EDGEMOOR
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Edgemoor's Quarterly Report

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Summer 2012

The Market Takes a Breather

After beginning 2012 with a strong quarter, the S&P 500 fell abruptly in the second quarter before rallying to the final bell in June. The net result was a -2.8% return that, while disappointing, was consistent with our belief that a near-term pullback was possible. Given all of the headline issues surrounding European sovereign debt problems, slowing growth in China and other emerging markets, and economic and political challenges here at home, high volatility is likely to remain with us through the coming quarters. Still, we expect a positive overall market trend over the longer term, primarily due to steady increases in corporate earnings and reasonable current valuations.

Outlook for the Rest of 2012 and Beyond

Several big issues will be looming over the global economy and markets in the coming months. Following are our thoughts regarding some of these, as well as the reasons we expect the markets to provide positive returns in the face of various threats.

European sovereign debt

Perhaps the largest question on investors' minds is, "What happens to Greece, the rest of the European Union, and the world as a result of the sovereign debt crisis spreading across Europe?" Partly as a result of the austerity measures taken by European governments to trim budget deficits, the Euro block is in recession, one that appears to be relatively mild for the core countries while worse in Greece, Portugal, and Spain.

While we expect to see continued but slow progress toward a resolution, we also do not rule out the possibility of Greece's dropping out of the Euro zone. Consequently, we are limiting our direct investment in European securities until we gain more clarity on the outcomes. Nobody knows for sure how the Greek drama will end and what the broader impact of the sovereign debt crisis will be on Spain, Italy, and other vulnerable nations. However, the various governments and agencies involved have made progress in reaching a solution, including the direct injection of capital into struggling banks, one of the primary catalysts for the June rally in the markets. We are cautiously optimistic that eventual resolution of these problems will calm the markets and enable the Eurozone and global economy to avoid the worst-case scenarios.

Emerging markets economic growth

Economic growth in China, India, and other large emerging markets has slowed in recent quarters, primarily because of languishing economies in their largest export markets. We expect the Chinese government and others to provide more stimulus to boost their economies. Growth may not rebound to historical rates, but we believe economic expansion in emerging markets will continue to be higher than in North America, Europe, and elsewhere.

We have direct exposure to emerging markets through our investment in the WisdomTree Emerging Markets Equity Income exchange traded fund. In addition, we get indirect exposure through our ownership of the large capitalization, multinational companies that sell into these markets and are mainstays of our portfolios.

U.S. economy and politics

Here at home, our economy faces threats from the oft-mentioned fiscal cliff at the end of 2012, which refers to the potential for expiration of tax cuts, automatic spending cuts, and removal of other stimulus from our economy. As if that were not enough, we also have elections in November, another debt ceiling debate on the horizon, and an economy that is recovering but not fast enough to generate as many jobs as politicians and the public have been expecting.

U.S. voters are preoccupied with the upcoming Presidential and Congressional elections, and their concerns are understandable. However, it is our opinion that the impact of the elections on the economy and markets is less important than many observers believe. Whatever the outcome, November and the following few months will remove some uncertainty that should help the markets.

Regarding the various elements that lead to the potential fiscal cliff, we believe it most likely that Congress gives itself an extension of the year-end deadline to reach a solution. Although it will be frustrating to see our elected officials once again avoid making tough decisions, a delay will give the economy more time to gain momentum and lawmakers more time to arrive at reasonable compromises for sound economic policy. If necessary to boost the economy, the Federal Reserve will provide more stimulus beyond the already announced extension through year-end of its bond purchasing program, known as Operation Twist.

What We're Buying

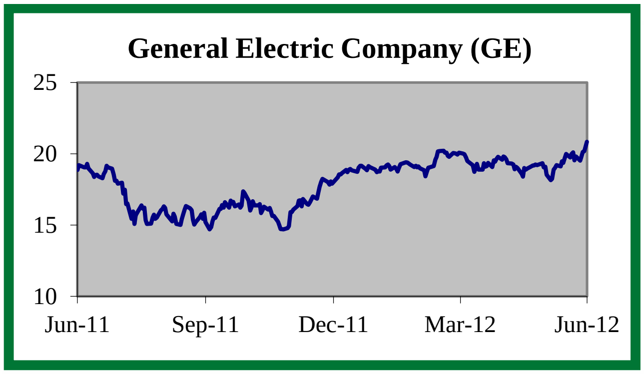
In this environment, we are sticking with the large capitalization, dividend paying, multinational firms that we see as having the best combination of financial strength and attractive valuations. Dividend payments by U.S. companies are on pace to set a record in 2012, yields have risen, and the S&P 500 trades at a modest 13 times estimated earnings of about $104 per share for 2012, a multiple that is significantly lower than normal. Companies should continue to post solid earnings growth to support higher valuations, even though earnings are not likely to increase as much in the second quarter as they have in previous quarters during this recovery. We see many high quality companies trading at significant discounts to their intrinsic values and are seizing the opportunities to make solid long-term investments.

For income investments, we continue to favor preferred stocks, master limited partnerships, and high-yielding equities over bonds. Our income portfolios are currently yielding about 6% and also offer some potential for capital appreciation, both of which we consider to be far more attractive than opportunities in bonds today. With the 10-year Treasury yielding 1.7% at the end of the quarter, we believe purchasers of those securities will at best lose ground to inflation and are likely to suffer principal losses as interest rates rise. Most corporate bonds also have low yields and are not attractive long-term investments.

Analysis of Selected Stocks

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

General Electric Company (GE)



Price (6/30/2012)	$20.84	Forward P/E	11.1
Market Cap. ($B)	$220.8	Price / Sales	1.5
Dividend Yield	3.3%	Price / Book	1.8
Return on Equity	10.5%		

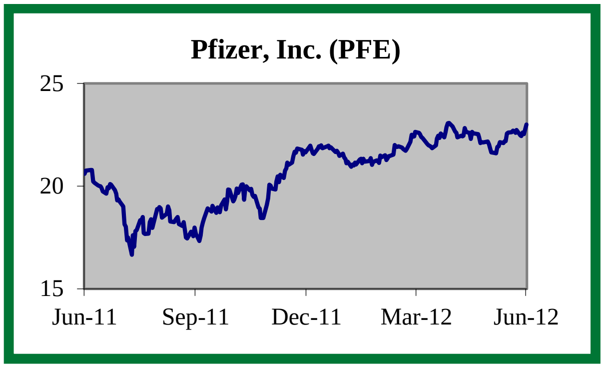
General Electric (GE) has been transforming itself since the financial crisis of 2008 nearly crippled this once-believed unshakeable industrial giant. By shedding underperforming businesses and restructuring others, GE has once again positioned itself to be the leader in all major markets in which it competes.

Today, GE operates through four main operating segments (down from six), which include Energy Infrastructure, Technology Infrastructure, Home and Business Services, and Capital Services. Its portfolio of businesses is focused on the industrialization of growing economies, in particular in energy, aviation, and transportation infrastructure. Specific offerings include clean energy products (wind, gas, and solar), water treatment systems, drilling and production equipment, and railway and transportation solutions. These high-potential areas are expected to drive GE's growth over the next several years, as evidenced by a record backlog today of $200 billion in infrastructure orders.

GE Capital Services, the financial services arm, has also rebounded significantly since the financial crisis. The unit returned to profitability last year, even as its portfolio has continued to shrink. In May 2012, GE Capital Services announced that it will resume paying dividends to its parent during the quarter, with an initial dividend of $475 million. A subsequent, one-time dividend of $4.5 billion is expected before year-end 2012, with a constant payout equal to 30% of divisional earnings expected thereafter. GE has indicated that it will use these proceeds to repurchase shares and/or increase its own dividend, to the direct benefit of shareholders.

The ongoing streamlining of GE's businesses will further buoy its profitability, balance sheet strength, and overall market position in the global economy. We expect this stock to also reward shareholders over time, while offering an attractive dividend yield, currently 3.3%, along the way. At a current valuation of 11.1x forward earnings (versus 13x for the S&P 500), we continue to view GE as a core, long-term holding of our equity portfolio.

Pfizer, Inc. (PFE)



Price (6/30/2012)	$23.00	Forward P/E	9.4
Market Cap. ($B)	$172.0	Price / Sales	2.7
Dividend Yield	3.7%	Price / Book	2.1
Return on Equity	11.1%		

Founded in 1849 and with annual sales near $70 billion, Pfizer is the world's largest pharmaceutical company. Pfizer generates nearly 90% of its sales from a diverse portfolio of top-selling prescription drugs including Lipitor, Celebrex, Lyrica, Viagra, and Norvasc.

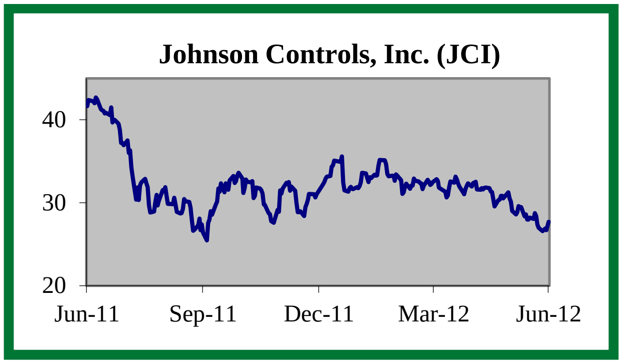
The recent loss of patent protection on Lipitor represents a headwind for Pfizer, but we believe the company's size and scale, portfolio diversity, and powerful development pipeline position it well to withstand this challenge. Its 2009 acquisition of Wyeth broadened the company's portfolio of drugs significantly (most notably in the biotech and vaccine arenas) and as a result reduced Lipitor to 16% of total sales from 23% in 2010. Beyond 2012, the patent losses should become even more manageable, as Pfizer's huge pipeline of new drugs starts coming on line.

As part of the Wyeth merger, Pfizer also undertook a major cost-cutting effort, reducing its cost base by $4 billion through a structural realignment, reduction of marketing support for drugs losing patent protection, and rationalization of research and development spending. The success of these measures has allowed Pfizer to increase operating margins (to 24% from 14% in 2010) and free cash flow (to $17 billion from $9.9 billion in 2010), even as sales growth has moderated.

In our view, new drug development will be one of the primary drivers of long-term growth. Pfizer has more than 80 new products in its pipeline and another 90 in discovery phase. Another key element of the company's growth strategy is its emphasis on emerging markets, which positions Pfizer to benefit from the accelerating demand for health-care products in countries like Brazil, India, China, and Turkey.

All of these factors contribute to the wide economic moat this global industry leader has built for itself. We believe the stock, trading at a forward price/earnings ratio of 9.4x, is a solid long-term investment at its current valuation. Furthermore, it offers an attractive dividend yield of 3.7% with the potential for further dividend increases. Overall, we see Pfizer continuing to play a leading role in the global recession-resistant pharmaceuticals industry for many years to come.

Johnson Controls, Inc. (JCI)



Price (6/30/2012)	$27.71	Forward P/E	8.3
Market Cap. ($B)	$18.9	Price / Sales	0.5
Dividend Yield	2.6%	Price / Book	1.6
Return on Equity	14.8%		

Founded in 1885, Johnson Controls (JCI) is one of the world's largest manufacturers of automotive parts and equipment including interior systems and batteries. JCI also provides building efficiency systems that are used for energy management, fire safety, and security maintenance.

Though the share price has fallen since we began buying, we consider JCI to be a solid equity holding with significant upside for shareholders. JCI has been successfully diversifying its business for several years, reducing its exposure to the automotive industry from a high of 69% of revenues in 2005 to the current level of 49%.

Still, JCI has benefited in the last year from the resurgence of the Detroit auto makers since the lows of the financial crisis. The auto segment posted double-digit revenue gains in the first half of fiscal year 2012, driven by solid growth in North America which more than offset expected declines in Europe. Of particular note is that JCI's growth came both from the launch of new products and from strategic acquisitions of competing suppliers. The auto sector should see even stronger growth in the second half of 2012 due to seasonal upswings in vehicle sales. JCI's rapid rebound has proven that it has the balance sheet strength and financial flexibility to withstand even the harshest cyclical downturn to hit the automotive sector.

JCI's Building Efficiency Group has also increased revenues significantly in recent years, and we expect the trend to continue. This $14.9 billion revenue segment now accounts for 36% of total company sales, up from 21% just six years ago. Unlike the auto business, the building efficiency sector is highly predictable and stable, with more than 83% of sales coming from repeat business from existing customers that need upgrades, retrofits, or service of their building equipment. As more businesses and governments seek more environmentally friendly buildings, JCI's unique ability to deliver a one-stop solution of energy efficient equipment and services will position this segment to prosper, especially in emerging markets.

JCI's financial health is strong, with an investment grade credit rating, a low-leverage balance sheet, and ample liquidity. The stock, which we started buying earlier this year, trades at a below-market forward P/E of 8.3x and offers an attractive 2.6% dividend yield. We also see the potential for dividend increases, as management has stated its intention to boost the payout to 30% of profits from the current ratio of 25% in the near term.

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

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 $540 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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