Edgemoor's Quarterly Report

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What to Expect?

Stocks soared while bonds treaded water. Such was the tale of the tape in the first quarter of 2012. Should investors expect more of the same for the remainder of this year and beyond? We are cautiously optimistic about the potential for further increases in stock prices, particularly for high-quality holdings, but we do expect the ride to get bumpier again and will not be surprised to see a correction after the market's long and strong rebound from last September. Bonds, however, are likely to disappoint.

Has the Bond Market Peaked?

The first quarter of 2012 witnessed a barely positive return of 0.3% in the overall U.S. bond market, which is a negative real return after inflation. The 10-Year Treasury currently yields just 2.0%, which is also less than the 2.9% inflation rate over the last twelve months.

The Federal Reserve continues to hold short-term rates near zero by setting the federal funds rate at 0.25% and long-term rates low through purchases of Treasury Bonds. Sooner or later, however, inflation will rear its ugly head, and the Fed will be compelled to abandon its quantitative easing and tighten the money supply. When the Fed does act, the impact on low yielding long-term bonds will be significant: interest rates will rise, and bond prices will fall. In the past, Treasurys offered risk free returns, but with yields less than the rate of inflation, Treasurys now inflict *return free risk.*

For several quarters now, Edgemoor has purchased very few bonds, buying instead high yielding securities including master limited partnership units and preferred stocks, which yield 6% to 7%. We have also bought common stocks, such as utilities, which offer yields of 4% and higher with the potential for further dividend increases. We believe that these income investments will provide better overall returns than bonds and will prove far more resilient than low yielding bonds when we inevitably face rising inflation and interest rates.

Does the Equity Market Still Have Room to Run?

The stock market delivered spectacular returns in the first quarter of 2012, with the S&P 500 index climbing 12.6% for the best start to a year since 1998. Improving U.S. economic data and greater stability in Europe were the primary catalysts for the rise, and the result and relatively smooth journey no doubt pleased investors.

Heading into this year, all eyes were on Europe, the primary source of investor angst. Conditions there improved substantially in the first quarter, though some would argue that the day of reckoning has simply been postponed. We take comfort in the success of the European Central Bank's recent efforts to support the European banking system through the Long-Term Refinancing Operation, which lends money to European banks at 1%. In addition, the ultimately successful restructuring of Greece's debts bought some time for Greece and other European countries to strengthen their economies and finances, but their sovereign debt problems are far from over.

Turning to Asia, China's economic growth rate has been slowing for several quarters and threatens to dampen the global economic recovery. Investors cautiously watched trends in China and other emerging markets for signs of further slowing but still found reason to bid U.S. stock prices up based on domestic results.

In the United States, data indicated continued economic recovery. GDP increased at an annual rate of 3% in the fourth quarter of 2011, and most economists forecast similar growth for the full year 2012. Other indicators such as the Institute for Supply Management's index of U.S. manufacturing activity also pointed to slow, steady expansion.

The news related to employment was particularly encouraging, as the economy added over 200,000 jobs in each of December through February, the best jobs results in two years, and unemployment dipped to 8.3%. At the beginning of April, however, the labor department reported the addition of only 120,000 jobs in March, disappointing investors and sending stocks lower early in the second quarter.

Financial stocks rallied in the first quarter as the latest round of bank stress tests found the majority of U.S. banks able to withstand even the most adverse market scenarios. As a result, several of the healthiest banks moved to boost dividends. We have been cautious about investing in banks since the financial crisis but recently added PNC to our portfolio because, as discussed below, we believe that PNC and others are in a good position to prosper as our economy continues to improve. Technology stocks, in which we have significant exposure, also led performance in the first quarter.

Reflecting the stabilization of Europe and greater investor comfort with equities, the S&P 500 index had no days with fluctuations of 2% or more in the first quarter of 2012, following such moves on an average of 17 days in each of the previous two quarters. We do not expect the unusually smooth and steady path upward in the first quarter to continue, however, and the first few weeks of the second quarter have reminded us that we cannot be complacent.

Outlook

Even after the market's recent rally, we see more room for price appreciation as corporations continue to profit from pent-up demand both in the United States and abroad, particularly in emerging markets, and as price/earnings multiples rise to historical levels. The trailing price/earnings ratio for the S&P 500 index is about 14 today, below its historical average and also lower than the market's peak in October 2007, when the ratio was about 17. Earnings likely increased only about 1% in the first quarter, but we expect better profit growth for the remainder of 2012.

Further support for higher stock prices should come from companies' efforts to return cash to shareholders. Flush with cash, businesses are boosting dividends and buyback programs. Even technology companies, traditionally reluctant to pay dividends, are finally jumping on this bandwagon. Most notable was Apple's announcement of a dividend and share repurchase plan that will return some of its $98 billion of cash to shareholders.

Our optimism, we know, is not without its risks, primarily related to China, Europe, the Middle East, and U.S. political issues. Even after slowing, the Chinese economy continues to expand at about 7% per year. However, the decrease in demand for commodities and other imported goods could hurt those countries that rely on China as a large export market. Exports to China account for only 2% of U.S. GDP, so the direct impact of a Chinese slowdown on the U.S. economy is limited. Many developing nations, which tend to be rich in natural resources, depend more heavily on Chinese demand and are at greater risk.

Political tensions in the Middle East, particularly Iran, could disrupt oil production and transportation and lead to a further spike in energy costs. Such a scenario poses a threat, at least in the short term, to global economic growth in both developed and developing regions.

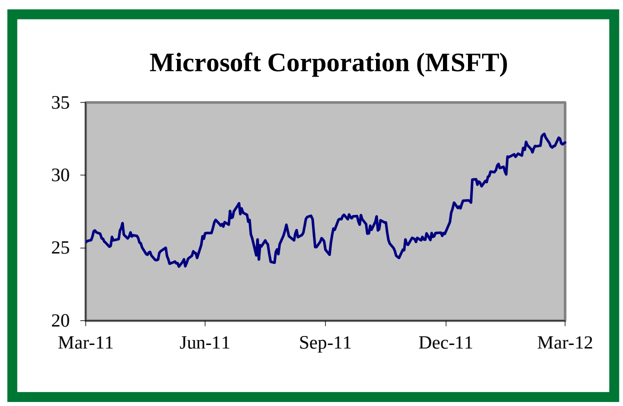
Here at home, election-year politics and further stalemates in Congress could threaten the economic recovery. Numerous budgetary and tax issues loom large, as does another debt ceiling debate, and we think it is unlikely that any serious progress on these fronts happens before the November elections. Uncertainty surrounding resolution of these issues is significant and will most likely result in greater market volatility for the remainder of 2012.

We continue to find companies trading at discounts to our calculation of intrinsic value. Potential returns on stocks at current valuations are particularly attractive compared to the low yields on bonds. In this environment, we continue to favor high-quality, large capitalization stocks with strong balance sheets. Most of the companies we own operate globally, providing exposure to emerging markets that are expanding their economies faster than those in the developed world. We also prefer companies paying significant dividends, which provide current returns while we wait patiently for capital appreciation.

Analysis of Selected Stocks

Following is a discussion of several of the securities we own and have been buying recently.

Microsoft Corporation (MSFT)



Price (3/30/2012)	$ 32.25	Forward P/E	10.7
Market Cap ($B)	$ 270.6	Price/Book	4.2
Dividend Yield	2.5%	Price/Sales	3.8
Return on Equity	41.7%		

Microsoft is the world's largest software maker and has enjoyed for decades a near-monopoly position in desktop operating systems and its

Office productivity suite. Today, while it still derives 75% of revenues from its Windows operating systems, the company also operates profitable and growing business lines in Server Products & Tools, Online Services, Business Services, and Entertainment & Devices.

The shift from personal computers (PCs) to mobile devices and web-based applications is changing how businesses and consumers alike utilize technology for everything from communications to productivity to e-commerce and entertainment. Consequently, Microsoft has been steadily shifting its business strategy from a PC-centric model to one focused on a mobile, cloud-based computing platform.

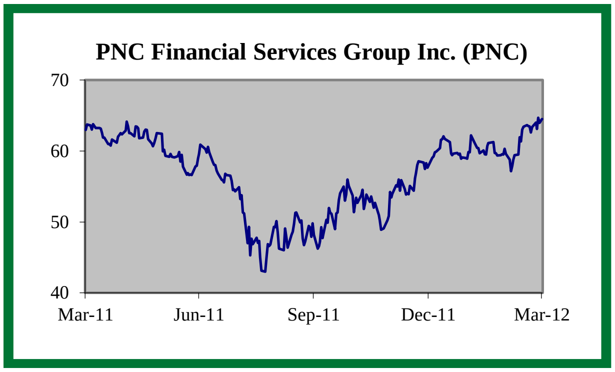
The company's server and business application software products are in the best position to ride the cloud computing wave. Microsoft's new software plus service delivery model has been designed to leverage the company's core software capabilities with a service component that delivers applications and data to customers on multiple devices at multiple price points via the Internet. This strategy positions Microsoft well to transition its large, installed base of commercial customers to a hosted, subscription-based platform without significant switching costs or competitive threats. Microsoft's Azure platform also enjoys a first-mover advantage and is considered the largest and perhaps most technologically advanced platform for the cloud.

For consumers, Microsoft is also making strides. Its new Windows phone platform should drive market-share gains and could create the next $1 billion revenue segment for the company. Also, Microsoft's XBox gaming division holds the potential to compete directly with Apple devices as a full-fledged, multi-media computing console.

Amidst all this change, Microsoft remains on solid financial footing. It held $52 billion of cash and cash equivalents on its balance sheet at the end of 2011, compared to $12 billion in long-term debt. The company generates a hefty $26 billion in annual cash flow, which amply supports annual R&D spending of $2.3 billion and annual dividend growth that has averaged 12.4% for the past five years.

While we know any transition carries both opportunities and risks, we believe Microsoft will successfully navigate the shift to cloud computing while still delivering solid returns for shareholders. With its stock trading at a 10.7x forward P/E and offering an attractive 2.5% dividend yield, we consider Microsoft to be a solid core holding with substantial growth potential.

PNC Financial Services Group Inc. (PNC)



Price (3/30/2012)	$ 64.74	Forward P/E	9.6
Market Cap ($B)	$ 34.0	Price/Book	1.0
Dividend Yield	2.2%	Price/Sales	2.4
Tier 1 Capital	10.3%	Return on Equity	9.9%

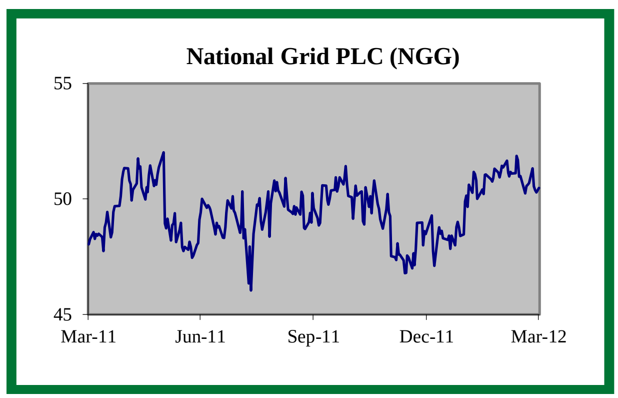
PNC is a diversified financial services company and one of the ten largest bank holding companies in the United States. It has grown in recent years primarily through selective acquisitions of distressed or poorly-performing banks (National City in 2008, RBC Bank in 2012), resulting in a doubling of assets and an expanding network of 2,500 branches throughout the Midwest, Mid-Atlantic, and Florida.

PNC management has navigated the financial crisis with great discipline, avoiding many of the pitfalls of subprime mortgages and complex securitizations that plagued so many of its competitors. As a result, the bank has emerged as one of the strongest super-regionals, with a healthy Tier 1 capital ratio of 10.3%, steadily declining loan losses at 2.2% of total loans, and a stable, low-cost deposit-funding base covering 70% of total assets.

In the recently announced Federal Reserve stress test of major U.S. banks, PNC performed well. Under highly adverse scenarios (13% unemployment, a 21% further decline in housing prices, and a 50% drop in the stock market), PNC's Tier 1 capital ratio fell from 10.3% to 5.9%, still well above the minimum requirements. As a result, and with the Fed's permission, the bank's board authorized a modest stock repurchase plan and said it will consider future common stock dividend increases.

As we have tracked the recovery of the banking sector over the last year, we have been continuously impressed by PNC's results. Management has maintained strict discipline in its pursuit of acquisitions, in its core underwriting and balance sheet management, and in overall expense controls. As such, we chose PNC as the first bank stock to be added to our core equity portfolio in several years, and we expect it to continue to perform well and reward shareholders.

National Grid PLC (NGG)



Price (3/30/2012)	$ 50.46	Forward P/E	10.2
Market Cap ($B)	$ 36.8	Price/Book	2.8
Dividend Yield	5.8%	Price/Sales	1.6
Return on Equity	28.8%		

National Grid (NGG) is one of the world's 15 largest utilities by revenue and is the dominant utility in the United Kingdom, where it generates 60% of profits. National Grid entered the U.S. market in 2007 with its acquisition of New York-based Keyspan and now generates 40% of its profits on this side of the pond.

National Grid's business is different from most regulated utilities. It fills the enviable position between energy suppliers and energy consumers as the owner of the wires and pipes through which power flows. Hence, the company operates like a regulated toll road, collecting fees when electricity or gas moves through its system. National Grid controls power lines and natural gas pipes in England and Wales serving 11 million customers. In the United States, it serves approximately 7.6 million customers throughout the Northeast.

National Grid is subject to regulated rate cycles in both the United Kingdom and United States that set allowed, after-tax returns. National Grid has done a good job increasing profits (+16% in 2011) even in the face of flat or declining rates. The company has consistently earned 1%-2% above its allowed real returns by earning operating performance incentives in its U.K. operations. In the United States, no such rate incentives or inflation protection exist. Nonetheless, National Grid has met its pledge to raise its dividend 8% annually for the past seven years, and its shares currently yield an attractive 5.8%.

In addition to an increasing payout, we expect capital appreciation in National Grid's stock as the company's networks become more and more valuable with the increased demand for natural gas transmission. Public policy mandates for cleaner-burning power and alternative energy sources continue to gain momentum both in the United States and Europe, driving upgrades to and expansion of current infrastructure. National Grid's ability to fund the large capital investments required to meet these mandates should provide earnings growth over the long term.

National Grid's balance sheet and credit profile are strong. It is modestly leveraged at an adjusted debt/total capital ratio of 62%, covers interest expense from earnings over 4.0 times, and generates an attractive 28.8% return on equity.

National Grid possesses all of the important characteristics we look for in a utility stock: a high current yield with growth potential supported by an essential service business that keeps demand consistent, returns reliable, and the dividend sustainable.

Source for charts and text: Morningstar, Value Line, S&P, Credit Suisse, company reports, EIA estimates.

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INVESTMENT ADVISORS

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