Edgemoor's Quarterly Report

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Surprise!

Thanks in large part to the continued rise of oil prices, most of the second quarter provided a welcome break from the market's dramatic plunge and recovery during the first three months of the year. Then came the unexpected Brexit vote outcome in late June, just in time to provide some turmoil.

We did not believe the market's sharp drop following the vote would last, and as we begin the second half of 2016, U.S. stocks have quickly recovered from the U.K. referendum. It will be years before we really know the impact of the United Kingdom's withdrawal from the European Union, but we are optimistic that global markets will weather this storm as they have many others in the past. In our opinion, there continue to be attractive securities to add to our portfolios in the midst of a market that is trading overall at close to fair value.

Value Stocks Have Outperformed Growth Stocks over the Long Term

Before reviewing the second quarter and providing our market outlook in detail, we want to share the reasons we are optimistic regarding the potential for value stocks, including those that comprise the bulk of our equities portfolios, to outperform growth stocks and the broad market. While value stocks have now lagged growth for an unusually long period, they have performed much better than growth over extended periods of time throughout the history of the stock market, a trend that we believe will resume.

For as long as we have been investing, we have been strong proponents of the value approach, which espouses the virtues of buying securities that are trading for less than their intrinsic value. To determine intrinsic value for a particular security, we carefully examine the prospects of the underlying business, including such factors as senior management's skills and experience, brand strength, efficiency in production and delivery of goods or services, and barriers to entry into the issuing company's markets. When favorable, these characteristics can combine to provide a competitive advantage that enhances the company's long-term prospects.

We consider purchasing a stock when it trades in the market for considerably less than its intrinsic value. Buying at a significant discount to intrinsic value provides appreciation potential and a margin of safety.

Studies over many years show that value approaches to investing similar to ours have outpaced not just the broad market but also decisively outperformed strategies that focus more on growth. Simply put, the growth approach emphasizes more rapid increases in revenues, earnings, and stock prices, with less emphasis on purchasing securities at a significant discount to intrinsic value according to the fundamental measures used in the value approach. Most analyses comparing results of value and growth strategies use metrics such as multiples of price to book value, price to sales, or price to earnings to segment the market into growth and value stocks, with value stocks being those with the lowest multiples and growth the highest.

According to two recent reports[i], value has almost always outperformed growth over periods of five or ten years, with value returns exceeding growth by an average of about 5% per year. However, value has lagged growth in recent years, and in 2015 growth stocks beat value by nine percentage points (Russell 1000 Growth Index vs. Russell 1000 Value Index), a particularly large margin. Much of the surge in growth in 2015 was due to stocks such as Facebook, Amazon, Netflix, and Tesla, which in our opinion are good but overvalued companies trading at very high multiples of their earnings that make them vulnerable to potential stock price declines.

Following their surge through 2015, growth stocks as a group now trade at an unusually high premium to value stocks. In fact, value stocks are currently trading at the largest discount to growth since 1942. The stocks we are buying trade for an average of approximately 12 times forward earnings, a significant discount to the broad market and an even greater discount to growth stocks.

When value stocks have traded at a major discount to growth in the past, periods of significant outperformance have followed. We believe value stocks are now poised for a rebound relative to growth and will most likely follow their historical pattern of not just closing the gap but resuming their outperformance.

We do not know exactly when this rebound will happen, but we know that stocks have historically returned to trading based on the fundamental measures that support their intrinsic values. We are willing to be patient as we await the rewards that have historically come from sticking with a proven value-oriented approach to investing.

The Brexit Is Coming

Just when we had put the first quarter's plunge and recovery far enough behind us to begin to enjoy the relative calm of the second quarter, along came the U.K. voters' decision on June 23rd to leave the European Union. A rising tide of nationalism and concerns about the British economy, immigration, and income inequality overcame the views of many that the United Kingdom faced grave economic and other risks if the nation were to leave the union.

Stock markets plunged around the world on the heels of the vote, and bond yields fell as investors sought the safety of U.S. Treasurys and other sovereign debt. Fortunately, the U.S. stock market quickly recovered its losses, followed by most markets in Asia and Europe.

In the wake of the referendum, politicians will begin the process of trying to figure out new trade, migration, and other agreements to minimize the disruption of Britain's exit from the European Union. Britain's new Prime Minister, Theresa May, has indicated that she will not invoke the article to exit the European Union before 2017. Even then, negotiating terms of the exit may take two years or longer, so we do not expect significant changes anytime soon.

Since continuing trade between the United Kingdom and the European Union is in the best interests of almost all involved, we expect the ultimate agreements will represent less change from the status quo than many fear. However, the U.K. economy may slip into recession due to the uncertainty regarding potential changes. The European and other economies around the world will probably also feel some negative effects, but we do not expect the Brexit process to lead to a recession in the United States. While Brexit has grabbed the headlines lately, we expect investors to return their attention soon to issues such as the U.S. Federal Reserve's actions on interest rates, economic trends in China, and the presidential campaign in the United States.

The Broader Picture

Despite the disruption caused by the Brexit referendum, economic conditions in the United States remain fairly steady. The June employment report showed strong hiring, easing concerns about weakness in the May release. The sharp rebound in oil prices from February lows boosted the energy sector, one of the second quarter's best performers. The housing, services, and manufacturing sectors appear to be healthy, with the manufacturing sector recently reporting expansion for the fourth straight month following five months of contraction. Consumer spending has been up 2.5%-3% over last year, an indication of consumer optimism.

While the U.S. economy continues on its path of steady growth, we do not think conditions are robust enough for the U.S. Federal Reserve to hike interest rates until next year. Ongoing support from the Fed and other central banks to maintain low interest rates should help to minimize the impact of Brexit and other potential threats.

With companies beginning to report results over the coming weeks, expectations are for a decline in S&P 500 earnings compared to the prior year. We believe earnings will begin to pick up in the second half of the year as the economy continues to strengthen.

Elsewhere in the world, Japan's economy continues to struggle, as the central bank's efforts to provide stimulus through negative rates on Japanese government bonds have been ineffective thus far. Compounding the difficulty has been a flight to the yen in the wake of the Brexit vote, which has caused the yen to rise sharply and threatens Japanese exporters. However, we expect Prime Minister Abe's ongoing efforts to reform corporate practices and boost the Japanese economy will lead to improvement there.

China and other emerging markets have seen slowing growth but showed signs of renewed strength in the second quarter, largely due to the rally in many commodities prices. The European economy has been doing fairly well, thanks in part to the European Central Bank's policies. Both manufacturing and employment have improved there recently, though the Brexit decision raises questions about future trends. Overall, we expect the global economy to continue to expand and the United States to outperform most other economies.

A Note on Interest Rates and Income Investments

Interest rates around the world remain at historic lows due to fears and concerns related to Brexit, central banks' stimulative policies dating from the financial crisis, and generally slow global economic growth. In fact, yields are negative on nearly $13 trillion in sovereign debt, representing over one-third of the global total. With their current low yields, bonds offer unappealing returns and expose investors to potential losses if interest rates rise.

Edgemoor has always taken a broad approach to income investing, drawing on a variety of income asset classes other than bonds, including utilities, preferred stocks, real estate investment trusts (REITs), and midstream energy companies, to generate income for client portfolios. Through the first half of 2016, our income investments have outperformed both bonds and equities, led by utilities, which were the best performing sector in the S&P 500. In addition, REITs, pipeline companies, telecoms, and preferred stocks also posted solid returns in the first half of 2016, offset somewhat by our convertible holdings.

As the likelihood of a Federal Reserve rate hike has diminished and bond yields again hit historic lows, yield-hungry investors have bid up the prices of many of our income generating securities. While we have enjoyed the performance of our income portfolios so far this year, we are taking a cautious approach to investing new money at these elevated valuations, and we may look to selectively trim some of our income holdings.

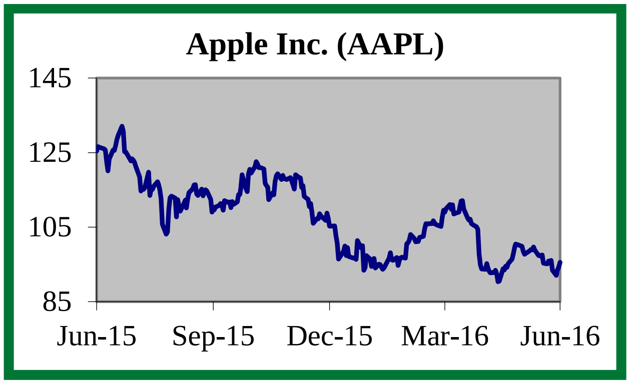
However, we continue to find opportunities in some income asset classes such as preferred stocks, midstream energy companies, and convertible securities. Low interest rates tend to boost economic growth, which is beneficial to stocks, and they make bonds less attractive relative to high yielding stocks. As a critical input into various valuation models, low interest rates also justify higher price/earnings multiples for income oriented equities.

As we have said for some time, generating meaningful income from a traditional fixed income portfolio in a low interest rate environment is a challenge. Nevertheless, the current yield on our income investments is approximately 5%, much higher than the yields on government and high-quality corporate bonds, and we believe our holdings offer the potential for solid long-term returns.

Analysis of Selected Securities

Following is a discussion of two 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 (6/30/2016)	$ 95.60	Forward P/E	10.2
Market Cap ($B)	$ 519.9	Price/Book	4.0
Dividend Yield	2.4%	Price/Sales	2.4
Return on Equity	39.1%		

Founded in 1976 in Steve Jobs's garage, Apple is now the largest company in the S&P 500 index as measured by its market capitalization of $520 billion. The maker of the iPhone, iPad tablet, Mac computers, iPod digital media player, and the Apple watch also provides software and services including Apple Music, Apple Pay, and iCloud.

Apple's unique strength lies in its expertise in 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%). Apple now has an installed base of users across its entire ecosystem of products and services of nearly one billion people worldwide.

Apple is increasingly focused on software and services as it looks to boost the percentage of revenues it derives from more sustainable service offerings. Recent initiatives include better integrated operating systems for iPhone (iOS), Mac (macOS), and watch (wOS); continued expansion of the ApplePay electronic payments platform; and the introduction of the iCloud Drive, which makes all files accessible across multiple devices. All of these efforts are aimed at improving the user experience, maintaining customer loyalty, and driving long-term growth.

Apple still derives roughly 65% of its total revenues from the iPhone, which this year saw its sales decline for the first time. Much of the slowdown occurred in China, where both regulatory challenges and currency exchange rates impacted results. In addition, overall growth in the global smartphone market has slowed as penetration rates have topped 40% worldwide and competition has ramped up. But even as the life-cycle of smartphones lengthens and many users opt to keep their phones longer, we expect Apple's sales growth to resume with the launch of the modestly upgraded iPhone 7 in September 2016 and the highly-innovative iPhone 8 in 2017, complete with wireless charging, enhanced Siri commands, and a flexible OLED screen.

Even as its growth has slowed, Apple still generates enormous revenues and cash flow and reported $233 billion of cash on its balance sheet at the end of the second quarter of 2016. Since 2015, CEO Tim Cook has been increasingly returning this cash to shareholders, initiating the company's first-ever dividend in the first quarter of 2015 (and boosting it twice since then), as well as authorizing a share buyback program which now totals $250 billion to be spent by March 2018.

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 has underperformed the broad market so far in 2016, is currently valued at just 10.2 times forward earnings, compared to 16 times for the S&P 500 index. Net of cash, the price-to-earnings multiple drops to an astonishingly low 6 times 2017 earnings. In our view, Apple's stock is undervalued and offers good long-term growth prospects, along with an attractive 2.4% dividend yield.

Merck & Co., Inc. (MRK)

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Price (6/30/2016)	$	57.61	Forward P/E	15.4
Market Cap ($B)	$	160.9	Price/Book	3.7
Dividend Yield		3.2%	Price/Sales	4.2
Return on Equity		10.1%		

Merck is a global healthcare company and the second largest U.S drug maker by revenues. The company delivers innovative health solutions through a vast offering of prescription drugs, vaccines, and biologic therapies as well as animal health products. Its pharmaceutical products treat a broad range of conditions including cardiovascular disease, cancer, asthma, and osteoporosis, while its strong line-up of vaccine products treats hepatitis B, HPV, pediatric diseases, and shingles.

As with all branded pharmaceutical companies, patent expirations pose a risk to existing drug offerings over time and require constant re-investment into new drug offerings. In our view, Merck is in an especially good position with regard to both, as the company appears to be through the worst of the patent expirations that it has faced over the last five years, and its substantial R&D investments in new drug development areas like immuno-oncology treatments appear to us to be yielding important new blockbuster drugs.

Immuno-oncology is one of the fastest growing and most promising new drug treatment areas, with an estimated $34 billion sales potential by 2022. Merck has been a leader in developing immuno-cancer therapies for several years, including its newest offering, Keytruda, which was approved in 2014 and successfully treated former President Carter's cancer in 2015. Merck enjoys an estimated 20% market share in immuno-therapies, whose proven ability to prolong lives represents major improvement in treatment options for cancer patients.

We consider Merck's financial position to be strong, with enormous cash flow generating power, low debt, and high returns on equity. The company enjoys a wide economic moat from both existing patent-protected drugs as well as its robust pipeline of new drugs. In addition, its worldwide salesforce not only drives current drug sales but also makes Merck an attractive partner to smaller but promising third-party drug developers. With a 3.2% dividend yield and a price/forward earnings ratio of 15.4, we believe Merck's shares offer a compelling value.

[i] Dodge & Cox, *Staying the Course in Value Investing*, April 2016 and John Alberg and Michael Seckler, *Now is the Time for Value to Outperform Growth*, Advisor Perspectives, February 1, 2016.

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 $780 million as of June 30, 2016 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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