EDGEMOOR
INVESTMENT ADVISORS

Edgemoor's Quarterly Report

Suite 315
7250 Woodmont Avenue
Bethesda, MD 20814
301-543-8881
www.edgemoorinv.com
www.edgemoorblog.com

Spring 2014

Treading Water in Choppy Seas

Following its huge surge in 2013, the stock market finished the first quarter of 2014 with a slight gain. Along the way, the market had its first significant decline since last fall, pulling back almost 6% in late January before recovering and hitting new record highs in March. The drop rattled investors, who had grown accustomed to (and fond of, no doubt) the market's steady climb last year. However, despite warnings from some that stocks were overvalued and due for a sharp fall, investors digested economic reports, corporate earnings, and geopolitical events and concluded that it was simply time for the market to take a breather.

We continue to believe that stocks are likely to rise modestly through the remainder of the year, though we predict more volatility and expect to see stocks decline again temporarily, as the S&P 500 index has not suffered a 10% correction since 2011. In contrast, we consider bonds overvalued and forecast negative returns as rates rise over the next year. Read on for more details behind our outlook and comments on a hot current topic, high frequency trading.

The Polar Vortex and Other Natural Wonders

There's nothing like a modest return in the markets to make us revert to talking about the weather. During the first quarter we learned a new term, polar vortex, and suffered through the worst winter weather in years in much of the United States. We are relieved to know that our children will not be required to stay in school much beyond the scheduled release date, but it remains to be seen what the impact of the winter storms will be on the economy and corporate earnings.

Economic reports have been mixed but generally indicate slow, steady growth. Encouraging news regarding consumer sentiment, employment, and the manufacturing and service sectors give us confidence that the recovery will continue and that the chances of a significant slowdown are remote.

New Federal Reserve chair Janet Yellen seems committed to providing ongoing support of the U.S. economy by keeping interest rates low, while at the same time slowly weaning the economy and markets off the Fed's bond purchases. As we have noted in previous reports, the combination of low interest rates, modest but steady economic expansion, and tame inflation provides a favorable environment for stocks.

Just as we invoked the weather early in our commentary, corporate chieftains will be doing the same as they report quarterly earnings. Analysts currently expect a decline of about 1% from the first quarter of 2013, though we expect consumers and businesses will make up for some of the shortfall in first quarter spending over the next few months.

Elsewhere in the world, the outlook is a bit more tepid, and concerns about emerging markets were the primary catalysts for the market's fall in late

January. The strengthening of the U.S. dollar and economy has caused investors to shift money from emerging markets into U.S. investments. In addition, credit conditions and economic prospects in China are uncertain, and most analysts expect a slowing of expansion there. A decline in demand growth from the largest developing market would disproportionately hurt other developing countries, which rely more heavily than developed nations on exports of raw materials to China.

Russia's activities in Crimea also shook markets, though the impact on the global economy appears to be minimal so far. Of particular concern is the effect of any changes in the flow of energy resources to Europe, which relies heavily on imports of Russian natural gas. The economic recovery in Europe has picked up some steam but is still fragile, and a disruption of the gas supply would at least slow the rate of recovery there.

U.S. bonds held up well in the first quarter as investors sought refuge from emerging markets and mixed economic signals. However, we think this strength in bonds is temporary, since rates will most likely rise further as the economy improves and the Fed continues to gradually reduce its bond purchases. For income investments, we still favor master limited partnerships, high-yielding common stocks, convertible securities, real estate investment trusts (REITs), and preferred stocks over bonds.

High Frequency Trading

My mouse and I favor low-frequency trading, otherwise known as buy and hold. - C.W. Barron in the April 7, 2014 *Barron's*

It has been hard to miss the uproar in the news over the past few weeks regarding high frequency trading, fueled by the release of Michael Lewis's book *Flash Boys*. We have been following this story and also had the opportunity to hear Lewis speak in Washington on his book tour. There are valid reasons for concern regarding high frequency trading and its impact on the markets, but we want to reassure you that we think its impact on our ability to manage portfolios and generate attractive long-term returns is negligible.

High frequency trading refers to the practice of some investors to use technological advantages to glean data regarding major market purchases and sales before others and trade on this data to their advantage. As a result, large, institutional traders such as banks, pension plans, and mutual funds suffer a negative impact on their trades. Complicit in this practice are electronic exchanges that provide preferential access to trading data for certain investors.

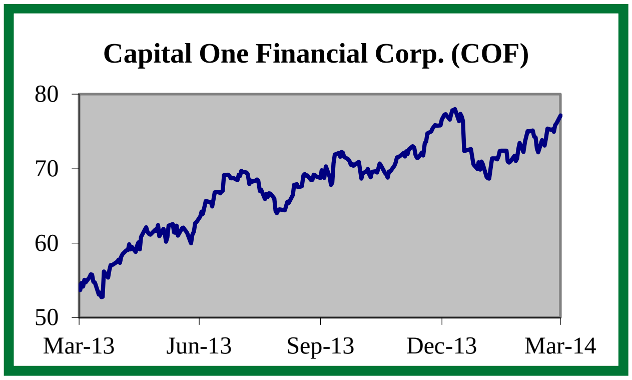
The overriding concern is that high frequency traders may hurt other investors who do not have access to the same data at the same time. Lewis tells a convincing tale and concludes that investors are harmed. We agree that some elements of the practice are unethical, and perhaps illegal, and we are glad to see various regulatory and law enforcement agencies investigating. However, due to the size of our trades and the long holding periods of our investments, we do not believe that high frequency trading materially impacts our returns.

We are fans of Michael Lewis and recommend *Flash Boys* and his other works. Just sleep well knowing that the issues raised are not presenting obstacles to our ability to help you achieve your long-term financial goals.

Analysis of Selected Securities

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

Capital One Financial Corp. (COF)



Price (03/31/2014)	$ 77.16		Forward P/E	10.4
Market Cap ($B)	$ 41.8		Price/Book	0.9
Dividend Yield	1.7%		Price/Sales	1.7
Return on Equity	9.7%			

Capital One Financial has transformed itself from a credit card company into one of the largest, full-service bank holding companies in the United States, focused on consumer and commercial lending. Since the financial crisis of 2008-2009, Capital One has made a series of opportunistic acquisitions in both traditional and nontraditional banking markets, such as the 2012 acquisitions of ING Direct's online banking business and HSBC's consumer credit business, which have allowed the company to build national scale and a low-cost, stable funding base.

Capital One operates in three major segments - credit card lending, consumer banking (auto and home loans), and commercial lending - all of which have grown steadily over the last five years. In fact, since 2009 the company has nearly doubled its assets, deposits, and revenues. Credit cards still constitute the largest part of its business, at 45% of total loans.

Capital One has managed its credit card portfolio well through the crisis and recovery by expanding it smartly and keeping loan losses below the industry average. Management has consciously traded slower loan growth for higher credit quality by shunning practices like offering low introductory rates on high-risk credit card balance transfers, which we believe sets Capital One apart from many of its competitors and will benefit the company over the long term.

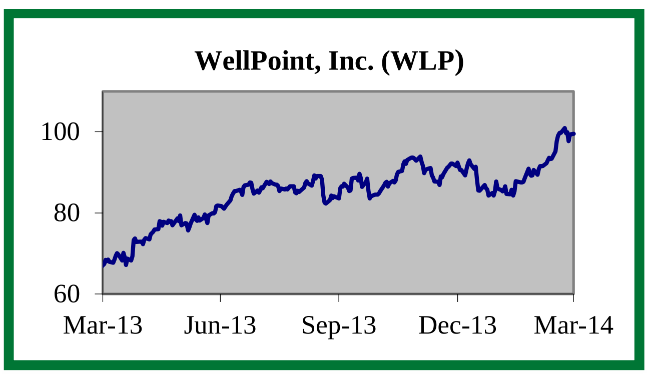
Capital One has also established itself as a leading online banker in the United States. The acquisition of ING's online banking business greatly improved Capital One's liquidity and solidified its cheaper funding base, enabling it to win loan business with competitive pricing. Over time, more online funding could also lessen the need for expensive branches, which would help Capital One's overall cost structure.

In its commercial banking operations, Capital One has utilized its low-cost deposit base to gain significant market share in densely-populated markets like the Mid-Atlantic and New York regions, while maintaining attractive net interest margins on its loan products. We expect this business to be a major growth catalyst, increasing returns and providing a stable source of capital for the bank.

Now that it has fulfilled its goal of achieving national scale, Capital One's management has returned its focus to building shareholder value. During 2013, the Federal Reserve approved both a major increase to the company's quarterly dividend from $0.05/share to the present $0.30/share (1.7% yield) and a $1 billion share buyback through 2014. In the most recent Comprehensive Capital Analysis and Review, completed in March 2014, the Fed gave approval once again to Capital One's plan to return better than 50% of its cash flow to shareholders this year through buybacks and dividend increases.

Overall, Capital One has successfully grown its many diverse business lines into a unified bank that serves its customers well, maintains strong expense controls, and produces resilient and attractive risk-adjusted returns. We believe shareholders will continue to reap the rewards of this success.

WellPoint, Inc. (WLP)



Price (03/31/2014)	$	99.70	Forward P/E	10.1
Market Cap ($B)	$	28.1	Price/Book	1.1
Dividend Yield		1.8%	Price/Sales	0.4
Return on Equity		10.3%		

WellPoint is one of the largest managed care organizations in the United States, insuring over 35 million people or nearly 1 of every 13 insured Americans. WellPoint holds the exclusive license for Blue Cross/Blue Shield plans in 14 states, including California, Georgia, New York, and Ohio. The company provides health insurance services to individuals, groups, and government-sponsored plans through a plethora of options including HMOs, PPOs, and self-insured plans. WellPoint also provides specialty products including dental, vision, behavioral health, and pharmacy benefit management plans. Finally, the company conducts general insurance operations in all fifty states and Puerto Rico, offering group term, disability, workers' compensation, and long-term care insurance.

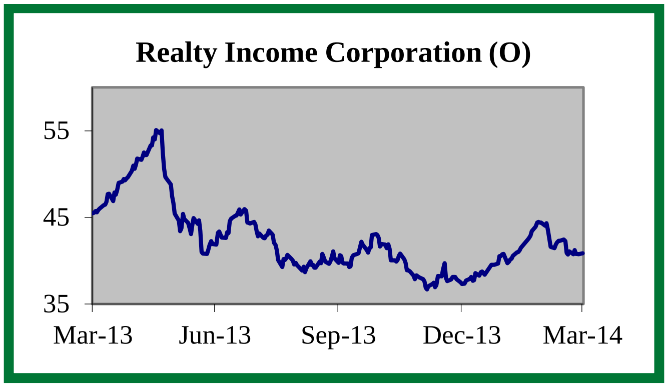
WellPoint's unmatched scale and strong operating leverage have given it significant bargaining power when negotiating discounts with healthcare providers. As a result, WellPoint is able to maintain solid profit margins in the highly competitive managed care industry.

The recently implemented Affordable Care Act has presented both opportunities and challenges for WellPoint. Enrollment mandates have boosted the company's membership ranks, particularly among government-sponsored plans, which now contribute 45% of revenues. In California, WellPoint's largest Blue Cross market, open enrollment on its exchange is expected to boost revenues by $600 million in 2014. But headwinds do exist. The operating costs associated with the new exchanges will add to WellPoint's cost structure in the near term. But over the long term, WellPoint's massive scale and pricing leverage should enable it to capitalize on coverage expansion and generate healthy returns.

WellPoint's financial position is solid. The company generates free cash flow of $2.5 billion annually and has a conservatively leveraged balance sheet at 0.4x debt/equity. Management has been using free cash flow to benefit shareholders, increasing dividends every year since they were reinstated in 2011 (current yield is 1.8%). The company has also repurchased nearly 20% of its outstanding shares since 2010, further boosting per share returns to shareholders.

Despite all of the uncertainty in healthcare markets, WellPoint has positioned itself to benefit from long-term gains in enrollment. We expect its strong market position and numerous competitive advantages to continue to benefit shareholders in the post-reform marketplace. With shares currently trading at an attractive 10.1x forward P/E and 1.1x price/book value, WellPoint represents a good long-term value position.

Realty Income Corporation (O)



Price (03/31/2014)	$	40.86	Forward Price/AFFO*	15.8
Market Cap ($B)	$	9.2	Price/Book	1.9
Dividend Yield		5.2%	Price/Cash Flow	15.5
Return on Equity		6.2%	Debt/Equity	0.9

* Forward Price/Adjusted Funds from Operations

Realty Income is a real estate investment trust (REIT) engaged in acquiring and managing primarily retail properties across the United States. As of December 31, 2013, Realty Income owned more than 3,800 properties, the vast majority of which are freestanding, single-tenant properties located in 49 states and Puerto Rico and leased under long-term agreements to more than 200 different retailers representing 49 industries.

Founded in 1970 and publicly traded since 1994, Realty Income stands out as one of the oldest and best managed companies in the REIT space. It has always employed conservative, Warren Buffett-inspired investing principles, including careful qualification of tenants, active monitoring of properties, and the use of triple–net lease structures that require the tenants, not Realty Income, to pay property taxes, insurance, and maintenance costs. As a result, the company enjoys very high earnings margins (92% on average), low tenant turnover (leases are generally 15-20 years), and high average occupancy (98% on average since 1970).

The company's properties provide a stable and reliable cash flow stream from which to pay dividends. In fact, Realty Income was one of the very few REITs to weather the financial crisis unscathed, maintaining and growing its dividend throughout. We expect dividend growth to continue, albeit modestly, given the company's proven ability to attract long-term tenants, keep operating costs low, and diversify its risk across properties, geographies, and industries.

Realty Income has a strong and conservatively structured balance sheet. Although its debt-to-equity ratio is 0.9x, the majority of this debt is mortgage debt at the individual property level, not at the corporate level, so any recourse by a lender is strictly against the property. The company's consistent ability to raise both debt and equity capital has also allowed it to take advantage of attractive acquisitions when other less-capitalized competitors could not. In 2013 alone, the company completed $4.7 billion of acquisitions, which increased revenues and earnings per share by 6% and 8.4%, respectively.

With a current yield of 5.2%, a valuation of 15.8x forward earnings (based on adjusted funds from operations, a common earnings metric for REITs), and a long history of strong, steady performance, Realty Income is an attractive income equity to hold through all types of market conditions.

Source for charts and text: Morningstar, S&P, Schwab, Value Line, and Argus research 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 $725 million 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.

Thomas P. Meehan – President
(301) 543-8881
tmeehan@edgemoorinv.com

Timothy C. Coughlin, CFP® – Managing Director
(301) 543-8371
tcoughlin@edgemoorinv.com

R. Jordan Smyth, Jr., CFA – Managing Director
(301) 543-8370
jsmyth@edgemoorinv.com

Paul P. Meehan, CFA – Managing Director
(301) 543-8373
pmeehan@edgemoorinv.com

Gay S. Truscott, CFP® – Senior Vice President
(301) 543-8375
gtruscott@edgemoorinv.com

Christine J. Potts – Vice President
(301) 543-8365
cpotts@edgemoorinv.com

Sara R. Parker – Vice President
(301) 543-8363
sparker@edgemoorinv.com

Anne Baker – Executive Assistant
(301) 543-8366
abaker@edgemoorinv.com

Suite 315
7250 Woodmont Avenue
Bethesda, MD 20814
(301) 543-8358 fax

www.edgemoorinv.com
www.edgemoorblog.com