EDGEMOOR
INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Stocks Rise and Bonds Fall

The stock market continued its run up during the second quarter, following a big surge in the first. The S&P 500 index returned 13.8% for the first six months of 2013, more than the average full-year gain over the stock market's history and the best first half since 1999. Bonds, on the other hand, returned -2.4% during the half as interest rates rose and bond prices fell.

Volatility also increased, with the stock market dropping almost 6% before rebounding at the end of June. Although corrections of 5% or more are quite common, this decline after months of a relatively smooth rise rattled investors and intensified their focus on the U.S. Federal Reserve and China, currently the two primary influences on global markets.

We expect ongoing volatility in the face of weakening foreign economies and uncertainty about central bank policies. However, we see signs of strength in the United States, view the stock market as reasonably valued, and are happy to take advantage of the opportunities presented by the uncertainty and volatility. Bond prices are likely to continue their decline as interest rates rise and investors contemplate the end of the Fed's support of the bond market.

The Taper and China

Two issues at the forefront for investors are the Fed's plan to reduce its efforts to stimulate the U.S. economy and slowing growth in China. Because of the size of the U.S. and Chinese economies and increasing global interdependence, what happens in the United States and China has a large impact on the rest of the world.

For several years, the Fed has provided stimulus to the U.S. economy to help it emerge from the financial crisis and resulting recession, primarily by keeping short-term interest rates near zero and by purchasing $85 billion of U.S. government and agency securities per month (a.k.a. quantitative easing). Since last contracting in the second quarter of 2009, U.S. GDP has been rising, albeit slowly, and the stock market has more than doubled since its bottom. Though probably not yet healthy enough to stay on track without this support, the economy is approaching the point at which the Fed will be able to slow its stimulus measures. Employers are hiring steadily, the housing sector is gaining steam, and most signs point to a continuation of these trends, despite the decrease in spending resulting from the sequester and other fiscal policy changes.

As obvious as it seems that the Fed will someday have to reign in its efforts, the markets are extremely sensitive to the timing and often react strongly to any change, real or perceived, in the Fed's plans. Such was the case in June, when the stock market shuddered at Fed Chairman Ben Bernanke's comments related to a potential reduction in its bond purchasing program later in 2013. Investors ignored Bernanke's attempts to tie any Fed tapering to an improving economy and lower unemployment and sent stocks down sharply over the following few weeks. We considered this market drop to be an overreaction, were pleased to see stocks rebound as the quarter ended, and expect the Fed to continue to provide support to the U.S. economy until conditions improve substantially.

China is grabbing headlines due to concerns about rising debt and a potential bubble in real estate. A credit-fueled construction boom has resulted in debt levels rivaling those in the United States before the financial crisis and in Japan before it entered its long period of stagnation. In addition, the construction funded by this debt has produced residential and commercial real estate developments that stand empty, as well as roads, bridges, and other infrastructure projects that are woefully underutilized.

Even with all of this spending, the growth rate of the Chinese economy has slowed, though at approximately 7%, it remains heady compared to the developed world. The slowdown in China has already hurt other countries' economies, particularly in emerging markets that depend on China as a major customer for commodities such as iron ore and copper. We are keeping a close eye on these developments.

Finally, no tour of world economic conditions is complete without a stop in Europe, which remains fragile as it tries to achieve economic growth in the face of various austerity measures and ongoing sovereign debt challenges. Plenty of risk remains, but the European Union appears to be taking steps to address the issues, and we are optimistic that conditions will not deteriorate to the point that the EU drags the rest of the world into a recession.

Where to Invest Now

Overall, we see a strengthening U.S. economy and slower growth in other areas of the world. As a result, we are focusing more of our investment on domestic opportunities than in recent years, expecting to benefit from a rebound in U.S. manufacturing and housing. The manufacturing sector should continue to benefit from improved efficiencies and the availability of cheap energy, and housing will remain on the rise due to pent up demand, population growth, and low interest rates. Valuations for stocks are reasonable, with the S&P 500 index trading at slightly less than 15 times estimated 2013 earnings.

Bonds, however, are overvalued and offer lower yields than many high quality stocks. As rates rise further, bond prices will continue to fall, potentially more than offsetting coupon payments and leading to losses for investors. For our income investments, we continue to favor master limited partnerships, convertible securities, telecom stocks (see discussion of Vodafone below), and other high yielding equities, all of which offer the potential for rising dividends and price appreciation. We also like preferred stocks and believe their higher coupon rates provide some cushion against rising interest rates, though we are closely monitoring credit market conditions and trends.

Analysis of Selected Stocks

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

Cisco Systems, Inc. (CSCO)

Price (6/30/2013)	$ 24.34	Forward P/E	11.8
Market Cap ($B)	$ 128.3	Price/Book	2.3
Dividend Yield	2.8%	Price/Sales	2.8
Return on Equity	17.8%		

Cisco is a world leader in communications equipment, best known for its long-time dominance of the market for routers (50%+ share) and switches (60%+ share) used in enterprise data networks. These core platforms account for nearly two-thirds of Cisco's product revenues and provide it with durable competitive advantages including significant scale, customer loyalty, and meaningful switching costs.

In addition to these core products, Cisco has expanded aggressively in recent years both organically and through more than 130 acquisitions into the related areas of software, services, storage, and security. These high-margin, high-quality services have extended the company's reach both within existing customers' networks as well as to new users like wireless enterprises and cloud computing networks.

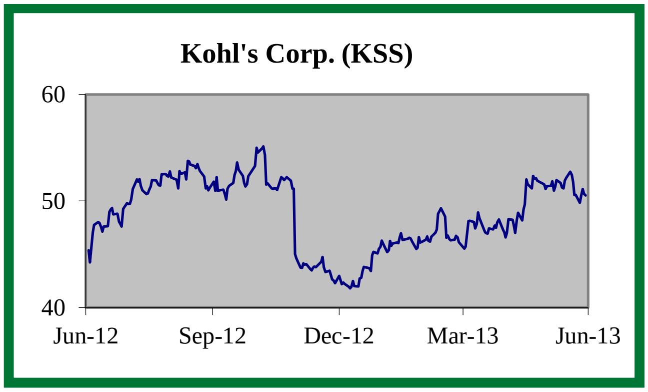
Cisco has emerged from a challenging three-year period, including a difficult foray into the consumer market (think Flip video cameras, the Umi video conferencing system), and now is a leaner, more focused competitor. It has cut nearly $1 billion in costs, streamlined an overly bureaucratic operating structure, and eliminated underperforming sectors.

We expect the company to benefit from continued growth in Internet traffic, as well as the convergence of voice, video, and data traffic. The push into cloud computing, while considered a threat by some to Cisco's market position, should increase network traffic and, therefore, stimulate demand for the company's networking and data center products.

Management has proven to be very shareholder friendly, committing to return 50% of free cash flow to shareholders annually. The company's dividend has grown from $0.12 per share in 2011 (the year it commenced) to $0.62 per share in 2013 and $0.68 per share projected for 2014. Cisco has also aggressively repurchased shares throughout 2012 and 2013, spending $3.4 billion in the last three quarters alone and reducing share count by over 3.5%.

Cisco is financially strong, with robust free cash flow ($10.8 billion for 2013), high return on equity (17.8%), and manageable leverage (0.23 debt-to-equity). With nearly $6 per share in cash, a forward price/earnings ratio of 11.8, and a current 2.8% dividend yield, Cisco is an attractive stock with solid upside potential.

Kohl's Corp. (KSS)



Price (6/30/2013)	$ 50.51	Forward P/E	10.6
Market Cap ($B)	$ 11.2	Price/Book	1.9
Dividend Yield	2.8%	Price/Sales	0.6
Return on Equity	15.9%		

Kohl's operates 1,150 department stores located in 49 states and caters to middle-income, value-focused customers. With its "Expect Great Things" tag line, Kohl's has positioned itself as a niche retailer offering a wide selection of brand-name apparel, excellent value, and convenient off-mall locations. These factors helped Kohl's weather the recession better than most retailers and gain market share in its aftermath.

The company's store format is less costly to operate than the mall-based format of most department store chains, providing a significant cost advantage over its competitors. In addition, Kohl's has enjoyed higher profit margins than the industry average, giving it more room to maneuver through economic cycles. Finally, the company has a very loyal customer base and generates 58% of its sales from company credit card holders, who tend to be repeat buyers and spend at higher average levels than non-card holders. Few retailers come close to these card holder spending levels.

The company has invested heavily in technology in the last few years to improve its operations and expand its more profitable and less capital intensive online sales. Growing at more than 40% per year, online sales will top $1.4 billion in 2013 and are forecasted to grow to 10% of total sales of $19 billion by 2015.

The company's financial health is strong. Kohl's generates approximately $2 billion annually in operating cash flow which, after a moderate store expansion budget, has been more than sufficient to fund $1 billion each year in share buybacks and dividends. Kohl's has repurchased nearly 25% of outstanding shares in the last two years and plans to buy more this year.

With an attractive forward price/earnings ratio of 10.6, a healthy dividend of 2.8%, and good growth prospect, Kohl's is one of our core value holdings.

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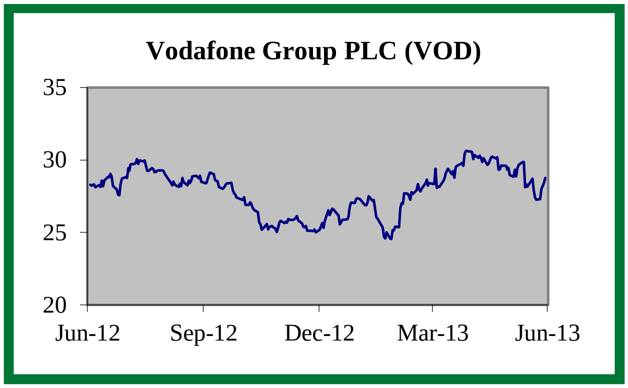
Vodafone Group PLC (VOD)



Price (6/30/2013)	$ 28.75	Forward P/E	39.1
Market Cap ($B)	$ 136.5	Price/Book	1.2
Dividend Yield	5.6%	Price/Sales	2.0
		Price/Cash Flow	8.3

Vodafone Group PLC is the largest wireless phone company in the world measured by the number of countries served – 22 in which it has a majority or joint equity interest and 40 in which it holds minority or partnership interests. Vodafone operates in three major geographic regions: Europe (69% of revenues, 72% of earnings), Asia Pacific and the Middle East, and Africa and Central Europe.

The company also owns 45% of Verizon Wireless, the largest wireless carrier in the United States and widely considered to be Vodafone's most valuable asset. Based on reported overtures by Verizon, the value of Vodafone's stake is estimated to be between $75 and $100 million. So far, management has shown no interest in selling, instead benefiting from over $8.3 billion in dividends payments received in 2012.

These dividends added to the already strong free cash flow that Vodafone generates from its diverse geographic markets. Germany, India, and Turkey are particularly strong markets for Vodafone, with continued growth in its emerging markets offsetting persistent sluggishness in Western Europe. In most markets, Vodafone is the #1 or #2 wireless company, giving it strength, scale, and pricing power. Additionally, because it is not an incumbent telephone operator, Vodafone has no legacy problems like underfunded pensions, civil servant employees, or stiff regulatory mandates inhibiting its growth or access.

Vodafone has also become increasingly focused on returns to shareholders, using its free cash flow and proceeds from the sale of non-core assets to buy back stock and increase its already generous 5.6% dividend. Management has stood by its commitment to increase the dividend 7% annually through 2014.

Despite continuing headwinds in many major European markets, Vodafone's diverse, global operations have allowed it to perform respectably overall in the current economic climate. The company should continue to benefit from increased penetration in emerging markets, growth in data services worldwide, and the increasing value of its Verizon Wireless stake. Along the way, investors will benefit from a healthy and growing dividend.

Source for charts and text: Morningstar, Value Line, S&P, 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 $650 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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