EDGEMOOR
INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Fall 2012

Here We Go

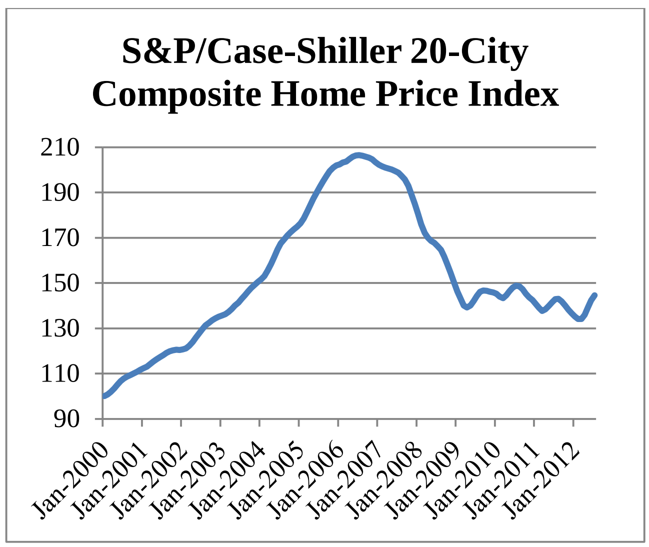
The Presidential debates have begun, heralding the final push to the U.S. elections in November. The candidates continue to parse, and often rewrite, their own and their opponents' histories, and they also offer prophesies of what is to come. If you are looking for more political opinions and forecasts, turn elsewhere, as we will not be adding our voices to the din. For our views of the quarter past and the coming months in the markets, read on.

Third Quarter Review

Stocks recovered from the market's early summer swoon and maintained their strength in the third quarter in the face of many uncertainties. In sharp contrast to last summer, stocks were able to recover each time they stumbled and avoided big pullbacks. As is usually the case, patient investors who stayed the course were rewarded with solid returns.

A primary catalyst for stocks' third quarter strength was the combined efforts of the U.S. Federal Reserve, European Central Bank, and other central banks around the world to reassure investors that they will do "whatever it takes" (in the words of ECB president Mario Draghi) to ward off the various threats to the global economy and financial system. The U.S. Fed pledged to keep interest rates at their current low levels through mid-2015 and announced another round of bond purchasing, commonly known as QE3. The ECB unveiled plans to shore up struggling European banks by buying sovereign debt of struggling nations such as Spain and Portugal, and the Chinese government announced more infrastructure investment designed to maintain economic growth in the largest emerging market. Each of these moves soothed investors' nerves and led stocks higher.

In the United States, economic news was mixed overall but largely positive regarding the housing market. As shown in the chart below, the S&P/Case-Shiller home price index turned up significantly for the first time since its plunge in 2008 and 2009.



Home prices have now risen for four straight months in the twenty largest metro areas.

Various other measures of housing health, including sales of new and existing homes, building permits, and housing starts, also pointed to a welcome uptick in the sector that was a root cause of the financial crisis and has recovered more slowly than the rest of the economy.

What's to Come?

We believe the stock market will end the year higher than its current level, though the relatively smooth sailing of the past few months is unlikely to continue. Whatever the outcome of the elections, the markets will be relieved to have the uncertainty removed, only to turn full attention to the looming U.S. fiscal cliff, ongoing debt problems in Europe, and slowing emerging market economies. While these issues and slow economic growth in the United States and abroad will cause volatility in the near term, we are confident that the market today still offers opportunities for us to make profitable long-term investments.

Investors are worried, as evidenced by funds flows (money moving out of equities funds and into bond funds) and price/earnings ratios for the broad market that remain below historical averages. In addition to the problems abroad, concerns also include the health of the U.S. economy. GDP growth was only 1.3% in the second quarter, hurt by the drought that reduced farm production, following an increase of 2% in the first. The threat of spending cuts at the beginning of 2013 as a result of the fiscal cliff only adds to the anxiety.

Despite these obstacles, there are reasons for optimism regarding the markets. First, the previously mentioned moves by central bankers are buying time for the underlying fundamentals of the global economy to improve. A stronger global economy should be better able to handle the looming challenges. We also expect U.S. lawmakers to reach some compromise, probably including a postponement of deadlines, on the fiscal cliff issues that will avoid or mitigate damage to the economy.

Second, the signs of a rebound in the U.S. housing market offer encouraging news. Although housing directly accounts for only 2%-3% of domestic GDP, the indirect benefits of a stronger housing sector are much greater. As home prices rise and reduce the number of mortgages that exceed the values of corresponding homes, more homeowners will be able to refinance their mortgages at interest rates that are near record lows, freeing their dollars for personal spending. The recent rise in auto sales to an annual rate of 14.9 million, the highest since the third quarter of 2008, is proof of the pent-up demand and consumers' willingness to spend. Finally, improving home prices increase job mobility by enabling homeowners to sell their homes more easily in order to move to a better job market.

Third, the employment picture appears to be slowly brightening. The U.S. economy is steadily adding jobs at a rate of 146,000 per month in 2012, and the jobless rate fell in September to 7.8%, the lowest since early 2009. Unlike earlier reports, this most recent data from the Department of Labor also showed an increase in the total labor force, an indication that people are more optimistic about job opportunities. In addition, optimism related to the U.S. jobs outlook was one of the primary factors leading to the substantial increase in consumer sentiment in

September, as measured by the latest Thompson Reuters/University of Michigan Surveys of Consumers.

Finally, due to the relatively low cost of domestic energy and declining U.S. labor costs, the United States is experiencing a manufacturing renaissance. Companies are choosing to locate manufacturing facilities in the United States rather than abroad to take advantage of favorable costs and proximity to the largest consumer market. Still in its early stages, this trend bodes well for the U.S. economy.

Turning more specifically to the markets, we believe corporate earnings continue to support valuations above current levels. Earnings are likely to be weak for the third quarter, due primarily to the impact of lower commodities demand on the materials and energy sectors, but should pick back up in the fourth quarter and beyond as consumers and businesses gain greater visibility on fiscal policies and economies improve. Meanwhile, corporations hold record levels of cash and are repurchasing shares at an annual rate of nearly $430 billion this year, a process that returns cash to shareholders and increases per share earnings. Dividends also continue to increase, as cash payments by U.S. companies climbed 19% year-over-year in the third quarter. Since companies paid dividends equal to only 34% of earnings on average, compared to 52% historically, we think dividends have more room to rise.

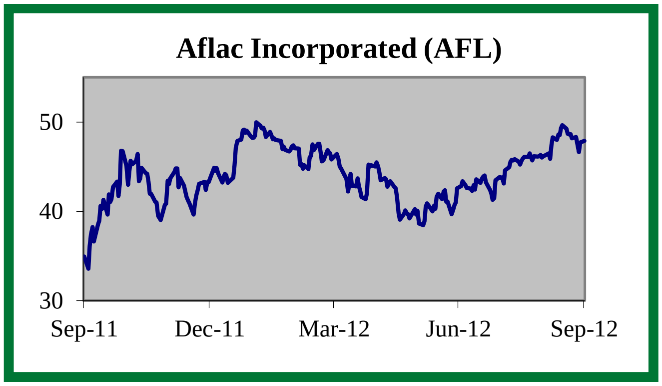
Finally, market valuations remain reasonable. Earnings have been increasing faster than the market, and the S&P 500 index now trades at less than 13x estimated earnings for 2013, below the historical price/earnings ratio of about 15x. With the earnings yield (earnings/price) on the stock market at nearly 8%, stocks are also favorably priced relative to bonds. Based on historical market performance following periods when valuations have been similarly attractive and interest rates and inflation low, conditions are ripe for above-average market returns over the coming years.

In this environment, we continue to favor large capitalization, multinational firms that have strong balance sheets and offer rising dividend payments and attractive yields. The stocks of many such companies have recently lagged the benchmarks due partly to their exposure to emerging markets, where economic growth rates slowed this year. We still believe emerging markets offer the best potential for future sales and earnings growth for these companies, and we are happy to be able to buy such high quality shares at below-market valuations.

Analysis of Selected Stocks

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

Aflac Incorporated



Price (9/30/2012)	$47.88	Forward P/E	6.9
Market Cap. ($B)	$22.4	Price / Book	1.6
Dividend Yield	2.8%	Price / Sales	0.9
Return on Equity	19.7%		

Aflac is the world's largest underwriter of supplemental insurance products, which it sells into the two largest insurance markets in the world, the United States and Japan. Aflac holds a virtual monopoly in the cancer insurance market in Japan, where the company earns 75% of its revenues and 81% of profits. The company's product offerings in the United States include life, accident, disability, and long-term care insurance, though the company is perhaps best known for its advertising campaign featuring the Aflac duck.

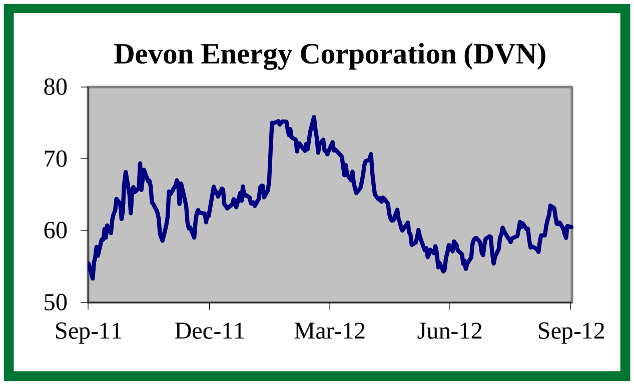
Aflac uses a unique distribution model of selling its insurance products directly to consumers, primarily through their workplaces. This low-cost, direct model has allowed Aflac to remain consistently profitable with above-average margins and to enjoy high customer retention rates of nearly 95% in Japan and over 75% in the United States.

In Japan, Aflac insures an estimated 50 million people, making it the largest individual insurer in the country. In 2007, Japan Post chose Aflac to be the exclusive provider of cancer insurance products, an increasingly popular product given Japan's aging population. Along with the banks, the post office system is a traditional channel for financial transactions in Japan. Aflac's share of the bank market is also impressive, with the company holding long-standing agreements with over 90% of Japanese banks to sell its insurance products.

Aflac navigated its way through the financial crisis prudently, capitalizing on its niche markets, strong brand recognition, and low-cost business model. It has rewarded shareholders with 26 consecutive years of dividend increases, and we expect that record to continue. Most recently, Aflac has reduced its investment exposure to the debt of European peripheral countries (the PIIGS), which we applaud even as the move risked slowing the growth of earnings in the near term.

Over the longer term, we expect Aflac's strong market position, consistent earnings power, and shareholder friendly policies to continue to build value for shareholders. Selling currently at a 6.9x forward P/E and yielding 2.8%, Aflac is an attractive buy.

Devon Energy Corporation



Price (9/30/2012)	$60.50	Forward P/E	11.6
Market Cap. ($B)	$24.6	Price / Book	1.1
Dividend Yield	1.3%	Price / Sales	2.2
Return on Equity	11.1%		

Based in Oklahoma City, Devon Energy is one of the largest independent oil and gas exploration and production (E&P) companies in the United States. It also owns substantial midstream assets (pipelines and facilities) that transport, process, and store oil, natural gas, and natural gas liquids.

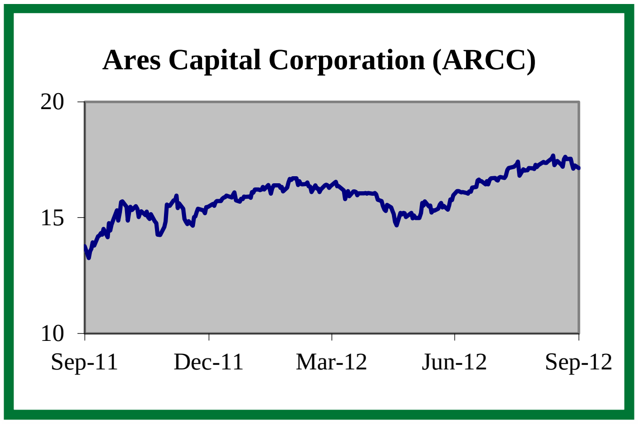
Since late 2009, Devon has aggressively sold nearly $10 billion of non-core assets as part of a strategic repositioning of its portfolio to focus on U.S. and Canadian onshore resources. The sale of its offshore and international assets was particularly well-timed, with its deep water Gulf assets sold just before the BP oil spill. In addition, the sales have allowed the company to pay down debt, fund higher-return onshore projects, and complete a $3.5 billion share repurchase program. As a result of this restructuring, Devon now has a focused portfolio of high growth oil and liquids assets which generate more attractive margins than dry gas production, given today's historically low natural gas prices.

Devon's balance sheet is rock solid, with ample liquidity (including $5.5 billion of cash), low leverage ($2.5 billion of net debt or 38% debt/equity), and manageable debt maturities. This financial strength gives Devon maximum flexibility to both develop existing plays and capture new acreage that will drive future growth and profitability.

Devon's competitive cost structure and ample liquidity give it a strategic advantage over its peers in terms of flexibility in the timing, volume, and profitability of its production plans. Therefore, the risk of a sustained period of low energy prices is of less concern to Devon than to most E&P companies.

We view Devon as a best-in-class, pure-play energy company led by a highly capable management team that has proven itself to be both disciplined and opportunistic. At an 11.6x P/E ratio and with the strong prospect of an increasing dividend payout over time, this stock is a core energy holding with long-term upside.

Ares Capital Corporation



Price (9/30/2012)	$17.14	Forward P/E	9.5
Market Cap. ($B)	$4.3	Price / Book	1.2
Dividend Yield	8.6%	Price / Sales	5.2
Return on Equity	10.8%	Debt/Equity	0.6

Ares Capital is a specialty finance company that makes debt and equity investments in U.S. middle market companies. The firm's investment objective is to generate both current income and capital appreciation by investing primarily in first- and second-lien loans and subordinated debt and, to a lesser extent, equity in privately-held companies. With a dominant market share in the middle market, Ares has enjoyed high quality deal flow, strong pricing power, and consistent access to capital.

Regulated as a business development company (BDC), Ares is required to pay out 90% of its taxable income in the form of dividends to its shareholders to avoid corporate-level taxation. Ares is the largest BDC by market capitalization ($4.3 billion) and was among the best performing BDCs during the financial crisis. Its acquisition of competitor Allied Capital in April 2010 roughly doubled the size of the company and, at 60% of Allied's book value, was attractively priced and highly accretive to shareholders.

Ares offers shareholders an attractive 8.6% dividend yield, in addition to disciplined growth. The company has increased dividends in three of the last four quarters, and core earnings cover the current annual dividend of $1.52 by a comfortable 1.1 times. Also, undistributed earnings provide incremental support of the dividend above core earnings. The backlog of undistributed earnings from 2011 allowed Ares to pay an extra dividend of $0.05 per share in the third quarter of 2012, which the company expects to repeat in the fourth quarter.

The company's strong balance sheet has ample liquidity, conservative investment assets, and low leverage. Its portfolio of largely senior secured, floating rate loans is well positioned to boost earnings as interest rates rise in the future. And as traditional bank lenders have exited the middle market due to regulatory constraints and problem mortgage portfolios, non-bank lenders like Ares have and will continue to benefit. Overall, we regard Ares as an attractive income investment with the potential for further growth and appreciation.

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 $585 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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