p each which are issued and fully paid.<br>The Company has been granted authority to buy back a limited number of its own Ordinary shares for cancellation. During the year 3,562,887 Ordinary shares were bought back for cancellation. The Directors are seeking to renew this authority at the forthcoming Annual General Meeting. |
| Management Fee | Herald Investment Management Limited's annual remuneration is 1.0% of the Company's net asset value based on middle market prices, calculated on a monthly basis payable in arrears. |
| Wind-Up | At the Annual General Meeting of the Company held in April 2007 shareholders voted in favour of the Company continuing to operate as an investment trust. The next continuation vote is in 2010 and every third year thereafter. |
| AIC | The Company is a member of the Association of Investment Companies. |

None of the views expressed in this document should be construed as advice to buy or sell a particular investment.

Investment trusts are UK public listed companies and as such comply with the requirements of the UK Listing Authority. They are not authorised or regulated by the Financial Services Authority.

# YEAR'S SUMMARY

| | 31 December 2008 | 31 December 2007 | % change |
|---|---|---|---|
| Total assets (before deduction of bank loans and derivative financial instruments) | £275.8m | £343.5m | |
| Bank loans | £50.0m | – | |
| Derivative financial instruments | £15.1m | – | |
| Equity shareholders' funds | £210.7m | £343.5m | |
| Net asset value per Ordinary share | 252.6p | 395.0p | (36.1) |
| Share price* | 184.0p | 312.0p | (41.0) |
| FTSE 100 | 4,434.2 | 6,456.9 | (31.3) |
| FTSE All-Share | 2,209.3 | 3,286.7 | (32.8) |
| FTSE Small Cap | 1,854.2 | 3,420.3 | (45.8) |
| Hoare Govett Smaller Companies Index plus AIM (capital gains ex. investment companies) | 1,804.3 | 3,562.9 | (49.4) |
| Russell 2000 (small cap) Technology Index (in sterling terms) | 57.6 | 72.1 | (20.1) |
| Benchmark composite index | | | (40.6) |
| Dividend per Ordinary share | 1.55p | 0.50p | 210.0 |
| Special dividend per Ordinary share | 3.45p | – | |
| Revenue per Ordinary share | 5.59p | (1.57p) | |
| Expense ratio | 1.13% | 1.25% | |
| Discount | 27.2% | 21.0% | |

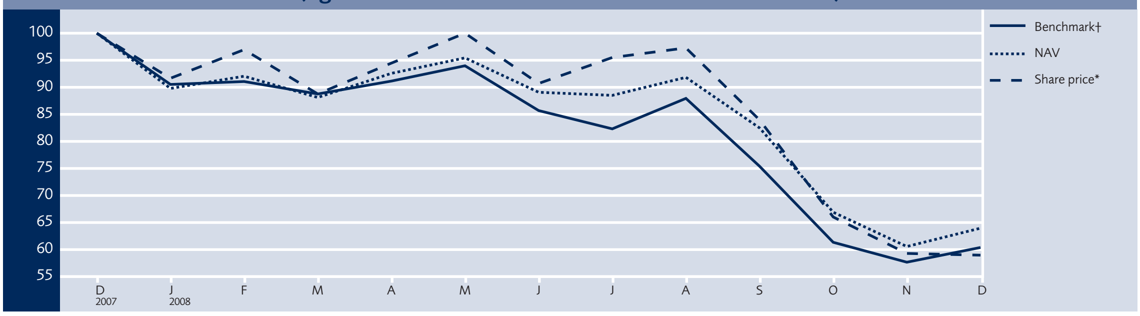
| | Year to 31 December 2008 | | Year to 31 December 2007 | |
|---|---|---|---|---|
| **Year's high and low** | **High** | **Low** | **High** | **Low** |
| Share price* | 317.0p | 167.0p | 424.8p | 300.0p |
| Net asset value | 397.6p | 231.7p | 482.3p | 376.3p |
| Discount | 29.6% | 12.4% | 8.6% | 21.0% |

| | 31 December 2008 | 31 December 2007 |
|---|---|---|
| **Total return per Ordinary share** | | |
| Revenue | 5.59p | (1.57p) |
| Capital | (149.07p) | (37.82p) |
| Total | (143.48p) | (39.39p) |

*At mid market price.

**HERALD'S SHARE PRICE, DILUTED NAV AND BENCHMARK**

**(figures have been rebased to 100 at 31 December 2007)**




Source: Baillie Gifford & Co

†2/3 Hoare Govett Smaller Companies Index plus AIM (capital gains ex. investment companies) and 1/3 Russell 2000 (small cap) Technology Index (in sterling terms).

Dividends are not reinvested.

*At mid market price.

Past performance is not a guide to future performance.

# LONG TERM PERFORMANCE SUMMARY

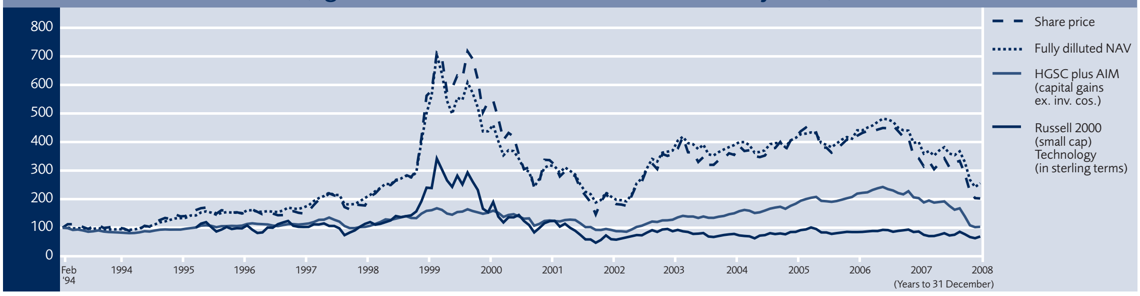
The following charts indicate how an investment in Herald has performed relative to its comparative indices (applied retrospectively) and its underlying fully diluted net asset value over the period since inception of the Company.

| | 31 December 2008 | Inception 16 February 1994 | % change |
|---|---|---|---|
| Net asset value per Ordinary share | 252.6p | 98.7p | 155.9 |
| Share price | 184.0p | 90.9p | 102.4 |
| Hoare Govett Smaller Companies Index plus AIM (capital gains ex. investment companies) | 1,804.3 | 1,750.0 | 3.1 |
| Russell 2000 (small cap) Technology Index (in sterling terms) | 57.6 | 83.2* | (30.8) |
| FTSE 100 | 4,434.2 | 3,417.7 | 29.7 |
| FTSE All-Share | 2,209.3 | 1,717.8 | 28.6 |
| FTSE Small Cap | 1,854.2 | 2,076.1 | (10.7) |

*At 9 April 1996 being the date funds were first available for international investment.

**RELATIVE PERFORMANCE OF HERALD'S FULLY DILUTED NAV AND SHARE PRICE TO THE COMPONENT INDICES OF THE COMPOSITE BENCHMARK† SINCE INCEPTION**

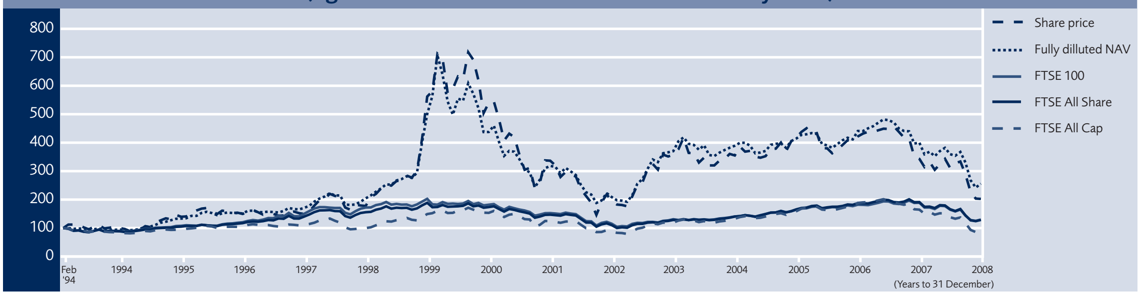
**(figures have been rebased to 100 at 16 February 1994)**




Source: Thomson Financial Datastream/Baillie Gifford & Co

**RELATIVE PERFORMANCE OF HERALD'S FULLY DILUTED NAV AND SHARE PRICE TO FTSE INDICES SINCE INCEPTION**

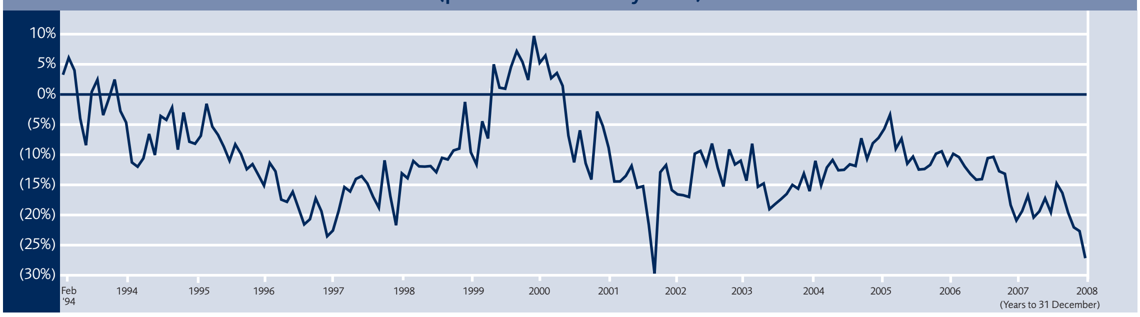
**(figures have been rebased to 100 at 16 February 1994)**




Source: Thomson Financial Datastream

**PREMIUM/(DISCOUNT) TO FULLY DILUTED NET ASSET VALUE**

**(plotted on a monthly basis)**




Source: Thomson Financial Datastream

The premium/(discount) is the difference between Herald's quoted share price and its underlying fully diluted net asset value.

†From 1 January 2006, the benchmark was changed to $^2/_3$ Hoare Govett Smaller Companies Index plus AIM (capital gains ex. investment companies) and $^1/_3$ Russell 2000 (small cap) Technology Index (in sterling terms).

# DIRECTORS, MANAGER AND ADVISERS

## Directors

Martin Boase, MA, FIPA (Chairman) was appointed to the Board on 11 January 1994 and is Chairman of the Nomination Committee. He formed advertising agency Boase Massimi Pollitt plc in 1968 which was floated on the London Stock Exchange in 1983. He was chairman of the Advertising Association from 1987 to 1992 and is currently chairman of Jupiter Dividend and Growth Trust PLC.

Clay Brendish, CBE was appointed to the Board on 23 July 2001. He has been non-executive chairman of Close Beacon Investment Fund since 1995, Echo Research Limited since July 2003, Anite plc since October 2005 and GlobeOp Financial Services since June 2007. He is a trustee of the Economist Newspapers Limited together with the Foundation for Liver Research. Clay's other non-executive directorship is with BT Group plc. He has been in the computer systems environment and high technology industry for over 30 years. He was formerly executive chairman of Admiral plc and, in turn, deputy chairman of CMG plc when the companies merged. He has also held a number of Government advisory posts.

Julian Cazalet was appointed to the Board on 18 January 2008. He was managing director – corporate finance at JPMorgan Cazenove until his retirement in December 2007. A Chartered Accountant he joined Cazenove in 1973 and was made a Partner in 1978. From 1989 he worked in Corporate Finance and advised investment trusts in addition to his work with industrial and commercial companies. He is a director of the White Ensign Association Limited, Deltex Medical Group plc and Charles Taylor Consulting plc.

Tim Curtis was appointed to the Board on 22 July 2004. He was chief executive of Zetex plc (formerly Telemetrix PLC), and is non-executive chairman of RaceCourse Technical Services Ltd and Chairman of CMR Fuel Cells PLC. Former non-executive directorships were with IBS OPENSystems plc between 2005 and 2008, TVS Entertainment plc, Dobson Park Industries plc and Pace Micro Technology plc. Tim was previously a director of Unitech plc.

Douglas McDougall, OBE was appointed to the Board on 13 February 2002 and is Chairman of the Audit Committee and the senior independent director. He has extensive experience in the fund management industry and is a former senior partner of Baillie Gifford & Co. He is chairman of The Law Debenture Corporation plc, Foreign & Colonial Eurotrust plc, The Independent Investment Trust PLC and The Scottish Investment Trust PLC and is a director of The Monks Investment Trust PLC, Pacific Horizon Investment Trust PLC and Stramongate Assets plc. He is a former chairman of IMRO, of the Association of Investment Companies and of the Fund Managers' Association.

All Directors are members of the Audit Committee and of the Nomination Committee.

## Secretary

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Calton Square
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Edinburgh EH1 3AN
Tel: 0131 275 2000

## Registered Office

10-11 Charterhouse Square
London EC1M 6EE

## Company Number

2879728 (England and Wales)

## Manager

Herald Investment Trust plc is managed by Herald Investment Management Limited ('HIML'). The senior director of HIML with prime responsibility for the management of Herald Investment Trust is Katie Potts.

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London EC2R 6DA

Registrars
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Huddersfield HD8 0LA
Tel: 0871 664 0300
(calls cost 10p per minute plus network extras)
E-mail: shareholder.services@capitaregistrars.com
Website: www.capitaregistrars.com

# CHAIRMAN'S STATEMENT

2008 has been a tumultuous year for stock markets, and the decline in net asset value per share of 36.1% compares to a decline in the hybrid benchmark of 40.6%. Disappointing trading reports from investee companies were few and far between and insignificant overall, but the world was chasing liquidity, and the legitimate fear was that the seriousness of the credit squeeze would now affect the wider economy, and hence profits in due course. A year ago the forecast for the profitable stocks in the portfolio was 14.7x 2007 earnings: the portfolio at the end of 2008 is valued at 9.7x the earnings reported in 2007. This implies a derating of 34% on historic numbers, which nearly matches the decline in NAV, albeit on a somewhat different portfolio. A year ago the forecast p/e for 2008 was 11.6x, and is now estimated to be 9.5x; so prospective forecasts have fallen a little in aggregate, but this still represents a derating of 18%. There has at the margin been some destruction of value when companies have failed to raise new money but this has been more than offset by the opportunity to take stakes at exceptionally good valuations. Unlike bank shareholders where there has been a permanent destruction of value, the portfolio essentially remains sound, and profits continue to grow, albeit at a slower rate.

The net asset value of the Trust was weak in the second half of 2007, but January 2008 was worse than any month in 2007, and the decline in January of 10.2% exceeded the decline for 2007 as a whole. For the Trust's shareholders there was then a period of relative stability with the year to date loss reduced a little by the end of August both in absolute and relative terms. Then the crunch harshly took its bite in September, October and November with the NAV per share declining 10.2%, 18.9% and 9.5% in those months respectively. This reflected a further liquidity squeeze in the smaller companies markets around the world. Overall the NAV decline for the year was 36.1%.

The outperformance in the year against the hybrid benchmark would have been markedly greater but for the material adverse impact of a £15m marked to market provision on a 30 year interest rate swap on £50m bank borrowings. A facility of £75m was agreed in April, and £50m of this was drawn down, at a fixed margin for 3 to 5 years (c5.6%). In the spring it seemed obvious that the credit crunch was in its early stage, and that having cash in a world of distress selling would offer the potential for superior longer term returns. In light of the deteriorating macro-economic background at the year end this was invested in cash and Government bonds, in the expectation that valuations would be even more attractive in 2009. While it is exciting to have this war chest, it is a challenge to time the market bottom. Having purposefully deleveraged and repositioned the portfolio more defensively in the second half of 2007 liquid assets peaked at £40m in the first quarter, and in hindsight the Manager reinvested this cash too early, but the severity of the autumn's instability, though recognised as a possibility, seemed unlikely.

The UK still accounts for the majority of the portfolio. The weighted return of the targeted sectors was similar to the decline of the Hoare Govett Small Companies Index including AIM of 47.7% (total return). In contrast the total return of the UK portfolio was -35.8% which was usefully ahead of the index. The capital decline was £75m. The US portfolio declined 32.3% in £ terms, or £25m. The Russell 2000 Technology index was down 42.3%, or 20.1% in £ terms. Local currency returns in Europe and the Far East were -48.4% (-£3.4m) and -51.7% (-£11m) respectively. Both portfolios were reduced in the autumn of 2007 but in retrospect should have been cut even more aggressively. The volume sensitive manufacturing orientation of the Far East meant that it would always be the most vulnerable to a global recession, and it is the one area where there have been widespread reductions in profit forecasts. Had the severity of the global slowdown been anticipated clearly the weightings would have been further reduced, and the outlook for 2009 appears particularly difficult. In contrast the UK and US portfolios are reasonably defensive. As stated above the interest rate swap reflected a year end write down of £15m, albeit the 30 year gilt and swap rates have been exceptionally volatile and at the time of writing this loss has been reduced to £9m. This was partially offset by £4m unrealised bond gains at the year end.

The income statement includes the recovery of £2.9m of VAT paid in previous years, including interest, following the judgment by the European Court of Justice, which will obviously not recur. The Board, therefore, declares a special dividend of 3.45p per share to represent the recovery of VAT and recommends a final dividend of 1.55p per share. The underlying improvement is from a loss of £1.4m to a profit of £1.8m. This significantly reflects three factors: a 29% increase in investment income, which ought to be sustainable, albeit bond income will be replaced by dividend income; a £1.2m increase in deposit interest, which is expected to decline materially; and a significant decline in the management fee reflecting the absence of VAT as well as the decline in assets.

It is disappointing that the discount to the net asset value widened during the year to 27.2% at the year end. The Manager and the Board firmly believe that it is important to consider share buy-backs and marketing to facilitate liquidity in the shares, but that a formulaic buy-back mechanism is entirely inappropriate. The current stock market valuations on a wider basis reflect the havoc caused by there being so many distressed sellers in the market. The policy of this Company is to take material stakes in smaller companies, which are never easily acquired or realised, and in the current market conditions which remain extremely difficult it is unlikely that full liquidity could be achieved at even a 27% discount. Furthermore, the Trust has over the years participated in many primary issues and placings for emerging companies that need outside capital. It is rewarding to see how many of these have developed into successful companies from meagre beginnings, and this is a vital ingredient in the wider prosperity of the economy. It is to be hoped that a positive by-product of these troubled times will be greater recognition of the value of fundamental investing for the development of sound businesses creating long term value both for the investors in the Company, the employees in the investee companies and the wider economy. It is your Board's belief that patient investors will benefit in the long run from the ability not only to avoid being a distressed seller, but also to buy stocks at distressed valuations. The robustness of the closed end structure is especially desirable in current market conditions.

The fragility of the banking system, and the associated contraction of credit is a worry to everyone. There are bound to be adverse repercussions in the profitability of companies within the portfolio. Nevertheless, whilst the Manager is fearful of the knock-on effects of the bleak macro environment, this is offset by excitement that the Trust is in a strong position to exploit the break down in liquidity and funding in the smaller company world, in a sector which has a number of resilient characteristics including strong balance sheets.

*Martin Boase*
Chairman

6 March 2009

# INVESTMENT MANAGER'S REPORT

It is disappointing to report a 36.1% decline in NAV for 2008. In the context of a decline in NAV of this magnitude a small measure of outperformance is small consolation for shareholders. With hindsight I should have positioned the portfolio more defensively than I did.

The excess leverage in the housing and general property market was there for all to see, but the technology sector is not interest rate sensitive. On average the portfolio companies have net cash. Indeed on the basis of the last published accounts the Trust's share of underlying net cash and debt is £16-17m cash. Technology has become mission critical for most enterprises, and our policy was to minimise exposure to discretionary corporate or consumer expenditure, including consumer advertising, and to focus on recurring revenue expenditure, and on companies that would benefit from the inevitable decline in sterling. So whilst I was aware of the problems close to home including the gross excesses in parts of the City, and the UK property world, I had anticipated greater resilience in other parts of the world. There were no housing bubbles in France and Germany. Australia, Canada, Russia and the Middle East were so resource strong, while emerging economies such as China and India were discovering consumption. They would keep the US technology sector going with their demands, and the UK local difficulty seemed less threatening. What I had misjudged, or failed to understand, was that economies were so fragile elsewhere in the world. The property bubbles in Spain and Ireland were so much worse than ours, much of Russian growth and demand was based on excess leverage too, the German and French banks have mysteriously large gross balance sheets, and frighteningly small net balance sheets. It transpires that much of the emerging market growth has been built on leverage too. I also realise that while I was painfully aware of certain City excesses and instabilities I was unaware of others. In particular I thought that they were focused on the hedge fund world and investment banks. However I had not realised the scale of leverage in certain debt related hedge funds, or how much the clearing banks had participated in off-balance sheet arrangements through SIVs and so on.

More evident and close to home I have been incredulous about the scale of price declines of certain shares, and the prices at which shares have changed hands in volume. At the small end I believe many transactions have taken place not because they have been investment decisions but because of liquidity requirements. Redemptions from retail mutual funds are to be expected. Unfortunately, as a consequence of a long period of stock market growth, and the decline of the corporate pension scheme, the mutual fund world has grown, which has led to an untoward level of redemptions from private investors understandably frightened by the media and the financial shocks. This has been compounded by a surprising degree of private investing through contracts for difference on margin, and perhaps most significantly I am astonished by the degree of smaller company investing from leveraged hedge funds. The deleveraging of the latter combined with redemptions has led to a further tap on the market. It is interesting to see data from the National Statistics Office showing that foreigners own 40% of UK listed shares, insurance companies 15%, other financial institutions (hedge funds) 10% and pension funds only 13%. The worry I have is that foreign owners and certain financial investors do not have the solid long term view that pension funds and insurance companies had. It is demonstrated by the fact that often Herald is the only or the major institutional shareholder on a register. Traditionally pension funds had solid positive cash flows, and cared about the health of the companies in which they were investing, because they had stakes that they knew that they could not trade, and overall they were of such a size that they prospered if the portfolios prospered. One of the tragic unintended side effects of the abolition of ACT relief for pension funds has been not only the demise of the defined benefit pension, but the wholesale switch to bond investing, leaving a high proportion of equity in low quality hands. We now realise that fiscally there is a huge incentive for pension funds who receive interest before tax, but dividends after tax, to ditch equities in favour of bonds (and private equity), but it is only in this downturn that I realise how damaging that has been for the instability of the equity market, and for the ability of companies to raise equity in troubled times. The silver lining is that if cash is available there are bargains to be had.

If the disappearance of pension and insurance companies from the small capitalisation registers is one trend, unfortunately the other stable source of small company investors has been investment trusts, which are the ideal vehicles for small capitalisation long term investing, but they have been under siege too. One side effect is that worthwhile liquidity is only generally attained by corporate take-overs. In the last eighteen months the Company has received bids which have completed of £90m realising a total profit from these investments over history of £65m. Take-overs in 2008 included the completion of the

Northgate Information deal, which was announced in December 2007, and was the largest holding at the end of 2007. British Aerospace announced a bid in July for Detica, the largest holding in the fund at that time. Icos Vision, then our largest European holding, was acquired by KLA Tencor, and there were many smaller takeovers. Whilst the valuation of some of these exits has been disappointing, the liquidity has been useful in the current environment.

Unfortunately the performance of our holdings was overshadowed by general economic developments. The table below shows unprecedently low p/es. The weakening economy suggests that there will be downgrades for 2009 for many companies, but the weakness of sterling will provide a material tailwind to profits from overseas subsidiaries and margins on exports. The data below is incomplete data and distorted by the vagaries of accounting, but provides a useful flavour. Since IFRS was introduced most companies produce a headline number as well as a GAAP number. The table below uses Bloomberg's adjusted figure. The trouble with GAAP is that it profoundly diverges from cash flow which, particularly in uncertain times, is ultimately the characteristic we seek. The numbers in the TMT orbit that are generally suspect are the inconsistent approach to capitalisation of R&D, share based payments which are non-cash, and amortisation of intangibles but not goodwill. Crudely, good companies try to maximise tax allowable amortisation, and minimise tax, whilst bad companies try to maximise reported profits.

| **Market value as % of total equities** | **UK** | **US** | **Europe** | **Far East** | **Total** |
|---|---|---|---|---|---|
| Companies profitable in 2007 and 2008 (as % of Total Market Value) | 49.1% | 23.0% | 3.1% | 5.4% | 80.6% |
| Companies unprofitable in 2007 and profitable in 2008 (as % of Total Market Value) | 2.3% | 1.0% | 0.3% | 0.5% | 4.1% |
| Companies unprofitable in 2007 and 2008 (as % of Total Market Value) | 3.3% | 0.9% | – | – | 4.2% |
| Companies profitable in 2007 and unprofitable in 2008 (as % of Total Market Value) | 0.2% | 0.2% | 0.1% | 0.4% | 0.9% |
| Missing data | 5.5% | 3.9% | 0.1% | 0.7% | 10.2% |
| Total | 60.4% | 29.0% | 3.6% | 7.0% | 100.0% |
| **Earnings growth %** | | | | | |
| 2008: Companies always profitable (2007 and 2008) | 9.8% | 8.7% | 10.6% | (10.0%) | 7.7% |
| 2009: Companies always profitable (2007 and 2008) | 11.8% | 5.1% | 15.2% | 4.9% | 10.2% |
| 2009: Companies unprofitable in 2007 and profitable in 2008 | 57.5% | 19.7% | 252.6% | (13.5%) | 30.5% |
| **Earnings growth %** | | | | | |
| Total portfolio 2008* | 34.4% | 21.1% | 13.0% | (32.8%) | 22.5% |
| Total portfolio 2009* | 26.3% | 12.0% | 21.7% | 80.4% | 27.2% |
| **P/E profitable stocks with estimates only** | | | | | |
| 2007 | 8.7x | 15.8x | 11.0x | 6.4x | 9.7x |
| 2008 | 8.2x | 15.0x | 10.0x | 8.6x | 9.5x |
| 2009 | 7.3x | 14.2x | 8.8x | 7.7x | 8.6x |
| **P/E of all stocks with estimates only** | | | | | |
| 2007 | 21.0x | 24.7x | 12.6x | 7.5x | 18.8x |
| 2008 | 9.8x | 17.7x | 10.7x | 11.5x | 11.4x |
| 2009 | 7.5x | 15.8x | 8.8x | 6.4x | 8.7x |

*The calculation for 2008 and 2009 earnings growth is based only on companies with data available in each of the respective years.
Source: JCF Group and brokers estimates

There are a number of positive side effects to the macro scene described above. Whilst the absence of likeminded investors is a frustration and has adversely affected valuations, it is also a source of opportunity and excitement. It would be dispiriting if we had no resources to buy assets, or to support companies in need of cash because we have none. In the last year several portfolio companies have gone into liquidation. Two or three went under because we chose to cut our losses, one because we had inadequate resources to support the business single handedly, and one because some of the Directors wiped out the debt by putting the business into administration and buying back on a pre-pack arrangement. This is an extremely worrying hazard, and the evaporation of the pension funds to help police such events is regrettable. On the other side of the coin a couple of small rescue funding investments at distressed levels provided near instant gratification with corporate take-over bids at useful premiums shortly thereafter. Others we have rewardingly been able to support include a company which lost its overdraft facility when its Icelandic bank went into administration.

The key to exploiting these opportunities is to have cash. A borrowing facility was completed in April giving £25m for 2 years, which is undrawn at 0.6% over LIBOR, £25m for 3 years at 0.65% over LIBOR and £25m for 5 years at 0.7% over LIBOR. A 30 year interest rate swap was also entered into at 4.9% including margin, fixing the rate. In the short term the swap has proved superficially expensive. It is valued daily at the rate it would cost to close the swap which spiked up to £15m at the year-end. Since the year-end long rates have risen somewhat and the paper loss has declined to c£9m. Longer term it seems that the Government has no option but to expand the money supply. This combined with sterling's weakness, and the excess borrowing by Governments all over the world provides a reasonable expectation that long rates will rise. With borrowing costs at 5.6%, and p/es of c7x the mathematics is appealing, but stock selection will be key.

## UK

Historically the UK stock market has always provided more liquidity even in small companies than Continental and Emerging markets. While European markets have certainly proved as difficult as would have been expected, the UK has for reasons described above proved worse than I have known in my City career. The prospective p/e of 7.5x is astonishingly low because within the average some companies are in an early stage of profitability and growth, and still have quite high multiples. For the average to be as low as 7.5x dictates that a number of companies are on p/es of 3-4x. The issue is how resilient will profits prove. There is a case for saying that the arbitrageurs in the bond market drove down the price to reduce risk premium to an absurd level, which has now dramatically reversed. In many ways in the equity market, such a sustained period of economic growth has led to an evaporation of safety premiums for resilient companies. The focus for the Trust has been on businesses with a high recurring element of subscription, maintenance, and monthly fee type businesses, which should be durable.

The performance has benefited from the Detica takeover which accounted for 8% of the UK portfolio at the bid price. This gave a profit of £7.9m during the year, and a £15.6m profit throughout the period of ownership. Ironically it performed particularly poorly in the fourth quarter of 2007, so there was an element of rebound in this. Telecom Plus performed well with several profit upgrades leading to a £3.5m increase in value during the year. Elsewhere holdings that increased in value during the year included SSP, IBS OPENSystems, Mediasurface, Northgate Information Solutions, Conchango, Axon and Xpertise which were all subject to takeover bids.

In contrast Imagination Technologies proved the most expensive with a decline in value of £7.8m. Ironically Apple Inc announced that they had taken a stake in December, and two days later Intel increased its stake, which is a consoling endorsement of our steadfast support. It is sad that a company with such an outstanding client list commands so little respect in the UK media and financial community. The technology which has been so impressive is the semiconductor IP which is designed in by the top semiconductor companies, which uses multi-threading technology for use in power efficient mobile graphics. In particular it is designed into the iPhone and to the Nokia N95 on a royalty basis. It has also been the technology enabler for digital radio, with a market share of c90% for semiconductors in these products, and it manufactures radios under its own Pure brand. The stock market marks it down when the broadcasters make negative comments about the poor returns the broadcasters make on the digital platform. Meanwhile the retailers placed diffident orders for Christmas, and appear to have generally run out of stock. Phoenix IT declined by £3.4m. The company had a major 5 year contract for disaster recovery with Lehman brothers and the share price collapsed when Lehman's went into administration before the first year was complete. There was no commensurate bounce when Nomura announced that they had renewed, and profits delivery has been fine. A further seven investments declined by £2-3m and 17 declined by £1-2m demonstrating how widespread the derating has been. Holdings of note where there has been disappointing trading are Arc International, Interactive Prospect Targeting, TMN, Invu, Local Radio Company, Plasmon and Xaar which collectively accounted for an £11m decline, which is relatively small in relation to the overall £75m decline. At the year end SDL was the largest holding in the fund, and in spite of a succession of profits upgrades during the year the holding still declined by £1.8m.

## US

The benchmark targets a third of the portfolio in the US, but an underweight position has consistently been run. Astonishingly the Russell 2000 Technology Index was 80 in January 1985, and reached 82.8 at the end of 2008. Furthermore it was 130 at the end of August, so was viciously hit . The underweight view reflected valuations that persistently exceeded those in the UK. The growing UK clouds and more reasonable valuations than I had ever seen prompted additional investment in May. Although this meant assets were acquired on an exchange rate in excess of $1.90, there has been a sharp decline in valuations, which are still not as cheap as the UK, but there is much greater intelligent interest in the sector, and robust balance sheets have enabled material share repurchases to facilitate the distress sellers. In spite of this, the unwinding of the hedge funds has taken a heavy toll on share prices.

Several holdings in the US have grown into the top 20. Websense acquired a UK company in which Herald was a very early shareholder, and held at takeover. Websense has beaten brokers expectations every quarter since, and has a recurring subscription model for providing companies' control over employee internet access. It still fell 21% in $ terms over the year. Actel designs and manufactures FPGAs with a particular focus on flash. It has a huge cash balance, and targets doubling sales over 3-4 years organically. Epiq is a long standing holding which specialises in software and services for Chapter 11 and Chapters 7 and 13, and ought to offer a growth market. Advent has also been a long standing holding, which was increased following a satisfactory visit in May. Again it is a rental model for fund management software. The evaporation of the hedge fund industry and the closure of so many funds was not anticipated, so the shares halved. The drag on the portfolio was from investments in companies which unlike the UK portfolio, have genuinely disappointed including Silicon Motion Technology and Anadigics. Losses on 13 holdings exceeded $2m. There now appears to be sound value.

## Europe

The European portfolio has shrunk to a mere £7m. This reflected halving big long standing positions in Logitech and United Internet in December 2007 and the take-overs of Icos Vision, Sez, Horizon and Trolltech. The remaining holdings declined so much that the overall return was -48% in local currency alleviated by currency to give a £ return of -30%, but only £3.3m in value. It is difficult to see how the companies in the technology sector can cope with the strength of the Euro, and the media sector is unappealing in a recessionary world. Furthermore the particularly troubled economies such as Ireland and Spain do not easily have currency devaluation as an option to release the pressures. I find it hard to work out how the stresses will not grow to breaking point, but the UK will be the beneficiary of some of the pressures.

## Far East

The Far East has been too exposed to manufacturing companies, and had the weakness in the global economy been anticipated the holdings would have been further reduced. The holdings are concentrated in Korea and Taiwan. The Korean Won has been as weak as sterling so there has been no currency cushion. However, the decline of almost 50% versus the Japanese Yen will be enormously helpful for the price sensitive products produced by Samsung and LG. The portfolio has shrunk to £15m and holds relatively little appeal in the current macro environment, but will be important as the global economy stabilises.

## Conclusion

The macro environment remains uncertain. The degree of inter-related leverage will make this recession global without precedence. Furthermore, the UK has a particularly troubled and important financial sector. However, while the macro environment is overwhelmingly depressing, companies continue to deliver. There is a disconnection between the pessimism in the financial world, and companies who carry on trading well, with exceptionally low valuations. This, together with low interest rates, provides grounds for optimism.

| PERFORMANCE ATTRIBUTION (in sterling terms) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Benchmark allocation | | Herald asset allocation | | Performance* | | Contribution to relative return | Contribution attributable to: | |
| **Equity markets** | 01.01.08 % | 31.12.08 % | 01.01.08 % | 31.12.08 % | Herald % | Benchmark % | % | Stock selection % | Asset allocation† % |
| UK | 66.7 | 66.7 | 62.4 | 60.3 | (35.8) | (47.7) | 14.2 | 13.8 | 0.4 |
| Europe ex. UK | – | – | 5.0 | 3.2 | (30.4) | – | 0.6 | – | 0.6 |
| Americas | 33.3 | 33.3 | 17.5 | 29.5 | (32.3) | (20.1) | (6.1) | (4.1) | (2.0) |
| Asia Pacific ex. Japan | – | – | 7.8 | 7.1 | (41.0) | – | (0.3) | – | (0.3) |
| Emerging Markets | – | – | – | 0.4 | (58.1) | – | (0.1) | – | (0.1) |
| Bonds | – | – | 3.7 | 15.5 | 21.1 | – | 5.8 | – | 5.8 |
| Cash | – | – | 3.6 | 15.0 | 6.0 | – | 7.2 | – | 7.2 |
| Swap | – | – | – | (7.2) | N/A | – | (6.7) | – | (6.7) |
| Loans | – | – | – | (23.8) | 4.0 | – | (8.1) | – | (8.1) |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | (36.6) | (39.3) | 4.5 | 9.1 | (4.1) |

Past performance is not a guide to future performance.
Source: HSBC.
*The above returns are calculated on a total return basis with net income reinvested. Dividends and interest are reinvested on a cash basis, unlike the NAV calculation where income is recognised on an accruals basis. Relative performance may differ as a result.
Contributions cannot be added together, as they are geometric; for example, to calculate how a return of (36.6%) against a benchmark return of (39.3%) translates into a relative return of 4.5%, divide the portfolio return of 63.4 by the benchmark return of 60.7 and subtract one.

†Asset allocation includes the contribution attributable to currency movements.

*Katie Potts*
6 March 2009

| INVESTMENT CHANGES (£'000) | | | | |
|---|---|---|---|---|
| | **Valuation at 31 December 2007** | **Net acquisitions/ (disposals)** | **Realised and unrealised appreciation/ (depreciation)** | **Valuation at 31 December 2008** |
| Equities* | | | | |
| UK | 214,017 | (12,377) | (75,114) | 126,526 |
| Continental Europe | 17,277 | (7,050) | (3,407) | 6,820 |
| Americas | 60,188 | 26,599 | (24,968) | 61,819 |
| Asia Pacific | 26,583 | (65) | (11,557) | 14,961 |
| Emerging Markets | – | 1,332 | (579) | 753 |
| Total equities | 318,065 | 8,439 | (115,625) | 210,879 |
| Bonds: | | | | |
| UK bonds | – | 13,937 | 963 | 14,900 |
| Euro bonds | 7,545 | 1,677 | 805 | 10,027 |
| US$ bonds | 5,223 | (97) | 2,344 | 7,470 |
| Total bonds | 12,768 | 15,517 | 4,112 | 32,397 |
| Total investments | 330,833 | 23,956 | (111,513) | 243,276 |
| Net liquid assets | 12,664 | 19,795 | 54 | 32,513 |
| Total assets | 343,497 | 43,751 | (111,459) | 275,789 |

The figures above for total assets comprise assets less current liabilities before deduction of bank loans and derivative financial instruments.
*Equities includes convertibles and warrants.

# TOP TWENTY HOLDINGS

AT 31 DECEMBER 2008

*A brief description of the twenty largest holdings in companies is as follows:*

## SDL

SDL is the leader in Global Information Management (GIM) solutions that empower organisations to accelerate the delivery of high-quality multilingual content to global markets. Its enterprise software and services integrate with existing business systems to manage the delivery of global information from authoring to publication and throughout the distributed translation supply chain. Global industry leaders that rely on SDL include: ABN-Amro, Best Western, Bosch, Canon, Chrysler, CNH, Hewlett-Packard, Microsoft, Philips, SAP, Sony, SUN Microsystems and Virgin Atlantic. SDL has implemented more than 480 enterprise GIM solutions, deployed over 150,000 software licenses and provides access to on-demand translation portals for 10 million customers per month. Over 1,000 service professionals deliver consulting, implementation and language services through its global infrastructure of more than 50 offices in 30 countries.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 3.4 |
| % of issued share capital held | | 5.6 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 9.49 | 11.53 |
| Shares (m) | 4.23 | 4.22 |

## Imagination Technologies Group

Imagination creates market-leading embedded graphics, video and display acceleration, multi-threaded processing and multi-standard receiver technology and licenses this IP (Intellectual Property) to global semiconductor and system companies. These technologies are used in the following markets: digital radio and audio, mobile phone multimedia, personal media player, car navigation and driver information, personal navigation, mobile internet device (MID), digital TV and set-top box, and mobile TV. Imagination has been particularly successful in selling graphics technology to the mobile phone and LCD TV sectors and is a pioneer in developing Digital Audio Broadcasting Technology (DAB). Imagination Technology incorporates this technology in its 'Pure Digital' radio brand which is the number one supplier of radios in the UK. The group has a highly skilled workforce of over 450 people, of which over 80% are R&D engineers.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 3.4 |
| % of issued share capital held | | 6.6 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 9.29 | 15.40 |
| Shares (m) | 14.98 | 12.52 |

## Telecom Plus

Telecom Plus supplies fixed wire and mobile telecommunications services, gas, and electricity to residential and small business customers in the United Kingdom. Telecom Plus was incorporated in 1996 and began operations in 1997 providing a unique range of low-cost telephony services to the residential and SOHO markets. They use the collective buying power of individual users to negotiate bulk buying deals with major suppliers, passing the benefit back to their customers. Telecom Plus does not advertise, and has no shops. Instead, they rely on word of mouth recommendations from satisfied customers, and from a network of Independent Distributors. An advanced billing system means the customer receives a single monthly bill covering all the services provided.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 2.9 |
| % of issued share capital held | | 4.0 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 8.08 | 5.25 |
| Shares (m) | 2.64 | 2.84 |

## Phoenix IT Group

Established in 1980, the Group provides a growing range of complementary IT infrastructure support services including systems management, communications, remote telephone support, high-touch field services, project and consultancy services and business continuity and disaster recovery services. Often these services are sold and delivered as a managed service where Phoenix manages complex IT infrastructures to agreed levels of service under long term contracts. In May 2007 Phoenix acquired ICM for £130m in cash and shares, ICM had been a portfolio holding since 2002.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 1.8 |
| % of issued share capital held | | 3.9 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 4.97 | 5.37 |
| Shares (m) | 2.95 | 1.73 |

## Websense

Websense is the global leader in integrated web, data and e-mail security, providing essential information protection for more than 42 million employees at more than 50,000 organisations worldwide. Headquartered in San Diego, California, Websense distributes its solutions through a global network of channel partners. Websense software and hosted security solutions help organisations block malicious code, prevent the loss of confidential information, and enforce internet use and security policies. Websense has its roots in web filtering and continues to develop its core strength in discovering and classifying content across all its product offerings. In March 2007 Websense acquired SurfControl for $400m in cash, SurfControl had been a portfolio holding since 1998.

| | | |
|---|---|---|
| Country | | America |
| % of total assets | | 1.7 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 4.82 | 1.83 |
| Shares (m) | 0.47 | 0.22 |

## Diploma

A group of specialised distribution businesses serving industries with long term growth potential and with the opportunity for sustainable superior margins through the quality of customer service, depth of technical support and value-adding activities. The three sectors the company focuses on are life sciences, seals and controls.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 1.5 |
| % of issued share capital held | | 3.1 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 4.21 | 7.09 |
| Shares (m) | 3.45 | 0.76 |

## SQS Software Quality Systems

Founded in Cologne, Germany, in 1982, SQS Group (SQS) is the largest independent provider of software testing and quality management services in the world. The company tests web, e-commerce, infrastructure, security and client server applications. With more than 4,800 successfully completed projects under its belt, SQS has a strong customer base, including half of the DAX 30 companies, almost one third of the STOXX 50 companies and 36 FTSE 100 companies. SQS has around 1,400 employees worldwide. The clients include Barclays, BP, Credit Suisse, Daimler, Deutsche Bank, Deutsche Post, Dresdner Bank, MessageLabs, Phoenics, T-Mobile, T-Systems, and Zurich Group.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 1.5 |
| % of issued share capital held | | 7.4 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 4.17 | 3.74 |
| Shares (m) | 1.94 | 1.34 |

## Group NBT

Group NBT is a leading provider of domain names and internet-related services. Established in 1995, the company has registered hundreds of thousands of domain names and hosts tens of thousands of websites. Group NBT's clients come from many industries and include well-known companies such as British Airways, The New Statesman and Centrica. Group NBT currently has over 250 employees worldwide, with offices in London, Copenhagen, New York, Nice, Munich, Zurich, Oslo and Madrid. With five market-leading brands, Group NBT is now made up of the following companies: NetBenefit, providing high quality managed hosting services in both the UK and continental Europe; NetNames, providing registration services for every top level domain available and providing corporate domain name management to large organisations through its industry leading NetNames Platinum Service, which is now used by over 30% of the FTSE 100; Easily.co.uk, a top UK provider of cost effective web hosting and domain name services to UK businesses and consumers; Speednames, the dominant provider of domain name services in Denmark; Ascio, which is responsible for the provision of domain name services indirectly through more than 300 partnerships including telecom operators, web hosting companies, internet access providers and IP law firms; and Envisional, whose services monitor the Internet for brand abuse, fraud, counterfeiting and piracy.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 1.4 |
| % of issued share capital held | | 8.0 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 3.97 | 3.57 |
| Shares (m) | 2.03 | 1.78 |

## Electrocomponents

Electrocomponents is the leading high service distributor of electrical, electronic and industrial supplies. Starting in 1937 in London selling spare parts for radios the Group now has operations in 26 countries covering 82% of the world's GDP, with distributors in many more. Turnover is around £900m, of which 59% comes from the international business and one third of sales are via e-commerce. Electrocomponents trades as RS in the UK, most of Europe and Asia, Radiospares in France, Radionics in Republic of Ireland and Allied Electronics in North America. In total Electrocomponents offers 450,000 products which are sold to 1.6 million customers.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 1.3 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 3.70 | – |
| Shares (m) | 2.66 | – |

## Actel

Actel is attacking power consumption at both the semi-conductor and the system levels with its innovative low-power and mixed-signal FPGA solutions. As the leading non-volatile FPGA supplier, Actel leverages its silicon, tools, power-smart IP, and packaging technologies to offer comprehensive solutions that provide chip designers with low power, small footprint, maximum security and reliability. From portable and automotive systems to medical instrumentation, satellite orbit control, networking line cards, and telecom switches and routers, Actel broadly impacts a range of global electronics products with a range of innovative ultra-low power programmable solutions.

| | | |
|---|---|---|
| Country | | America |
| % of total assets | | 1.3 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 3.61 | 2.00 |
| Shares (m) | 0.44 | 0.29 |

## Epiq Systems

Epiq Systems is a leading provider of integrated technology products and services for the legal profession. Epiq's software applications and Web-based platforms offer case management and document management solutions for electronic disclosure. Epiq's solutions streamline the administration of bankruptcy, litigation, financial transactions and regulatory compliance matters. Technology solutions cover electronic discovery, document review, legal notification, claims administration and controlled disbursement. Clients include leading law firms, corporate legal departments, bankruptcy trustees and other professional advisors for support of administratively complex matters spanning litigation and regulatory compliance. Epiq has a relationship with over 1,000 law firms including 47 of the 50 largest global firms.

| | | |
|---|---|---|
| Country | | America |
| % of total assets | | 1.3 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 3.48 | 2.62 |
| Shares (m) | 0.30 | 0.30 |

## Wilmington Group

Wilmington is one of the UK's leading providers of information and training for professional business markets. The Group provides training, arranges industry events and publishes magazines, directories, databases and special reports focused primarily on its principal sectors of Legal and Regulatory, Healthcare, Media and Entertainment and Design and Construction.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 1.2 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 3.32 | 5.26 |
| Shares (m) | 2.48 | 2.53 |

## Alternative Networks

Alternative Networks is a UK business communications service provider. The Group offers a full range of fixed line, mobile, voice and data products. Launched in 1994, Alternative Networks has achieved a track record of consistently profitable growth and in February 2005 listed on the Alternative Investment Market. Alternative Networks is a reseller for providers such as BT, $O_2$ and Vodafone and equipment vendors like Avaya and Mitel. The Group caters to a broad range of telecoms needs, including both stand alone products and fully converged solutions, for larger SMEs and smaller corporate customers in the UK. It has over 4,500 business customers which include clients such as JC Decaux, Channel 4, Miele and Securitas. The Group has grown rapidly, now employing over 430 people, across four UK sites.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 1.1 |
| % of issued share capital held | | 4.6 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 3.17 | 3.27 |
| Shares (m) | 2.05 | 2.05 |

## Wind River Systems

Wind River Systems is a global leader in device software optimisation (DSO). Wind River enables companies to develop, run, and manage device software better, faster and at lower cost. Wind River technology is currently deployed in more than 300 million devices worldwide by industry leaders like Apple, Hewlett-Packard, Boeing, Motorola, NASA, and Mitsubishi. Wind River Professional Services enable leading electronics vendors like Philips, Siemens, Nortel and Samsung to design, develop and deploy innovative products on or ahead of schedule, at or below budget. Founded in 1981, Wind River is a publicly held company headquartered in Alameda, California, with operations worldwide.

| | | |
|---|---|---|
| Country | | America |
| % of total assets | | 1.1 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 3.14 | – |
| Shares (m) | 0.50 | – |

## Advent Software

Advent Software offers integrated software, products and services for automating and integrating data and work flows across the investment management organisation, as well as between the investment management organisation and external parties. Advent's products increase operational efficiency, improve the accuracy of client information and reporting, and enable better decision making. Each solution focuses on specific mission-critical functions of the front, middle and back offices and is designed to meet the needs of the particular client, as determined by size, assets under management and complexity of the investment environment. With more than 4,500 client firms, Advent has established itself as a leading provider of mission-critical applications to meet the demands of investment management operations around the world.

| | | |
|---|---|---|
| Country | | America |
| % of total assets | | 1.0 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 2.78 | 2.71 |
| Shares (m) | 0.20 | 0.10 |

## M&C Saatchi

M&C Saatchi was launched in 1995, with the aim of becoming the world's most sought after advertising agency. The company is now the world's largest independent network, with headquarters in London and regional centres covering America, Asia Pacific and Europe. M&C Saatchi employs over 1,000 people and works for more than 200 clients.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 1.0 |
| % of issued share capital held | | 5.6 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 2.62 | 3.91 |
| Shares (m) | 3.40 | 3.15 |

## StatPro Group

StatPro is a leading provider of portfolio analytics and data solutions for the global asset management industry. Having grown from a one product company, StatPro now offers clients eight core products including data and enterprise reporting solutions. This range of products enables StatPro to provide a unique integrated product offering. Over the past 14 years, StatPro has developed its products in close collaboration with international asset managers and can offer data and software solutions for risk management, fixed income analysis, performance measurement, attribution analysis, GIPS compliance and reporting. StatPro has around 400 client contracts in 25 countries with 11 offices worldwide. StatPro has grown its recurring revenue from less than £1m in 1999 to £22m in 2007 (94% renewal rate in 2007).

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 0.9 |
| % of issued share capital held | | 12.8 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 2.58 | 4.40 |
| Shares (m) | 6.98 | 5.18 |

## Alterian

Alterian empowers marketers with an integrated marketing software platform combining database, online and operational marketing applications on a shared data infrastructure. The Alterian Integrated Marketing Platform makes it practical and cost effective for marketers to execute an integrated marketing strategy across online and offline channels. It is the integration of analytics, content and execution through Alterian's industry leading tools, which enables marketers to drive a seamless, multi-channel customer experience. Alterian's analytically led software is delivered to approximately 1,000 marketing departments, across 26 countries, via an international network of more than 100 business partners, including marketing services providers, agencies and systems integrators. Customers include market leaders such as Princess Cruises, General Motors, Zurich, Astra Zeneca, HSBC, Dell and Vodafone. In July 2008 Alterian acquired Mediasurface, a web content management business for £18m in cash and shares, Mediasurface had been a portfolio holding since 2006.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 0.9 |
| % of issued share capital held | | 7.5 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 2.46 | 3.85 |
| Shares (m) | 4.31 | 3.35 |

## Euromoney Institutional Investor

Euromoney is a leading international business-to-business media group focused primarily on the international finance, metals and commodities sectors. It publishes more than 70 magazines, newsletters and journals, including Euromoney, Institutional Investor and Metal Bulletin. It also runs an extensive portfolio of conferences, seminars and training courses and is a leading provider of electronic information and data covering international finance, metals and emerging markets. Its main offices are in London, New York and Hong Kong and more than a third of its revenues are derived from emerging markets.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 0.9 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 2.42 | 3.74 |
| Shares (m) | 1.10 | 1.00 |

## IDOX

IDOX is a specialist information and knowledge management business with its origins in supplying the UK local authority sector. IDOX focuses on the development and delivery of software products and content for information and knowledge sharing, recruitment and training of information professionals at all levels and consultancy services. The software division provides local authorities with software which delivers seamless integration and automation, from user interfaces through to document storage. The managed services division offers a range of managed services including Unity and UKPlanning. The information services division offers a combination of a comprehensive information service with fully developed web based document management solutions. TFPL provide services in consultancy, recruitment and training.

| | | |
|---|---|---|
| Country | | United Kingdom |
| % of total assets | | 0.9 |
| % of issued share capital held | | 8.4 |
| | 31/12/08 | 31/12/07 |
| Valuation (£m) | 2.39 | 2.92 |
| Shares (m) | 28.97 | 25.97 |

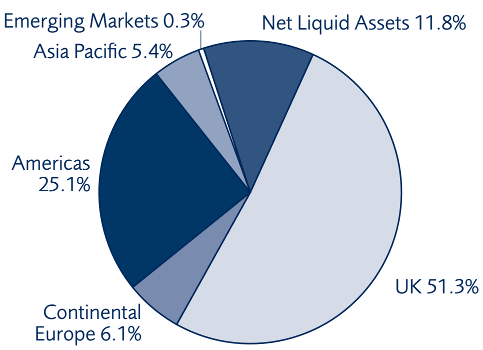
Note: A figure is presented for % issued share capital held only if greater than 3%.

# CLASSIFICATION OF INVESTMENTS

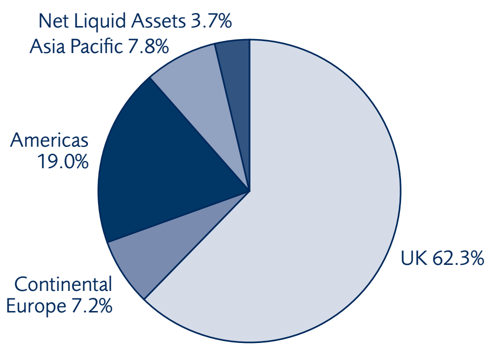
| Classification | UK % | Continental Europe % | Americas % | Asia Pacific % | Emerging Markets % | 2008 Total % | 2007 Total % |
|---|---|---|---|---|---|---|---|
| **EQUITIES:** (including convertibles and warrants) | | | | | | | |
| **BASIC MATERIALS** | **–** | **–** | **–** | **0.3** | **–** | **0.3** | **0.8** |
| Chemicals | – | – | – | 0.3 | – | 0.3 | 0.8 |
| **INDUSTRIALS** | **6.4** | **0.1** | **1.2** | **1.6** | **–** | **9.3** | **9.6** |
| Aerospace and defence | 0.6 | – | – | – | – | 0.6 | 0.4 |
| Electronic and electrical equipment | 0.9 | 0.1 | 0.8 | 1.6 | – | 3.4 | 4.6 |
| Support services | 4.9 | – | 0.4 | – | – | 5.3 | 4.6 |
| **CONSUMER GOODS** | **0.1** | **–** | **–** | **–** | **–** | **0.1** | **0.3** |
| Leisure goods | 0.1 | – | – | – | – | 0.1 | 0.3 |
| **HEALTH CARE** | **–** | **–** | **0.2** | **–** | **–** | **0.2** | **0.2** |
| Health care equipment and services | – | – | 0.2 | – | – | 0.2 | 0.2 |
| **CONSUMER SERVICES** | **8.2** | **0.6** | **0.4** | **0.3** | **–** | **9.5** | **13.8** |
| Media | 7.6 | 0.6 | – | 0.3 | – | 8.5 | 12.7 |
| Travel and leisure | 0.6 | – | 0.4 | – | – | 1.0 | 1.1 |
| **TELECOMMUNICATIONS** | **4.3** | **–** | **–** | **–** | **–** | **4.3** | **3.0** |
| Fixed line telecommunications | 4.1 | – | – | – | – | 4.1 | 2.7 |
| Mobile telecommunications | 0.2 | – | – | – | – | 0.2 | 0.3 |
| **FINANCIALS** | **0.6** | **–** | **–** | **–** | **–** | **0.6** | **0.5** |
| General financial | – | – | – | – | – | – | 0.1 |
| Equity investment instruments | 0.6 | – | – | – | – | 0.6 | 0.4 |
| **INFORMATION TECHNOLOGY** | **26.3** | **1.8** | **20.6** | **3.2** | **0.3** | **52.2** | **64.4** |
| Software and computer services | 19.1 | 1.0 | 11.8 | 0.8 | 0.3 | 33.0 | 40.9 |
| Technology hardware and equipment | 7.2 | 0.8 | 8.8 | 2.4 | – | 19.2 | 23.5 |
| **TOTAL EQUITIES** (including convertibles and warrants) | **45.9** | **2.5** | **22.4** | **5.4** | **0.3** | **76.5** | |
| Total equities – 2007 (including convertibles and warrants) | 62.3 | 5.0 | 17.5 | 7.8 | – | | **92.6** |
| **BONDS** | **5.4** | **3.6** | **2.7** | **–** | **–** | **11.7** | **3.7** |
| **NET LIQUID ASSETS** | **11.4** | **0.2** | **–** | **0.2** | **–** | **11.8** | **3.7** |
| **TOTAL ASSETS** (before deduction of bank loans and derivative financial instruments) | **62.7** | **6.3** | **25.1** | **5.6** | **0.3** | **100.0** | |
| Total assets – 2007 | 65.8 | 7.3 | 19.0 | 7.9 | – | | **100.0** |
| **BANK LOANS** | **(18.1)** | **–** | **–** | **–** | **–** | **(18.1)** | **–** |
| **DERIVATIVE FINANCIAL INSTRUMENTS** | **(5.5)** | **–** | **–** | **–** | **–** | **(5.5)** | **–** |
| **EQUITY SHAREHOLDERS' FUNDS** | **39.1** | **6.3** | **25.1** | **5.6** | **0.3** | **76.4** | |
| Equity shareholders' funds – 2007 | 65.8 | 7.3 | 19.0 | 7.9 | – | | **100.0** |
| Number of equity investments (including convertibles and warrants) | 115 | 14 | 68 | 33 | 1 | 231 | 238 |

# GEOGRAPHICAL SPREAD OF INVESTMENTS

**31 December 2008**




**31 December 2007**



# DETAILED LIST OF INVESTMENTS

AT 31 DECEMBER 2008

| Classification | Name | Value £'000 | % |
|---|---|---|---|
| **UNITED KINGDOM** | | | |
| Aerospace and defence | † Cohort | 1,555 | 0.6 |
| Electronic and electrical equipment | † Andor Technology | 313 | |
| | † Coe Group | 146 | |
| | e2v Technologies | 931 | |
| | * ID Data Group | – | |
| | † Orpak Systems | 411 | |
| | † RCG Holdings | 361 | |
| | Xaar | 455 | |
| | | 2,617 | 0.9 |
| Support services | Acal | 1,201 | |
| | † Datacash Group | 1,332 | |
| | Diploma | 4,214 | |
| | † Eckoh Technologies | 391 | |
| | Electrocomponents | 3,704 | |
| | † Maintel | 623 | |
| | † Opsec Security | 1,346 | |
| | † Tangent Communications | 125 | |
| | † Thirdforce | 542 | |
| | | 13,478 | 4.9 |
| Leisure goods | Alba | 266 | |
| | † ¶ Bright Things | 94 | |
| | | 360 | 0.1 |
| Media | † Apace Media | 33 | |
| | † Avesco | 139 | |
| | Bloomsbury Publishing | 1,590 | |
| | † Burst Media | 111 | |
| | Centaur Media | 542 | |
| | Chime Communications | 769 | |
| | † Coolabi | 239 | |
| | Creston | 169 | |
| | † Digital Marketing Group | 680 | |
| | † Ebiquity | 608 | |
| | † Ekay | 333 | |
| | Euromoney Institutional Investor | 2,417 | |
| | † Expomedia Group | 5 | |
| | † First Artist | 47 | |
| | † Freshwater UK | 206 | |
| | † Independent Media Distribution | 817 | |
| | † Independent Media Support Group | – | |
| | † Interactive Prospect Targeting | 30 | |
| | * JumpTV | 130 | |
| | † Local Radio Company | 133 | |
| | † M&C Saatchi | 2,618 | |
| | † Media Corporation | 127 | |
| | † Next Fifteen Communications | 1,267 | |
| | † Pixel Interactive Media | 253 | |
| | Quarto Group | 956 | |
| | † Research Now | 1,222 | |
| | † Ten Alps | 1,117 | |
| | † TMN Group | 263 | |
| | † Touch Group | 431 | |
| | † UBC Media Group | 222 | |
| | † Vision Media Group | 86 | |
| | Wilmington Group | 3,320 | |
| | | 20,880 | 7.6 |
| Travel and leisure | † Mama Group | 1,729 | 0.6 |

# DETAILED LIST OF INVESTMENTS *continued*

AT 31 DECEMBER 2008

| Classification | Name | Value £'000 | % |
|---|---|---|---|
| **UNITED KINGDOM (continued)** | | | |
| Fixed line telecommunications | † Alternative Networks | 3,170 | |
| | † Freedom 4 | 66 | |
| | † Spectrum Interactive | 38 | |
| | Telecom Plus | 8,078 | |
| | | 11,352 | 4.1 |
| Mobile telecommunications | † 2 Ergo Group | 493 | |
| | † Broca | 42 | |
| | | 535 | 0.2 |
| Non-life insurance | * ‡ Culver Holdings | 36 | – |
| Equity investment instruments | * HIML Holdings Limited | 207 | |
| | * Herald Ventures II | 1,331 | |
| | * HIML Jersey Ltd | – | |
| | | 1,538 | 0.6 |
| Software and computer services | † @UK | 12 | |
| | Alphameric | 1,607 | |
| | Alterian | 2,456 | |
| | † Atlantic Global | 94 | |
| | † Bango | 829 | |
| | † Brady | 231 | |
| | † Business Control Solutions | 162 | |
| | † Business Systems Group | 601 | |
| | † Clarity Commerce Solutions | 175 | |
| | † Dealogic | 544 | |
| | Electronic Data Processing | 779 | |
| | Fidessa Group | 1,918 | |
| | GB Group | 839 | |
| | Gresham Computing | 1,207 | |
| | † Group NBT | 3,965 | |
| | † IDOX | 2,390 | |
| | Intec Telecom Systems | 956 | |
| | * Intechnology | 551 | |
| | † Intelligent Environments | 550 | |
| | † Invu | 160 | |
| | Kewill Systems | 782 | |
| | Kofax | 1,824 | |
| | † Manpower Software | 1,081 | |
| | † Maxima Holdings | 1,837 | |
| | † OMG | 1,461 | |
| | † OneClickHR | 305 | |
| | † Patsystems | 1,001 | |
| | Phoenix IT Group | 4,965 | |
| | † Portrait Software | 182 | |
| | † Redstone | 52 | |
| | SDL | 9,485 | |
| | * ‡ Servicepower Technologies | 559 | |
| | † Silanis International | 83 | |
| | † SQS Software Quality Systems | 4,172 | |
| | † StatPro Group | 2,583 | |
| | † Strategic Thought Group | 888 | |
| | † Xploite | 783 | |
| | * † ‡ Zoo Digital Group | 649 | |
| | | 52,718 | 19.1 |

# DETAILED LIST OF INVESTMENTS *continued*

AT 31 DECEMBER 2008

| Classification | Name | | Value £'000 | % |
|---|---|---|---|---|
| **UNITED KINGDOM (continued)** | | | | |
| Technology hardware and equipment | † Amino Technologies | | 1,477 | |
| | Arc International | | 1,426 | |
| | BATM Advanced Communications | | 1,260 | |
| | * Celoxica Holdings | | 18 | |
| | CML Microsystems | | 472 | |
| | Imagination Technologies Group | | 9,285 | |
| | † Innovision Research & Technology | | 514 | |
| | † IQE | | 900 | |
| | † Itis | | 65 | |
| | † MTI Wireless Edge | | 337 | |
| | Northamber | | 950 | |
| | † Redline Communications | | 42 | |
| | † Sandvine | | 200 | |
| | † Toumaz | | 1,504 | |
| | Wolfson Microelectronics | | 1,278 | |
| | | | 19,728 | 7.2 |
| | TOTAL UNITED KINGDOM EQUITIES | | 126,526 | 45.9 |
| **CONTINENTAL EUROPE** | | | | |
| Electronic and electrical equipment | Eltek | Norway | 17 | |
| | Nordic Semiconductor | Norway | 268 | |
| | | | 285 | 0.1 |
| Media | High Co | France | 293 | |
| | NRJ Group | France | 971 | |
| | PubliGroupe | Switzerland | 142 | |
| | Roularta Media Group | Belgium | 311 | |
| | | | 1,717 | 0.6 |
| General financial | Inspire Investments | Israel | 117 | – |
| Software and computer services | * Atex | Norway | – | |
| | InfoVista | France | 542 | |
| | Isra Vision Systems | Germany | 433 | |
| | Skillsoft | Ireland | 199 | |
| | United Internet | Germany | 1,448 | |
| | | | 2,622 | 1.0 |
| Technology hardware and equipment | Logitech International | Switzerland | 1,925 | |
| | Soitec | France | 154 | |
| | | | 2,079 | 0.8 |
| | TOTAL CONTINENTAL EUROPEAN EQUITIES | | 6,820 | 2.5 |
| **AMERICAS** | | | | |
| Electronic and electrical equipment | Atmi | | 2,146 | |
| | Powerwave Technologies | | 79 | |
| | RF Monolithics | | 43 | |
| | | | 2,268 | 0.8 |
| Support services | 3Par | | 823 | |
| | Harris Interactive | | 127 | |
| | | | 950 | 0.4 |
| Leisure goods | THQ | | 130 | – |
| Health care equipment and services | SonoSite | | 530 | 0.2 |
| Media | Jupitermedia | | 109 | |
| | Multivision Comms | | – | |
| | | | 109 | – |
| Travel and leisure | Ctrip.com International | | 989 | 0.4 |

# DETAILED LIST OF INVESTMENTS *continued*

AT 31 DECEMBER 2008

| Classification | Name | Value £'000 | % |
|---|---|---|---|
| **AMERICAS (continued)** | | | |
| Software and computer services | Actuate | 1,857 | |
| | Advent Software | 2,778 | |
| | Aladdin Knowledge Systems | 1,140 | |
| | Descartes Systems Group | 1,098 | |
| | Epiq Systems | 3,480 | |
| | Falconstor Software | 576 | |
| | Fundtech | 1,072 | |
| | Ilinc Communications | 113 | |
| | Intraware | 462 | |
| | Keynote Systems | 1,976 | |
| | Liveperson | 253 | |
| | Macrovision | 1,319 | |
| | Mentor Graphics | 897 | |
| | Netease.com | 615 | |
| | NetScout Systems | 1,799 | |
| | PDF Solutions | 95 | |
| | Pegasystems | 860 | |
| | Phoenix Technologies | 241 | |
| | Retalix | 474 | |
| | ¶ Smart Online | – | |
| | Supportsoft | 1,537 | |
| | Vasco Data Security | 1,436 | |
| | Web.com Group | 629 | |
| | Websense | 4,822 | |
| | Wind River Systems | 3,137 | |
| | | 32,666 | 11.8 |
| Technology hardware and equipment | Actel | 3,609 | |
| | Adaptec | 570 | |
| | ADC Telecommunications | 757 | |
| | Alliance Fiber Optic Product | 422 | |
| | Alvarion | 606 | |
| | Anadigics | 521 | |
| | Arris Group | 966 | |
| | AXT | 362 | |
| | Ceva | 483 | |
| | Emulex | 921 | |
| | Exar | 255 | |
| | Extreme Networks | 1,993 | |
| | F5 Networks | 1,588 | |
| | Finisar | 182 | |
| | Harris Stratex Net | 197 | |
| | IGO | 243 | |
| | Lantronix | 390 | |
| | Micros Systems | 1,133 | |
| | Mindspeed Techs | 158 | |
| | MIPS Technologies | 306 | |
| | MRV Communications | 871 | |
| | On Semiconductor | 699 | |
| | Power Integrations | 276 | |
| | Rackable Systems | 137 | |
| | Radware | 290 | |
| | Rimage | 278 | |
| | RIT Technologies | 130 | |
| | Silicon Image | 204 | |
| | Silicon Motion Technology | 947 | |
| | Sonicwall | 1,229 | |
| | STEC | 885 | |
| | Supertex | 2,166 | |
| | Virage Logic | 403 | |
| | | 24,177 | 8.8 |
| | TOTAL AMERICAN EQUITIES | 61,819 | 22.4 |

# DETAILED LIST OF INVESTMENTS *continued*

AT 31 DECEMBER 2008

| Classification | Name | | | Value £'000 | % |
|---|---|---|---|---|---|
| **ASIA PACIFIC** | | | | | |
| Chemicals | Techno Semichem | Korea | | 820 | 0.3 |
| Electronic and electrical equipment | BSE Holdings | Korea | | 429 | |
| | Dae Duck Electronics | Korea | | 236 | |
| | Fine Dnc | Korea | | 272 | |
| | Huan Hsin | Singapore | | 380 | |
| | Innotek | Singapore | | 223 | |
| | KH Vatec | Korea | | 985 | |
| | Simm Tech | Korea | | 248 | |
| | ¶ Surface Mount Technology | Singapore | | 82 | |
| | Tripod Technology | Taiwan | | 400 | |
| | UJU Electronics | Korea | | 443 | |
| | Unimicron Technology | Taiwan | | 370 | |
| | Wooree ETI | Korea | | 333 | |
| | | | | 4,401 | 1.6 |
| Media | Star Publications | Malaysia | | 852 | 0.3 |
| Software and computer services | Cyberlink | Taiwan | | 499 | |
| | Reckon | Australia | | 1,255 | |
| | Springsoft | Taiwan | | 554 | |
| | | | | 2,308 | 0.8 |
| Technology hardware and equipment | Ardentec | Taiwan | | 330 | |
| | Core Logic | Korea | | 124 | |
| | D-Link | Taiwan | | 891 | |
| | EMW Antenna | Korea | | 191 | |
| | Gemtek Technology | Taiwan | | 615 | |
| | Global Testing | Singapore | | 169 | |
| | Jadason Enterprises | Singapore | | 293 | |
| | King Yuan Electronics | Taiwan | | 220 | |
| | Kinsus Interconnect Technology | Taiwan | | 289 | |
| | Min Aik Technology | Taiwan | | 554 | |
| | Mitac International | Taiwan | | 453 | |
| | Nepes | Korea | | 210 | |
| | Phicom | Korea | | 275 | |
| | Powertech Technology | Taiwan | | 1,422 | |
| | STS Semiconductor and Telecommunications | Korea | | 120 | |
| | ZyXEL Communications | Taiwan | | 424 | |
| | | | | 6,580 | 2.4 |
| | TOTAL ASIA PACIFIC EQUITIES | | | 14,961 | 5.4 |
| **EMERGING MARKETS** | | | | | |
| Software and computer services | Datatec | South Africa | | 753 | 0.3 |
| | TOTAL EMERGING MARKETS EQUITIES | | | 753 | 0.3 |
| | Value of equity stocks | | 210,217 | | |
| | Convertible loan stocks having an element of equity | | 661 | | |
| | Warrants having an element of equity | | 1 | | |
| TOTAL EQUITY INVESTMENTS | | | | 210,879 | 76.5 |
| FIXED INTEREST | UK Treasury Note 4% 2016 | | 8,586 | | |
| | UK Treasury Note 4.25% 2011 | | 6,314 | | |
| | Norway 5.25% 2009 | | 10,027 | | |
| | US Treasury Note 4.25% 2010 | | 7,470 | | |
| TOTAL FIXED INTEREST | | | | 32,397 | 11.7 |
| NET LIQUID ASSETS | | | | 32,513 | 11.8 |
| TOTAL ASSETS AT MARKET VALUE (before deduction of bank loans and derivative financial instruments) | | | | 275,789 | 100.0 |

(† denotes holding listed on AIM)
(* denotes unlisted security)
(‡ denotes holding wholly or partly in convertible loan stock)
(¶ denotes holding wholly or partly in warrants)

# TEN YEAR RECORD

| CAPITAL | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| At 31 December | Total assets £'000 | Bank loans £'000 | Equity shareholders' funds £'000 | Net asset value per share p | Diluted net asset value per share* p | Share price p | Warrant price p | (Discount)/ premium† % |
| 1998 | 170,982 | – | 170,982 | 206.25 | 201.70 | 161.50 | 77.50 | (19.9) |
| 1999 | 432,620 | (3,343) | 429,277 | 517.44 | 494.22 | 511.00 | 411.00 | 3.4 |
| 2000 | 378,607 | (3,233) | 375,374 | 447.55 | 431.43 | 491.00 | 382.50 | 13.8 |
| 2001 | 275,624 | (2,892) | 272,732 | 322.94 | 314.53 | 306.00 | 212.50 | (2.7) |
| 2002 | 199,900 | (22,310) | 177,590 | 210.23 | 206.68 | 177.00 | 79.00 | (14.4) |
| 2003 | 350,209 | (29,325) | 320,884 | 365.44 | 365.44 | 325.25 | – | (11.0) |
| §2004 | 356,874 | (24,663) | 332,211 | 379.43 | 379.43 | 322.75 | – | (14.9) |
| 2005 | 358,293 | – | 358,293 | 409.22 | 409.22 | 379.75 | – | (7.2) |
| 2006 | 401,228 | (20,000) | 381,228 | 435.41 | 435.41 | 383.50 | – | (11.9) |
| 2007 | 343,497 | – | 343,497 | 394.96 | 394.96 | 312.00 | – | (21.0) |
| **2008** | **275,789** | **(65,079)#** | **210,710** | **252.63** | **252.63** | **184.00** | **–** | **(27.2)** |

* The diluted net asset value per ordinary share figures have been calculated in accordance with FRS22.
† (Discount)/premium is the difference between Herald's quoted share price and its underlying diluted net asset value.
§ The figures prior to 2004 have not been restated for the changes in accounting policies implemented in 2005.
\# Includes derivative financial investments.

| REVENUE | | | | | | GEARING RATIOS | |
|---|---|---|---|---|---|---|---|
| Period to 31 December | Gross revenue £'000 | Available for ordinary shareholders' £'000 | Earnings per ordinary share net** p | Dividend per ordinary share net p | Expense ratio†† % | Actual gearing‡‡ | Potential gearing§§ |
| 1998 | 3,845 | 1,134 | 1.37 | 0.90 | 1.36 | 94 | 100 |
| 1999 | 3,658¶ | 717 | 0.86 | 0.85 | 0.95 | 93 | 101 |
| 2000 | 6,508 | 778 | 0.93 | 0.85 | 1.40 | 86 | 101 |
| 2001 | 4,728 | 1,145 | 1.36 | 0.85 | 1.07 | 84 | 101 |
| 2002 | 3,539 | 627 | 0.74 | 0.85 | 1.21 | 108 | 113 |
| 2003 | 3,882 | 276 | 0.32 | 0.30 | 1.20 | 103 | 109 |
| 2004 | 4,776 | 301 | 0.34 | 0.30 | 1.20 | 97 | 107 |
| 2005 | 5,368 | 556 | 0.64 | 0.60 | 1.16 | 97 | 100 |
| 2006 | 6,492 | 1,922 | 2.19 | 1.20 | 1.13 | 102 | 105 |
| 2007 | 5,167 | (1,370) | (1.57) | 0.50 | 1.25 | 93 | 100 |
| **2008** | **7,629** | **4,742** | **5.59** | **1.55‡** | **1.13** | **101** | **131** |

** The calculation of earnings per ordinary share is based on the revenue from ordinary activities after taxation and the weighted average number of ordinary shares in issue (see note 9, page 43).
†† Ratio of total operating costs against average shareholders' funds.
‡‡ Total assets (including all debt used for investment purposes) less all cash and fixed interest securities (excluding convertibles) divided by shareholders' funds.
§§ Total assets (including all debt used for investment purposes) divided by shareholders' funds.
¶ Restated for the adoption of FRS16 'Current Tax'.
‡ The 2008 dividend excludes the special dividend of 3.45p.

| CUMULATIVE PERFORMANCE (taking 1998 as 100) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| At 31 December | Diluted net asset value per share* | Share price p | Benchmark¶¶ | Hoare Govett Smaller Cos & AIM Index | Russell 2000 Technology Index | Earnings per ordinary share | Dividend per ordinary share net | Retail price index |
| 1998 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| 1999 | 245 | 316 | 171 | 155 | 212 | 63 | 94 | 102 |
| 2000 | 214 | 304 | 150 | 148 | 136 | 68 | 94 | 105 |
| 2001 | 156 | 189 | 127 | 122 | 108 | 99 | 94 | 105 |
| 2002 | 102 | 110 | 84 | 90 | 53 | 54 | 94 | 109 |
| 2003 | 181 | 201 | 119 | 124 | 77 | 23 | 33 | 112 |
| 2004 | 188 | 200 | 127 | 146 | 69 | 25 | 33 | 116 |
| 2005 | 203 | 235 | 152 | 179 | 75 | 47 | 67 | 118 |
| 2006 | 216 | 237 | 171 | 213 | 75 | 160 | 133 | 123 |
| 2007 | 196 | 193 | 165 | 198 | 76 | (115) | 56 | 128 |
| **2008** | **125** | **114** | **98** | **100** | **61** | **408** | **172‡** | **130** |
| **Compound Annual Returns** | | | | | | | | |
| 5 year | (7.1%) | (10.8%) | (3.8%) | (4.2%) | (4.6%) | 77.2% | 38.9% | 3.0% |
| 10 year | 2.3% | 1.3% | (0.2%) | – | (4.8%) | 15.1% | 5.6% | 2.6% |

Past performance is not a guide to future performance.

The figures prior to 2004 have not been restated for the changes in accounting policies implemented in 2005.

¶¶ From 1 January 2006 the benchmark was charged to 2/3 Hoare Govett Smaller Companies Index plus AIM (capital gains on investment companies) and 1/3 Russell 2000 (small cap) Technology Index (in sterling terms).

# DIRECTORS' REPORT

The Directors present their report and accounts for the year ended 31 December 2008.

## Business Review

### Business and Status

The Company is an investment company within the meaning of Section 833 of the Companies Act 2006.

The Company carries on business as an investment trust. It was approved by HM Revenue & Customs as an investment trust under Section 842 of the Income and Corporation Taxes Act 1988 for the year ended 31 December 2007, subject to any matters that may arise from any subsequent enquiry by HM Revenue & Customs into the Company's tax returns. In the opinion of the Directors the Company has conducted its affairs so as to enable it to continue to obtain such approval and it will continue to seek approval under Section 842 of the Income and Corporation Taxes Act 1988 each year.

### Investment Policy

Herald's objective is to achieve capital appreciation through investments in smaller quoted companies, in the areas of telecommunications, multi-media and technology (TMT). Investments may be made across the world. The business activities of investee companies will include information technology, broadcasting, printing and publishing and the supply of equipment and services to these companies.

While the policy is global investment in the above target areas the approach is to construct a diversified portfolio through the identification of individual companies which offer long term growth potential, typically over a five year horizon or more. The portfolio is actively managed and does not seek to track any benchmark. With a remit to invest in smaller companies with market capitalisation generally below £1bn, there tends to be a correlation with the performance of smaller companies, as well as those of the technology sector. A degree of volatility relative to the overall market should be expected.

The risk associated with the illiquidity of smaller companies is reduced by generally restricting the stake in any one company to less than 10% of the shares in issue. A number of investments are in early stage companies, which have a higher stock specific risk but the potential for above average growth. Stock specific risk is reduced by having a diversified portfolio of over 200 holdings. In addition, to contain the risk of any one holding, the Manager generally takes profits when a holding reaches more than 5% of the portfolio. The Manager actively manages the exposure within the constraint that illiquid positions cannot be traded for short term movements.

The Company has a policy not to invest more than 15% of gross assets in other UK listed investment companies.

From time to time, fixed interest holdings, non equity or unlisted investments may be held on an opportunistic basis.

The Company recognises the long term advantages of gearing and has a maximum gearing limit of 50% of net assets. Borrowings are invested primarily in equity markets but the Manager is entitled to invest in other securities in the companies in the target areas when it is considered that the investment grounds merit the Company taking a geared position. The Board's intention is to gear the portfolio when appropriate with borrowings to around 30% of net assets. Gearing levels are monitored closely by the Manager and reviewed by Directors at each Board Meeting.

The Company may use derivatives which will be principally, but not exclusively, for the purpose of efficient portfolio management (i.e. for the purpose of reducing, transferring or eliminating investment risk in its investments, including protection against currency risk).

A detailed analysis of the Company's investment portfolio is set out on pages 16 to 20 and in the Investment Manager's Report.

### Performance

At each Board meeting, the Directors consider a number of performance measures to assess the Company's success in achieving its objectives.

The key performance indicators (KPIs) used to measure the progress and performance of the Company over time are established industry measures and are as follows:

- the movement in net asset value per ordinary share compared to the benchmark;
- the movement in the share price;
- the discount; and
- the total expense ratio.

A historical record of these measures is shown on pages 2, 3 and 21.

In addition to the above, the Board considers peer group comparative performance.

### Review of the Year and Future Trends

A review of the year and the investment outlook is contained in the Chairman's Statement and the Investment Manager's Report on pages 5 to 11.

### Principal Risks and Uncertainties

The Company's assets consist mainly of listed securities and its principal risks are therefore market related and include market risk (comprising currency risk, interest rate risk and other price risk), liquidity risk and credit risk. An explanation of those risks and how they are managed are contained in note 20 to the accounts on pages 47 to 52.

Other risks faced by the Company include the following:

Regulatory risk – failure to comply with applicable legal and regulatory requirements could lead to suspension of the Company's Stock Exchange Listing, financial penalties or a qualified audit report. Breach of Section 842 of the Income and Corporation Taxes Act 1988 could lead to the Company being subject to tax on capital gains. The Manager's Compliance Officer and Baillie Gifford's Heads of Business Risk & Internal Audit and Regulatory Risk provide regular reports to the Audit Committee on their monitoring programmes. The Manager monitors investment movements and the Secretary monitors the level of forecast income and expenditure to ensure the provisions of Section 842 are not breached.

Operational/Financial Risk– failure of the Secretary's accounting systems or those of other third party service providers could lead to an inability to provide accurate reporting and monitoring or a misappropriation of assets. The Audit Committee reviews the Secretary's Report on Internal Controls and the reports by other key third party providers are reviewed by the Secretary on behalf of the Audit Committee.

### Employees

The Company has no employees. The executive responsibility for investment management has been delegated to Herald Investment Management Limited.

### Social and Community Issues

As an investment trust, the Company has no direct social or community responsibilities. Its principal responsibility to shareholders is to ensure that the investment portfolio is properly invested and managed. Details of the Company's policy on socially responsible investment are set out on page 32.

### Financials

The financial highlights for the year under review are as follows: the net asset value per share decreased by 36.1% during the year, compared to a decrease in the benchmark of 40.6%, the dividend for the year (excluding the proposed special dividend of 3.45p) increased by 210% to 1.55p per share and the discount widened from 21.0% to 27.2%.

## Results and Dividend

The net revenue return after tax was £4,742,000 (2007 – net revenue loss of £1,370,000) and the capital loss £126,538,000 (2007 – capital loss of £32,947,000) giving a total loss of £121,796,000 (2007 – total loss of £34,317,000) for the period.

The Directors recommend a dividend of 1.55p per Ordinary share for the year ended 31 December 2008. The Directors also recommend the payment of a special dividend of 3.45p representing the VAT recovery. If approved at the Annual General Meeting the final and special dividends will be payable on 30 April 2009 to holders registered on 14 April 2009. The ex-dividend date is 8 April 2009.

The net asset value (NAV) of the Company at 31 December 2008 represented a value of 252.6p per Ordinary share. This represented a decrease of 36.1% during the year and a rise of 155.9% since the date of committal of funds (16 February 1994) after allowing for launch expenses of 1.3p per share.

## The Board

The Directors at the year end, and their interests in the Company, all of which are beneficially owned, were:

| Name | Number of Ordinary Shares 31 December 2008 | 1 January 2008 |
|---|---|---|
| Martin Boase | 57,500 | 50,000 |
| Clay Brendish | 14,700 | 14,700 |
| Julian Cazalet | 50,000 | – |
| Timothy Curtis | 6,500 | 2,000 |
| Douglas McDougall | 233,500 | 225,000 |

Mr C J Cazalet purchased 25,000 shares on 25 February 2009. There have been no other changes intimated in the above Directors' interests up to 5 March 2009.

Mr C M Brendish retires by rotation and, being eligible, offers himself for re-election.

In accordance with the Combined Code on Corporate Governance Mr M Boase, who is 76 and who has served on the Board for more than nine years, retires and offers himself for re-election.

The Board has reviewed the performance of Messrs Boase and Brendish. Their performance continues to be effective and each remains committed to the Company. Their contribution to the Board is valued highly and the Board recommends their re-election to shareholders.

The Company maintains Directors' and Officers' Liability insurance.

During the year the Company entered into deeds of indemnity in favour of each of the Directors. The deeds cover any liabilities that may arise to a third party, other than the Company, for negligence, default or breach of trust or duty. The Directors are not indemnified in respect of liabilities to the Company, any regulatory or criminal fines, any costs incurred in connection with criminal proceedings in which the Director is convicted or civil proceedings brought by the Company in which judgement is given against him.

## Management and Administration

For the entire year under review the management of the Company was contracted to Herald Investment Management Limited ('HIML'). HIML is authorised and regulated by the Financial Services Authority.

The management contract is subject to 12 months' notice by either party. The senior director of HIML with prime responsibility for the management of Herald Investment Trust is Katie Potts, who is also a substantial shareholder of HIML. HIML is remunerated at a monthly rate of 0.08333% of the Company's net asset value calculated using middle market prices. Compensation fees would only be payable in respect of this 12 month period if termination were to occur sooner.

At 31 December 2008 the Company was the beneficial owner of 13.86% of the Ordinary share capital of HIML Holdings Limited.

Administration of the Company and its investments is contracted by HIML to Baillie Gifford & Co, who also act as Company Secretary.

Custody of investments is contracted to The Bank of New York Mellon.

The Board considers the Company's investment management and secretarial arrangements for the Company on an ongoing basis and a formal review is conducted annually. The Board considers, amongst others, the following topics in its review: investment performance in relation to the investment policy and strategy; the continuity of personnel managing the assets and reporting to the Board; the level of service provided in terms of the accuracy and timeliness of reports to the Board and the frequency and quality of both verbal and written communications with shareholders. Following the most recent review the Board is of the opinion that the continued appointment of Herald Investment Management Limited as investment manager, on the terms agreed, is in the interests of shareholders due to the experience of the Manager and the quality of information provided to the Board.

## Significant Shareholdings

At 5 March 2009 the Directors have been notified of the following major shareholdings in the Company:

| Name | Ordinary Shares | % of issue† |
|---|---|---|
| Asset Value Investors Limited (Indirect)* | 6,103,115 | 7.3 |
| LLoyds Banking Group plc (previously HBOS plc) (Direct) | 4,598,326 | 5.5 |
| (Indirect) | 3,274,571 | 3.9 |
| Rathbone Brothers Plc (Indirect) | 4,306,555 | 5.2 |
| Legal & General Group Plc (Direct) | 3,519,006 | 4.2 |

*Includes British Empire Securities & General Trust plc
†Based on issued share capital at 31 December 2008 of 83,408,123 Ordinary shares

## Payment of Suppliers

It is the Company's payment policy to obtain the best possible terms for all business. The Company negotiates with its suppliers the terms on which business will take place and abides by such terms.

The Company did not have any trade creditors at 31 December 2007 or 2008.

## Disclosure of Information to Auditors

The Directors confirm that so far as each of the Directors is aware there is no relevant audit information of which the Company's auditors are unaware and the Directors have taken all the steps that they ought to have taken as Directors in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

## Independent Auditors

The Auditors, Ernst & Young LLP, are willing to continue in office and in accordance with sections 385 and 390A of the Companies Act 1985 resolutions concerning their reappointment and remuneration will be submitted to the Annual General Meeting.

## Share Capital

### Capital Structure

At 31 December 2008 the Company's capital structure consisted of 83,408,123 Ordinary shares of 25p each (2007 – 86,971,010 Ordinary shares). There are no restrictions concerning the holding or transfer of the Company's ordinary shares and there are no special rights attached to any of the shares.

### Dividends

The Ordinary shares carry a right to receive dividends which are declared from time to time by an ordinary resolution of the Company (up to the amount recommended by the Directors) and to receive any interim dividends which the Directors may resolve to pay.

### Capital Entitlement

On a winding up, after meeting the liabilities of the Company, the surplus assets will be paid to ordinary shareholders in proportion to their shareholdings.

### Voting

Each ordinary shareholder present in person or by proxy is entitled to one vote on a show of hands and, on a poll, to one vote for every share held.

Information on the deadlines for proxy appointments can be found on page 54.

## Annual General Meeting

At the Annual General Meeting of the Company to be held on 22 April 2009 the following resolutions will be proposed as special business.

### Authority to Repurchase the Company's Ordinary Shares

At the Company's Annual General Meeting held on 22 April 2008 it was resolved that the Company be authorised to purchase in the market up to 12,896,874 Ordinary shares (14.99% of its Ordinary share capital in issue at that time). During the year to 31 December 2008 the Company bought back 3,562,887 Ordinary shares (nominal value £890,722 which comprised 4.1% of the issued share capital at 1 January 2008) on the

### Authority to Repurchase the Company's Ordinary Shares (continued)

London Stock Exchange for cancellation. Between 1 January 2009 and the date of this report, the Company bought back a further 700,000 Ordinary shares (nominal value £175,000 which comprised 0.8% of the issued share capital at 1 January 2009) on the London Stock Exchange for cancellation. The Board continues to believe that the ability of the Company to purchase its own Ordinary shares in the market will potentially benefit all shareholders of the Company. The repurchase of Ordinary shares at a discount to the underlying net asset value (''NAV'') should enhance the NAV per Ordinary share of the remaining shares and may also enable the Company to address more effectively any imbalance between supply and demand for the Company's Ordinary shares.

Accordingly, the Directors are now recommending in Resolution 8 that this authority to purchase the Company's own Ordinary shares should be renewed and should now expire at the Company's Annual General Meeting to be held in 2010. Authority will be sought to purchase up to 14.99% of the Company's Ordinary shares in issue at the date of the passing of the resolution (the maximum permitted under the Listing Rules of the UK Listing Authority) at a price that is not less than 25p per share (the nominal value of each share) and must not exceed the higher of (a) 105% of the average of the middle market quotation (as derived from the Daily Official List of the London Stock Exchange) for the five business days immediately preceding the day of purchase and (b) the higher of the last independent trade and the highest current independent trade on the London Stock Exchange. The authority being sought, the full text of which can be found in Resolution 8 in the Notice of Annual General Meeting, will last until the date of the Annual General Meeting in 2010. The decision as to whether the Company repurchases any shares will be at the absolute discretion of the Board and will only be considered when it is in the interests of the Company and its shareholders as a whole. It is the intention that purchases will only be made at a discount to net asset value.

### Adoption of New Articles of Association

Over the past year, and since the Articles of Association (the 'Articles') of the Company were last updated in 2008, company law in the United Kingdom has undergone major reform through the coming into force of parts of the Companies Act 2006 (the '2006 Act'). Accordingly, the Board considers it prudent to replace the Company's existing Articles of Association with new articles which take account of these developments (the 'New Articles').

The 2006 Act is being brought into force in stages. The first changes came into force in January 2007 and the final changes are scheduled to come into force in October of this year. At this year's Annual General Meeting, the Company proposes to adopt provisions which reflect changes in the law brought about by the 2006 Act in respect of, amongst other things, electronic communications, notice periods for meetings, postponement of meetings and director indemnities. Further changes are likely to be required next year to reflect the final set of changes which will take effect from October.

A copy of the New Articles will be available for inspection at the offices of Herald Investment Management Limited, 10–11 Charterhouse Square, London, EC1M 6EE during normal business hours on any day (Saturdays, Sundays and public holidays excepted) from the date of the notice of the Annual General Meeting (the 'Notice') until the conclusion of the Annual General Meeting.

A summary of the material changes proposed to be brought about by the adoption of the New Articles is set out in the Appendix to the Notice of Annual General Meeting on page 55.

## Recommendation

The Directors unanimously recommend all holders to vote in favour of all the Resolutions to be proposed at the Annual General Meeting by completing and returning the enclosed form of proxy. The proxy form should be returned to the Company's Registrar as soon as possible but in any event so as to arrive no later than 48 hours before the time of the Annual General Meeting.

By order of the Board

*Baillie Gifford & Co*
Secretaries

6 March 2009

# DIRECTORS' REMUNERATION REPORT

## Directors' Remuneration Report

The Board has prepared this report in accordance with the requirements of Schedule 7A to the Companies Act 1985. An ordinary resolution for the approval of this report will be put to the members at the forthcoming Annual General Meeting.

The law requires the Company's auditors to audit certain of the disclosures provided. Where disclosures have been audited, they are indicated as such. The Auditors' opinion is included in their report on pages 34 and 35.

## Remuneration Committee

The Company has five Directors all of whom are non-executive (see page 4). There is no separate remuneration committee and the Board as a whole considers changes to Directors' fees from time to time. The Company Secretary, Baillie Gifford & Co, provides advice when the Board considers the level of Directors' fees.

## Policy on Directors' Fees

The Board's policy is that the remuneration of Directors should be set at a reasonable level that is commensurate with the duties and responsibilities of the role and consistent with the requirement to attract and retain Directors of the appropriate quality and experience. It should also reflect the experience of the Board as a whole, be fair and comparable to that of other investment trusts that are similar in size. It is intended that this policy will continue for the year ending 31 December 2009 and subsequent years.

The fees for the non-executive Directors are determined within the limits set out in the Company's Articles of Association. Shareholders approved an increase of the aggregate limit to £100,000 at the Annual General Meeting held on 14 April 2004. Non-executive Directors are not eligible for bonuses, pension benefits, share options, long term incentive schemes or other benefits.

The Board carried out a review of the level of Directors' fees during the year and concluded that the fees should remain unchanged at £22,500 for the Chairman and £15,000 for each Director.

## Directors' Service Contracts

It is the Board's policy that none of the Directors has a service contract. All of the Directors have been provided with appointment letters. The terms of their appointment provide that a Director shall retire and be subject to re-election at the first Annual General Meeting after their appointment. Directors are thereafter obliged to retire by rotation, and, if they wish, to offer themselves for re-election, at least every three years after that. There is no notice period and no provision for compensation upon early termination of appointment.

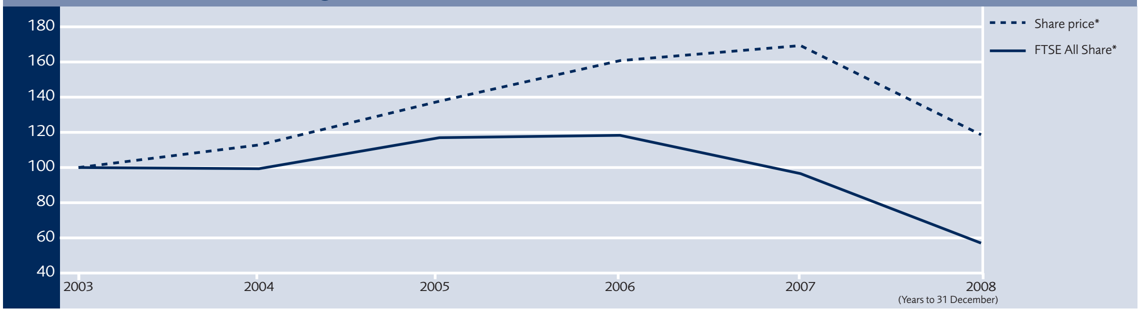
| Name | Date of appointment | Due date for re-election |
|---|---:|---:|
| Martin Boase | 11 January 1994 | AGM 2009 |
| Clay Brendish | 23 July 2001 | AGM 2009 |
| Julian Cazalet | 18 January 2008 | AGM 2011 |
| Timothy Curtis | 22 July 2004 | AGM 2010 |
| Douglas McDougall | 13 February 2002 | AGM 2011 |

## Company Performance

The graph below compares, for the five financial years ended 31 December 2008, the total return (assuming all dividends are reinvested) to ordinary shareholders compared to the total shareholder return on a notional investment made up of shares in the component parts of the FTSE All-Share Index. This index was chosen for comparison purposes, as it is the best measure of performance for UK listed companies.

HERALD'S SHARE PRICE AND FTSE ALL SHARE INDEX*

(figures have been rebased to 100 at 31 December 2003)




Source: Thomson Financial Datastream

*Total return (assuming all dividends are reinvested)

Past performance is not a guide to future performance.

## Directors' Emoluments for the Year (audited)

The Directors who served in the year received the following emoluments in the form of fees:

| | Fees 2008 £ | Fees 2007 £ |
|---|---|---|
| Directors who served during the year: | | |
| Martin Boase (Chairman) | 22,500 | 22,500 |
| Clay Brendish | 15,000 | 15,000 |
| Julian Cazalet (appointed 18 January 2008) | 14,325 | – |
| Timothy Curtis | 15,000 | 15,000 |
| Douglas McDougall | 15,000 | 15,000 |
| | 81,825 | 67,500 |

## Approval

The Directors' Remuneration Report on pages 27 and 28 was approved by the Board of Directors on 6 March 2009 and signed on its behalf by

*Douglas McDougall*

Director

# CORPORATE GOVERNANCE

## Compliance

The Board is committed to achieving and demonstrating high standards of Corporate Governance. This statement outlines how the principles of The Combined Code on Corporate Governance, published in June 2006 (the ''Combined Code'') were applied throughout the financial year.

The Board believes that the Company has complied throughout the year with the provisions of the Combined Code.

The Association of Investment Companies (AIC) has published its own Code of Corporate Governance which provides a framework of best practice for investment companies. The Board is of the opinion that the Company has complied with the recommendations of the AIC Code.

## The Board

The Board has overall responsibility for the Company's affairs. It has a number of matters reserved for its approval including strategy, approval of the financial statements, investment policy, borrowings, gearing, treasury matters, dividend and corporate governance policy. The Board also reviews the investment transactions, revenue budgets and performance. Full and timely information is provided to the Board to enable the Board to function effectively and to allow Directors to discharge their responsibilities.

The Board currently comprises five Directors all of whom are non-executive. The executive responsibilities for investment management and administration have been delegated to Herald Investment Management Limited ('HIML') and Baillie Gifford & Co respectively, and in the context of a Board comprising entirely non-executive Directors, there is no chief executive officer. Mr D C P McDougall is the senior independent director.

The Directors believe that the Board has a balance of skills and experience which enable it to provide effective leadership and proper governance of the Company. Information about the Directors, including their relevant experience, can be found on page 4.

There is an agreed procedure for Directors to seek independent professional advice if necessary at the Company's expense.

## Independence of Directors

All the Directors are considered by the Board to be independent of the Manager and free of any business or other relationship which could interfere with the exercise of their independent judgement.

The Chairman, Martin Boase, was independent at the date of his appointment and, notwithstanding that Mr Boase holds 6.03% of the ordinary share capital of the investment management company, the Board has concluded that he continues to be independent. The Board believes that Mr Boase's shareholding has not, in the past, given rise to a conflict of interest or affected his independent judgement, nor is it expected to do so in the future. As Mr Boase has been a Director for more than nine years and is over 70 years of age, he has agreed to offer himself for re-election annually. The Directors recognise the importance of succession planning for company boards and review the Board composition annually. However, the Board is of the view that length of service will not necessarily compromise the independence or contribution of Directors of an investment trust company, where continuity and experience can be a benefit to the Board. The Board subscribes to the view expressed in the AIC Code that long-serving directors should not be prevented from being considered as independent. Following a formal performance evaluation, the Board is of the view that Mr Boase continues to be independent. The Board considers that none of Mr Boase's other commitments interfere with the discharge of his responsibilities to the Company and is satisfied that he makes sufficient time available to serve the Company effectively. There has been no significant change to the Chairman's other commitments during the year.

The Board considers Mr C J Cazalet to be independent notwithstanding that he was a managing director – corporate finance at JPMorgan Cazenove, the Company's broker, until his retirement in 2007. In the view of the Board, Mr Cazalet is independent of the Manager in character and judgement and his independence is not compromised by any previous relationship with the Company.

## Terms of Appointment

Letters which specify the terms of appointment are issued to Directors. The letters of appointment are available for inspection on request.

Under the provisions of the Company's Articles of Association, a Director appointed during the year is required to retire and seek election by shareholders at the next Annual General Meeting. Directors are required to submit themselves for re-election at least once every three years. Directors who have served for more than nine years offer themselves for re-election annually.

## Meetings

There is an annual cycle of Board meetings which is designed to address in a systematic way overall strategy, review of investment policy, investment performance, marketing, revenue budgets, dividend policy and communication with shareholders. The Board considers that it meets sufficiently regularly to discharge its duties effectively. The table below shows the attendance record for the Board and Committee meetings held during the year. All the Directors attended the Annual General Meeting.

| | Board | Audit Committee | Nomination Committee |
|---|---|---|---|
| **Number of meetings** | **6** | **2** | **2** |
| Martin Boase | 6 | 2 | 2 |
| Clay Brendish | 4 | 2 | 1 |
| Julian Cazalet | 6 | 2 | 1 |
| Timothy Curtis | 6 | 2 | 2 |
| Douglas McDougall | 6 | 2 | 2 |

## Nomination Committee

The Nomination Committee consists of all the Directors and the Chairman of the Board is Chairman of the Committee. The Committee meets on an annual basis and at such other times as may be required. The Committee has written terms of reference which include reviewing the Board, identifying and nominating new candidates for appointment to the Board, Board appraisal, succession planning and training. The Committee also considers whether Directors should be recommended for re-election by shareholders. The terms of reference are available on request and on the Manager's website: **www.heralduk.com**.

## Performance Evaluation

The Nomination Committee met to assess the performance of the Chairman, each Director, the Board as a whole and its Committees, after inviting each Director and the Chairman to consider and respond to a set of questions. The appraisal of the Chairman was led by Mr D C P McDougall. The appraisals and evaluations considered amongst other criteria, the balance of skills of the Board, the contribution of individual Directors and the overall effectiveness of the Board and its Committees. Following this process it was concluded that the performance of each Director, the Chairman, the Board and its Committees continues to be effective and each Director and the Chairman remain committed to the Company.

## Induction and Training

Training for new Directors is tailored to the particular circumstances of the individual appointee. Regular briefings are provided on changes in regulatory requirements that could affect the Company and the Directors. Directors receive other relevant training as necessary.

## Remuneration

As all the Directors are non-executive, the provisions of the Combined Code in respect of Directors' remuneration are not relevant to the Company except to the extent that they relate specifically to non-executive directors. Consequently there is no requirement for a separate remuneration committee. Directors' fees are considered by the Board as a whole within the limits approved by shareholders. The Company's policy on remuneration is set out in the Directors' Remuneration Report on pages 27 and 28.

## Internal Controls and Risk Management

The Directors acknowledge their responsibility for the Company's system of internal controls and for reviewing its effectiveness. The system of internal controls is designed to manage rather than eliminate risk and can only provide reasonable but not absolute assurance against material misstatement or loss.

The Board confirms that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the Company, in accordance with the guidance ''Internal Controls: Revised Guidance for Directors on the Combined Code.''

The Directors confirm that they have reviewed the effectiveness of the system and they have procedures in place to review its effectiveness on a regular basis.

The practical measures to ensure compliance with regulation and company law, and to provide effective and efficient operations and investment management, have been delegated to HIML and Baillie Gifford & Co, as detailed in the Directors' Report. The Board acknowledges its responsibilities to supervise and control the discharge by the Manager and Secretary of their obligations.

The Manager has been delegated responsibility for the design, implementation and maintenance of control policies and procedures to safeguard the assets of the Company and to manage its affairs properly. This responsibility also extends to maintaining effective operational and compliance controls and risk management.

The Company's investments are segregated from the investment and administration functions through the appointment of The Bank of New York Mellon as independent custodian of the Company's investments.

The Manager has a compliance function in accordance with the Financial Services Authority regulations. The Manager's compliance function provides the Board with a report on monitoring procedures on a regular basis. In addition, Baillie Gifford & Co conducts an annual review of its own system of internal controls which is documented within an internal controls report which has been designed to comply with Technical Release AAF 01/06 – Assurance Reports on Internal Controls of Service Organisations made available to Third Parties. This report is independently reviewed by Baillie Gifford & Co's auditors. A copy of the internal controls report is submitted to the Board. The Baillie Gifford & Co heads of Business Risk & Internal Audit and Regulatory Risk provide the Board with regular reports on Baillie Gifford & Co's monitoring programmes as they relate to the secretarial and administrative function.

A detailed risk map is prepared which identifies the significant risks faced by the Company and the key controls to manage these risks are confirmed as in place and operating effectively.

These procedures ensure that consideration is given regularly to the nature and extent of the risks facing the Company and that they are being actively monitored. Where changes in risk have been identified during the year they also provide a mechanism to assess whether further action is required to manage the risks identified. The Board confirms that these procedures have been in place throughout the Company's financial year, are operating effectively and continue to be in place up to the date of approval of this Report.

## Internal Audit

The Audit Committee carries out an annual review of the need for an internal audit function. The Committee continues to believe that the compliance and internal control systems and the internal audit function in place within the Investment Manager and Company Secretary provide sufficient assurance that a sound system of internal control, which safeguards shareholders' investment and the Company's assets, is maintained. An internal audit function, specific to the trust, is therefore considered unnecessary.

## Accountability and Audit

The respective responsibilities of the Directors and the auditors in connection with the Financial Statements are set out on pages 33 to 35.

## Going Concern

The accounts have been prepared on the going concern basis as it is the Directors' opinion that the Company will continue in operational existence for the foreseeable future.

## Audit Committee

An Audit Committee has been established consisting of all the independent non-executive Directors. Its authority and duties are clearly defined within its written terms of reference which are available on request from the Company and on the Manager's website: **www.heralduk.com**. Mr DCP McDougall is Chairman of the Audit Committee. The Committee's responsibilities, which were discharged during the year, include:

## Audit Committee (continued)

- monitoring and reviewing the integrity of the half-yearly and annual financial statements and the internal financial controls;
- making recommendations to the Board in relation to the appointment of the external auditors and approving the remuneration and terms of their engagement;
- developing and implementing policy on the engagement of the external auditors to supply non-audit services (there were no non-audit services provided in the period);
- reviewing and monitoring the independence, objectivity and effectiveness of the external auditors;
- reviewing the arrangements in place within HIML whereby their staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters insofar as they may affect the Company;
- reviewing the terms of the Investment Management Agreement; and
- considering annually whether there is a need for the Company to have its own internal audit function.

The Committee considers the experience and tenure of the audit partner and staff and the nature and level of services provided. The Committee receives confirmation from the auditors that they have complied with the relevant UK professional and regulatory requirements on independence. The Committee does not believe that there has been any impairment to the auditors' independence.

## Relations with Shareholders

The Board places great importance on communication with shareholders. The Company's Manager meets regularly with institutional shareholders and reports to the Board. The Chairman is available to meet with shareholders as appropriate. Shareholders wishing to communicate with the Chairman or any other Director may do so by writing to him at the registered office of the Company which is shown on page 4.

The Company's Annual General Meeting provides a forum for communication with all shareholders. The level of proxies lodged for each resolution is announced at the meeting and is published on the Manager's website subsequent to the meeting. The notice period for the Annual General Meeting is at least twenty working days. Shareholders and potential investors may obtain up-to-date information on the Company from the Manager's website: **www.heralduk.com**.

## Voting Policy and Socially Responsible Investment

The Company has given discretionary voting powers to the investment manager, HIML. The Manager votes against resolutions it considers may damage shareholders' rights or economic interests. The Company believes that it is in the shareholders' interests to consider environmental, social and governance factors when selecting and retaining investments and has asked the Manager to take these issues into account as long as the investment objectives are not compromised. The Manager does not exclude companies from its investment universe purely on the grounds of environmental, social and governance issues but adopts a positive engagement approach whereby matters are discussed with management with the aim of improving the relevant policies and management systems. The Manager's policy has been reviewed and endorsed by the Board.

## Conflicts of Interest

Each Director submits a list of potential conflicts of interest to the Board for approval on an annual basis. These are considered carefully by the Board, taking into account the circumstances surrounding them and, if considered appropriate, are approved for a period of one year. Having considered the lists of potential conflicts there were no situations which gave rise to a direct or indirect interest of a Director which conflicted with the interests of the Company.

On behalf of the Board

*Douglas McDougall*
Director

6 March 2009

# STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RELATION TO THE FINANCIAL STATEMENTS

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company as at the end of the year and of the net return for the year. In preparing the financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates which are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors confirm that they have complied with the above requirements in preparing the financial statements.

The Directors are responsible for ensuring that proper accounting records are kept which disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Under applicable law and regulations, the Directors are also responsible for preparing a Directors' Report, Directors' Remuneration Report and Corporate Governance Statement that comply with that law and those regulations.

We confirm that to the best of our knowledge:

- the financial statements, prepared in accordance with the applicable accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company; and
- the Annual Report includes a fair view of the development and performance of the business and the position of the Company, together with a description of the principal risks and uncertainties that the Company faces.

By order of the Board

*Douglas McDougall*

6 March 2009

# INDEPENDENT AUDITORS' REPORT

## TO THE MEMBERS OF HERALD INVESTMENT TRUST plc

We have audited the financial statements of Herald Investment Trust plc for the year ended 31 December 2008 which comprise the Income Statement, Balance Sheet, Reconciliation of Movements in Shareholders' Funds, Cash Flow Statement and the related notes 1 to 21. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

### Respective Responsibilities of Directors and Auditors

The Directors are responsible for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with applicable United Kingdom law and Accounting Standards (United Kingdom Generally Accepted Accounting Practice) as set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you whether, in our opinion, the Directors' Report is consistent with the financial statements. In addition, we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2006 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Company's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Company Summary, Year's Summary, Long Term Performance Summary, Directors, Managers and Advisers, Chairman's Statement, Investment Manager's Report, Top Twenty Holdings, Classification of Investments, Geographical Spread of Investments, Detailed List of Investments, Top Ten Record, Directors' Report, unaudited part of the Directors' Remuneration Report, Corporate Governance Statement, Statement of Directors' Responsibilities in relation to the Financial Statements, Notice of Annual General Meeting, Appendix to the Notice of Annual General Meeting and Further Shareholder Information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

### Basis of Audit Opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgments made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

## Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Company's affairs as at 31 December 2008 and of its net loss for the year then ended;
- the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the Financial Statements.

ERNST & YOUNG LLP
*Registered Auditor*
Edinburgh

6 March 2009

# INCOME STATEMENT

FOR THE YEAR ENDED 31 DECEMBER 2008

| | Notes | 2008 Revenue £'000 | 2008 Capital £'000 | 2008 Total £'000 | 2007 Revenue £'000 | 2007 Capital £'000 | 2007 Total £'000 |
|---|---|---|---|---|---|---|---|
| Losses on investments | 10 & 13 | – | (126,592) | (126,592) | – | (32,898) | (32,898) |
| Currency gains/(losses) | 15 | – | 54 | 54 | – | (49) | (49) |
| Income | 2 | 7,629 | – | 7,629 | 5,167 | – | 5,167 |
| Investment management fee | 3 | (2,808) | – | (2,808) | (4,252) | – | (4,252) |
| Recovered VAT | 4 | 2,506 | – | 2,506 | – | – | – |
| Other administrative expenses | 5 | (321) | – | (321) | (268) | – | (268) |
| **Net return before finance costs and taxation** | | 7,006 | (126,538) | (119,532) | 647 | (32,947) | (32,300) |
| Finance costs of borrowings | 6 | (2,128) | – | (2,128) | (1,883) | – | (1,883) |
| **Net return on ordinary activities before taxation** | | 4,878 | (126,538) | (121,660) | (1,236) | (32,947) | (34,183) |
| Tax on ordinary activities | 7 | (136) | – | (136) | (134) | – | (134) |
| **Net return on ordinary activities after taxation** | | 4,742 | (126,538) | (121,796) | (1,370) | (32,947) | (34,317) |
| **Net return per Ordinary share** | 9 | 5.59p | (149.07p) | (143.48p) | (1.57p) | (37.82p) | (39.39p) |

The Board proposed on 17 February 2009 a dividend of 1.55p per Ordinary Share (31 December 2007 – 0.50p). An additional special dividend of 3.45p is also proposed. More information on dividend distributions can be found in note 8 on page 43.

The total column of this statement is the profit and loss account of the Company.

All revenue and capital items in the above statement derive from continuing operations. No operations were acquired or discontinued during the year.

A Statement of Total Recognised Gains and Losses is not required as all gains and losses of the Company have been reflected in the above statement.

The accompanying notes on pages 40 to 52 are an integral part of the financial statements.

# BALANCE SHEET
AT 31 DECEMBER 2008

| | Notes | 2008 £'000 | 2008 £'000 | 2007 £'000 | 2007 £'000 |
|---|---|---|---|---|---|
| **Fixed assets** | | | | | |
| Investments held at fair value through profit or loss | 10 | | 243,276 | | 330,833 |
| **Current assets:** | | | | | |
| Debtors | 11 | 1,803 | | 839 | |
| Cash and short term deposits | 18 | 31,547 | | 12,155 | |
| | | 33,350 | | 12,994 | |
| **Creditors:** | | | | | |
| Amounts falling due within one year | 12 | (50,837) | | (330) | |
| Derivative financial instruments | 13 | (15,0279) | | – | |
| | | (65,916) | | (330) | |
| Net current (liabilities)/assets | | | (32,566) | | 12,664 |
| **TOTAL NET ASSETS** | | | 210,710 | | 343,497 |
| **Capital and reserves** | | | | | |
| Called-up share capital | 14 | | 20,852 | | 21,743 |
| Share premium | 15 | | 73,738 | | 73,738 |
| Capital redemption reserve | 15 | | 1,100 | | 209 |
| Capital reserve | 15 | | 109,072 | | 246,171 |
| Revenue reserve | 15 | | 5,948 | | 1,636 |
| **EQUITY SHAREHOLDERS' FUNDS** | | | 210,710 | | 343,497 |
| **NET ASSET VALUE PER ORDINARY SHARE** | 16 | | 252.63p | | 394.96p |

The accounts were approved by the Board of Directors and authorised for issue on 6 March 2009 and signed on their behalf by

*Douglas McDougall*
Director

The accompanying notes on pages 40 to 52 are an integral part of the financial statements.

# RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

FOR THE YEAR ENDED 31 DECEMBER 2008

| | Notes | Called up share capital £'000 | Share premium £'000 | Capital redemption reserve £'000 | Capital reserve Realised £'000 | Capital reserve Unrealised £'000 | Revenue reserve £'000 | Total share-holders' funds £'000 |
|---|---|---|---|---|---|---|---|---|
| Shareholders' funds at 1 January 2008 | | 21,743 | 73,738 | 209 | 247,789 | (1,618) | 1,636 | 343,497 |
| Revaluation of interest rate swap | 13 | – | – | – | – | (15,079) | – | (15,079) |
| Net return on ordinary activities after taxation | 15 | – | – | – | 10,634 | (122,093) | 4,742 | (106,717) |
| Shares bought back | 14 | (891) | – | 891 | (10,561) | – | – | (10,561) |
| Dividends paid during the year | 8 | – | – | – | – | – | (430) | (430) |
| **Shareholders' funds at 31 December 2008** | | 20,852 | 73,738 | 1,100 | 247,862 | (138,790) | 5,948 | 210,710 |

FOR THE YEAR ENDED 31 DECEMBER 2007

| | Notes | Called up share capital £'000 | Share premium £'000 | Capital redemption reserve £'000 | Capital reserve Realised £'000 | Capital reserve Unrealised £'000 | Revenue reserve £'000 | Total share-holders' funds £'000 |
|---|---|---|---|---|---|---|---|---|
| Shareholders' funds at 1 January 2007 | | 21,889 | 73,738 | 63 | 233,361 | 48,125 | 4,052 | 381,228 |
| Net return on ordinary activities after taxation | | – | – | – | 16,796 | (49,743) | (1,370) | (34,317) |
| Shares bought back | 14 | (146) | – | 146 | (2,368) | – | – | (2,368) |
| Dividends paid during the year | 8 | – | – | – | – | – | (1,046) | (1,046) |
| **Shareholders' funds at 31 December 2007** | | 21,743 | 73,738 | 209 | 247,789 | (1,618) | 1,636 | 343,497 |

The accompanying notes on pages 40 to 52 are an integral part of the financial statements.

# CASH FLOW STATEMENT

FOR THE YEAR ENDED 31 DECEMBER 2008

| | Notes | 2008 £'000 | 2008 £'000 | 2007 £'000 | 2007 £'000 |
|---|---|---|---|---|---|
| **Net cash inflow from operating activities** | 17 | | 6,092 | | 187 |
| **Servicing of finance** | | | | | |
| Loan interest | | (1,614) | | (2,156) | |
| **Net cash outflow from servicing of finance** | | | (1,614) | | (2,156) |
| **Financial investment** | | | | | |
| Purchase of investments | | (100,426) | | (82,697) | |
| Sale of investments | | 76,331 | | 108,457 | |
| **Net cash (outflow)/inflow from financial investment** | | | (24,095) | | 25,760 |
| **Equity dividend paid** | 8 | | (430) | | (1,046) |
| **Net cash (outflow)/inflow before financing** | | | (20,047) | | 22,745 |
| **Financing** | | | | | |
| Shares repurchased | 14 | (10,561) | | (2,368) | |
| Loans drawn down | | 50,000 | | 60,000 | |
| Loans repaid | | – | | (80,000) | |
| **Net cash inflow/(outflow) from financing** | | | 39,439 | | (22,368) |
| **INCREASE IN CASH** | 18 | | 19,392 | | 377 |
| **RECONCILIATION OF NET CASH FLOW TO MOVEMENT IN NET (DEBT)/FUNDS** | 18 | | | | |
| Increase in cash for period | | | 19,392 | | 377 |
| (Increase)/decrease in bank loans | | | (50,000) | | 20,000 |
| **MOVEMENT IN NET (DEBT)/FUNDS IN PERIOD** | | | (30,608) | | 20,377 |
| **NET FUNDS/(DEBT) AT 1 JANUARY** | | | 12,155 | | (8,222) |
| **NET (DEBT)/FUNDS AT 31 DECEMBER** | | | (18,453) | | 12,155 |

The accompanying notes on pages 40 to 52 are an integral part of the financial statements.

# NOTES TO THE ACCOUNTS

## 1. Accounting policies

The Financial Statements for the year to 31 December 2008 have been prepared on the basis of the accounting policies set out below, which are consistent with those in the Company's Annual Financial Statements at 31 December 2007.

(a) Accounting convention

The financial statements are prepared on the assumption that approval as an investment trust will continue to be granted by HM Revenue & Customs.

The Directors consider the Company's functional currency to be sterling as the Company's shareholders are predominantly based in the UK and the Company is subject to the UK's regulatory environment.

The financial statements have been prepared in accordance with The Companies Act, applicable UK accounting standards and the AIC's revised Statement of Recommended Practice "Financial Statements of Investment Trust Companies" issued in 2003, revised 2005.

In order to better reflect the activities of the Company and in accordance with guidance issued by the AIC, supplementary information which analyses the profit and loss account between items of a revenue and capital nature has been presented in the Income Statement.

Financial assets and financial liabilities are recognised in the Company's balance sheet when it becomes a party to the contractual provisions of the instrument.

(b) Investments

Purchases and sales of investments are accounted for on a trade date basis.

All investments are designated as valued at fair value through profit or loss upon initial recognition and are measured at subsequent reporting dates at fair value. The fair value of listed security investments is bid value, or in the case of FTSE 100 constituents, at last traded prices issued by the London Stock Exchange. Investments on the Alternative Investment Market are included at their bid value. The fair value of unlisted investments uses valuation techniques determined by the Directors on the basis of latest information in line with the relevant principles of the International Private Equity and Venture Capital Valuation Guidelines.

Gains and losses arising from changes in the fair value of investments are taken to capital reserve.

(c) Income

Dividend income is accounted for when the entitlement to the income is established (normally on the ex-dividend date). Franked income is stated net of tax credits. Unfranked investment income includes the taxes deducted at source. Interest from fixed interest securities is recognised on an effective yield basis. Underwriting commission and interest receivable on deposits are recognised on an accruals basis.

(d) Expenses

All expenses are accounted for on an accruals basis and are charged through the revenue column of the income statement except where they relate directly to the acquisition or disposal of an investment (transaction costs) and, are taken to the income statement as a capital item.

(e) Finance costs

Finance costs are accounted for on an accruals basis and are charged through the revenue column of the income statement.

(f) Financial instruments

The Company uses interest rate swaps to hedge the cash flow risk arising from interest rate fluctuations. The swap is marked to the value at which the position can be closed out daily. The fair value calculation is based on an external model and external prices which are regularly checked to the swap providers valuation. The current intention is to hold the swap for the long term, it is marked to the close out valuation daily. Gains or losses arising on the fair value of the interest rate swap during the year are taken to the profit and loss account via the unrealised capital reserve.

In accordance with FRS 26: 'Financial Instruments: Measurement', derivative instruments are valued at fair value and are included in current assets or current liabilities in the balance sheet.

(g) Deferred taxation

Deferred taxation is provided on all timing differences which have originated but not reversed at the balance sheet date, calculated on an undiscounted basis, and based on enacted tax rates relevant to the benefit or liability. Deferred tax assets are recognised only to the extent that it is more likely than not that there will be taxable profits from which underlying timing differences can be deducted.

(h) Foreign currency

Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction. Monetary assets and loans denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date. Exchange differences of a revenue nature are taken to the revenue account. Those of a capital nature are taken to capital reserve.

## 1. Accounting policies (continued)

(i) Capital reserve

The Company is precluded by its Articles from making any distribution of capital profits by way of dividend.

Realised reserve – gains and losses on realisation of investments, realised exchange differences of a capital nature and purchases of the Company's own shares for cancellation are dealt with in this reserve.

Unrealised reserve – changes in the fair value of investments are dealt with in this reserve.

## 2. Income

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| **Income from investments** | | |
| Franked dividends from listed investments | 2,425 | 2,334 |
| Franked dividends from unlisted investments (inc AIM) | 1,051 | 846 |
| Unfranked income from unlisted (inc AIM) UK convertible bonds | 22 | 24 |
| UK unfranked investment income | 466 | – |
| Overseas dividend income | 1,002 | 1,014 |
| Overseas interest | 565 | 58 |
| | 5,531 | 4,276 |
| **Other income** | | |
| Deposit interest | 2,066 | 891 |
| Underwriting commission | 32 | – |
| | 2,098 | 891 |
| Total income | 7,629 | 5,167 |
| **Total income comprises:** | | |
| Dividends from equity securities designated at fair value through profit or loss | 4,478 | 4,194 |
| Interest from financial assets designated at fair value through profit or loss | 1,053 | 82 |
| Deposit interest | 2,066 | 891 |
| Underwriting commission | 32 | – |
| | 7,629 | 5,167 |

## 3. Investment management fee

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| Investment management fee | 2,808 | 3,866 |
| Unrecovered VAT thereon (see note 4) | – | 386 |
| | 2,808 | 4,252 |

Herald Investment Management Limited are appointed investment managers under a management agreement which is terminable on twelve months' notice. Their fee is calculated on a monthly rate of 0.08333% of the Company's net asset value based on middle market prices. The management fee is levied on all assets except the holding in Herald Ventures II Limited Partnership managed by Herald Investment Management Limited.

## 4. VAT recovered

In 2007 the European Court of Justice ruled that investment trust management fees should be exempt from VAT. Since then, HMRC has accepted the Managers' repayment claims for the period from 2001 to 2007. £2,506,000 of VAT together with £370,000 of interest was received by the Manager on behalf of the Company in respect of this period. These amounts have been paid to the Company and recognised in the current year.

## 5. Other administrative expenses

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| Custodian's fees | 30 | 58 |
| Registrars' fees | 19 | 16 |
| Directors' fees | 82 | 68 |
| Auditors' fees – statutory audit | 16 | 14 |
| Miscellaneous expenses | 174 | 112 |
| | 321 | 268 |

## 6. Finance costs of borrowings

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| Bank loans repayable within one year | 2,460 | 1,883 |
| Interest on swap | (332) | – |
| | 2,128 | 1,883 |

## 7. Taxation

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| **Analysis of charge in year** | | |
| Overseas taxation | 136 | 134 |

**Factors affecting tax charge for year**
The tax charge for the year is lower than the standard rate of corporation tax in the UK (28.49%).

The differences are explained below:

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| Revenue return on ordinary activities before taxation | 4,878 | (1,236) |
| Revenue return on ordinary activities multiplied by the standard rate of corporation tax in the UK of 28.49% (2007 – 30%) | 1,390 | (371) |
| Income not taxable | (990) | (954) |
| Overseas withholding tax claimed as a deduction | (39) | (40) |
| Overseas withholding tax | 136 | 134 |
| Movement in excess management expenses | (359) | 1,357 |
| Movement in overseas income accrual | (2) | 8 |
| Current tax charge for the year | 136 | 134 |

Capital returns are not included in the above analysis; as an Investment Trust, the Company's capital gains are not taxable.

There is no UK corporation tax charge at 31 December 2008 or 31 December 2007 as the Company has unrelieved management expenses which are available to be carried forward. The tax charge for 31 December 2008 and 2007 comprises overseas withholding taxes written off.

At 31 December 2008 the Company had surplus management expenses of £18m (2007 – £20m) which have not been recognised as a deferred tax asset. This is because the Company is not expected to generate taxable income in a future period in excess of the deductible expenses of that future period and, accordingly, it is unlikely that the Company will be able to reduce future tax liabilities through the use of existing surplus expenses.

## 8. Ordinary dividend

| | 2008 | 2007 | 2008 £'000 | 2007 £'000 |
|---|---|---|---|---|
| **Amounts recognised as distributions in the period:** | | | | |
| Previous year's final (paid 1 May 2008) | 0.50p | 1.20p | 430 | 1,046 |

We also set out below the total dividends payable in respect of the financial year, which is the basis on which the requirements of Section 842 of the Income and Corporation Taxes Act 1988 are considered. The revenue available for distribution by way of dividend for the year is £4,742,000 (2007 – £Nil).

| | 2008 | 2007 | 2008 £'000 | 2007 £'000 |
|---|---|---|---|---|
| **Dividends paid and proposed in the period:** | | | | |
| Proposed final dividend per Ordinary share | 1.55p | 0.50p | 1,293 | 435 |
| Proposed special dividend per Ordinary share# | 3.45p | – | 2,877 | – |
| | 5.00p | 0.50p | 4,170 | 435 |
| Adjustment to provision for 2007 final dividend re shares bought back | | | – | (5) |
| | | | 4,170 | 430 |

The current year's proposed dividend will be paid on 30 April 2009 to all shareholders on the register at the close of business on 14 April 2009. The ex-dividend date is 8 April 2009.

#The proposed special dividend of 3.45p represents the recovery of VAT from HMRC – see note 4 on page 41.

## 9. Net return per Ordinary share

| 2008 Revenue | 2008 Capital | 2008 Total | 2007 Revenue | 2007 Capital | 2007 Total |
|---|---|---|---|---|---|
| 5.59p | (149.07p) | (143.48p) | (1.57p) | (37.82p) | (39.39p) |

Revenue return per Ordinary share is based on the net revenue gain on ordinary activities after taxation of £4,742,000 (2007 – revenue loss of £1,370,000) and on 84,885,186 Ordinary shares (2007 – 87,114,983) being the weighted average number of Ordinary shares in issue during the year.

Capital return per Ordinary share is based on the net capital loss for the financial year of £126,538,000 (2007 – net capital loss of £32,947,000) and on 84,885,186 Ordinary shares (2007 – 87,114,983) being the weighted average number of Ordinary shares in issue during the year.

There are no dilutive or potentially dilutive shares in issue.

## 10. Fixed assets – investments

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| **Financial assets designated at fair value through profit or loss** | | |
| Listed UK equity investments – London Stock Exchange | 70,405 | 116,549 |
| – AIM | 53,223 | 95,254 |
| – debt investments | 14,900 | – |
| Listed Overseas – equity investments | 84,353 | 104,045 |
| – debt investments | 17,497 | 12,768 |
| Unquoted* | 2,898 | 2,217 |
| Total investments in financial assets at fair value through profit or loss | 243,276 | 330,833 |

## 10. Fixed assets – investments (continued)

| | Listed in UK £'000 | Listed overseas £'000 | AIM £'000 | Unquoted £'000 | Total £'000 |
|---|---|---|---|---|---|
| Cost of investments at 1 January 2008 | 79,199 | 126,467 | 115,776 | 11,009 | 332,451 |
| Fair value adjustment at 1 January 2008 | 37,350 | (9,654) | (20,522) | (8,792) | (1,618) |
| Fair value of investments at 1 January 2008 | 116,549 | 116,813 | 95,254 | 2,217 | 330,833 |
| Movements in the year: | | | | | |
| Purchases at cost | 39,840 | 40,197 | 19,839 | 550 | 100,426 |
| Sales – proceeds | (40,881) | (19,022) | (15,856) | (563) | (76,322) |
| – realised profit/(loss) | 20,356 | (1,080) | (1,265) | (7,431) | 10,580 |
| Amortisation of fixed income book cost | (4) | (144) | – | – | (148) |
| Movement in fair value | (50,555) | (36,282) | (37,069) | 1,813 | (122,093) |
| Change in listing | – | 1,368 | (7,680) | 6,312 | – |
| Fair value of investments at 31 December 2008 | 85,305 | 101,850 | 53,223 | 2,898 | 243,276 |
| Cost of investments at 31 December 2008 | 98,510 | 147,786 | 110,814 | 9,877 | 366,987 |
| Fair value adjustment at 31 December 2008 | (13,205) | (45,936) | (57,591) | (6,979) | (123,711) |
| Fair value of investments at 31 December 2008 | 85,305 | 101,850 | 53,223 | 2,898 | 243,276 |

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| **(Losses)/gains on investments designated at fair value through profit or loss** | | |
| Realised gains on sales | 10,580 | 16,845 |
| Movement in fair value | (122,093) | (49,743) |
| | (111,513) | (32,898) |

*The unquoted balance comprises Celoxica at £18,000, Culver Holdings at £36,000, HIML Holdings Limited, Herald Ventures II and HIML Jersey Ltd included at their aggregated cost of £1,538,000, Intechnology at £551,000, Jump TV at £130,000, Servicepower Technology at £256,000, Zoo Digital at £369,000 and Atex at zero.

At 31 December 2008 the Company was the beneficial owner of 13.86% (2007 – 13.86%) of the Ordinary share capital of both HIML Holdings Limited and HIML Jersey Ltd. HIML Holdings Limited is incorporated in the United Kingdom whereas HIML Jersey Ltd is incorporated in Jersey.

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| **Transaction costs** | | |
| The following transaction costs were incurred during the period | | |
| Purchases | 546 | 387 |
| Sales | 189 | 354 |
| | 735 | 741 |

## 11. Debtors

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| **Due within one year:** | | |
| Income accrued | 1,650 | 763 |
| Sales for subsequent settlement | – | 9 |
| Taxation recoverable | 10 | 4 |
| Swap interest | 94 | – |
| Other debtors and prepayments | 49 | 63 |
| | 1,803 | 839 |

## 12. Creditors

| | 2008<br>£'000 | 2007<br>£'000 |
|---|---|---|
| **Amounts falling due within one year:** | | |
| Bank loans | 50,000 | – |
| Other creditors and accruals | 837 | 330 |
| | 50,837 | 330 |

Included in other creditors and accruals is £173,000 (2007 – £288,000) in respect of the investment management fee.

During the year, the Company replaced its existing 364 day £50 million multi-currency loan facility and entered into a £75 million multi-currency variable rate loan facility with The Royal Bank of Scotland plc. The new facility comprises three £25 million tranches expiring on 31 May 2010, 2011 and 2013. Arrangement fees on this facility totalling £112,500 have been written off through finance costs of borrowings.

At 31 December 2008, there were outstanding drawings of £50 million (2007 – Nil). Interest on the loans is payable in quarterly instalments in January, April, July and October. A non-utilisation fee of 0.30% is payable on the £25 million undrawn. The estimated repayment value of the loan at 31 December 2008 was £50 million. The indicative costs of repaying the loan as at 31 December 2008 were not material in the context of the above figures.

The interest on £50 million of this facility has been fixed for the long term through a 30 year interest rate swap but may vary on periodic renewals of the debt facility to the extent that the mark up over LIBOR charged by a lending bank varies. The fair value of the interest rate swap contract at 31 December 2008 was an estimated liability of £15 million (2007 – £Nil) which was based on the marked to market value.

The main covenant relating to the loan is:

Total borrowings shall not exceed 25% of the Company's Gross Assets adjusted by deducting:

(i) the market value of any unlisted investments (excluding AIM);

(ii) the amount by which the market value of any single investment represents more than 7.5% of the Company's gross assets; and

(iii) the amount by which the aggregate market value of the ten largest investments exceeds 45% of gross assets.

## 13. Derivative financial instruments

| | 2008 | | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | Notional contract amount £'000 | Fair value assets £'000 | Fair value liabilities £'000 | Fair value balance £'000 | Notional contract amount £'000 | Fair value assets £'000 | Fair value liabilities £'000 | Fair value balance £'000 |
| Total derivative assets/(liabilities) held for trading | 50,000 | 31,054 | (46,133) | (15,079) | – | – | – | – |

## 14. Called-up share capital

| | | 2008 | 2007 |
|---|---|---|---|
| Authorised: | | | |
| Ordinary shares of 25p: | Number | 109,000,000 | 109,000,000 |
| | £'000 | 27,250 | 27,250 |
| Allotted, issued and fully paid: | | | |
| Ordinary shares of 25p: | Number | 83,408,123 | 86,971,010 |
| | £'000 | 20,852 | 21,743 |

At the Annual General Meeting in April 2008, Shareholders granted the Company authority to purchase shares in the market up to 12,896,874 Ordinary shares (equivalent to 14.99% of its issued share capital at that date). In the year to 31 December 2008, a total of 3,562,887 (2007 – 585,000) Ordinary shares with a nominal value of £890,722 (2007 – £146,250) were bought back at a total cost of £10,561,000 (2007 – £2,368,000). At 31 December 2008 the Company had authority to buy back a further 10,268,474 Ordinary shares. Under the provisions of the Company's Articles share buy-backs are funded from the capital reserve.

## 15. Capital and Reserves

| | Share premium £'000 | Capital redemption reserve £'000 | Capital reserve Realised £'000 | Capital reserve Unrealised £'000 | Revenue reserve £'000 |
|---|---|---|---|---|---|
| At 1 January 2008 | 73,738 | 209 | 247,789 | (1,618) | 1,636 |
| Shares purchased for cancellation | – | 891 | (10,561) | – | – |
| Net gain on realisation of investments | – | – | 10,580 | – | – |
| Movement in fair value of investments | – | – | – | (122,093) | – |
| Movement in fair value of interest rate swap | – | – | – | (15,079) | – |
| Other exchange differences | – | – | 54 | – | – |
| Dividends appropriated during the year | – | – | – | – | (430) |
| Net revenue return for the year | – | – | – | – | 4,742 |
| Balance at 31 December 2008 | 73,738 | 1,100 | 247,862 | (138,790) | 5,948 |

The revenue reserve represents the only reserve from which dividends can be funded.

The Institute of Chartered Accountants in England and Wales, in its technical guidance TECH 01/08, states that profits arising out of a change in fair value of assets, recognised in accordance with Accounting Standards, can be treated as realised, provided the change recognised can be readily converted into cash. Securities listed on a recognised stock exchange are generally regarded as being readily convertible into cash and hence unrealised profits in respect of such securities, currently included within the Unrealised Capital Reserve, can be regarded as distributable under Company Law.

## 16. Net asset value per Ordinary share

The net asset value per Ordinary share and the net assets attributable to the Ordinary shareholders at the year end calculated in accordance with the Articles of Association were as follows :

| | 2008 | 2007 | 2008 £'000 | 2007 £'000 |
|---|---|---|---|---|
| Ordinary shares | 252.63p | 394.96p | 210,710 | 343,497 |

Net asset value per Ordinary share is based on net assets as shown above and on 83,408,123 (2007 – 86,971,010) Ordinary shares, being the number of Ordinary shares in issue at each date.

## 17. Reconciliation of net return before finance costs and taxation to net cash inflow from operating activities

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| Net return on ordinary activities before finance costs and taxation | (119,532) | (32,300) |
| Losses on investments | 126,592 | 32,898 |
| Currency (gains)/losses | (54) | 49 |
| Increase in accrued income | (887) | (258) |
| Decrease in debtors | 14 | 42 |
| Decrease in creditors | (103) | (67) |
| Amortisation of fixed income book cost | 148 | – |
| Income tax (suffered)/repaid | (4) | 6 |
| Overseas tax suffered | (136) | (134) |
| Realised currency profit/(loss) | 54 | (49) |
| Net cash inflow from operating activities | 6,092 | 187 |

## 18. Analysis of changes in net funds

| | At 1 January 2008 £'000 | Cash flows £'000 | At 31 December 2008 £'000 |
|---|---|---|---|
| Cash at bank and in hand | 12,155 | 19,392 | 31,547 |
| Loans due within one year | – | (50,000) | (50,000) |
| | 12,155 | (30,608) | (18,453) |

## 19. Contingent Liabilities, Guarantees and Financial Commitments

At 31 December 2008 and 31 December 2007 the Company had a commitment to participate in Herald Ventures II Limited Partnership. The Company's commitment is limited to £3 million, drawn down in tranches, over a 5 year period. The first tranch was drawn down in October 2004, with a total of £1,650,000 being drawn down at 31 December 2007 with a further £300,000 in the year to 31 December 2008.

## 20. Financial Instruments

In accordance with the corporate objective of maximising capital appreciation the Company invests in securities on a worldwide basis. The Company makes use of gearing to achieve improved performance in rising markets and has an interest rate swap, the purpose of which is to hedge the variability in cash flows arising from interest rate fluctuations on bank loans. The Company's other financial instruments consist of cash, short term debtors and creditors.

The main risks arising from the Company's financial instruments are:

**A. Market Risk**

(i) Other price risk, being the risk that the value of investment holdings will fluctuate as a result of changes in market prices caused by factors other than interest rate or currency rate movement.

(ii) Interest rate risk, being the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates; and

(iii) Foreign currency risk, being the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

**B. Credit Risk**, being the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

**C. Liquidity Risk**, being the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.

These risks and the policy for managing them have been applied throughout the year and are summarised below. Further detail is contained in the Business Review – Investment Policy section on page 22.

**A. Market Risk**

**(i) Other Price Risk**

The Company's investment portfolio is exposed to market price fluctuations which are monitored by the Manager in pursuance of the corporate objective. Securities held by the Company are valued at bid prices, whereas material unlisted investments are valued by the Directors on the basis of the latest information in line with the relevant principles of the International Private Equity and Venture Capital Valuation Guidelines (Accounting Policy (b)). These valuations also represent the fair value of the investments, see note 10 on pages 43 and 44.

A full list of the Company's investments is given on pages 16 to 20. In addition, a geographical analysis of the portfolio, an analysis of the investment portfolio by broad industrial or commercial sector and a review of the 20 largest equity investments by their aggregate market value, are shown on pages 12 to 15.

***Other Price Risk Sensitivity***

33.4% of the Company's equity investments at 31 December 2008 (2007 – 36.6%) were listed on the main list of the London Stock Exchange and a further 25.2% (2007 – 29.9%) on AIM. The NASDAQ Stock Exchange accounts for 28.5% (2007 – 18.0%) and other stock exchanges 11.6% (2007 – 14.7%). A 10% increase in stock prices at 31 December 2008 would have increased total net assets and net return on ordinary activities after taxation by £21,000,000 (2007 – £32,000,000). A decrease of 10% would have had an equal but opposite effect. The portfolio does not target any exchange as a benchmark, and the performance of the portfolio has a low correlation to generally used indices.

The shares of Herald Investment Trust plc have an underlying NAV per share. The NAV per share of Herald Investment Trust plc fluctuates on a daily basis. In addition, there is volatility in the discount/premium the share price has to NAV.

## 20. Financial Instruments (continued)

### (ii) Interest Rate Risk

The majority of the Company's assets are equity shares and other investments which neither pay interest nor have a maturity date. However, the Company does hold Convertible Bonds and Government Securities, the interest rate and maturity dates of which are detailed below. Interest is accrued on sterling cash balances at a rate linked to the UK base rate.

The Company has borrowings, from time to time. The aim of the use of gearing is to enhance long term returns to shareholders by investing borrowed funds in equities and other assets. Gearing is actively managed. How and where borrowings are invested is reviewed by the Board in consultation with the Manager at every Board meeting. In light of the decisions made, appropriate adjustments to the gearing position are then made by the Manager.

At the year end the Company had borrowings of £50m (2007 – £Nil). Under the terms of an interest rate swap, the interest payable on the bank loans has been fixed.

The interest rate risk profile of the financial assets and financial liabilities at 31 December was:

**Financial Assets**

| | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|
| | Fair value £'000 | Weighted average interest rate/ interest rate | Weighted average period until maturity/ maturity date | Fair value £'000 | Weighted average interest rate/ interest rate | Weighted average period until maturity/ maturity date |
| Fixed rate: | | | | | | |
| UK bonds | 14,900 | 4.1% | 5 years | – | – | – |
| European bonds | 10,027 | 5.25% | 4 months | 7,545 | 5.25% | 2 years |
| US bonds | 7,470 | 4.25% | 2 years | 5,223 | 4.5% | 2 years |
| UK convertible bonds | 405 | 7.0% | 3 years | 405 | 7.0% | 4 years |
| Cash: | | | | | | |
| Other overseas currencies | 563 | | | 340 | – | |
| Sterling | 30,984 | 4.6% | | 11,815 | 5.6% | |
| | 31,547 | | | 12,155 | | |

The cash deposits generally comprise call or short term money market deposits with original maturities of less than 3 months which are repayable on demand. The benchmark rate which determines the interest payments received on cash balances is the bank base rate.

**Financial Liabilities**

| | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|
| | £'000 | Net Interest rate paid | Loan Facility expires | £'000 | Net Interest rate paid | Loan Facility expires |
| Bank Loan | 25,000 | 5.6% | May 2011 | – | – | – |
| | 25,000 | 5.7% | May 2013 | – | – | – |
| Total | 50,000 | 5.65% | | – | – | |

The fixed rate of interest on the loans of 5.65% reflects a weighted average interest paid of 6.7%, offset by a weighted average of 1.1% received from the swap. The Company's facilities are rolling on a quarterly basis with the facility on a £25m tranche expiring in April 2011 and a £25m tranche expiring in April 2013. While the 30 year swap remains in place, the net interest payable will effectively be fixed for the duration of the term of the facility.

## 20. Financial Instruments (continued)

### (ii) Interest Rate Risk (continued)

| | 2008 | | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | Notional contract amount £'000 | Fair value assets £'000 | Fair value liabilities £'000 | Fair value balance £'000 | Notional contract amount £'000 | Fair value assets £'000 | Fair value liabilities £'000 | Fair value balance £'000 |
| Total derivative assets/(liabilities) held for trading | 50,000 | 31,054 | (46,133) | (15,079) | – | – | – | – |

***Interest rate risk sensitivity***

***(a) Cash***

An increase of 100 basis points in interest rates as at 31 December 2008 would have a direct effect on net assets. Based on the position at 31 December 2008, over a full year, an increase of 100 basis points would have increased the net return on ordinary activities after taxation by £315,000 (2007 – increased net return on ordinary activities after taxation by £122,000) and would have increased the net asset value per share by 0.38p (2007 – increased the net asset value per share by 0.14p). A decrease of 100 basis points would have had an equal but opposite effect. The calculations are based on the cash balances as at the respective balance sheet dates and are not representative of the year as a whole.

***(b) Fixed rate bonds***

An increase of 100 basis points in bond yields as at 31 December 2008 would have decreased total net assets and total return on ordinary activities by £825,000 (2007 – decreased total net assets and total return on ordinary activities by £311,000) and would have decreased the net asset value per share by 0.99p (2007 – decreased the net asset value per share by 0.36p). A decrease in bond yields would have had an equal and opposite effect. The Convertible loan stocks having an element of equity are not included in this analysis as given the nature of the businesses and the risk profile of the balance sheets they are considered to have more equity like characteristics.

***(c) Bank loans***

The effect of an increase or decrease of 100 basis points in 3 month LIBOR interest rates as at 31 December 2008 on the interest cost of the bank loans and the net income return has been eliminated through a 30 year floating interest rate to fixed interest rate swap. The swap generates payments or charges that offset changes in the 3 month LIBOR interest rate, so that the interest payable on the bank loans is effectively converted to a fixed rate loan at 4.8975% plus margin cost. The initial term of the swap on commencement at 30 years did not match the term of the loans, therefore, hedge accounting is not used and mark to market gains or losses on the swap are captured in the net return on ordinary activities as set out in (d) below.

***(d) Floating interest rate to fixed interest rate swap***

A decrease of 100 basis points on 30 year interest rates as at 31 December 2008 would have a direct mark to market effect on the value of the swap and net assets. Based on the position as at 31 December 2008, over a full year, a decrease of 100 basis points would have decreased the gains on investments and net return on ordinary activities after taxation by £10,994,000 (2007 – decreased the gains on investments and net return on ordinary activities after taxation by £Nil) and would have decreased the net asset value per share by 13.18p (2007 – decreased the net asset value per share by Nil). An increase of 100 basis points would have had an equal but opposite effect.

### (iii) Foreign Currency Risk

The Company's reporting currency is sterling, but investments are made in overseas markets as well as the United Kingdom and the asset value can be affected by movements in foreign currency exchange rates.

Furthermore many companies trade internationally both through foreign subsidiaries, and through exports. The greatest foreign currency risk occurs when companies have a divergence in currencies for costs and revenues. A much less risky exposure to currency is straight translation of sales and profits. The List of Investments on pages 16 to 20 breaks down the portfolio by geographic listing. However the location of the stock market quote only has a limited correlation to the costs, revenues and even activities of those companies, and so this note should not be regarded as a reliable guide to the sensitivity of the portfolio to currency movements. For example, the holdings in the portfolio that have suffered most from US$ weakness are UK companies with dollar revenues and sterling costs.

The Company does not hedge the sterling value of investments that are priced in other currencies. Overseas income is subject to currency fluctuations. The Company does not hedge these currency fluctuations because it is impossible to quantify the effect for the reasons stated above. However, from time to time the Manager takes a view by holding financial assets or liabilities in overseas currencies.

## 20. Financial Instruments (continued)

### (iii) Foreign Currency Risk (continued)

Exposure to currency risk through asset allocation by currency of listing is indicated below:

**At 31 December 2008**

| | Investments £'000 | Cash and deposits £'000 | Loans £'000 | Other debtors and creditors * £'000 | Net exposure £'000 |
|---|---|---|---|---|---|
| US dollar | 69,489 | 23 | – | 41 | 69,553 |
| Norwegian krone | 10,312 | – | – | 344 | 10,656 |
| Taiwan dollar | 7,021 | 540 | – | – | 7,561 |
| Korean won | 4,686 | – | – | – | 4,686 |
| Euro | 4,151 | – | – | 19 | 4,170 |
| Other overseas currencies | 6,191 | – | – | 9 | 6,200 |
| Exposure to currency risk on translation of valuations of securities listed in overseas currencies | 101,850 | 563 | – | 413 | 102,826 |
| Sterling | 141,426 | 30,984 | (50,000) | (14,526) | 107,884 |
| | 243,276 | 31,547 | (50,000) | (14,113) | 210,710 |

*Includes net non-monetary liabilities of £29,000.

**At 31 December 2007**

| | Investments £'000 | Cash and deposits £'000 | Loans £'000 | Other debtors and creditors * £'000 | Net exposure £'000 |
|---|---|---|---|---|---|
| US dollar | 66,094 | – | – | 228 | 66,322 |
| Euro | 17,810 | – | – | 9 | 17,819 |
| Other overseas currencies | 32,912 | 340 | – | 3 | 33,255 |
| Exposure to currency risk on translation of valuations of securities listed in overseas currencies | 116,816 | 340 | – | 240 | 117,396 |
| Sterling | 214,017 | 11,815 | – | 269 | 226,101 |
| | 330,833 | 12,155 | – | 509 | 343,497 |

*Includes net non-monetary liabilities of £277,000.

***Foreign currency risk sensitivity***

At 31 December 2008, had sterling strengthened by 10% (2007: 5%) in relation to all currencies, with all other variables held constant, total net assets and net return on ordinary activities after taxation would have decreased by the amounts shown below based solely on translation of securities quoted in currencies overseas. A 10% (2007: 5%) weakening of sterling against all currencies, with all other variables held constant, would have had an equal but opposite effect on the financial statement amounts. However companies whose cost base diverges in currency terms from its sales will in the longer term have a significantly greater effect on valuation than simple translation. In the short term investee companies generally cover their currency exposure to varying degrees. There is insufficient publicly disclosed information to quantify this, but in the long term this effect is expected to dwarf simple translation of foreign listings in terms of both risk and reward, because many investee companies trade globally. Furthermore the country of listing is not necessarily an indication of the geography of some or even any operational activities for investee companies. The Manager does not use financial instruments to protect against currency movements. From time to time financial leverage has been made using debt in overseas currencies.

## 20. Financial Instruments (continued)

**(iii) Foreign Currency Risk (continued)**

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| US dollar | 6,955 | 3,316 |
| Norwegian krone | 1,066 | – |
| Taiwan dollar | 756 | – |
| Korean won | 469 | – |
| Euro | 417 | 891 |
| Other overseas currencies | 620 | 1,663 |
| | 10,283 | 5,870 |

### B. Credit Risk

Credit risk is the risk that a counterparty to a financial instrument will fail to discharge an obligation or commitment which it has entered into with the Company. The Manager monitors counterparty risk on an ongoing basis.

The Company has investments in convertible loan stocks that have an element of equity, these securities are viewed as having a risk profile similar to the equity holdings. This is because the convertibles held are in nascent technology companies that may be loss making and may have weak balance sheets. For this reason these stocks are categorised as equity holdings.

The fixed interest securities held are UK, Norwegian and US Government securities.

***Credit Risk Exposure***

The exposure to credit risk at 31 December was:

| | 2008 £'000 | 2007 £'000 |
|---|---|---|
| Fixed interest investments | 32,397 | 12,768 |
| Cash and short term deposits | 31,547 | 12,155 |
| Debtors and prepayments | 1,803 | 839 |
| | 65,747 | 25,762 |

None of the Company's financial assets are past due or impaired.

### C. Liquidity Risk

The Company's policy with regard to liquidity is to provide a degree of flexibility so that the portfolio can be repositioned when appropriate and that most of the assets can be realised without an excessive discount to the market price. The Company's unlisted investments are not readily realisable, but these only amount to 1.1% of the Company's total assets at 31 December 2008 (2007: 0.6%).

In practice, liquidity in investee companies is imperfect, particularly those with a market value of less than £100 million. To reduce this liquidity risk it is the policy to diversify the holdings and generally to restrict the holding in any one company to less than 10% of the share capital of that company. Furthermore the guideline is for no single investment to account for more than 5% of the assets of the Company.

The market valuation of each underlying security gives an indication of value, but the price at which an investment can be made or realised can diverge materially from the bid or offer price depending on market conditions generally and particularly to each investment. 36% (£88m) (2007: 36% (£119m)) of the portfolio is invested in stocks with a market capitalisation below £100 million, where liquidity is expected to be more limited. If these stocks had on average a realisable value 20% below the bid price the value of the total fund would be adversely affected by 7.2% (2007: 7.5%).

## 20. Financial Instruments (continued)

### C. Liquidity Risk (continued)

***Liquidity Risk Exposure***

Contractual maturities of the financial liabilities at the year end, based on the earliest date on which payment can be required are as follows:

| | 2008 | | | | | 2007 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | One year or less £'000 | In more than one year but not more than two years £'000 | In more than two years but not more than five years £'000 | Five years or more £'000 | Total £'000 | One year or less £'000 | In more than one year but not more than two years £'000 | In more than two years but not more than five years £'000 | Five years or more £'000 | Total £'000 |
| Bank loans | 2,061 | 1,592 | 53,351 | – | 57,004 | – | – | – | – | |
| Derivative financial instruments | 717 | 1,187 | 2,018 | 19,321 | 23,243 | – | – | – | – | – |
| Other creditors | 228 | – | – | – | 228 | 330 | – | – | – | 330 |
| | 3,006 | 2,779 | 55,369 | 19,321 | 80,475 | – | – | – | 330 | |

**Fair Value of Financial Assets and Liabilities**
The Directors are of the opinion that the financial assets and liabilities of the Company are stated at fair value in the balance sheet.

## 21. Capital Management

The Company does not have any externally imposed capital requirements. The capital of the Company is the Ordinary share capital as detailed in note 14. It is managed in accordance with its investment policy in pursuit of its investment objective, both of which are detailed on page 22, and shares may be repurchased as explained on pages 25 and 26.

# NOTICE OF ANNUAL GENERAL MEETING

Notice is hereby given that the Annual General Meeting of Herald Investment Trust plc will be held at 10-11 Charterhouse Square, London EC1M 6EE on 22 April 2009 at 11.30 am for the following purposes:

To consider and, if thought fit, approve resolutions 1 to 7 as ordinary resolutions and resolutions 8 and 9 as special resolutions.

## Ordinary Business

1. To receive and adopt the Directors' report, the annual accounts and the Auditors' report in respect of the year ended 31 December 2008.
2. To approve the Directors' Remuneration Report for the year ended 31 December 2008.
3. To declare a final dividend of 1.55p per share and a special dividend of 3.45p per share in respect of the year ended 31 December 2008.

To consider resolution No. 4, special notice having been received of the intention to propose the resolution as an ordinary resolution (see note 6).

4. To re-elect Mr M Boase, who is aged 76, as a Director of the Company.
5. To re-elect Mr C M Brendish as a Director of the Company.
6. To reappoint Ernst & Young LLP as Independent Auditors to the Company to hold office until the conclusion of the next Annual General Meeting at which accounts are laid before the Company.
7. To authorise the Directors to determine the remuneration of the Independent Auditors.

## Special Business

8. That, the Company be generally and subject as hereinafter appears unconditionally authorised in accordance with Section 166 of the Companies Act 1985 (the 'Act') to make market purchases (within the meaning of Section 163 of the Act) of its issued shares of 25p each in the capital of the Company in substitution for any existing authority under section 166 of the Act but without prejudice to any exercise of any such authority prior to the date hereof.

   PROVIDED ALWAYS THAT

   (i) the maximum number of shares hereby authorised to be purchased shall be 14.99% of the issued share capital on the date on which this resolution is passed;

   (ii) the minimum price which may be paid for a share shall be 25p;

   (iii) the maximum price (exclusive of expenses) which may be paid for a share shall not be more than the higher of (a) 105% of the average of the middle market quotations (as derived from the Daily Official List of the London Stock Exchange) for the shares for the five business days immediately preceding the date of purchase and (b) the higher of the last independent trade and the highest current independent trade on the London Stock Exchange;

   (iv) any purchase of shares will be made in the market for cash at prices below the prevailing net asset value per share (as determined by the Directors) ;

   (v) unless previously varied, revoked or renewed, the authority hereby conferred shall expire at the conclusion of the Annual General Meeting of the Company to be held in 2010; and

   (vi) the Company may make a contract to purchase shares under the authority hereby conferred prior to the expiry of such authority and may make a purchase of shares pursuant to any such contract notwithstanding such expiry.

9. That, the document now before this meeting and initialled by the Chairman for the purpose of identification be and is hereby appointed as the new Articles of Association of the Company, in substitution for, and to the exclusion of, the existing Articles of the Company.

By order of the Board

*Baillie Gifford & Co*
Secretaries

Registered Office:
10-11 Charterhouse Square
London EC1M 6EE

12 March 2009

# NOTICE OF ANNUAL GENERAL MEETING *continued*

NOTES

1. A shareholder entitled to attend, speak and vote at the meeting is entitled to appoint one or more proxies to attend, speak and, on a poll, to vote in his stead. Such proxy need not be a member of the Company.
2. A form of proxy is enclosed and to be valid must be lodged with the Registrars of the Company not later than forty-eight hours before the time fixed for the meeting.
3. Pursuant to Regulation 41 of the Uncertificated Securities Regulations 2001, the Company specifies that only those shareholders entered on the Register of Members of the Company as at 6.00 pm on 20 April 2009 or, in the event that the meeting is adjourned, on the Register of Members 48 hours before the time of any adjourned meeting, shall be entitled to attend or vote at the meeting in respect of the number of ordinary shares registered in their name at that time. Changes to the entries on the Register of Members after 6.00 pm on 20 April 2009 or, in the event that the meeting is adjourned, in the Register of Members 48 hours before the time of any adjourned meeting, shall be disregarded in determining the rights of any person to attend or vote at this meeting, notwithstanding any provisions in any enactment, the Articles of Association of the Company or other instrument to the contrary.
4. In order to facilitate voting by corporate representatives at the meeting, arrangements will be put in place at the meeting so that (i) if a corporate shareholder has appointed the Chairman of the meeting as its corporate representative with instructions to vote on a poll in accordance with the directions of all of the other corporate representatives for that shareholder at the meeting, then on a poll those corporate representatives will give voting directions to the Chairman and the Chairman will vote (or withhold a vote) as corporate representative in accordance with those directions; and (ii) if more than one corporate representative for the same corporate shareholder attends the meeting but the corporate shareholder has not appointed the Chairman of the meeting as its corporate representative, a designated corporate representative will be nominated, from those corporate representatives who attend, who will vote on a poll and the other corporate representatives will give voting directions to that designated corporate representative. Corporate shareholders are referred to the guidance issued by the Institute of Chartered Secretaries and Administrators on proxies and corporate representatives – **www.icsa.org.uk** – for further details of this procedure. The guidance includes a sample form of representation letter if the Chairman is being appointed as described in (i) above.
5. The right to appoint a proxy does not apply to persons whose shares are held on their behalf by another person and who have been nominated to receive communications from the Company in accordance with section 146 of the Companies Act 2006 ('nominated persons'). Nominated persons may have a right under an agreement with the registered shareholder who holds the shares on their behalf to be appointed (or to have someone else appointed) as a proxy. Alternatively, if nominated persons do not have such a right, or do not wish to exercise it, they may have a right under such an agreement to give instructions to the person holding the shares as to the exercise of voting rights.
6. In accordance with section 293 of the Companies Act 1985 special notice has been given to the Company of the resolution to reappoint a Director who is over the age of 70.
7. No Director has a contract of service with the Company.
8. Copies of the existing Articles of Association of the Company and the proposed revised Articles of Association will be available for inspection during normal business hours on any day (Saturdays, Sundays and public holidays excepted) until the close of the Annual General Meeting at the registered office of the Company.
9. As at 5 March 2009, the latest practicable date prior to publication of this document, the Company had 82,708,123 ordinary shares in issue with a total of 82,708,123 voting rights.
10. Any person holding 3% of the total voting rights in the Company who appoints a person other than the Chairman as his proxy will need to ensure that both he and such third party complies with their respective disclosure obligations under the Disclosure and Transparency Rules.

# APPENDIX TO THE NOTICE OF ANNUAL GENERAL MEETING

Explanatory Notes of Principal Changes to the Company's Articles of Association

1. **Articles which duplicate statutory provisions**
   Provisions in the current articles which replicate provisions contained in the Companies Act 2006 are in the main amended in the new articles to bring them in line with the Companies Act 2006.

2. **Form of resolutions**
   The current articles contain provisions referring to 'extraordinary' resolutions and 'extraordinary' general meetings. These provisions have been removed in the new articles as the concept of extraordinary resolutions has not been retained under the Companies Act 2006.

3. **Convening meetings**
   The provisions in the current articles dealing with the convening of general meetings and the length of notice required to convene general meetings are amended in the new articles to conform to new provisions in the Companies Act 2006. In particular a general meeting to consider a special resolution can now be convened on 14 days notice whereas previously 21 days notice was required.

4. **Postponement of general meetings**
   The new articles include the new regime under the Companies Act 2006 in relation to the postponement of general meetings.

5. **Age of Directors on appointment**
   The current articles contain a provision requiring a Director's age to be disclosed if he has attained the age of 70 or more in the notice convening a meeting at which the Director is proposed to be elected or re-elected. Such provision could now fall foul of the Employment Equality (Age) Regulations 2006 and so has been removed in the new articles.

6. **Power to refuse registration of share transfers**
   The Companies Act 2006 requires reasons to be given for a refusal by the Board to register a transfer of shares. The articles should be amended to reflect this.

7. **Proxies**
   Under the Companies Act 2006, proxies are entitled to vote on a show of hands, whereas under the current articles proxies are only entitled to vote on a poll. The time limits for the appointment of proxies have also been altered by the Companies Act 2006 so that weekends and bank holidays can now be excluded for purposes of the timing of delivering proxies. Multiple proxies may now be appointed provided that each proxy is appointed to exercise the rights attached to different shares held by the shareholder. The new articles reflect these changes.

8. **Electronic and web communications**
   Provisions of the Companies Act 2006 which came into force in January 2007 enable companies to communicate with members by electronic and/or website communications.

   Before the Company can communicate with a member by means of electronic communication (e.g. e-mail) the relevant member must be asked individually by the Company to agree that the Company may send or supply documents or information to him in electronic form and the relevant member must confirm their agreement to the Company (and should provide their e-mail address or other electronic contact details as required).

   Before the Company can communicate with a member by means of website communication, the relevant member must be asked individually by the Company to agree that the Company may send or supply documents or information to him by means of a website, and the Company must either have received a positive response or have received no response within the period of 28 days beginning with the date on which the request was sent. The Company will notify the member (either in writing, or by other permitted means) when a relevant document or information is placed on the website and a member can always request a hard copy version of the document or information.

9. **Provisions on the inspection of accounts and on a winding up**
   These provisions can be simplified as they duplicate many of the new provisions of the Companies Act 2006.

10. **Directors' indemnities and loans to fund expenditure**
    The law in relation to Director indemnities was updated by the Companies (Audit, Investigations and Community Enterprise) Act 2004 and these updates are duplicated in the Companies Act 2006. As a result of the 2004 changes a company is now expressly permitted to indemnify its Directors against liability to certain third parties and also may pay a Director's defence costs in civil, criminal or regulatory proceedings. The current articles can be updated generally to reflect these developments.

    The Companies Act 2006 also makes some additional changes to the scope of Directors' indemnities. The current articles can be updated to reflect this and can also be amended generally to encompass associated companies of the Company in accordance with provisions under the Companies Act 2006.

11. **General**
    Generally the opportunity has been taken to bring clearer language into the new articles.

# FURTHER SHAREHOLDER INFORMATION

- **How to Invest** The Company's shares are traded on the London Stock Exchange. They can be bought by placing an order with a stockbroker or by asking a professional adviser to do so.
- **Sources of Further Information on the Trust** The price of shares is quoted daily in the *Financial Times*, *The Daily Telegraph* and *The Times*. The NAV per share is calculated and released daily to the London Stock Exchange and monthly to the Association of Investment Companies.
- **Key Dates** Ordinary shareholders normally receive a dividend in respect of each financial year which is normally paid late April/early May. The AGM is normally held in April.
- **Taxation** The price of the Ordinary shares (adjusted for the price of attributable warrants) on 21 February 1994, which was the first day of trading, was 90.9p. The amount attributable to the warrants for the purpose of capital gains tax is 9.1p per share issued (1994 Annual Report). Up to 5 April 1998 the basis for calculating non-trading gains or losses was the difference between that price, or any subsequent purchase price, and the sale price, using the indexation allowance for inflation. However, this indexation allowance was frozen at 5 April 1998, and replaced by a taper relief. Taper relief, however, cannot create or increase a loss. Any shareholder uncertain of his or her position is recommended to seek expert advice.
- **ISAs** The Ordinary shares of the Company are qualifying investments for individual saving accounts.

**Herald is an investment trust. Investment trusts offer investors the following:**

- Participation in a diversified portfolio of shares.
- Constant supervision by experienced professional managers.
- The Company is free from capital gains tax on capital profits realised within the portfolio.
- The opportunity to achieve improved performance for shareholders' funds in rising markets by the borrowing of additional money.