Edgemoor's Quarterly Report

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

April 2018

The Return of Volatility

After rising steadily for nine consecutive quarters and through January of this year, the stock market fell in February as volatility returned with a vengeance and investors became concerned about signs of higher inflation and potential trade wars. Following this jolt, March brought turmoil in the technology sector primarily due to data security and privacy issues. The S&P 500 declined 0.8% for the first quarter, a mild drop that did not fully reflect the angst felt by most investors as they watched the formerly calm market suddenly swing sharply. Bonds and other income investments fell more than stocks as interest rates rose.

The same worries linger as we begin the second quarter. However, there remain reasons for optimism, including steady economic growth and strong gains in corporate earnings. We believe the good news is likely to outweigh the bad through the course of the year, leading to modest gains in the market, but we also expect ongoing volatility.

First Quarter in Review

Stocks got off to a good start in January as the market celebrated December's tax bill, which is expected to provide a boost to corporate profits and consumer spending. The market hit a rough patch in late January and early February, when the S&P 500 index fell just over 10% and experienced its first correction (a drop of 10%-20% from the previous high) since early 2016. Stocks declined as data showed January wage growth accelerated at a more rapid rate than anticipated, stoking fears that a pickup in growth and inflation would cause the Fed to raise rates more quickly than expected. Volatility rose sharply: the CBOE Volatility Index, or VIX, spiked to 37 in early February, its highest level since 2015. The VIX fell back to about 20 but remains nearly double its average level throughout 2017, the calmest year since its inception in 1993.

Adding to investor concerns, the Trump administration announced its intention to impose tariffs on steel and aluminum imports, drawing criticism from trading partners and raising fears that affected countries would retaliate. Tariffs that might help the struggling U.S. steel industry avoid further declines are bad news for the much larger number of domestic companies purchasing steel for use in manufacturing products. These firms also employ far more people than the steel industry, and the net effect of tariffs on the U.S. economy would likely be negative.

Stocks recovered from their early February swoon, but then the technology sector came under pressure in March, dragging the major indexes down with it. Technology stocks now comprise 27% of the S&P 500 index, so moves in the technology sector have a dramatic impact on the broader stock market. The threat of increased regulation was the major issue, and the revelation of a large data breach at Facebook was the primary culprit. In addition, presidential tweets attacking

Amazon spooked investors, who feared the prospect of harmful actions by the government against this stalwart of the technology sector.

Meanwhile, the U.S. economy marched on, propelled by robust consumer spending and optimism about the tax cuts enacted at the end of last year. Consumer confidence remained high, employers added an average of 202,000 jobs each month during the quarter, unemployment stayed low at 4.1%, and wages increased 2.7% since last March. Fourth quarter GDP increased 2.9%, and we believe first quarter 2018 GDP will come in equally strong at 2.5%-3.0%. Core inflation was tame at 1.8%, below the U.S. Federal Reserve's target of 2.0%.

Elsewhere around the world, economic expansion also continued in the first quarter, though there are some signs of slowing growth in Europe. As in the United States, stocks fell in other major developed markets, while they rose slightly in emerging markets.

As expected, the Fed raised the federal funds rate by 0.25% in March to 1.75%. The Fed confirmed its plans to raise rates 0.25% a total of three times this year and lifted its forecast of the number of rate increases and the level of interest rates in 2019 and 2020, an indication that the Fed believes economic growth will continue. Reflecting the Fed's move on rates and its economic outlook, bonds fell and yields rose during the quarter, with the yield on the 10-year Treasury ending at 2.7%. In fact, bonds fell more than stocks as investors anticipated more increases in interest rates over the next few years.

Our Outlook

Investors remain concerned about market volatility, the trajectory of interest rates and inflation, the risk of a global trade war, and the potential for greater scrutiny and regulation of technology companies. The most recent AAII survey of investor sentiment showed individual investors to be the most pessimistic in at least seven months, a stark contrast to the bullish sentiment in January.

However, we believe strong corporate earnings, reasonable valuations, and steady economic growth will continue to support stocks in this tenth year of the current bull market. Earnings for S&P 500 companies rose 21% in the fourth quarter compared to the same quarter a year earlier and are projected to climb 25% in 2018, an extraordinary rate of growth that is partly due to the impact of corporate tax cuts. The recent market pullback presents some buying opportunities, and we think the technology stocks we own will still be able to deliver robust gains in revenues and earnings even if they face additional regulation.

We expect the U.S. economy to continue its steady expansion even as the Fed removes some of the monetary stimulus it has provided since the Great Recession and continues to gradually raise rates. We believe the markets should take the Fed's expected moves in stride, but any larger or more frequent rate increases would likely rattle investors. The synchronized global expansion that began last year should continue in 2018, with global growth projected to reach 3.7%, the best since the Great Recession.

Solid global economic growth has the potential to support equity markets outside the United States and boost revenues for U.S. multinationals. Of course, threats of tariffs could lead to a trade war that saps economic growth. Particularly worrisome is the escalation of U.S. threats directed at China. After leading with proposed tariffs on $50 billion of Chinese imports, which China quickly matched with its own tariffs on the same value of U.S. exports, President Trump recently added another $100 billion to his tariff goals. As global leaders move beyond threats and into the negotiation stage over the next several months regarding these latest trade issues, particularly between the United States and China, we will keep a close eye on developments and the potential impact on the securities we own.

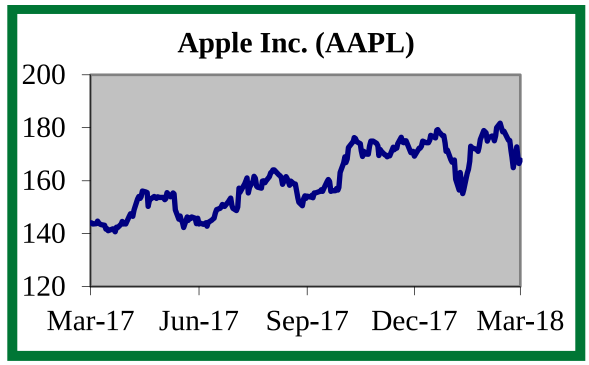
The primary risks to our positive outlook, in our view, are rising interest rates and further protectionist measures disrupting global trade, both of which could hinder economic growth around the world. Over the longer term, the increase in government debt resulting from recent tax cuts and greater government spending poses long-term risks to the U.S. and global economies.

Because corporate earnings have risen sharply while stock prices fell slightly, the forward price/earnings multiple of the S&P 500 index has fallen to about 16.5, down from 18.6 in late January and the lowest since November 2016. The stocks we own trade at a lower average price/earnings multiple, since we seek stocks trading for a significant discount to our estimates of their intrinsic values. We have already seen one correction in 2018 and would not rule out another; however, we currently expect stock prices at the end of 2018 to be higher than today and intend to follow our disciplined investment strategy.

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.

Apple Inc. (AAPL)



Past performance is not indicative of future results. Please see disclosures on page 9.

Price (03/31/2018)	$ 167.78	Forward P/E	14.9
Market Cap ($B)	$ 854	Price/Book	6.0
Dividend Yield	1.5%	Price/Sales	3.6
Return on Equity	37.1%	Debt/Equity	1.2

Founded in 1976 in Steve Jobs's garage, Apple is currently the largest company in the S&P 500 index as measured by its market capitalization of $854 billion, up from $520 billion when we last reviewed Apple in early 2016. Given its continuing strong momentum, we would not be surprised to see Apple become the first-ever trillion-dollar company in the S&P 500.

Apple is best known as the maker of the iPhone, iPad tablet, Mac computers, iPod digital media player, and the Apple Watch. In addition, the company provides an array of software and services including Apple Music, Apple Pay, iTunes, and iCloud storage services. We believe Apple's unique strength lies in its expertise integrating hardware, software, and services into one technological ecosystem, which leads to a seamless user experience across multiple devices, high switching costs, and intense customer loyalty (retention rates are close to 90%). The appeal of Apple's products and services has led to enormous growth in Apple's installed base of users, which today numbers nearly 1.3 billion people worldwide.

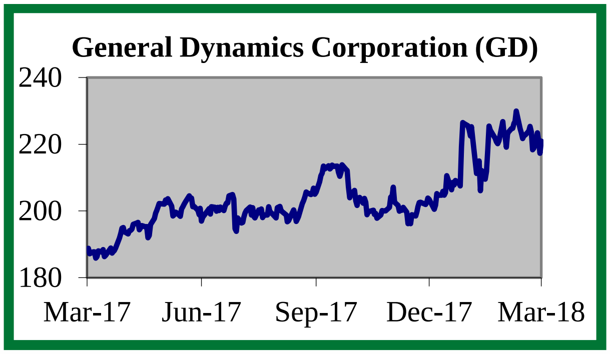
Apple has increasingly focused on software and services to boost the percentage of revenues the company derives from higher margin and more sustainable service offerings. Recent initiatives include better integrated operating systems for iPhone (iOS), Mac (macOS), and Apple Watch (wOS); continued expansion of the Apple Pay electronic payments platform; and growth of the iCloud Drive, which makes all files accessible across multiple devices. Overall service revenues grew by 23% in 2017 to nearly $30 billion and are expected to continue this positive trajectory.

Apple still derives roughly 70% of its total revenues from the iPhone, with the newly introduced iPhone 8, iPhone 8 Plus, and iPhone X pushing up the average selling price (ASP) of smartphones 15% in the fourth quarter of 2017, even as unit sales dropped slightly to 77 million. The higher ASP drove double-digit revenue, earnings, and cash flow growth in the quarter, and total cash now stands at $285 billion, or approximately $32 per share.

Apple is expected to be one of the biggest beneficiaries of recent U.S. tax reform, which will enable the company to repatriate a large portion of its overseas cash and cut its future tax rate to an estimated 15%. Expected uses of the repatriated cash are likely to be further dividend increases and stock buybacks, with the company committing to return $300 billion to shareholders by March 2019. In addition, analysts believe that Apple could pursue a large media acquisition, as the company has already started investing in its own digital content, including films and TV shows.

In our opinion, all of these initiatives mark the transition of Apple from a high-growth technology company to a mature, value-oriented business with an increased focus on shareholder returns. Apple stock, which is currently valued at 14.9 times forward earnings, remains priced at a discount to the overall market and to historical averages. Net of cash, the forward price-to-earnings multiple drops to just 12 times, which is especially compelling for a company currently poised to deliver 18% average earnings growth for the next several years.

General Dynamics Corporation (GD)



Past performance is not indicative of future results. Please see disclosures on page 9.

Price (03/31/2018)	$ 220.90	Forward P/E	19.7
Market Cap ($B)	$ 65.5	Price/Book	5.7
Dividend Yield	1.5%	Price/Sales	2.2
Return on Equity	26.0%	Debt/Equity	0.4

Virginia-based General Dynamics is the world's fourth largest defense contractor and the second largest maker of corporate jets. The company will operate in five primary business lines following its pending acquisition of information technology (IT) services firm CSRA later this year: Aerospace (24% of pro forma 2018 revenues), Combat Systems (16%), Marine Systems (23%), Information Technology (25%), and Mission Systems (12%). The company derives approximately 61% of its revenues from the U.S. government, 25% from foreign sales, and the remainder from Gulfstream business jets.

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 Aerospace segment, which includes Gulfstream business jets, enjoys a commanding position in the high end of the large-cabin jet market, with a fleet of over 2,000 aircraft in service and a backlog of orders valued at over $12.4 billion. Production levels are expected to remain strong for the next several years as the company ramps up production of its new G650 and G280 models. High demand in Asia is another long-term driver of growth in this segment.

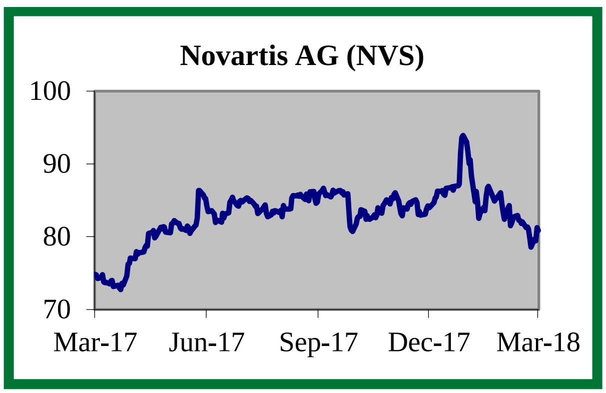
General Dynamics's Combat and Marine Systems segments are enjoying a resurgence of growth tied to increased military spending by the current administration. New products like the upgraded M1A1 Abrams tank and the VA-class nuclear submarines form the backbone of U.S. defense and give General Dynamics an incumbency advantage over its competitors. The backlog in these two segments remains strong at nearly $43 billion, representing more than two years' worth of sales.

The IT Services segment is also benefitting from overall growth in the industry as well as rapid consolidation of providers. General Dynamics has announced plans to acquire CSRA, a government IT services firm, in mid-2018 for $9.6 billion, including the assumption of $3 billion of debt. The deal will nearly double the size of General Dynamic's IT services business and make it one of the largest IT contractors for the U.S. government, with a size, scale, and cost advantage that few other firms can match.

General Dynamics is known for its focus on efficient operations and its commitment to delivering shareholder value. Since 2013, CEO Phebe Novakovic has overseen the expansion of the company's net profit margin by nearly 30% and an increase in the return on shareholder equity to 26% from 20%. The balance sheet is currently strong with $3 billion of cash and just $4 billion of debt. In 2017, General Dynamics raised its dividend for the 20th consecutive year, and the company continues to use excess cash to buy back its stock. Over the past three years, General Dynamics has returned nearly $10 billion to shareholders in the form of dividends and buybacks, a trend we expect to continue.

GD stock trades at 19.7 times forward earnings, in line with both its historical range and industry averages. We believe earnings will continue to grow and boost the share price over the coming years.

Novartis AG (NVS)



Past performance is not indicative of future results. Please see disclosures on page 9.

Price (03/31/2018)	$ 80.85	Forward P/E	15.0
Market Cap ($B)	$ 185.2	Price/Book	2.5
Dividend Yield	3.7%	Price/Sales	3.8
Return on Equity	10.3%	Debt/Equity	0.3

Swiss firm Novartis AG is one of the world's largest pharmaceutical companies and holds leading positions in multiple key healthcare businesses, including branded prescription drugs, generic drugs, eye-care products, and consumer products. While most of its competitors focus solely on the high-margin branded pharmaceutical segment, Novartis runs several complementary operations that serve to reduce overall volatility and create cross-segment sales opportunities.

Novartis is organized into three operating divisions: Innovative Medicines (68% of sales), Sandoz generics (20%), and Alcon eye care (12%). Growth in Innovative Medicines has been driven by both strength in existing drug lines as well as a robust late-stage pipeline of new drugs. Novartis also differentiates itself by the sheer number of blockbuster drugs in its portfolio, including recently-launched Entresto for heart failure and psoriasis drug Cosentyx, both of which have experienced dramatic surges in sales. In addition, four of its in-development drugs were recently designated "Breakthrough Therapies" by the FDA for their newly-indicated treatments.

The company's Sandoz generics group, while facing stiff competition and pricing pressure in the U.S., still plays an important role in the overall portfolio by extending the sales cycle of many in-house drugs by promoting their generic alternatives as patents expire. Similarly, Novartis's Alcon eye care division has seen a rebound in its overall performance since being acquired in 2011 and is expected to contribute significantly to the consumer group as it captures more sales from the fast-growing eye care industry.

Novartis has been repositioning its portfolio to divest non-core assets and focus on high margin products. The company sold its animal health segment to Eli Lilly last year and recently announced the sale of its vaccine unit to Glaxo for $13 billion. Other possible divestitures include its 33% stake in Roche (estimated to be worth $15 billion) and a possible spin-off of Alcon in 2019 for close to $20 billion. Armed with significant cash from these sales, Novartis would be well positioned to make a major acquisition, with many analysts predicting Bristol-Myers Squibb, with its leading share in immunotherapy, as a possible target.

Novartis shares are attractively priced at 15 times forward earnings and offer a healthy 3.7% dividend yield. We believe future prospects for Novartis are good due to its diverse, well-positioned operating platform and strong pipeline of new products.

Source for charts and text: Morningstar, S&P, Schwab, ValueLine, Black Diamond Performance Reporting, Yahoo Finance, 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 $920 million as of March 31, 2018 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

Robert H. Roane – Analyst and Assistant Trader
(301) 543-8364
rroane@edgemoorinv.com

Christine J. Potts – Vice President
(301) 543-8881
cpotts@edgemoorinv.com

Sara R. Parker – Vice President
(301) 543-8881
sparker@edgemoorinv.com

Anne B. Baker – Senior Executive Administrator
(301) 543-8366
abaker@edgemoorinv.com

Suite 315
7250 Woodmont Avenue
Bethesda, MD 20814
(301) 543-8881
(301) 543-8358 fax

www.edgemoorinv.com
www.edgemoorblog.com

Past performance is not indicative of future results. The information provided in this report should not be considered financial advice or a recommendation to buy or sell a particular security. There is no assurance that any securities discussed herein will be included in or excluded from an account's portfolio. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. The current yields of the specific securities referenced herein may not be a reliable guide to future performance. Yields and gross returns to individual investors will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Edgemoor Investment Advisors, Inc. reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. All recommendations for the last 12 months are available upon request.

The S&P 500 index is an unmanaged market-capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. The MSCI ACWI ex USA Index is an unmanaged market-capitalization-weighted index of 1,866 stocks representing 85% of the global equity opportunity set outside the United States. The S&P 500 index and MSCI ACWI ex USA Index are discussed for comparative purposes only. The comparisons have limitations because the indexes have volatility, investment, and other characteristics that differ from the investment strategies of Edgemoor. Further, it is not possible to invest directly in the indexes.

Edgemoor Investment Advisors, Inc. is an independent investment adviser registered under the Investment Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training. More information about Edgemoor Investment Advisors, Inc. including our investment strategies, fees, and objectives can be found in our ADV Part 2, which is available upon request.