EDGEMOOR INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Fall 2011

The market rhymes but is not likely to repeat

Goodbye and good riddance, third quarter 2011. Sovereign debt concerns in Europe, slowing economic growth worldwide, and political stalemates in the United States conspired to hit stocks hard in the three months just ended. The S&P 500 index flirted with official bear market territory, narrowly avoiding a close 20% below its recent peak in late April, and foreign markets fared even worse. The S&P 500 is still up about 70% from its nadir in March 2009, but investors are extremely jittery.

Many are comparing the current market drop to the much steeper decline in the fall of 2008. While there are some similarities, there are also important differences that we will discuss in detail below. Overall, we think the global economy and markets are in much better shape now, and we do not expect a return to the depths of the financial crisis that brought on the "Great Recession." However, volatility is likely to remain high, testing the patience of investors.

The European debt situation

The most important issue currently impacting the markets involves European sovereign debts. The problems start with Greece, whose fiscal deficit (15.4% of GDP) and overwhelming indebtedness (180% of GDP) are not helped by ineffective revenue collection and beleaguered politicians. Although Greece represents only 2% of the European Union's economy, banks throughout Europe have significant exposure to Greek debt and are, therefore, vulnerable if Greece defaults on its obligations. Other, much larger European nations also have excessive deficits and financial challenges, raising questions about the future stability of the EU and fate of the Euro currency.

The European Central Bank, IMF, US Federal Reserve, and others are all working hard on a solution to the EU's sovereign debt problems and have made some significant progress recently. The increase in funding of the European Financial Stability Fund, the ECB's reintroduction of year-long loans, and signs of cooperation from relatively healthy Germany are encouraging. More needs to happen, however, to deal with the likelihood that Greece will default or have its debt restructured at some point.

We think that an orderly Greek debt restructuring and stabilization of European banks is the best solution, and the sooner the better. Managing this political and financial process will be tricky, to say the least, but waiting longer to address the fundamental problems in Europe will only make the process more painful for the global economy. Managed skillfully, a Greek default does not have to drag down the rest of the world. In fact, clear progress on resolution of this situation could boost global confidence and markets. Fortunately, the direct exposure of US banks to Greek debt is relatively small, and domestic banks have significantly improved their balance sheets since the 2008 financial crisis.

Domestic economic outlook

The debt ceiling debate and subsequent downgrade of US government debt roiled markets in July and early August. Then, for several weeks in August and September a string of negative economic reports led many economists to boost their estimates of the odds that the United States could slip back into a recession. Nonetheless, economic surveys currently put the chances of a double-dip recession at less than 50%, and we agree that the US economy likely will continue along the path of slow, steady growth.

The primary reasons for our optimism include further increases in The Conference Board's Leading Economic Index®, greater activity in the manufacturing and service sectors, a pickup in construction spending in August, declining energy prices, tame inflation, low interest rates, and solid corporate earnings. Also, consumer spending has remained much stronger than many had expected, with same-store retail sales rising 3%-5% for the past year. Lackluster job growth is the greatest threat to this trend. September's increase of 103,000 jobs is encouraging, better than the average of 72,000 new jobs per month since April, but is still lower than needed to reduce the unemployment rate. We expect slow, steady progress on the jobs front as the economy continues to recover.

Today vs. 2008

While many observers have compared the current turmoil in the markets and global financial system to the dire situation in 2008, we see several important differences. First, the global financial system is much healthier today, due largely to the lessons learned a few years ago. Central bankers around the world realize the importance of coordinated efforts to ward off another crisis, and many have implemented fundamental changes that have strengthened the system.

Second, corporations hold record levels of cash, currently $2.0 trillion for US companies. According to S&P, this amount is enough to enable them to operate for 73 months. With this enormous cash cushion, companies are in a much better position to weather any downturn than they were in 2008.

Third, the stock market is more reasonably valued today. The ratio of stock prices to trailing earnings for the S&P 500 index is currently about 12, compared to 18 then and a long-term average of 15 to 16. This low valuation level reflects concerns about European debt, emerging market and US economic growth, political challenges here and abroad, and many other issues. Any significant indication that these fears are overblown could result in a market rally.

Where to invest today

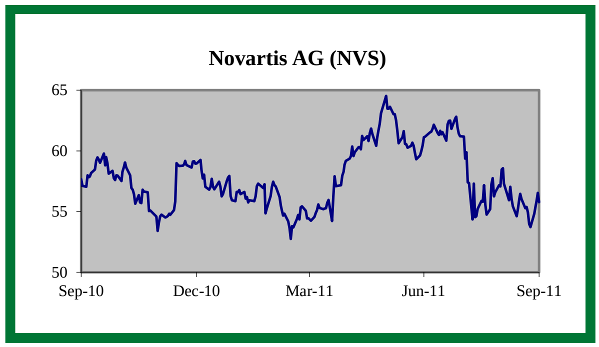
Plenty of reasons for concern remain, but positive indicators lead us to believe that the US economy and markets will continue to improve. We find securities valuations attractive and have been buying stocks that we think are trading for significantly less than their intrinsic values. We continue to favor stocks of large-capitalization, multinational companies with strong balance sheets, robust earnings, attractive dividend yields, and exposure to emerging markets.

As evidenced by the massive flow of money out of stock mutual funds and into bond and cash funds, many investors do not share our preference for high-quality stocks, instead favoring the perceived safety of bonds and cash. We think these investors are likely to be disappointed with their long-term returns and will probably see their investments fail to keep up with inflation. The 6% gap between the earnings yield of the S&P 500 (8%) and the yield on the 10-year Treasury note (2%) is one of the widest yield differentials in history, a bullish signal for stocks. Given the ability of corporations to increase dividend payments over time, we believe stocks offer greater protection against inflation and better long-term return prospects.

Analysis of Selected Stocks

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

Novartis AG (NVS)



Price (10/4/11)	$ 55.47	Price/Earnings (Fwd)	9.7
Market Cap	$ 134.6 Bn.	Price/Book	2.1
Dividend Yield	3.6%	Price/Sales	2.4
Return on Equity	16.0%		

Swiss firm Novartis AG is among the world's premier pharmaceutical companies, holding leading positions in branded prescription drugs, generic drugs, consumer healthcare, and eye-care products. While most competitors focus solely on the high-margin branded pharmaceutical segment, Novartis runs four complementary operations that serve to reduce overall volatility and create cross-segment opportunities. In an industry plagued by stagnant growth, Novartis has set itself apart with its diverse operating platform and superior late-stage pipeline of potential blockbuster drugs.

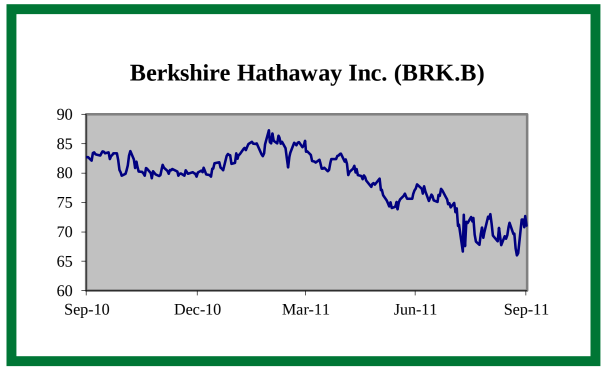
In its prescription pharmaceutical segment (60% of total sales and 72% of operating profits), Novartis has benefited from strong growth among existing drug lines, as well as successful launches of several new drugs. In addition, it has filed for over 60 new products to be launched between 2011 and 2015, which bodes well for the company's long-term growth prospects.

Its consumer and eye care segments (17% of sales, 12% of profits) have grown primarily through acquisition, most recently the purchase of Alcon, a leading producer of ophthalmic drugs, surgical devices, and eye care products. Together with its CIBA Vision unit, the Alcon acquisition moved Novartis into a global leadership position in the fast-growing eye care market.

The company faces relatively low near-term patent exposure, with only its hypertension drug Diovan losing patent protection in 2012. Robust growth in other operating segments should more than offset patent run-offs and allow Novartis to continue to post stable and consistent earnings growth.

We consider Novartis to be a best-in-class pharmaceutical company and a core equity holding for long-term investors. Novartis shares currently offer a 3.6% dividend yield, and we expect dividends to increase over time.

Berkshire Hathaway Inc. (BRK.B)



Price (10/4/11)	$ 73.17	Price/Earnings (Fwd)	13.7
BV/Share	$ 69.90	Price/Book	1.0
Market Cap	$ 165.0 Bn.	Price/Sales	1.2
Dividend Yield	0.0%	Return on Equity	8.0%

Berkshire Hathaway is an insurance-based conglomerate whose diversified holdings include Geico Insurance Co., General Reinsurance, Burlington Northern Santa Fe, MidAmerican Energy, and Dairy Queen. Led by Warren Buffett and his long-time partner Charlie Munger, Berkshire's strategy has been to build long-term shareholder value by acquiring undervalued businesses that have strong and consistent earnings power, little or no debt, and solid management teams who stay on to run their businesses under Berkshire's decentralized corporate structure. Berkshire rarely sells the companies it acquires. In addition to buying entire businesses, Berkshire also invests in stocks of large, well managed companies.

Berkshire's core insurance businesses generate the bulk of the low-cost capital Buffett uses to make new investments. Their combined $70 billion of annual float – unearned premiums and unpaid claim reserves – is essentially free money which, when combined with the operating cash flow of Berkshire's 70 other, non-insurance businesses, gives Buffett the capital and the clout to invest where he sees the best opportunities. Recent purchases include such marquee deals as the $10 billion purchase of Lubrizol and a $5 billion preferred stock investment in Bank of America.

The two biggest challenges facing Berkshire are growth and succession. Given the size of its operations - $145 billion in revenues, $20 billion+ in annual operating cash flow, $35-$40 billion in cash on hand, and $66 billion in equity investments – it is difficult to find deals that are large enough to be meaningful. This challenge led the company last month to announce a share-repurchase program for the first time in its history. Estimates are that $15 billion or more could be available in the near term to repurchase Class A and B shares at prices up to 110% of book value, essentially putting a floor on the stock price. We applaud this shareholder-friendly decision.

The second and most talked about challenge is that of succession. Who will replace Buffett and Munger, both octogenarians, in making the company's investment and capital allocation decisions? Berkshire has expanded its ranks by hiring two capable, though previously unknown, portfolio managers. While significant, these actions have not quelled investor questions and concerns over who will succeed Buffett as CEO.

We are encouraged by efforts to address succession and remain confident that Berkshire will thrive long after Buffett's departure. Berkshire has been a long-time holding of our core equity portfolio, and today's price of roughly 1x book value significantly undervalues the company.

BioMed Realty Trust Inc. – Series A Cumulative Preferred Shares (BMRPRA)

Preferred Shares:		*Company and Common Shares:*	
Price (10/4/11)	$ 24.90	Market Cap	$ 2.1 Bn.
Par Value	$ 25.00	Price/Earnings (Fwd)	75.8
Dividend Yield	7.4%	Price/Book	1.1
		Price/Revenues	5.1

BioMed Realty Trust, based in San Diego, is a healthcare real estate investment trust (REIT) that specializes in the life sciences sector. BioMed owns 85 properties comprising approximately 12.2 million square feet clustered in university and medical research hubs around Boston, Washington, DC, San Francisco, and San Diego. These favorable locations with high barriers to entry are a major competitive advantage to BioMed.

BioMed's specialized properties have attracted a premier tenant roster of leading life sciences and biomed companies (Elan, Genentech, Bristol Meyers Squibb) as well as research institutes (UC San Diego, the J. Craig Venter Institute). The tenant profile is stable and diversified, with nearly 90% of current annualized base rents coming from public companies and research institutions. Tenants' need for high-cost improvements like specialized laboratories, environmental controls, and upgraded utilities means that BioMed has enjoyed low tenant turnover and limited competition from less-capitalized property owners.

These factors and an experienced management team helped BioMed weather the difficult real estate market of the last several years. The company successfully accessed the capital markets throughout 2010 and 2011, raising over $1 billion of debt and equity capital. These financings allowed BioMed to lower its interest costs, extend maturities, and build a robust equity cushion that directly benefits preferred shareholders. The company is also the first and only life sciences REIT to receive an investment grade corporate credit rating from both S&P and Moody's.

With this lower cost capital, BioMed has been able to grow through the economic downturn. Revenues climbed 15% year-over-year due to strategic acquisitions, project completions, and annual rent escalations. The company faces less than 10% lease expiration through 2012, meaning earnings and cash flow should keep growing steadily.

The Series A preferred shares we own trade near par value of $25, yielding an attractive 7.4% in an environment in which the 10-year Treasury yields less than 2%. Given the company's steady revenue and earnings growth, we consider the dividend to be safe, and BioMed is a solid representative of many preferred securities that we own in our portfolios.

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 $475 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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