ANNUAL FINANCIAL REPORT FOR THE YEAR ENDED 31 DECEMBER 2013 (AUDITED)

This is the Annual Financial Report of Herald Investment Trust plc as required to be published under DTR 4 of the UKLA Listing Rules.

Results and dividend

The net asset value (NAV) of the Company at 31 December 2013 was 802.80p per Ordinary share (2012 – 632.78p). This represented an increase of 26.9% during the year. The discount narrowed from 18.9% to 14.7% resulting in a share price increase of 33.5% to 685.0p.

The Company made a small revenue loss of £307,000 giving a net return of (0.39)p per share. The Directors do not recommend a dividend (2012 – 1.00p) for the year ended 31 December 2013.

The financial information set out in this document does not constitute the Company's statutory accounts for 2012 or 2013. Statutory accounts for the years ended 31 December 2012 and 31 December 2013 have been reported on by the Independent Auditor. The Independent Auditor's Reports on the Annual Report and Financial Statements for 2012 and 2013 were unqualified, did not draw attention to any matters by way of emphasis, and did not contain a statement under 498(2) or 498(3) of the Companies Act 2006.

Statutory accounts for the year ended 31 December 2012 have been filed with the Registrar of Companies. The statutory accounts for the year ended 31 December 2013 will be delivered to the Registrar in due course.

The financial information in this Annual Financial Report has been prepared using applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice). The accounting policies adopted in this Annual Financial Report have been consistently applied to all the years presented and are consistent with the policies used in the preparation of the statutory accounts for the year ended 31 December 2013. The principal accounting policies adopted are unchanged from those used in the preparation of the statutory accounts for the year ended 31 December 2012.

STATISTICS AND PERFORMANCE

	31 December 2013	31 December 2012	% change
Total assets (before deduction of bank loans and derivative financial instruments)	£662.5m	£572.2m	
Bank loans	£25.0m	£50.0m	
Derivative financial instruments	£13.9m	£20.3m	
Shareholders’ funds	£623.6m	£501.9m	
Net asset value per Ordinary share	802.8p	632.8p	26.9
Share price	685.0p	513.0p	33.5
Numis Smaller Companies Index plus AIM (ex. investment companies)	4,728.3	3,704.0	27.7
Russell 2000 (small cap) Technology Index (in sterling terms)	1,269.4	917.6	38.3
Composite comparative index	275.1	210.0	31.0
Dividend per Ordinary share	–	1.00p	
Revenue earnings per Ordinary share	(0.39p)	0.94p	
Ongoing charges	1.04%	1.08%	
Discount to NAV	14.7%	18.9%	

LONG TERM PERFORMANCE SUMMARY

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

	31 December 2013	Inception 16 February 1994	% change
Net asset value per Ordinary share (including current year income)	802.8p	98.7p	713.4
Net asset value per Ordinary share (excluding current year income)	803.2p	98.7p	713.8
Share price	685.0p	90.9p	653.6
Numis Smaller Companies Index plus AIM (ex. investment companies)	4,728.3	1,750.0	170.2
Russell 2000 (small cap) Technology Index (in sterling terms)	1,269.4	688.7	84.3

CHAIRMAN'S STATEMENT AND REVIEW OF 2013

Herald's net asset value per share appreciated by 26.9% from 632.8p to 802.8p. This falls below our specialist comparative indices but compares well with more general equity indices. Over five years, our return has been 218% compared to 162% and 171% for our comparator indices.

For some years we have expressed disappointment that the market has ignored smaller companies, which seemed to offer sound value. The only exit for our holdings for an extended period of time was takeovers from private equity and corporate buyers at unappealing values, albeit at a premium to the market. Additionally, the market was conspicuously failing in its main function of providing primary capital to growing businesses. It has been a relief to see that the smaller companies asset class is being rediscovered. From September onwards the primary market has decisively re-opened. As the IPO market had been closed for about six years there appears to be a material backlog of companies seeking to list in the TMT sector. But valuations have not run up to the extent that corporate activity has disappeared. In fact cash takeovers totalling £37m occurred in the portfolio in 2013 and bids for Delcam and Andor, which were made late in the year and which have yet to complete, are valued at a further £9.2m. It is interesting to observe that we added to our holding in Andor during the market crisis in 2009, deliberately paying above 70p, which was the level of the takeover bid that we helped to fend off. The agreed price of 525p is more reasonable and provides proper value for our shareholders.

The regional performances within the Trust diverged. The UK portfolio returned 24.7%, which lagged the broader Numis Smaller Companies Index (extended to include AIM), which returned 30.9%. The North American portfolio returned 37.0% (Russell 2000 Tech Index +38.6%), and the European portfolio appreciated 59.0%. Although the Far East return was a more modest 10.7% this outperformed the local indices. The Trust has solidly built on the outperformance from more difficult years, leading to a total return for the Trust of 95.3% since the beginning of 2008, which pre-dates the period of the financial crisis and the subsequent recovery. The market strength has reflected a rerating, and seen strong performance from cyclical recovery stocks, which Herald had avoided on the downside. In addition there has been a certain return to momentum investing with some niche situations obtaining valuations that it is hard to justify mathematically. The NAV per share now stands decisively higher than the peak seen in the first quarter 2000 – the peak of the Dotcom bubble. In February 2000 the month end fully diluted NAV per share was 697p, but this was a very short lived spike.

At the end of 2013 the price earnings ratio of the profitable holdings in the portfolio was 16.4x on forecast earnings for 2013, versus 13.0x at the end of 2012. In contrast the average p/e of the profitable stocks in the portfolio at the end of February 2000 was higher by over four times. Although valuations are not as compelling as they were in 2008/9 they are much more solidly based than they were in 2000.

In previous years we have expressed enthusiasm for the TMT sector, citing the importance of the pricing power derived from intellectual property and brands. In an internet world of transparent pricing and efficient communications profit margins are hard to achieve without these attributes. Just as unskilled labour costs are declining in real terms in the developed world, skilled labour is becoming ever more valuable. So it is for companies. From the Herald micro stock picking view of the world, the fashion for emerging markets, with much GDP growth but little pricing power, seemed a little bewildering. It is reassuring that our fundamental perspective seems to have been vindicated by the relative underperformance of these markets in the recent past. Nevertheless the profits growth in our investee companies in 2013 has been the worst since 2002, with the brief exception of the temporary traumas in the financial crisis.

The slight loss on the profit and loss account reflects several factors listed in order of significance: first, a decline in dividends received of 1% versus a compound growth of 23.4% over the three previous years; secondly, lower interest rates on cash and bonds, the decision to take profits on the latter, and the amortisation of bonds to par; thirdly, a rise in costs including the interest paid on debt and the management fee (+13.8%) reflecting the growth of NAV during the year. The most significant and surprising factor is the decline in dividends after a lacklustre year in 2012. This reflects changes in the portfolio more than the absence of growth. Investors seem to have chased dividends which has led us to take profits and divert resources to earlier stage companies where there continues to be a reluctance to invest, and values are better. This has led to the percentage of the portfolio invested in unprofitable companies rising to around 30% from a historic average of around 17.5% and this trend may continue. This perhaps implies an increase in the risk of the portfolio, but the Manager argues that the market is thus far timid about investing in companies not yet profitable and that leads to more interesting valuations. Unquestionably there is higher stock specific risk, but this is reduced by diversification. No dividend will be recommended.

Baillie Gifford has undertaken the role of company secretary and administrator for the Trust since 2000. We were disappointed that they resigned during the year ahead of the requirement for this fund, in common with all other investment trusts, to be designated an Alternative Investment Fund by the Alternative Investment Fund Management Directive, (AIFMD) a new piece of legislation imposed by the European Union, which came into force in July 2013. We should like to thank Baillie Gifford for the exemplary service that they provided. From 1st November 2013 The Bank of New York Mellon has taken on the fund accounting role, and Law Debenture Corporate Services Limited has become company secretary. The Board has determined to appoint Herald Investment Management Limited as its Alternative Investment Fund Manager under the terms of the AIFMD.

We are delighted to welcome Dr Tom Black to the Board. He was chief executive of Detica, which was a rewarding holding in this fund until its takeover by British Aerospace. He now chairs Digital Barriers which is one of the few early stage companies to have raised capital in the desert years of 2008-2012, which is a measure of the high regard in which he is held by smaller companies fund managers.

Julian Cazalet
Chairman

INVESTMENT MANAGER'S REPORT

A year in which the net asset value per share appreciates 26.9% is a good year for Herald shareholders. Greater interest in smaller companies means that at last there is two way trade in underlying investee companies. In consequence, although the discount has narrowed in nominal terms, the discount to realisable value has probably widened. However it has not been an altogether easy year. Why is that?

First, the performance of underlying investee companies has disappointed more than pleased on the upside to a greater degree than any year since 2002, with the brief exception of the temporary disruption after the demise of Lehman Brothers. If the return on the fund was 26.9%, and the p/e on the profitable stocks in the portfolio appreciated by 26.1%, it implies almost zero profits growth. The reality was in fact somewhat better than this because takeovers were generally of profitable portfolio companies, and much of the cash generated was reinvested in earlier stage loss making companies. For several years the proportion of the portfolio in loss making companies has been around 17.5%, but this rose to 22.5% in 2012 and to 28.3% at the end of 2013. Furthermore the market has aggressively rerated dividend paying companies. We have chosen to take profits in some of these holdings in favour of earlier stage loss making companies, for which the market has less appetite and which seem to offer more potential upside. With portfolio changes it is hard to quantify at what rate profits have actually grown, but it feels like high single digits rather than the low double digit rate of growth to which we have been accustomed. The year has been more challenging in terms of profits growth for a number of reasons. Particularly in the first half economic growth was non-existent in Europe and below expectations in emerging markets. The PC market, which is central to the sector, declined in volume terms by 5% to 300m (source:IDC). The smartphone market has become commoditised. The defence market has declined as governments attempt to rein back fiscal deficits. The reaction to the financial crisis was tightly to control costs, including salary rises. Now the labour market for skills, particularly in the STEM (Science, technology, engineering and maths) space relevant to this portfolio is very tight and wage inflation has returned. In a low growth environment companies have to invest for growth and in a knowledge based world this means investing through the profit and loss account with development expense and branding, less in terms of capital expenditure. Offsetting these negatives technology continues to open up new markets.

Secondly, we had borrowings in place which were not fully utilised in equity investments. In hindsight this was a lost opportunity, but the markets seem to have climbed a wall of fear. The scale of quantitative easing is a huge macroeconomic experiment which I am not wise enough to understand. It seems that at any time interest rates will normalise, with implications for asset prices. We were also influenced by the fact that there were more downgrades in terms of profit expectations than upgrades. We have chosen to keep some ammunition at hand in expectation of a market wobble which has yet to materialise. Our recent policy has been to be invested no more than 100%.

Thirdly, the dominant UK and US portfolios have performed well in absolute terms, so the asset allocation has been good, but the portfolios have underperformed the most relevant indices a little, which upsets my competitive streak. I shall address the specifics in the geographic portfolio review, but more generally I reiterate that the mandate for this fund is generally to invest in quoted smaller companies in the TMT (telecoms media and telecommunications) sectors. With a global mandate it is anomalous that the weighting is so high in the UK. The reason is that there have been two severe crashes this century, in 2002-3 and 2008-9, which both led to exceptional buying opportunities in the UK. In addition the flight of pension funds and insurance companies from UK equities has led to a prolonged period where UK valuations have been relatively attractive. The strong UK and US returns this year have again vindicated this asset allocation choice.

Finally, there has been the burden of the introduction of the AIFMD and the change of administrator and company secretary. It is to be hoped in these respects that the worst is behind us.

Sector Background

The rather negative assessment of the headwinds is offset by a continued enthusiasm for the sector and relief that the asset class at last seems to be returning to favour. The use of the internet becomes ever more pervasive. If the smartphone/tablet boom is maturing, innovation is occurring in "the internet of things", which is a current buzzword.

Energy conservation continues to be a driver for innovation in semiconductors. In software the drivers are regulation in financial services, and marketing analytics as businesses come to terms with the internet. “Big data” is the buzzword here, which encompasses storage and transportation as well as analytics. The automotive industry is huge economically, but less relevant in terms of shareholder perception because profitably is low. However, there is now around 2km of cabling in a car, and 100m lines of software code, and innovation is occurring continuously in terms of energy efficiency, safety, infotainment, communication and comfort. For all these big trends there is a complex supply chain, and consequential derivative markets which smaller companies can exploit.

The internet has mushroomed because it is an unregulated open standard. Therein lie tremendous challenges. How do you control an unregulated environment? Initially security was about irritating viruses. Increasingly it is about professional theft of both money and ideas. Spying is no longer a world of John le Carre, but by computer. Meanwhile populations have the ability to communicate through mobile phones in a way only first world military could in the relatively recent past. It is no coincidence that the 2012 riots, the Arab spring, troubles in the Ukraine and other trouble spots have followed in quick succession. Edward Snowden and Wikileaks have alerted the world to the power of US intelligence. How do governments and companies react? All these issues will lead to increased expenditure. In addition IBM’s sharp decline in sales to China almost certainly reflects politics rather the economy.

UK

The UK portfolio delivered a total return of 24.7%. Although this was strong in absolute terms, the Numis Smaller Companies Index (excluding investment trusts but including AIM) was even stronger at 30.9%. However the technology subsector only appreciated 25.5%, media 28.1% and electronic and electrical equipment 34.6%. In contrast the sectors in industrials and consumer goods returned over 40%, reflecting cyclical recovery. From 31 December 2007 to 31 December 2013, Herald’s UK portfolio returned 124.9%, versus the Numis Index return of 54.8% over that period.

The major takeovers during the year were Ffastfill, Andor and Delcam. During the year the fund invested a total of £30m in 46 primary placings on the London Stock Exchange. Of these, twelve were initial public offerings. At last the market is receptive to new issues, and there appears to be a backlog of potential further offerings because the market was virtually closed for six years until September. There is a natural lifecycle, and Herald has always taken small positions in early stage loss making companies. There have been some interesting such companies recently, including a number with innovative new products. In total over the life of the fund £279m has been invested as primary capital, which is significant in relation to net outside capital (gross funds raised less buybacks) of £57m.

After the strong performance the valuations seem less compelling which begs the question - is it time to take profits? Reassuringly the UK portfolio is still on a p/e (profitable companies only) of 15.3x, which in comparison to valuations in other sectors and the wider market is not challenging, and reasonable by historic standards.

NORTH AMERICA

The North American portfolio had a return of 37.3%. The Sterling total return of the Russell 2000 Technology Index was 38.6%. There were several significant takeovers, at useful premiums, of long held investments - in particular MIPS, Retalix, Websense, Keynote and Exactarget. In aggregate cash bids totalled £21.5m. There was exceptional value in March and cash was invested, but unfortunately the proceeds of takeovers arrived after the rally had begun. Since then certain stocks which are not in our portfolio have been carried by momentum to valuations that struggle to make sense in terms of discounting future value. Many of these, such as the social media companies, have always been out of Herald’s size remit, others are small companies on large valuations, which we have underowned for market size reasons, and the desire to invest on valuations that can be justified by future cash flows. The SAAS companies (software as a service) is an area where we could have made better returns.

EMEA

The EMEA (Europe Middle East and Africa) portfolio has performed well +59.0%. This small portfolio has reflected strong returns on Opera Software and Nordic Semi in Norway and BE Semiconductor and Ordina in the Netherlands.

Far East

The Far East portfolio has lagged the UK, North American and EMEA portfolios with a return of 10.7%. However, this is a good return relative to relevant benchmarks in Taiwan (+5.0%) and Korea (-1.35%). We have deliberately had a relatively small holding in the Far East because, as a manufacturing centre for the technology sector, it does not have the proprietary strength of western countries and has borne the brunt of the weakness in hardware sales this year.

Summary

We continue to view the sector with enthusiasm and are coming to terms with higher valuations having been spoilt by such low values for several years. At last the market has normalised, there is much better liquidity and the smaller companies in TMT seem to be coming back into favour. Furthermore, there is also a flow of new companies in the UK with a requirement for capital and appealing valuations, and a continuing stream of takeover bids both in the UK and particularly in the US at worthwhile premiums.

Time weighted return (TWR) by geography

	31/12/2012-31/12/2013 YTD TWR Book
Asia	11.16%
Europe Middle East and Africa	58.97%
North America	37.04%
UK	24.82%
Foreign Bonds	-10.40%
UK Bonds	1.57%
Numis Smaller companies index (plus AIM ex investment trusts)	30.93%
Russell 2000 Technology Index	38.19%

Investment Changes (£'000)

	Valuation at 31 December 2012	Net acquisitions/ (disposals)	Appreciation/ (depreciation)	Valuation at 31 December 2013
Equities*				
UK	364,990	(12,090)	79,980	432,880
EMEA	14,797	(614)	8,497	22,680
North America	106,778	(8,499)	38,123	136,402
Asia Pacific	27,803	2,563	2,457	32,823
Total equities	514,368	(18,640)	129,057	624,785
Bonds:				
UK bonds	14,759	(14,505)	(254)	–
Euro bonds	14,015	7,830	(2,564)	19,281
Total bonds	28,774	(6,675)	(2,818)	19,281
Total investments	543,142	(25,315)	126,239	644,066
Net liquid assets	29,101	(9,887)	(742)	18,472
Total assets	572,243	(35,202)	125,497	662,538

The total assets figure above comprises assets less current liabilities before deduction of bank loans and derivative financial instruments.

* Equities includes convertibles and warrants.

Katie Potts

TOP TWENTY EQUITY HOLDINGS
AT 31 DECEMBER 2013

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

Telecom Plus		
Telecom Plus, which owns and operates the Utility Warehouse brand, is the UK's only fully integrated provider of a wide range of competitively priced utility services, spanning both the communications and energy markets. Telecom Plus provides over 500,000 homes and small businesses throughout the UK with Home Phone, Broadband, Mobile, Gas and Electricity all on a unified bill. 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.		Country United Kingdom % of total assets 2.7 31/12/13 31/12/12 Valuation (£m) 17.70 15.19 Shares (m) 1.00 1.65
Diploma		
Diploma is 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 2.3 31/12/13 31/12/12 Valuation (£m) 15.55 12.80 Shares (m) 2.3 2.35
M&C Saatchi		
M&C Saatchi is a global marketing services business working for clients across a wide variety of industry sectors. The company was founded in 1995. Starting with a strong base in the UK and Australia, M &C Saatchi have added new agencies and disciplines in Asia, USA and Europe. M&C Saatchi currently has 26 offices in 18 countries.		Country United Kingdom % of total assets 2.2 % of issued share capital held 6.5 31/12/13 31/12/12 Valuation (£m) 14.83 9.06 Shares (m) 4.45 5.15
Euromoney Institutional Investor		
Euromoney is a leading international business-to-business media group focused primarily on the international finance sector. It publishes more than 100 magazines, newsletters and journals, including the leading financial market titles Euromoney and Institutional Investor. 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 and emerging markets. Its main offices are located in London, New York and Hong Kong and nearly half its revenues and profits are derived from the United States.		Country United Kingdom % of total assets 2.0 31/12/13 31/12/12 Valuation (£m) 13.50 8.64 Shares (m) 1.00 1.00
Imagination Technologies Group		
Imagination Technologies - a global leader in multimedia, processor, communication and cloud technologies - creates and licenses market-leading processor solutions including graphics, video, vision, CPU and embedded processing, multi-standard communications, cross-platform V.VoIP and VoLTE and cloud connectivity. These silicon and software intellectual property (IP) solutions for systems-on-chip (SoC) are complemented by an extensive portfolio of software, tools and ecosystems. Target markets include mobile phone, connected home consumer, mobile and tablet computing, in-car electronics, networking, telecoms, health, smart energy and connected sensors. 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 a leading supplier of radios in the UK. Imagination's licensees include many of the world's leading semiconductor manufacturers, network operators and OEM/ODMs. Corporate headquarters are located in the United Kingdom, with sales and R&D offices worldwide. Apple and Intel are both investors in Imagination Technologies.		Country United Kingdom % of total assets 1.7 31/12/13 31/12/12 Valuation (£m) 11.45 19.55 Shares (m) 6.45 4.96

SDL		
SDL allows companies to optimise their customers' experience across the entire buying cycle. Through its web content management, analytics, social intelligence, campaign management and translation services, SDL helps organisations leverage data-driven insights to understand what their customers want, orchestrate relevant content and communications, and deliver engaging and contextual experiences across languages, cultures, channels and devices. SDL has over 1,500 enterprise customers, over 400 partners and a global infrastructure of 70 offices in 38 countries. SDL work with 72 of the top global 100 brands.		Country: United Kingdom % of total assets: 1.7 % of issued share capital held: 3.9 31/12/13 / 31/12/12 Valuation (£m): 11.31 / 14.89 Shares (m): 3.15 / 2.95

GB Group		
GB Group, the UK's leading identity management business, helps organisations realise the full value of their customer base by recognising and verifying all elements of a consumer's identity at every interaction. Through the application of technology, GB Group protects, predicts and provides information that is used to maximise customer value for some of the largest companies in the UK. The company provides an integrated and comprehensive range of data services to clients allowing them to interact effectively with their customers, improve long term profitability and reduce fraud.		Country: United Kingdom % of total assets: 1.6 % of issued share capital held: 6.8 31/12/13 / 31/12/12 Valuation (£m): 10.82 / 6.77 Shares (m): 7.52 / 7.52

ATMI		
ATMI Inc. is a supplier of materials, materials packaging and materials delivery systems used globally in the manufacture of microelectronics devices. The company's products consist of front-end semiconductor performance materials, sub-atmospheric pressure gas delivery systems for safe handling and delivery of toxic and hazardous gases, and materials packaging and dispensing systems. ATMI serves and provides applications and analytical support services to the semiconductor and flat-panel display industries. ATMI is devoted to constantly improving microelectronic manufacturing technologies, helping them drive their customers' industries forward.		Country: USA % of total assets: 1.6 31/12/13 / 31/12/12 Valuation (£m): 10.56 / 7.70 Shares (m): 0.58 / 0.60

Wilmington Group		
Wilmington Group plc is one of the UK's leading providers of Information, compliance and education for professional business markets. The Group provides business intelligence, information, training, education, events and support services for a variety of markets including the accountancy, banking, charities, financial services, healthcare, insurance, legal, and pensions sectors.		Country: United Kingdom % of total assets: 1.6 % of issued share capital held: 5.1 31/12/13 / 31/12/12 Valuation (£m): 10.53 / 9.40 Shares (m): 4.39 / 6.22

OpSec Security		
OpSec Security is a market leader in fighting counterfeits for brands, transaction cards, government documents and currency. OpSec delivers a comprehensive suite of end-to-end solutions, including advanced physical security technologies, supply chain track and trace services, and online and e-commerce monitoring and analysis for more than 300 companies across industry sectors and 50 governments worldwide. OpSec operates manufacturing and software development facilities and laboratories in the USA and Germany and has sales operations in the Americas, Europe, and Asia.		Country: United Kingdom % of total assets: 1.4 % of issued share capital held: 23.7 31/12/13 / 31/12/12 Valuation (£m): 9.46 / 9.93 Shares (m): 23.65 / 23.65

Advent Software		
Advent supplies investment management companies with integrated software products and services in portfolio administration, including workflows within the managers and external portfolio reporting. 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		Country: USA % of total assets: 1.4 31/12/13 / 31/12/12 Valuation (£m): 9.42 / 6.31 Shares (m): 0.45 / 0.48

investment environment. Advent has worked with more than 4,400 client firms in 60 countries. Advent has established itself as a leading provider of mission-critical applications to meet the demands of investment management operations around the world. It has adopted a rental model.

SQS

The SQS Group (SQS) is a leading specialist in software quality. The company's competitive edge stems mainly from its PractiQ methodology, which is based on many years of project experience and specialist knowledge across a wide range of industries. With over 7,000 completed projects, SQS has a strong customer base, including half of the DAX-30, almost a third of the STOXX-50 and 20 FTSE-100 companies. Customers include Allianz, Beazley, BP, Centrica, Commerzbank, Daimler, Deutsche Post, Generali, JP Morgan, Meteor, Reuters, UBS and Volkswagen. Founded in Cologne in 1982, SQS employs around 2,800 staff in Europe, Asia, North America and Africa. Along with a strong presence in Germany and the UK, SQS has further subsidiaries in Austria, Egypt, Finland, France, India, Ireland, the Netherlands, Norway, South Africa, Sweden, Switzerland, and the USA. SQS holds a majority stake in Thinksoft Global Services Ltd, the world's fourth-largest software testing specialist.

Country	Germany	
% of total assets		1.4
% of issued share capital held		6.2
	31/12/13	31/12/12
Valuation (£m)	9.37	5.05
Shares (m)	1.89	2.04

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 as well as 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		1.4
% of issued share capital held		9.2
	31/12/13	31/12/12
Valuation (£m)	9.23	12.42
Shares (m)	6.93	6.93

IDOX

Idox plc is a supplier of software solutions and services to the UK public sector and increasingly to highly regulated asset intensive industries around the world in the wider corporate sector. The Public Sector Software Division is a major supplier of software solutions and managed services to the public sector and is the leading applications provider to local government for core functions relating to land, people and property. Over 90% of UK local authorities are customers for document and case management solutions, workflow systems, content and related Web-based portals. The Idox Engineering Information Management Division is a leading supplier of engineering document management and control solutions to asset intensive industry sectors. Operating under the McLaren Software brand the division supplies solutions to leading international oil & gas, energy & utilities, manufacturing, life sciences, transportation and natural resources companies.

Country	United Kingdom	
% of total assets		1.4
% of issued share capital held		8.0
	31/12/13	31/12/12
Valuation (£m)	9.08	15.01
Shares (m)	27.94	28.32

Telit Communications

Telit is a global leader of machine-to-machine (M2M) communications providing wireless module technology via its brand Telit Wireless Solutions, enhanced by managed and value added services, including connectivity via its business unit m2mAIR. Telit has been dedicated to M2M communications for over 12 years and constantly advancing technological leadership from 6 R&D centers around the globe. Telit offers an extensive portfolio of quality cellular, short-range, and GNSS modules. By supplying business scalable products interchangeable across families, technologies, and generations, Telit is able to keep development costs low and uniquely protect customers' design investments. Telit sells its products through a network of 32 sales offices and 60 distributors to more than 5,000 customers in 80 countries around the world.

Country	United Kingdom	
% of total assets		1.3
% of issued share capital held		4.9
	31/12/13	31/12/12
Valuation (£m)	8.90	2.91
Shares (m)	5.08	5.38

NCC Group		
As a trusted adviser, NCC Group provides business critical IT assurance and protection to over 15,000 organisations worldwide, The Group provides organisations with expert software escrow and verification, security testing, website performance and software testing services. NCC has 16 locations across the UK, Europe, North America and Australia.		Country United Kingdom % of total assets 1.3 31/12/13 31/12/12 Valuation (£m) 8.88 7.30 Shares (m) 4.80 4.80

Kofax		
Kofax is a leading provider of data capture applications that enable enterprises to handle real-time, information-intensive communications from customers and provide an essential connection to their systems of record, which are typically large scale, rigid enterprise applications and repositories not easily adapted to more contemporary technology. Kofax software and solutions are utilised by 20,000 customers in financial services, insurance, government, healthcare, business process outsourcing and other markets. Kofax delivers these through its own sales and service organisation, and a global network of more than 800 authorised partners in more than 75 countries throughout the Americas, EMEA and Asia Pacific.		Country USA % of total assets 1.3 31/12/13 31/12/12 Valuation (£m) 8.56 6.07 Shares (m) 2.10 2.10

Allocate Software		
Allocate Software plc is a global workforce and corporate governance software solutions provider for organisations with large, multi-skilled workforces. With a blue chip client base spanning the public and private sector, its key vertical markets include healthcare, defence and maritime offshore oil and gas. At the core of the business is Allocate's workforce optimisation software, which streamlines the whole workforce management of multi disciplinary groups, across diverse locations. Headquartered in London, it employs around 300 people providing services and support to its increasing international customer base through regional offices in the UK, Australia, Malaysia, Sweden and the USA.		Country United Kingdom % of total assets 1.2 % of issued share capital held 12.7 31/12/13 31/12/12 Valuation (£m) 8.20 6.67 Shares (m) 8.55 8.55

Alternative Networks		
Alternative is one of the UK's leading independent telecommunications service providers. Established in 1994, it has grown steadily and dependably with a broad product portfolio that includes mobile, voice, data, systems, IT and software solutions. In addition, Alternative owns AKJ, which is the driving force behind the Synapse customer service and billing platform. 5,000 businesses and organisations use Alternative Networks for their vital communications. Based across six sites – London Head Office, London City, Reading, Wooborn Green, Chatham and Manchester – in total Alternative employs over 450 members of staff.		Country United Kingdom % of total assets 1.2 % of issued share capital held 3.8 31/12/13 31/12/12 Valuation (£m) 7.7 6.02 Shares (m) 1.83 2.13

Actuate		
Actuate founded and co-leads the BIRT open source project, which is used by more than 2.5 million developers around the globe and serves as the foundation of Actuate's commercial offerings. Applications built with BIRT and BIRT iHub deliver more business and consumer insights to more people than all Business Intelligence companies combined. Actuate's BIRT and BIRT iHub empower developers to rapidly develop custom, BIRT-based business analytics and customer communications applications. Applications built with one BIRT design can access and integrate any data, including unstructured sources. Headquartered in Silicon Valley, Actuate has over 5,000 customers globally in a diverse range of business areas including financial services, technology and the government.		Country USA % of total assets 1.1 % of issued share capital held 3.3 31/12/13 31/12/12 Valuation (£m) 7.42 5.48 Shares (m) 1.59 1.59

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

DISTRIBUTION OF INVESTMENTS

Classification	UK %	EMEA %	USA %	Asia Pacific %	2013 Total %	2012 Total %
EQUITIES: (including convertibles and warrants)						
OIL & GAS	**0.6**	**–**	**0.4**	**–**	**1.0**	**0.3**
Oil equipment services and distribution	0.5	–	–	–	0.5	0.3
Alternative energy	0.1	–	0.4	–	0.5	–
BASIC MATERIALS	**0.4**	**–**	**–**	**0.5**	**0.9**	**0.6**
Chemicals	0.4	–	–	0.5	0.9	0.6
INDUSTRIALS	**11.1**	**0.2**	**0.3**	**1.0**	**12.6**	**11.9**
Aerospace and defence	0.4	–	–	–	0.4	0.3
Electronic and electrical equipment	3.3	0.2	0.3	0.9	4.7	3.3
Support services	7.4	–	–	0.1	7.5	8.3
CONSUMER GOODS	**0.3**	**0.1**	**–**	**–**	**0.4**	**0.2**
Household goods and home construction	0.1	–	–	–	0.1	0.2
Leisure goods	0.2	0.1	–	–	0.3	–
HEALTH CARE	**0.7**	**0.2**	**0.2**	**–**	**1.1**	**0.7**
Health care equipment and services	0.7	0.2	0.2	–	1.1	0.7
CONSUMER SERVICES	**12.9**	**0.1**	**0.8**	**0.1**	**13.9**	**10.8**
Media	12.9	0.1	0.8	0.1	13.9	10.8
TELECOMMUNICATIONS	**3.9**	**–**	**–**	**–**	**3.9**	**3.8**
Fixed line telecommunications	3.8	–	–	–	3.8	3.7
Mobile telecommunications	0.1	–	–	–	0.1	0.1
FINANCIALS	**1.4**	**0.1**	**–**	**–**	**1.5**	**1.0**
Financial services	0.9	0.1	–	–	1.0	0.5
Equity investment instruments	0.5	–	–	–	0.5	0.5
TECHNOLOGY	**34.0**	**2.8**	**18.9**	**3.3**	**59.0**	**60.0**
Software and computer services	25.9	1.7	8.8	1.0	37.4	36.7
Technology hardware and equipment	8.1	1.1	10.1	2.3	21.6	23.3
TOTAL EQUITIES (including convertibles and warrants)	**65.3**	**3.5**	**20.6**	**4.9**	**94.3**	**89.3**
Total equities – 2012 (including convertibles and warrants)	63.2	2.6	18.6	4.9	**–**	**89.3**
BONDS	**–**	**2.9**	**–**	**–**	**2.9**	**5.6**
NET LIQUID (LIABILITIES) ASSETS	**2.8**	**–**	**–**	**–**	**2.8**	**5.1**
TOTAL ASSETS	**68.1**	**6.4**	**20.6**	**4.9**	**100.0**	
(before deduction of bank loans and derivative financial instruments)					**–**	
Total assets – 2012	70.2	5.2	18.6	6.0		**100.0**
BANK LOANS	**(3.8)**	**–**	**–**	**–**	**(3.8)**	**–**
DERIVATIVE FINANCIAL INSTRUMENTS	**(2.1)**	–	–	–	**(2.1)**	**–**
SHAREHOLDERS' FUNDS	**64.3**	**5.2**	**18.6**	**6.0**	**94.1**	
Shareholders' funds – 2012	57.9	5.2	18.6	6.0	**–**	**87.7**
Number of equity investments (including convertibles and warrants)	151	20	60	43	274	236

INCOME STATEMENT

FOR THE YEAR ENDED 31 DECEMBER

	2013 Revenue £'000	2013 Capital £'000	2013 Total £'000	2012 Revenue £'000	2012 Capital £'000	2012 Total £'000
Gains on investments	–	126,239	126,239	–	54,613	54,613
Currency losses	–	(742)	(742)	–	(39)	(39)
Gains on derivative instruments	–	6,362	6,362	–	60	60
Income	9,004	–	9,004	9,164	–	9,164
Investment management fee	(5,648)	–	(5,648)	(4,950)	–	(4,950)
Other administrative expenses	(368)	–	(368)	(329)	–	(329)
Net return before finance costs and taxation	2,988	131,859	134,847	3,885	54,634	58,519
Finance costs of borrowings	(3,108)	(3)	(3,111)	(2,998)	–	(2,998)
Net return on ordinary activities before taxation	(120)	131,856	131,736	887	54,634	55,521
Tax on ordinary activities	(187)	–	(187)	(137)	–	(137)
Net return on ordinary activities after taxation	(307)	131,856	131,549	750	54,634	55,384
Net return per Ordinary share	(0.39)p	168.50p	168.11p	0.94p	68.78p	69.72p

There is no final dividend proposed (2012 – 1.00p per Ordinary share).

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.

BALANCE SHEET
AT 31 DECEMBER

	2013 £'000	2013 £'000	2012 £'000	2012 £'000
Fixed assets				
Investments held at fair value through profit or loss		644,066		543,142
Current assets				
Debtors	1,554		1,985	
Cash and short term deposits	18,008		28,950	
	19,562		30,935	
Creditors:				
Amounts falling due within one year	(26,090)		(51,834)	
Derivative financial instruments	(13,935)		(20,297)	
	(40,025)		(72,131)	
Net current liabilities		(20,463)		(41,196)
TOTAL NET ASSETS		623,603		501,946
Capital and reserves				
Called up share capital		19,420		19,830
Share premium		73,738		73,738
Capital redemption reserve		2,532		2,122
Capital reserve		526,168		403,415
Revenue reserve		1,745		2,841
SHAREHOLDERS' FUNDS		623,603		501,946
NET ASSET VALUE PER ORDINARY SHARE (including current year income)		802.79p		632.78p
NET ASSET VALUE PER ORDINARY SHARE (excluding current year income)		803.18p		631.84p

RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

FOR THE YEAR ENDED 31 DECEMBER 2013

	Called up share capital £'000	Share premium £'000	Capital redemption reserve £'000	Capital reserve £'000	Revenue reserve £'000	Share-holders' funds £'000
Shareholders' funds at 1 January 2013	19,830	73,738	2,122	403,415	2,841	501,946
Net return on ordinary activities after taxation	–	–	–	131,856	(307)	131,549
Shares bought back	(410)	–	410	(9,103)	–	(9,103)
Dividends paid during the year	–	–	–	–	(789)	(789)
Shareholders' funds at 31 December 2013	19,420	73,738	2,532	526,168	1,745	623,603

FOR THE YEAR ENDED 31 DECEMBER 2012

	Called up share capital £'000	Share premium £'000	Capital redemption reserve £'000	Capital reserve £'000	Revenue reserve £'000	Share-holders' funds £'000
Shareholders' funds at 1 January 2012	19,924	73,738	2,028	350,721	2,888	449,299
Net return on ordinary activities after taxation	–	–	–	54,634	750	55,384
Shares bought back	(94)	–	94	(1,940)	–	(1,940)
Dividends paid during the year	–	–	–	–	(797)	(797)
Shareholders' funds at 31 December 2012	19,830	73,738	2,122	403,415	2,841	501,946

CASH FLOW STATEMENT
FOR THE YEAR ENDED 31 DECEMBER

	2013 £'000	2013 £'000	2012 £'000	2012 £'000
Net cash inflow from operating activities		2,623		3,526
Servicing of finance				
Loan and derivative interest	(3,019)		(2,998)	
Net cash outflow from servicing of finance		(3,019)		(2,998)
Financial investment				
Purchase of investments	(89,152)		(63,903)	
Sale of investments	113,498		65,041	
Net cash inflow from financial investment		24,346		1,138
Equity dividend paid		(789)		(797)
Net cash inflow before financing		23,161		869
Financing				
Bank loans drawn down	50,000		–	
Bank loans repaid	(75,000)		–	
Shares repurchased	(9,103)		(1,940)	
Net cash outflow from financing		(34,103)		(1,940)
Decrease in cash		(10,942)		(1,071)
Reconciliation of net cash flow to movement in net debt				
Decrease in cash for period		(10,942)		(1,071)
Decrease in debt for period		25,000		–
Movement in net debt in period		14,058		(1,071)
Net debt at 1 January		(21,050)		(19,979)
Net debt at 31 December		(6,992)		(21,050)

Accounting policies

The financial statements for the year to 31 December 2013 have been prepared on the basis of the accounting policies set out below, which are consistent with those in the Company's Annual Report and Financial Statements at 31 December 2012.

Income

	2013 £'000	2012 £'000
Income from investments and interest receivable		
Total income	9,004	9,164
Total income comprises:		
Dividends from equity securities designated at fair value through profit or loss	7,702	7,771
Interest from financial assets designated at fair value through profit or loss	1,170	1,280
Deposit interest	132	113
	9,004	9,164

Business model 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 1158 of the Corporation Tax Act 2010 for the year ended 31 December 2012, subject to matters that may arise from any subsequent enquiry by HM Revenue & Customs into the Company's tax return. In the opinion of the Directors the Company has subsequently conducted its affairs so as to enable it to continue to seek such approval. In accordance with recent changes to Section 1158, the Company has obtained approval as an investment trust from HM Revenue & Customs for accounting periods commencing on or after 1 January 2013.

Objective

The Company'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.

Investment policy – strategy

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 comparative index. 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 250 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. 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).

Share capital

At 31 December 2013 the Company's capital structure consisted of 77,679,546 Ordinary shares of 25p each (2012 – 79,323,283 Ordinary shares). During the year 1,643,737 (2012 – 375,000) shares were bought back and cancelled. 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. On a winding up, after meeting the liabilities of the Company, the surplus assets would be paid to Ordinary shareholders in proportion to their shareholdings.

Investment management agreement

The management of the Company and the implementation of its investment strategy is contracted to Herald Investment Management Limited ('HIML'). HIML is authorised and regulated by the Financial Conduct 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 the Company's portfolio 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. Careful consideration has been given by the Board as to the basis on which the management fee is charged. The Board considers that maintaining a relatively low level of ongoing charges is in the best interest of all shareholders. The Board is also of the view that calculating the fee with reference to performance would be unlikely to exert a positive influence over the long term performance.

The Board is of the opinion that the continued appointment of HIML 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.

Acquisition of own shares

At the Company's AGM held on 23 April 2013 the Company was authorised to purchase up to 11,814,300 of the Company's Ordinary shares (14.99% of its Ordinary share capital in issue at that time). During the year to 31 December 2013 the Company bought back 1,643,737 Ordinary shares (nominal value £410,934 which comprised 2.0% of the issued share capital at 1 January 2013) 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.

Significant financial issues relating to the 2013 financial statements

The Code requires us to describe any significant issues considered in relation to the financial statements and how those issues were addressed. There were no significant issues.

One matter that arose during the course of the audit was as follows. The Manager makes an estimate of the value of the unlisted stocks in the investment portfolio which the Board reviews and agrees. It is a part of the auditor's function to test whether those valuations meet the relevant accounting standards. The Committee has received reports from the Manager, with which it is satisfied, describing the basis for assumptions used and has discussed and agreed these with the auditor.

Following a detailed review of the financial statements and discussions with the Investment Manager, Administrator, Company Secretary and Auditor, the Audit Committee concluded that the financial statements themselves, and the annual report as a whole, are fair balanced and understandable.

Borrowings

The Company had a £50 million multi-currency variable rate loan facility with The Royal Bank of Scotland plc, which comprised two £25 million tranches expiring in May 2013. This was replaced on 6 February 2013 with a £50 million mulit-currency revolving advance facility maturing 31 December 2014.

At 31 December 2013, there were outstanding drawings of £25 million (2012 – £50 million). Interest on the loans is payable in quarterly instalments in January, April, July and October. The estimated repayment value of the loan at 31 December 2013 was £25 million.

The interest on the £50 million 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 2013 was an estimated liability of £13.9 million (2012 – £20.3 million).

The loan has been disclosed as due within one year as the Company has an unconditional and irrevocable right to prepay the advance under the terms and conditions of the loan agreement. The duration of the advance is 1, 3 or 6 months and the decision to rollover the loan is made at quarterly board meetings based on circumstances prevailing at the time. The decision to continue with the swap arrangement is reviewed at the same time as the loan agreement.

Principal risks and uncertainties

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 fair value or 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 policies for managing them have been applied throughout the year and are summarised below.

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.

Other Price Risk Sensitivity
26.5% of the Company's equity investments at 31 December 2013 (2012 – 29.9%) were listed on the main list of the London Stock Exchange and a further 38.2% (2012 – 38.0%) on AIM. The NASDAQ Stock Exchange accounts for 16.7% (2012 – 20.9%) and other stock exchanges 18.6% (2012 – 8.3%). A 10% increase in stock prices at 31 December 2013 would have increased total net assets and net return on ordinary activities after taxation by £62,500,000 (2012 – £51,100,000). A decrease of 10% would have had an equal but opposite effect. The portfolio does not target any exchange as a comparative index, 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.

(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. 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 £25 million (2012 – £50 million). 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

	2013 Fair value £'000	2013 Weighted average interest rate/ interest rate	2013 Weighted average period until maturity/ maturity date	2012 Fair value £'000	2012 Weighted average interest rate/ interest rate	2012 Weighted average period until maturity/ maturity date
Fixed rate:						
UK bonds	–	–	–	17,816	4.7%	4 years
Euro bonds	19,281	4.2%	3 years	14,015	5.0%	4 years
UK convertible bonds	256	8.0%	3 years	729	7.5%	2 years
Cash:						
Other overseas currencies	10,271			6,341		
Sterling	7,737	1.0%		22,609	0.7%	
	18,008			28,950		

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

	2013 £'000	2013 Net interest rate paid	2013 Loan facility expired/expires	2012 £'000	2012 Net interest rate paid	2012 Loan facility expired/expires
Bank Loan	25,000	1.9%	Dec 2014	25,000	1.7%	May 2013
				25,000	2.4%	May 2013
		1.9%			2.1%	
Interest rate swap	50,000	4.4%		50,000	4.0%	
Total		6.3%			6.1%	

At 31 December 2013, the Company had an unutilised committed borrowing facility of £25 million (2012: nil) with a cost associated rate of 0.54%.

The effective fixed rate of interest on the loans of 6.25% (2012 – 6.1%) reflects a weighted average variable interest rate paid of 1.87% (2012 – 2.1%), with a further weighted average of 4.38% paid on the swap (2012 – 4.0%). The Company's facility is rolling on a quarterly basis with the facility expiring in December 2014.

While the 30 year swap remains in place, the net interest payable will effectively be fixed for the duration of the term of the loan facilities at 4.8975% plus margin cost of 1.35% making a total of 6.2475%.

	2013 Notional contract amount £'000	2013 Fair value assets £'000	2013 Fair value liabilities £'000	2013 Fair value balance £'000	2012 Notional contract amount £'000	2012 Fair value assets £'000	2012 Fair value liabilities £'000	2012 Fair value balance £'000
Total derivative assets/(liabilities)	50,000	28,505	(42,440)	(13,935)	50,000	27,569	(47,866)	(20,297)

Interest rate risk sensitivity

(a) Cash

An increase of 100 basis points in interest rates as at 31 December 2013 would have a direct effect on net assets. Based on the position at 31 December 2013, over a full year, an increase of 100 basis points would have increased the net return on ordinary activities after taxation by £180,000 (2012 – £290,000) and would have increased the net asset value per share by 0.23p (2012 – 0.36p). 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 2013 would have decreased total net assets and total return on ordinary activities by £576,000 (2012 – £980,000) and would have decreased the net asset value per share by 0.74p (2012 – 1.24p). 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 2013 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% (2012 – 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 changes in the fair value of 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 2013 would have a direct effect on the fair value of the swap and net assets. Based on the position as at 31 December 2013, 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 £10,181,000 (2012 – £11,941,000) and would have decreased the net asset value per share by 13.11p (2012 – 15.05p). 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. 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.

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

At 31 December 2013

	Investments £’000	Cash and deposits £’000	Loans £’000	Other debtors and creditors * £’000	Net exposure £’000
US dollar	134,738	8,305	–	8	143,051
Norwegian krone	19,281	–	–	502	19,783
Korean won	14,489	–	–	110	14,599
Taiwan dollar	10,911	1,964	–	–	12,875
Euro	20,842	2	–	10	20,854
Other overseas currencies	10,930	–	–	11	10,941
Exposure to currency risk on translation of valuations of securities listed in overseas currencies	211,191	10,271	–	641	222,103
Sterling	432,875	7,737	(25,000)	(14,112)	401,500
	644,066	18,008	(25,000)	(13,471)	623,603

*Includes net non-monetary assets of £0.

At 31 December 2012

	Investments £’000	Cash and deposits £’000	Loans £’000	Other debtors and creditors * £’000	Net exposure £’000
US dollar	107,482	146	–	(68)	107,560
Norwegian krone	17,326	–	–	–	17,326
Korean won	14,609	–	–	26	14,635
Taiwan dollar	7,706	6,195	–	–	13,901
Euro	9,296	–	–	403	9,699
Other overseas currencies	6,974	–	–	–	6,974
Exposure to currency risk on translation of valuations of securities listed in overseas currencies	163,393	6,341	–	361	170,095
Sterling	379,749	22,609	(50,000)	(20,507)	331,851
	543,142	28,950	(50,000)	(20,146)	501,946

*Includes net non-monetary assets of £38,000.

Foreign currency risk sensitivity
At 31 December 2013, had sterling strengthened by 10% (2012 –10%) 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% (2012 – 10%) 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.

	2013 £'000	2012 £'000
US dollar	14,305	10,756
Norwegian krone	1,978	1,733
Korean won	1,460	1,463
Taiwan dollar	1,288	1,390
Euro	2,085	970
Other overseas currencies	1,094	697
	22,210	17,009

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 and Norwegian Government securities and UK corporate bonds.

Credit Risk Exposure

The exposure to credit risk at 31 December was:

	2013 £'000	2012 £'000
Fixed interest investments	19,281	31,831
Cash and short term deposits	18,008	28,950
Debtors and prepayments	1,554	1,985
	38,843	62,766

The maximum exposure in fixed interest investments was £38,570,000 (2012 – £33,170,000) and the minimum £19,281,000 (2012 – £26,228,000). The maximum exposure in cash was £61,320,000 (2012 – £36,288,000) and the minimum £13,702,000 (2012 – £17,863,000).

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.

(a) Equity Securities

The Company's unlisted investments are not readily realisable, but these only amount to 1.5% of the Company's total assets at 31 December 2013 (2012 – 2.1%).

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. 29% (£173 million) (2012 – 34% (£182 million)) of the portfolio is invested in listed 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 5.5% (2012 – 6.7%).

(b) Floating interest rate to fixed interest rate swap

The fair value of the swap is estimated by the Administrator and is compared to the swap provider's (RBS) valuation. We believe the RBS valuation to be reasonable. The RBS valuation methodology and assumptions may change at any time.

The swap valuation gives an indication of fair value, but the price at which the swap can be unwound or realised may diverge materially from this valuation depending on market conditions and liquidity.

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:

	2013 One year or less £'000	2012 One year or less £'000
Bank loans	25,120	50,492
Derivative financial instruments	14,481	24,136
Other creditors	597	470
	40,198	75,098

Fair values are measured using the following fair value hierarchy:

Level 1: reflects financial instruments quoted in an active market.

Level 2: reflects financial instruments whose fair value is evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables includes only data from observable markets.

Level 3: reflects financial instruments whose fair value is determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable market transactions in the same instrument and not based on available observable market data.

The tables below set out the fair value measurements using the fair value hierarchy.

At 31 December 2013

	Level 1 £'000	Level 2 £'000	Level 3 £'000	Total £'000
Financial assets				
Equity investments	615,394	–	5,529	620,923
Government debt securities	19,281	–	–	19,281
Other debt securities	–	–	3,862	3,862
Current assets	19,562	–	–	19,562
Total assets	654,237	–	9,391	663,628
Financial liabilities				
Bank loans	25,000	–	–	25,000

Derivatives	–	13,935	–	13,935
Current liabilities (excluding bank loans)	1,090	–	–	1,090
Total liabilities	26,090	13,935	–	40,025
Total net assets	628,147	(13,935)	9,391	623,603

A reconciliation of fair value measurements in Level 3 is set out below:

At 31 December 2013

	Equity Investments £'000
Opening balance at 1 January 2013	12,227
Purchases	2,093
Sales	(2,736)
Total gains or (losses):	
– on assets sold during the year	3,334
– on assets held at 31 December 2013	(5,527)
Closing balance at 31 December 2013	9,391

At 31 December 2012

	Level 1 £'000	Level 2 £'000	Level 3 £'000	Total £'000
Financial assets				
Equity investments	502,141	–	9,170	511,311
Government debt securities	23,020	–	–	23,020
Other debt securities	5,754	–	3,057	8,811
Current assets	30,935	–	–	30,935
Total assets	561,850	–	12,227	574,077
Financial liabilities				
Bank loans	50,000	–	–	50,000
Derivatives	–	20,297	–	20,297
Current liabilities (excluding bank loans)	1,834	–	–	1,834
Total liabilities	51,834	20,297	–	72,131
Total net assets	510,016	(20,297)	12,227	501,946

A reconciliation of fair value measurements in Level 3 is set out below:

At 31 December 2012

	Equity Investments £'000
Opening balance at 1 January 2012	9,556
Purchases	2,089
Sales	(944)
Total gains or (losses):	

– on assets sold during the year	(1,694)
– on assets held at 31 December 2012	3,220
Closing balance at 31 December 2012	12,227

Transfers into Level 3 relate to investments for which listing has been suspended during the year.

Other risks

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 Sections 1158 and 1159 of the Corporation Tax Act 2010 could lead to the Company being subject to tax on capital gains. The Manager and Administrator provide regular reports to the Audit Committee on their monitoring programmes. The Manager monitors investment positions and the Administrator monitors the level of forecast income and expenditure to ensure the provisions of Sections 1158 and 1159 are not breached.

Major regulatory change could impose disproportionate compliance burdens on the Company. In such circumstances representation is made to ensure that special circumstances of investment trusts are recognised.

Operational/financial risk – failure of the Administrator'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 Manager, Administrator and Company Secretary each have a comprehensive business continuity plan which facilitates continued operation of the business in the event of a service disruption or major disruption. The Audit Committee reviews the Administrator's Report on Internal Controls and the reports by other key third party providers are reviewed by the Administrator on behalf of the Audit Committee.

Discount volatility – the discount at which the Company's shares trade can widen. The Board monitors the level of discount and the Company has authority to buy back its own shares.

Gearing risk – the Company may borrow money for investment purposes. If the investments fall in value, any borrowings will magnify the extent of this loss. If borrowing facilities are not renewed, the Company may have to sell investments to repay borrowings.

All borrowings require the prior approval of the Board and gearing levels are discussed by the Board and Manager at every meeting. The majority of the Company's investments are in quoted securities.

Directors' responsibility statement pursuant to DTR4

The directors confirm that to the best of their knowledge:

- The financial statements have been prepared in accordance with applicable law and United Kingdom Accounting Standards (UK GAAP) and give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company;

- The management report includes a fair review 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 it faces.

Copies of the Company's annual report and financial statements will be available from the Company's registered office or at www.heralduk.com once published on 14 March 2014.

By order of the board
Law Debenture Corporate Services Limited
Secretary
25 February 2014