Edgemoor's Quarterly Report

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Good Riddance to 2022!

Most investors were happy to see 2022 come to an end. There were few places for investors to hide, as nearly every segment of the financial markets posted losses for the year. U.S. stocks posted their worst year since 2008, while many parts of the bond market suffered their biggest losses in history. The traditional role of income investments as a buffer to more volatile equity markets did not hold up, deepening the pain of balanced portfolios.

Fourth Quarter and Full Year in Review

The S&P 500 posted a negative total return for the year of 18.1%, just shy of bear market territory (a decline of 20% or more), where it had spent much of the year. A 7.6% gain in the fourth quarter brought some relief, boosting the index from its lowest point of a negative 25% total return in mid-October.

The tech-heavy Nasdaq fared even worse, down 33.1% for the year and down 3.2% in Q4. The collapse of many high-flying technology stocks like Tesla was responsible for the Nasdaq's bleak performance and resulted in the largest outperformance of value stocks (-8%) over growth stocks (-33%) since 2000.

Bonds had their worst year in history, with the Bloomberg Barclay's Aggregate Bond Index posting a 13% decline for the year. Prior year losses going back to 1976 had never exceeded negative 2% for the bond index.

Global diversification didn't help investors either, as both the European and emerging markets indices experienced double-digit losses. Ongoing economic and geo-political uncertainties throughout Europe tied to the war in Ukraine, China's economic slowdown related to its housing crisis and Covid lockdowns, and the sharp appreciation of the U.S. dollar all contributed to the poor performance of global stocks in 2022.

And in perhaps the most spectacular crash of the year, cryptocurrencies spent most of the year in severe decline, capped off by the collapse of crypto trading platform FTX in November. The largest cryptocurrency, bitcoin, lost over $550 billion in market value in 2022 as its price sank 65%.

Inflation and Interest Rates

The market's heightened volatility was directly related to larger-than-expected increases in inflation and interest rates throughout the year.

U.S. inflation hit a decades-high rate of 9.1% in June 2022, spurring the Federal Reserve to raise its benchmark Fed Funds rate at its fastest pace since the early 1980s. The Fed's seven interest rate hikes through the year resulted in the short-term, Fed Funds rate rising sharply to a target

range of 4.25% - 4.5% at year-end from near zero in January.

What started as relatively modest hikes in the first half of the year ramped up in June with the first of four 0.75% hikes in the second half of 2022. In December, the Fed took its foot ever-so-slightly off the pedal, with a 0.50% hike to finish the year.

Looking ahead, the good news is that the worst of the rate hikes is likely behind us, as the Fed is expected to slow its pace of rate increases in 2023. At its next meeting in February, many expect the Fed to raise rates by just 0.25% and end 2023 with an expected Fed Funds rate of around 5%.

Recession or Slow-cession?

Rising interest rates are intended to slow the economy just enough to dampen inflation. But a recent WSJ survey indicated that economists place roughly 65% odds on the U.S. economy slowing enough to fall into some level of recession in 2023. The depth and length of a potential recession, however, remain hotly debated.

In fact, several economists believe that 2023 might not bring a full-blown recession at all, but rather a "slow-cession" – or a period of less than 1% GDP growth in each of the next four quarters. They point to the strong labor market, healthy consumer and corporate balance sheets, and a well-capitalized financial system as reasons why the U.S. economy could avoid a significant economic contraction this year.

Even the housing market – which has suffered a significant fall-off in demand as mortgage rates have risen – isn't likely to spur a recession, as home values are expected to remain buoyed by a shortage of supply from more than a decade of limited new home construction.

Finally, the consumer remains the main driver of U.S. economic activity and most economists believe the U.S. consumer is poised to keep spending in 2023. With unemployment low, wages rising, consumer debt manageable, and consumer savings in excess of $1 trillion, many believe that the U.S. consumer is resilient enough to weather whatever storms brew up in 2023.

Other Bright Spots in the U.S. Economy

Declining inflation is another potential bright spot for the U.S. economy in 2023. The Consumer Price Index, or CPI, which is the broadest measure of inflation, hit a highpoint of 9.1% in June 2022 and has since declined steadily to its latest reading of 6.5% in December, which was the smallest 12-month increase since December 2021. The slowdown in inflation has been led primarily by declines in energy and car prices since the summer. The price of West Texas crude peaked at $117 per barrel in May 2022 and has since fallen back to roughly $80 as of mid-January.

The Core CPI, which excludes volatile food and energy prices, rose just 5.7% over the last 12-months in December, which also was the smallest increase since August. Overall, economists are forecasting core inflation to settle back in a range of 3%-4% by the end of 2023.

Outlook for 2023

Our outlook for the stock market is somewhat mixed. While we do expect inflation and interest rates to moderate in 2023, their negative impact on

corporate earnings is likely to become more pronounced in the first part of the year.

Corporate earnings began to slow in the latter half of 2022. The S&P 500 index reported earnings growth of 2.5% for Q3 2022, compared to 9.4% in Q1 and 5.8% in Q2. Current projections are for S&P earnings growth to decline 2.8% for Q4 2022, which, if correct, would mark the first earnings decline since the height of the pandemic in Q3 2020. The largest contributors to the projected earnings decline are the financial, communications services, and consumer discretionary sectors.

These uncertainties will likely lead to continued market volatility through mid-year. However, we believe a sustained market recovery could occur in the latter half of the year if/when the Fed signals an end to its aggressive rate-tightening stance.

Stock valuations have also started 2023 at more reasonable levels than at the beginning of 2022. The forward 12-month price/earnings ratio for the S&P 500 currently stands at 17.3 times, below the 5-year average of 18.3 times and well below the 23 times valuation at the beginning of 2022. The lower valuation starting point should translate into better compound returns for investors over the next 2 – 5 years.

Portfolio Actions and Implications

While we are maintaining our long-term, value-oriented investment philosophy, we have taken a more cautious view of equity markets for the near-term. Instead, we have been deploying cash in short-term U.S. Treasuries at attractive, risk-free yields in excess of 4.5%. A more detailed discussion of the Treasuries we favor can be found in the selected securities section to follow.

We do believe many sectors of the stock market are undervalued and offer attractive long-term return potential. Once we see signs of the Fed pulling back from its aggressive rate tightening, and that economic growth and corporate profits have stabilized, we will resume deploying cash in long-term equities.

We continue to employ our disciplined, active approach to individual security selection, as opposed to buying the broad market through mutual funds or ETFs. We believe our active approach is more tax efficient, cost effective, and offers better long-term return potential over a full market cycle for our clients.

Secure Act 2.0

We'd like to update our clients and friends on some new legislation affecting tax and retirement planning. The Secure Act 2.0, passed in December 2022, expands upon the Secure Act 1.0 which was passed in December 2019. Some of the highlights of the new law include:

- The age to start taking required minimum distributions (RMDs) from IRAs or retirement plans increases to 73 in 2023 and to 75 in 2033. If you turned 72 in 2022 or earlier, you will need to continue taking RMDs as scheduled.
- The penalty for failing to take an RMD will decrease to 25% from 50% (and to just 10% if corrected in a timely manner with the IRS).

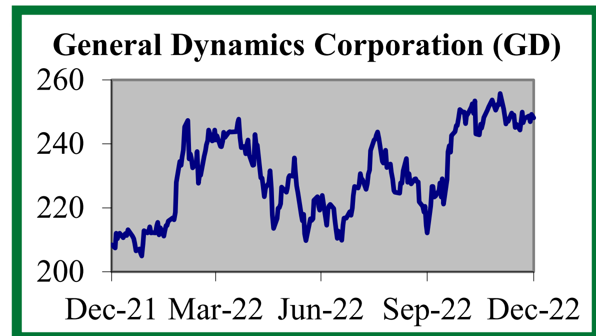
- Starting in 2024, RMDs will no longer be required from Roth accounts in employer retirement plans.
- Starting in 2024, 529 plan assets can be rolled over into a Roth IRA for the plan beneficiary.
- Starting in 2025, individuals ages 60 to 63 will be able to make catch-up contributions to a workplace plan up to $10,000.

There are many other provisions of the Secure Act 2.0, but we wanted to highlight these important few. As always, consult your financial advisor or tax professional to understand how the act applies to you.

Analysis of Selected Securities

Following is a discussion of three securities we own and have bought recently. Due to factors specific to each investment, we believe that these securities are priced attractively in the market today.

General Dynamics Corporation (GD)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 9.

Price (12/31/2022)	$ 248.11	Forward P/E	17.7
Market Cap ($B)	$ 68.2	Price/Book	3.9
Dividend Yield	2.0%	Price/Sales	1.8
Return on Equity	20.1%	Debt/Equity	0.6

Virginia-based General Dynamics is the world's fourth largest defense contractor and the second largest manufacturer of corporate jets. The company operates in four primary business lines: Aerospace (22% of 2021 revenues), Combat Systems (19%), Marine Systems (27%), and Technologies (32%). The company derives approximately 70% of its revenues from the U.S. government, 10% from foreign governments, and the remaining 20% from commercial customers. General Dynamics's well-diversified business mix and entrenched product offerings are the

source of the company's leading market positions and wide economic moat. The company ended the third quarter of 2022 with an order backlog of $88.8 billion, equivalent to more than two years of revenue, which provides a high degree of visibility into future years' sales.

The Aerospace segment, which is predominantly composed of Gulfstream jets, enjoys a commanding position in the high-end business jet market and provides diversification from defense spending. Sales activity recovered quickly from the pandemic-related slowdown and in 2022 the company experienced its best order performance in over a decade.

General Dynamics's Combat Systems segment produces land-based vehicles, such as the Abrams tank, the main battle tank of the U.S. Army since entering service in the 1980s. General Dynamics should continue to benefit from the incumbency advantage over its competitors in this large and stable market.

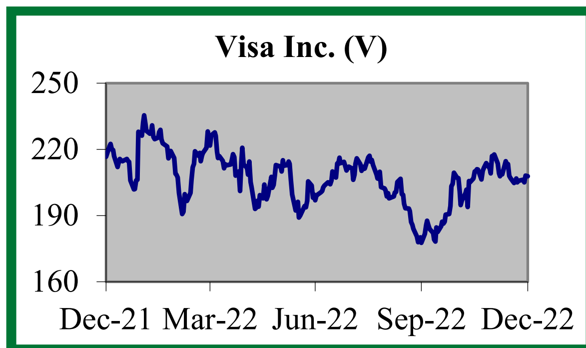
The company's Marine Systems segment is one of only two major shipbuilders in the United States and enjoys one of the widest economic moats in the defense industry. The segment accounts for nearly 48% of the company's $88.8 billion backlog, providing consistent and highly visible earnings over multi-decade procurement cycles. The crown jewel of the Marine Systems segment are the Virginia-class and Columbia-class submarines which benefit from steady, decades-long procurement cycles and uses technological capabilities that are unique even among defense contractors.

The Technologies segment includes IT Services and Mission Systems, the latter of which provides mission-critical products for military applications. Mission Systems is a durable and profitable business for General Dynamics due to its large installed base of products and high customer switching costs.

General Dynamics has committed itself to shareholder friendly policies, highlighted by 25 consecutive years of dividend increases and the use of excess cash to buy back stock. The company has grown its dividend at a compound annual rate of 9.5% over the past 11 years, and management remains committed to continued dividend growth. In total, over the past five years, General Dynamics has returned nearly $12 billion to shareholders in the form of dividends and share repurchases.

General Dynamics' stock trades at 17.7 times estimated 2023 earnings per share, in line with both its historical range and industry averages. Given the current war in Ukraine and other geopolitical tensions, we believe defense spending globally should remain strong for the foreseeable future and support further earnings growth for General Dynamics.

Visa Inc. (V)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 9.

Price (12/31/2022)	$ 207.76	Forward P/E	24.8
Market Cap ($B)	$ 439.0	Price/Book	12.4
Dividend Yield	0.9%	Price/Sales	15.1
Return on Equity	42.7 %	Debt/Equity	0.6

Visa operates the world's largest electronic payments network, connecting consumers, businesses, banks, and governments in nearly every type of financial transaction around the globe. The company also operates one of the world's largest ATM networks, Visa/PLUS, offering cash access in local currencies in more than 200 countries worldwide.

Visa is the clear leader in payment processing, with more than double the volume, transaction value, and cards than its next largest competitor, MasterCard. Visa processes approximately 637 million transactions per day, and its customers include over 15,100 financial institutions and 80 million merchants. There are over 3.3 billion Visa cards in circulation worldwide, more than twice that of Mastercard.

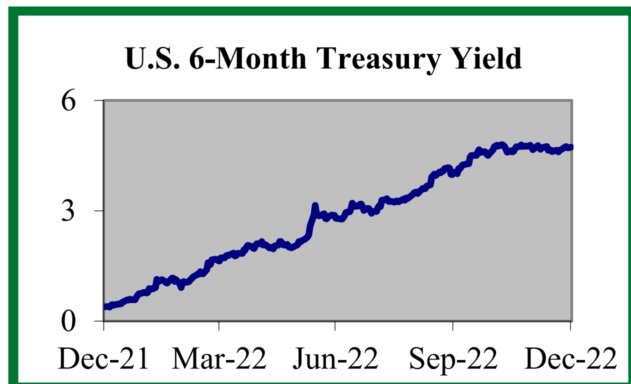
Much of Visa's growth over the years has been propelled by the increasing use of digital payments over cash transactions. Still, over 85% of the world's retail transactions are conducted with cash or checks, leaving a long runway for growth as more payments shift to digital form. In the U.S., cash accounts for 55% of transactions under $10, representing significant opportunity as Visa expands payment capabilities and merchants lower minimum charge requirements. Overall, the transition from cash to plastic brings numerous benefits to consumers including convenience, safety, and, in many cases, attractive rewards programs.

We believe Visa's financial position is strong with high operating margins, ample free cash flow, and modest debt. As of December 31, 2022, the company had $18.5 billion of cash and $20 billion in long-term debt. Visa carries a AA- debt rating from Standard and Poor's.

Management is shareholder-friendly, having doubled its dividend payout over the last five years and authorizing a new $12 billion share repurchase program in October 2022.

Visa stock trades at a premium to the market at 24.8 times 2023 earnings, but we believe that premium is justified by the company's dominant market position, strong brand equity, and significant growth prospects.

U.S. 6-Month Treasury Yield



Source for chart and financials: WSJ and MarketWatch. Past performance is not indicative of future results. Please see disclosures on page 9.

Yield (12/31/2022) 4.67%

The Fed raised interest rates seven times during 2022, bringing the federal funds rate to a target range of 4.25% - 4.50% at year-end from near zero in January. The first hike was announced in March, increasing the federal funds rate by 25 basis points, followed by a 50-basis point increase in May. From June through November, the Fed executed four 75-basis point increases, and in December, the Fed implemented a final hike for the year of 50 basis points.

The surge in short-term interest rates has generated very attractive opportunities in the fixed-income universe. For the first time in years, cash and short-duration bonds provide a meaningful return. As a result, in October we started buying Treasury securities with maturities ranging from three months to one year, at yields between 4.61% and 4.78%. In addition to very attractive yields, these bonds, backed by the full faith and credit of the U.S. government, carry very little risk.

After multiple rate hikes in 2022, the Fed will likely slow its rate increases during 2023. The Fed's next announcement will come on February 1st and the current consensus is calling for a 25-basis point increase. The market believes the federal funds rate will end 2023 at approximately 5.00%. We will continue to analyze the yield curve and purchase bonds that we think have the best rate-of-return potential.

Source for text and charts: Morningstar, S&P/CFRA, Schwab, ValueLine, Black Diamond Performance Reporting, Yahoo Finance, Bank of America, JP Morgan Markets, MarketWatch, WSJ and Argus reports.

Edgemoor Investment Advisors is an independent wealth management firm providing investment and financial planning advice to individuals, retirement plans, trusts, family foundations, and an equity mutual fund. We manage approximately $971 million as of December 31, 2022, for our clients and focus on long-term capital appreciation, preservation of capital, and income generation through disciplined management of value-oriented equity and income portfolios. Please contact us if you would like more information.

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The Barclays U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. The Index is frequently used as a stand-in for measuring the performance of the U.S. bond market. In addition to investment grade corporate debt, the Index tracks government debt, mortgage-backed securities (MBS) and asset-backed securities (ABS) to simulate the universe of investable bonds that meet certain criteria. In order to be included in the Index, bonds must be of investment grade or higher, have an outstanding par value of at least $100 million and have at least one year until maturity.

The NASDAQ stock exchange is the first electronic stock market listing over 5000 companies. The NASDAQ stock market comprises two separate markets, namely the Nasdaq National Market, which trades large, active securities and the Nasdaq Smallcap Market that trades emerging growth companies.

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