EDGEMOOR
INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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A Good Start

Continuing the rally that began last fall, the S&P 500 index returned 6.1%, including dividends, in the first quarter of 2017. Investors, consumers, and businesses gained confidence in ongoing economic growth, due to improvement in corporate earnings and anticipated policy actions by the federal government. Foreign markets also surged amid fairly consistent global economic expansion, optimism about the potential for higher corporate earnings, and generally low inflation and interest rates.

U.S. stock valuations are now a bit lofty overall, with the S&P 500 index trading at a multiple of earnings that is above its historical average. Nevertheless, we remain confident regarding the long-term prospects for our holdings, which trade at a significant discount to both the broad market and our estimates of intrinsic value.

Mostly Sunny

We believe the backdrop for market performance is currently favorable in many ways. Economic growth is steady in most regions of the world, and various indicators point to ongoing expansion. Consumer confidence in the United States is at a 16-year high, and businesses are also optimistic about their prospects. Unemployment remains below 5%, and inflation has approached the Federal Reserve's target level of 2%. Moderate inflation is positive for spending, corporate earnings, and overall economic growth, as it gives consumers and businesses an incentive to purchase goods and services sooner rather than later.

Commodity prices have risen in response to global demand, including from the large and influential Chinese market. Oil prices have eased recently but remain near $50 per barrel, a price far above the $26 of last February and one that has boosted energy company profits compared to last year.

Despite forecasts of further strengthening this year, the U.S. dollar has declined, partly due to concerns about potential policy changes that would restrict trade. This pullback is good news for U.S. exporters, whose goods are more competitively priced when the dollar declines.

Tempering the outlook are ongoing political squabbles in the United States and concerns about the economic implications of protectionist and anti-immigration movements around the world. Fortunately, the Trump administration appears to be moderating its stance toward the North American Free Trade Agreement, and we are optimistic that any changes will not unduly hinder the free trade that we believe benefits the U.S. and global economy overall. However, populist sentiment in Europe may lead to restrictions on trade and immigration that could derail economic expansion there, depending partly on the outcome of upcoming elections in France, Germany, and Italy.

Shifting Focus

Since the U.S. elections, investors have bid up stocks partly in anticipation of tax reform, regulatory easing, and infrastructure spending promoted by the White House. The shares of banks and construction companies, in particular, surged into the new year, based on expectations that banks would benefit from looser capital requirements and construction company revenues would rise on increased infrastructure spending.

More recently, investors have become warier of the timing and magnitude of the policy changes that will actually be enacted. While Trump has already begun to ease some regulations through executive orders, the process required to make changes to established policies is lengthy. In addition, the failed attempt to repeal the Affordable Care Act is an indication of the difficult battles to come over tax reform and infrastructure spending. Though many members of both political parties favor these initiatives, disagreement looms over the specifics of proposed changes and the impact on the federal debt.

In acknowledgement of the challenges to passing legislation to fulfill campaign promises and boost economic growth, investors have tempered their enthusiasm for bank and infrastructure stocks, which have declined from their previous highs. Instead, investors have shifted their focus to corporate earnings and have begun to favor those companies that appear to be benefitting already from realized and expected economic expansion. For example, technology companies rallied in the first quarter as earnings reports from the fourth quarter of 2016 confirmed solid growth trends.

Another important shift in the markets stems from the U.S. Federal Reserve's recent decision to raise short-term interest rates and confirmation of its plans to do so another 2-3 times this year. The Fed is also exploring ways to reduce its inventory of securities purchased as part of its effort to stimulate the economy after the financial crisis. Reducing these positions would put upward pressure on long-term interest rates and provide another signal of the Fed's confidence in the economy. As the Fed continues unwinding its support, investors will increasingly price securities based on economic and corporate fundamentals.

Both of these shifts in investor focus lead to the renewed importance of corporate profits, not broad macroeconomic factors, as the primary basis for stock valuation. Analysts expect first quarter 2017 earnings of S&P 500 index stocks to increase about 9% compared to last year, which would be the strongest result since 2011. Robust profits would confirm the health of the economy and provide support for current and potentially higher stock prices. In another encouraging sign, we expect corporate revenues to increase about 7%, the largest bump in five years and an indication that companies no longer must rely on cutting costs to increase earnings.

The overall market may need a boost from earnings to support current valuations, and we expect the market will pull back at some point, as it regularly does after long stretches of gains. However, we believe the stocks we own are somewhat protected from a broad downturn, since they trade on average at a multiple of earnings much lower than the multiple for the broad stock market. We remain optimistic for attractive long-term returns for our value-oriented positions.

For income holdings, we continue to favor securities other than bonds. Interest rates have ticked up since November, but yields are still near historically low levels. We are keeping an eye out for bonds that may become attractive as rates rise, but for now we prefer other asset classes with higher yields. Assets we are currently buying for income include common shares of utilities, telecommunication companies, pipeline companies, and real estate investment trusts, as well as preferred stocks and high-yielding closed-end funds that trade at a discount to net asset value.

Analysis of Selected Securities

Following is a discussion of three securities we own and have bought recently. Due to issues specific to each company, these stocks are, in our opinion, priced attractively in the markets today.

Lowe's Companies, Inc. (LOW)

Past performance is not indicative of future results. Please see disclosures on page 8.

Price (03/31/2017)	$ 82.21	Forward P/E	17.7
Market Cap ($B)	$ 70.70	Price/Book	10.7
Dividend Yield	1.6%	Price/Sales	1.2
Return on Equity	32.5%		

Lowe's is the second largest home improvement retailer in the world, generating $65 billion in annual sales and operating 2,375 stores in the United States, Canada, and Mexico. The states with the highest concentration of Lowe's stores are Texas, Florida, North Carolina, and California. The company sells products and services to both do-it-yourself retail customers (about 75% of sales) and to professional contractors (25%) for the maintenance, repair, remodeling, rebuilding, and decorating of homes and businesses.

Its size and scale afford Lowe's numerous competitive advantages, including consolidated purchasing power, operational leverage, and a low-cost edge tied to its automated distribution network that links vendors, distribution centers, and stores on one technology platform. This logistical advantage over chief rival Home Depot has bolstered returns and supported the company's wide economic moat even during economic downturns.

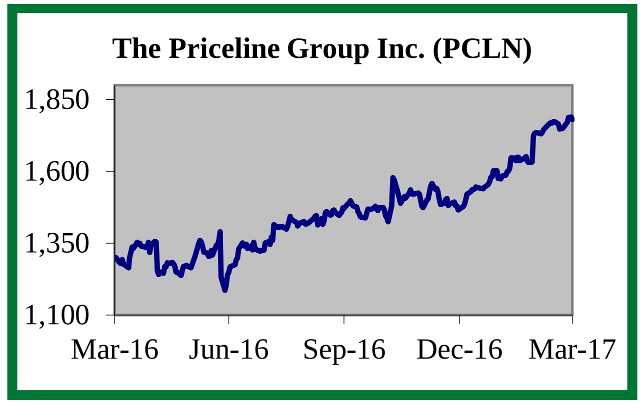
Lowe's experienced significant growth in recent years as the economic recovery led to a rebound in home improvement projects and related sales of big-ticket items like appliances and kitchens. In addition, unlike many retailers, Lowe's is largely insulated from internet competition due to the difficulty in shipping its large, bulky items and the company's emphasis on customer service, product knowledge, and end-to-end project solutions.

We believe Lowe's has the potential to enjoy continued growth from a sustained increase in housing prices (driven by demand in many major markets that continues to outstrip supply), an improving job market, and moderate GDP growth. In addition, with about two-thirds of homes in the U.S. now more than 25 years old, the upgrade cycle for home improvements is still in the early stages. Finally, Lowe's and Home Depot together account for only about 20% of the total retail home improvement market, leaving significant room for growth and consolidation in most major markets.

Lowe's is currently financially strong, with high returns on equity, strong cash flow generation, and low debt. The company owns more than 85% of its stores, which makes its real estate a significant asset that is carried on its balance sheet at an estimated 60% of non-depreciated value. Lowe's is also friendly to shareholders, with a strong record of share buybacks and dividend increases. The company has boosted its dividend every year since 2003, including through the 2008-2009 recession, most recently increasing it 25% in May 2016 to $1.40 per share. Lowe's repurchased $3.5 billion of its stock in the past year, and its board recently authorized a new $5 billion share repurchase plan.

Lowe's shares currently trade at 17.7x fiscal 2018 earnings, which is a discount to its five-year historical average. In our opinion, Lowe's deserves a premium valuation due to its strong growth prospects, and we believe there is potential upside for investors.

The Priceline Group Inc. (PCLN)



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Price (03/31/2017)	$1,779.97	Forward P/E	20.7
Market Cap ($B)	$ 86.9	Price/Book	8.8
Dividend Yield	0.0%	Price/Sales	8.2

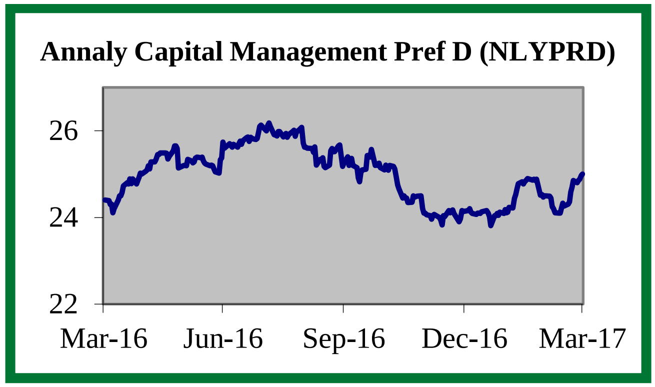
The Priceline Group provides a broad range of online travel services, including airline tickets, hotel rooms, car rentals, vacation packages, cruises, and restaurant reservations. The company connects consumers with providers of travel services across the world. Priceline's brands include Booking.com, Priceline.com, Agoda.com, KAYAK, Rentalcars.com and OpenTable. As of year end 2016, Priceline offered reservation services for over 1.1 million properties in 220 countries and in more than 40 languages worldwide.

The online travel category has seen rapid growth as consumer purchasing shifts from traditional channels to interactive online channels. Priceline has positioned itself well to benefit from this growth by establishing itself as the largest purveyor of online travel and hotel reservation services in the world. The company is currently the leader in the European and Chinese travel markets, and it is the fastest growing travel service in North America, Asia, and Latin America. Priceline generates the majority of its nearly $10 billion in annual revenues in international markets (55% from Europe alone). Priceline also enjoys a dominant position in mobile application bookings, which are the fastest growing segment of online travel services.

We project the company's five-year earnings growth rate to average 20% annually, reflecting the large, still-untapped market for online travel bookings. In addition, we expect Priceline to continue to enhance its offerings by improving functionality, selection, and pricing, by adding more content and merchandising, and by pursuing cross-selling opportunities among its various websites.

We believe the company is financially sound, with high returns on equity, current robust growth and cash flows, and a history of positive earnings surprises. Although the company does not pay a dividend, it has returned cash to shareholders through a $3 billion buyback program in place since 2015. Priceline shares are attractively valued at 20.7x 2018 earnings, which is in line with historical averages and we believe reflects the company's leading market position, strong growth prospects, and history of positive earnings surprises.

Annaly Capital Management Preferred Stock



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Price (03/31/2017)	$25.00	Preferred Coupon	7.5%
Par Value	$25.00	Market Cap ($B)	$11.3

Annaly Capital Management's preferred shares (NLYPRD and NLYPRE) are examples of the kind of income investments we seek for clients to generate what we believe are reliable, consistent, and attractive dividends as part of a diversified income portfolio.

With a market capitalization of $11.3 billion, Annaly Capital Management is the largest U.S. mortgage real estate investment trust (REIT). Annaly invests primarily in residential and commercial real estate mortgages, including mortgage-backed securities (MBS), collateralized mortgage obligations, agency callable debentures, and other mortgage-related securities. MBS, which represents approximately 80% of Annaly's total investment portfolio, are mortgages backed by government-sponsored agencies like Fannie Mae and Freddie Mac. In the remaining 20% of its portfolio, Annaly holds investments in non-agency residential mortgages and commercial mortgages.

Annaly's principal business is to generate income from the spread between the interest income on its mortgage-backed securities and the cost of borrowing to finance the purchases. Unlike many of its mortgage REIT peers, Annaly maintains a relatively low level of debt, with an overall leverage ratio of 6.4x equity at year end 2016. Other mortgage REITs carry leverage ratios as high as 12x equity. In addition, Annaly hedges a large portion of its mortgage portfolio to protect against the effects of rising interest rates.

In 2016, Annaly acquired fellow mortgage REIT Hatteras Financial for $1.5 billion in a deal that was accretive to both Annaly's book value and earnings. We view the Hatteras deal favorably, as it added complementary assets to Annaly's investment portfolio and broadened its investment options at an attractive price.

Annaly's preferred shares, which rank above its common stock in both dividend payments and liquidation value, carry what we believe to be attractive fixed coupon rates of about 7.5%, payable quarterly. In the current environment, we believe Annaly's high yielding preferred shares are an attractive income alternative to low-rate bonds.

We Welcome Bobby Roane to Edgemoor

We are pleased to announce the newest addition to our team, Bobby Roane. A native of Springfield, Virginia, Bobby joins us as an Analyst and Assistant Trader after 2 ½ years at Capital One Bank. Bobby graduated with distinction from the University of Virginia.

Source for charts and text: Morningstar, S&P, Schwab, Value Line, Black Diamond Performance Reporting, 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 $867 million as of March 31, 2017 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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