Edgemoor's Quarterly Report

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The Waiting Game

Stocks rose slightly in the first quarter as U.S. Federal Reserve chair Janet Yellen's remarks about gradual interest rate increases comforted investors, who are adjusting to lower oil prices, a stronger dollar, and mixed economic conditions around the world. The Fed still signals a rate increase sometime this year, but certain U.S. economic indicators have increased the odds that Yellen and the other Fed governors may not take action until late in the year. Whenever it finally happens, we expect the increase in rates to be gradual and believe the U.S. economy will continue to expand.

All in all, we remain optimistic that the stock market, bolstered by the economic benefits of lower energy prices and low interest rates, will again provide positive returns in 2015. Read on for more details of our views on current market conditions and opportunities for investors.

Worlds Apart

People around the world have become increasingly connected over time, beginning with early advances in transportation centuries ago and more recently due to the development of mind boggling communications technologies widely used today. So, too, have our economies become intertwined through widespread global trade. However, economic conditions today vary greatly between the United States and other regions, and it is important to understand the implications for investors.

The United States is currently the strongest of the major global economies, even though real GDP growth has been limited to 2%-2.5% for several years and is likely to remain in a similar range in 2015. Consumer spending continues to increase, though it slowed temporarily in the first quarter partly due to bad winter weather. One sign of consumer confidence and good news for the broader economy is the nearly 5% rise in prices for existing homes over the past year. Spending by consumers, which represents 70% of GDP, and by businesses has overcome lower government outlays over the past several years to boost the domestic economy.

U.S. employers steadily added jobs in the first quarter, continuing an upward trend that decreased the unemployment rate to 5.5%**.** However, workers are still waiting to reap the benefits of the improved labor market, as wages increased only 2% over the past year, roughly in line with inflation. Wal-Mart, Target, GAP, and McDonald's recently announced raises for their lowest paid employees, a move that may portend good news for consumers but greater inflation as the labor market tightens.

The dramatic fall in oil prices - over 50% since last summer - is both good and bad for the U.S. economy but should have a positive impact overall. Lower energy prices help consumers by reducing the cost of filling their car tanks and heating their homes, freeing them to spend more with retailers and other businesses. Manufacturers also pay less for energy and other raw materials, which boosts margins and profits. The most obvious businesses to be hurt by lower oil prices are in the energy sector, though the impact varies depending on each company's focus. Oil producers suffer the most, while others, including the pipeline companies we buy for our portfolios, can benefit from any increases in transported volumes due to the surge in U.S. production. A reduction in capital expenditures by energy exploration companies will be a drag on GDP this year but will eventually lead to lower production and higher oil prices. We expect oil and gas prices to remain low for much of this year and consequently have reduced our direct investments in energy producers.

Because of the relative strength in the U.S. economy and higher interest rates here, the dollar rose about 20% against a basket of world currencies over the past year. The dollar's strength makes the United States attractive to foreign investors, who prefer to avoid investments in weak currencies and also view the United States as a safe haven from uncertainty elsewhere in the world. While U.S. consumers benefit from lower prices of imported goods, the strong dollar makes goods produced by U.S. companies more expensive abroad and has caused exports to fall.

Meanwhile, some of the world's major economies are not faring as well as the United States and require more stimulus, so central banks abroad are easing rates. The European Central Bank recently began over $1 trillion of bond purchases, similar to the quantitative easing earlier employed by the U.S. Fed, in an attempt to boost the European economy. While government bond yields are low in the United States, they are still higher than in Europe, where the German and other governments recently issued bonds with negative yields. This interest rate gap is another factor that has enticed foreign investors to purchase U.S. bonds and stocks.

In Asia, China's central bank is keeping rates low in the face of GDP growth of about 7%, significantly below historical rates, and the Japanese central bank is pursuing a similar strategy to rouse Japan from years of economic stagnation. We do not expect either of these economies to boost global growth in the near term.

Where to Invest

Given this global setting, where do we find good investments today? For starters, the relative health of the U.S. economy provides select opportunities to make good investments here at home. The S&P 500 index is trading slightly above its long-term price/earnings ratio, but we are still able to find individual stocks that are attractive. Primarily due to reduced energy company profits, analysts project corporate earnings to decline in the first quarter, but earnings should rise for the full year, and interest rates will remain low even if, as expected, the Fed begins to increase rates. Both of these factors support higher stock prices, but our expectations are for modest returns.

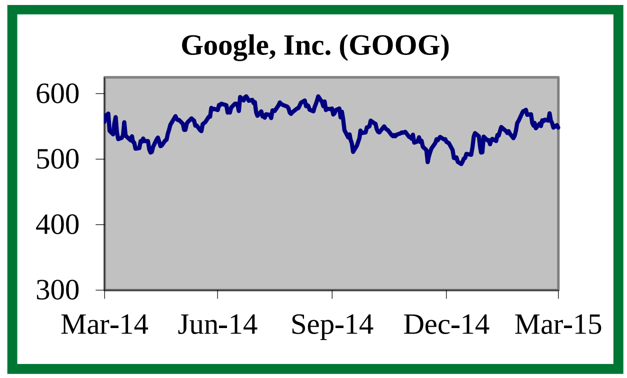
Europe and other foreign markets also present pockets of opportunity for disciplined, patient investors. Valuations are low relative to those in the United States, and the ECB's stimulative policies should begin to improve the region's economy and lift earnings. In Japan, Prime Minister Abe's economic reform policies are boosting growth. As discussed below, we are currently using several value-oriented mutual funds to gain diversified exposure to foreign markets.

For income, we continue to favor utilities, real estate investment trusts, preferred stocks, master limited partnerships, and convertible securities over bonds in the current environment of low interest rates that are likely to rise. These securities offer higher current yields than most bonds, and we expect many of them to increase their payouts to investors at rates higher than inflation.

Analysis of Selected Securities

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

Google, Inc. (GOOG)



Price (3/31/2015)	$ 548.00	Forward P/E	17.0
Market Cap ($B)	$ 373.0	Price/Book	3.6
Dividend Yield	0.0%	Price/Sales	5.7
Return on Equity	15.1%	Revenue Growth	20.3%

Google, Inc. is the dominant player in Internet search and online advertising with a commanding 60% market share worldwide. The company is also a full-service provider of Internet services to consumers, advertisers, and content providers.

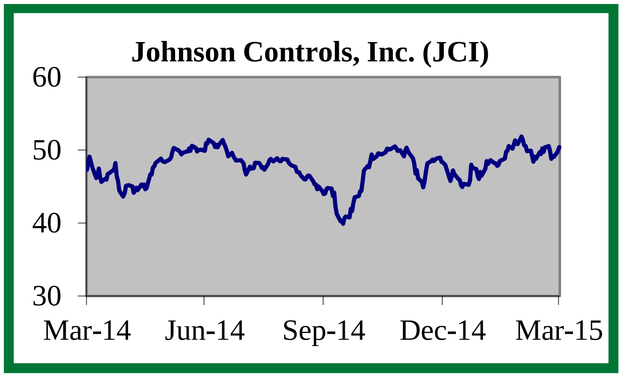
Over the last several years, Google has expanded its product offering to include email service Gmail, the Chrome Internet browser, Google Maps and Google Earth, and the mobile Android operating system. It also has acquired market-leading Internet platforms such as YouTube and DoubleClick. Together, these core assets provide a cohesive, end-to-end experience for consumers and, most importantly, drive Internet advertisers to Google sites.

The online advertising market is still considered to be in the early stages of growth. As digital ad spending continues to rise, it will increasingly consolidate around companies with broad platforms and unique assets. Google is such a company. Its 60% global market share in search eclipses all its competitors, none of which have more than a 10% share. Among mobile devices (phones and tablets), it is estimated that 90% of mobile searches are performed on Google. Consumers' use of Google is now almost habitual, creating a switching cost based on familiarity and not just technology, and should continue to protect Google's online dominance and fuel growth.

Google's financial position is as strong as its market presence. The company generated a record $66 billion of revenues in 2014, an increase of 19% over 2013. Google also generated $11.4 billion in free cash flow and holds $64 billion in cash and marketable securities. The company's long-term debt is just $3.2 billion, and total shareholder equity exceeds $100 billion.

While Google stock is trading roughly in line with the S&P 500 average of 17x forward earnings, it trades at a significant discount to that average when adjusted for Google's large cash position. Furthermore, we believe the company's higher than average growth prospects and strong competitive advantages make this stock an attractive long-term growth investment for investors.

Johnson Controls, Inc. (JCI)



Price (3/31/2015)	$ 50.40	Forward P/E	12.3
Market Cap ($B)	$ 32.6	Price/Book	3.1
Dividend Yield	1.9%	Price/Sales	0.8
Return on Equity	11.2%		

Johnson Controls, Inc. (JCI) is a diversified industrial manufacturer that holds leading market positions in three major business segments: Automotive Interiors, Building Efficiency Systems, and Power Solutions. The company began in 1885 as the inventor of the first electric room thermostat and today is an innovator in products ranging from advanced hybrid batteries to fire systems and energy management services.

JCI has long held a dominant market position as a manufacturer of components for automotive interiors, including seating and electronic displays. JCI's size and scale have afforded it competitive advantages that include being both the low cost producer and among the most innovative and technologically-advanced. But in recent years, JCI has successfully diversified away from this highly-cyclical sector, reducing Automotive Interiors' share of total company revenues to 51% in 2014 from 69% in 2005.

JCI has focused increasingly on the emerging Building Efficiency and Power Solutions segments, where gains have more than outpaced declines in Automotive. Building Efficiency grew to 33% of sales in 2014 from just 21% in 2005, while generating 80% of segment sales from highly profitable, repeat business. Power Solutions, which includes both traditional automotive batteries and the patented start-stop battery technology for hybrid vehicles, is a highly profitable segment with strong growth potential. European auto production is forecasted to increase its use of advanced battery systems to 75% in 2015 from 40% in 2011, while North American adoption should rise to nearly 60% this year from zero in 2011. As the dominant producer of these batteries, JCI is well-positioned to benefit from these trends.

JCI's financial position is strong, characterized by solid free cash flow, rising margins, and manageable debt. Management has also shown itself to be shareholder friendly, committing to paying out 30% of earnings and initiating a $3.65 billion share repurchase program for 2014-2016, of which half has been completed to date. The stock is attractively valued at 12.3x forward earnings and pays a growing dividend which currently yields 1.9%.

Dimensional Fund Advisors International Mutual Funds

Having underperformed in recent years, foreign stocks have done better than U.S. stocks so far in 2015, a trend we expect to continue. While the strength of the dollar has masked the return of foreign stock markets for U.S. investors, we believe that exchange rates will even out over time and that the attractiveness of overseas stock markets is compelling. As a result, we increased and broadened our direct exposure to foreign stocks by adding funds from Dimensional Fund Advisors (DFA) to our portfolios.

DFA is a global investment firm that was founded in 1981 and today manages nearly $400 billion for investors worldwide. DFA takes a unique approach to investment management, viewing it as a science by which investment strategies are developed based on large bodies of empirical research and subject to rigorous review and testing. This disciplined approach allows DFA to avoid chasing trendy investment themes and ultimately to generate higher returns than traditional index funds.

We began investing in select international DFA funds in 2014 – specifically buying the DFA International Core Equity Fund (DFIEX) and the DFA International Small Cap Value Fund (DISVX) – to gain broad, multi-cap, international exposure and to complement the individual foreign stocks in our portfolios like Nestle (NSRGY), Novartis (NVS), and Sanofi (SNY). We chose DFA as a manager after a lengthy review of its investment philosophy, procedures and performance, as well as face-to-face meetings with its portfolio managers and academic advisors. We liked DFA's value orientation, disciplined process, and low cost.

DFA does not take a traditional market-weight approach to portfolio construction, instead selecting its own criteria which empirical data shows to have historically resulted in higher expected returns. This approach has led DFA to favor companies with lower valuations, smaller market capitalizations, and stronger profitability than market-weighted averages. DFA funds also have a structural cost advantage because they do not track an index and therefore are not forced to trade at a particular time, which results in lower overall turnover (generally less than 10%) and lower expenses. Finally, DFA's board of directors is composed of an impressive group of leading academics who help set and monitor the firm's quantitative strategies and provide the foundation of the firm's strong governance.

We believe international, multi-cap exposure is an important component of diversified portfolios and currently presents among the most attractive market opportunities for investors. Accordingly, our investments in DFA international funds will represent a core allocation in our client portfolios.

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 $825 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.

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