EDGEMOOR
INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Ignore Washington and Don't Buy Bonds

Greetings from Bethesda, MD, uncomfortably close to the epicenter of the latest federal government shutdown and debt ceiling stalemate. Alas, we wish we could influence our political leaders to reach agreement on these issues, so that the rest of us could live our lives without the headaches and distractions of the current battle in Washington. Since we have no such power, we will instead maintain our focus on the markets and deliver in the paragraphs to follow our latest thoughts regarding investing today, including the reasons we remain bullish on equities but are not buying bonds.

More Good Returns for Stocks

First, a recap of the year so far, which has been very kind to stocks while less so to bonds. Ignoring the "sell in May and go away" mantra, the S&P 500 index continued its strong run through the third quarter, rising 5.2% to finish up 19.8% for the first nine months of 2013. Bonds, however, had a loss of 1.9% for the year through September, as evidenced by the Barclays U.S. Aggregate Bond Index.

The U.S. Federal Reserve's efforts to keep interest rates low and stimulate the economy remain among the primary factors influencing the markets. Concern in August that the Fed would reduce its bond purchases, given slow but steady improvement in economic conditions, caused stocks to drop about 5% during the month, only to recover to a new high when the Fed backed off its plans to taper in September.

Five years after the market's historic swoon in the fall of 2008, stocks have recovered their losses and more, yet we are still bullish. It now appears that the Fed is unlikely to reduce its economic stimulus this year, good news for the stock market. In addition to the Fed's support, underpinnings of the market rally that we expect to continue include improving economies in the United States and abroad - even in Europe - and rising corporate earnings.

We foresee more volatility as Congress and the White House continue to wrangle. We do not pretend to know what will happen or when, though we consider a default on government bonds to be unlikely and do not expect the current crisis and debate to have a long-term impact on the economy or markets. Meanwhile, we are holding the stocks we own and looking for opportunities to buy as the battles over the budget and debt ceiling settle down.

Why We Are Avoiding Bonds

While bullish on stocks, we remain bearish on bonds. In the last several editions of our quarterly report, we have briefly outlined the case for shunning bonds in today's market environment. Because we still believe in this approach, even more now than before, we want to offer some greater detail behind our reasoning.

Before we do so, however, it is important to note that we do not always avoid bonds. In the past we have purchased bonds when they offered much higher yields than those available today. For example, several years ago in the wake of the financial crisis we were able to purchase investment grade bonds maturing within five years and offering yields to maturity of approximately 8%. Investors had dumped these debt securities, along with just about everything else they owned, fearing that the crisis would get even worse. We saw opportunity in buying these bonds, which were backed by healthy companies we believed would recover from the recession, and we pounced.

Unfortunately, no such opportunity exists today. After a long, prosperous run dating back to the early 1980s, bond yields have fallen to historical lows. As a result, basic math conspires against today's investor and makes bonds unappealing investments.

The best outcome for someone buying a bond today would be for rates to remain at current levels until the bond matures, which would result in a return to the bondholder equal to the coupon rate of the bond. However, yields are currently too low on Treasurys and many other bonds to allow the bondholder to outpace inflation. In other words, the 2.7% coupon offered on a 10-year Treasury note bought today will make payments to the bondholder that, adjusted for inflation and taxes, are less than the purchase price of the bond.

More likely - and here is where the bond math gets downright cruel - the investor buying today will see the value of the bond fall when interest rates rise further, which we believe they are destined to do. History shows that interest rates tend to rise and fall in cycles lasting roughly thirty years each, and we are currently at the end of the latest bullish cycle. In a recent study, market analyst Louise Yamada found that the average interest rate on government bonds since our nation's founding has been about 5.2%. Furthermore, interest rates have a remarkable tendency to rise after periods spent below the historical average and fall from levels above the average. With the U.S. 30-year Treasury bond currently yielding 3.7%, Yamada concludes that rates will rise in the coming years. We agree and expect investors purchasing bonds today will lose money as rates return to normal levels.

Of course, there are always exceptions to market patterns, and there may be some bonds that offer attractive returns, at least in the short term. The point we are making is that bonds as an asset class are not appealing today, particularly relative to other opportunities.

What to Buy for Income

Given the dour outlook for bonds, where might investors look for income in today's markets? As noted in earlier reports, we favor a variety of securities that provide higher income and/or offer the potential for increased payouts over time, which protect an investor from inflation.

For example, while bonds provide fixed payments at a stated coupon rate, common stocks and master limited partnerships distribute a portion of their cash flows as dividends or distributions. As the earnings and cash flows of the companies issuing these securities improve, these firms are able to increase their payouts to shareholders. In fact, purchasers of these securities expect payouts to rise, part of the return potential that attracts investors to buy them. Also, the dividends and distributions paid by these securities are taxed at a lower rate than interest income from bonds.

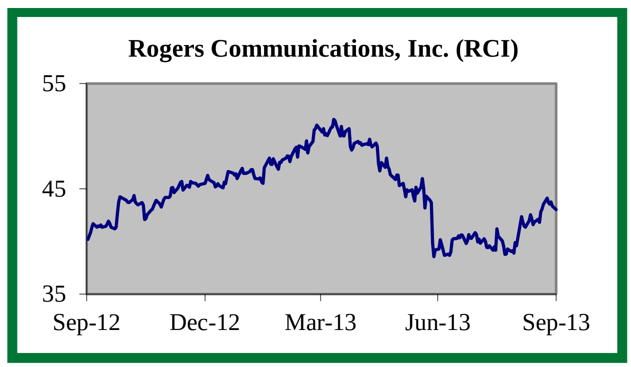
Convertible securities also provide attractive yields and appreciation potential. Convertibles, like bonds, pay a fixed amount of interest or dividend, but they also offer the opportunity to benefit from appreciation in the value of the underlying common stock.

Finally, high yielding preferred stocks also continue to play a role in our income portfolios. Given that most are callable in five years or sooner, we are careful to buy these securities close to, or preferably below, par value to minimize the potential for loss of value if they are called. Because of their fixed payments, we target preferreds that carry yields well above current bond rates, which provides protection against rising rates.

Analysis of Selected Securities

Following is a discussion of several of the securities we own and have been buying recently. Rogers Communications and Spectra Energy are both good examples of income investments that offer yields higher than that of the 10-year Treasury and also have the potential for dividend growth to offset inflation. The third, Express Scripts, is a growing company in the health care sector.

Rogers Communications, Inc. (RCI)



Price (9/30/2013)	$ 43.01	Forward P/E	11.9
Market Cap ($B)	$ 22.1	Price/Book	5.4
Dividend Yield	3.9%	Price/Sales	1.8
Return on Equity	48.5%		

Rogers Communications is the largest wireless communications provider in Canada, as well as the country's #1 cable TV company and the top Internet service provider to businesses. Operating in a virtual oligopoly with two other large telecom incumbents – Bell Canada and Telus - RCI has several powerful competitive advantages, including a high-quality subscriber base, the most reliable network in the country, and the largest and fastest growing share of the smartphone market in Canada.

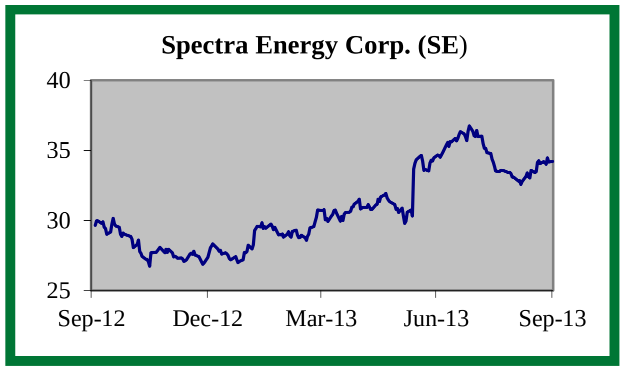
Rogers possesses many of the characteristics we look for in our income investments, including a high current yield with growth potential supported by an essential services business. Rogers generates the majority of its revenues from wireless services, including voice and data, and enjoys a subscriber base that is 85% under contract, leading to low turnover, high margins, and steady, recurring revenues. The wireless industry in Canada is an estimated two to three years behind that of the United States, meaning that cellphone penetration is still poised to grow at double-digit rates for the next several years. And with the largest share of Canada's smartphone market, Rogers should continue to benefit from growth in high-margin data services, which command almost double the rate of voice-only wireless plans.

Rogers' market position is well entrenched. A recent decision by AT&T and Verizon not to enter the Canadian wireless market by participating in an upcoming spectrum auction was good news for incumbent players like Rogers. These U.S. giants did not see a benefit in investing heavily in infrastructure, spectrum, and operations to become the fourth player competing against an oligopoly of three companies that jointly control 90% of the Canadian wireless market.

Rogers' financial position is solid, with strong free cash flow, stable margins, and reasonable leverage. Management has shifted its focus in the last several years from an aggressive acquisition strategy to one with an eye toward capital allocation, cost-cutting, and shareholder returns. The company has raised its dividend by more than 10% annually over the past five years and reinitiated its stock buyback program earlier this year.

With its attractive and growing 3.9% dividend, reasonable valuation of 11.9 times forward earnings, and continuing good growth prospects in Canada, RCI is a solid, core income investment for the long term.

Spectra Energy Corp. (SE)



Price (9/30/2013)	$ 34.23	Forward P/E	16.1
Market Cap ($B)	$ 23.2	Price/Book	2.6
Dividend Yield	3.6%	Price/Sales	4.3
Return on Equity	10.9%		

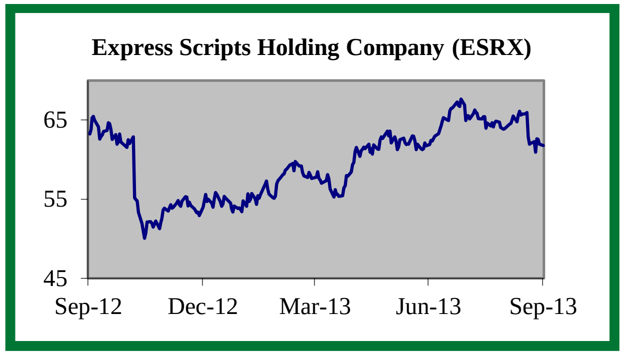
Spectra Energy, a 2007 spin-off from Duke Energy, is another example of an attractive and growth-oriented income investment. Spectra is one of the largest pure-play midstream natural gas companies in North America, operating over 19,000 miles of transmission pipelines and controlling nearly 7% of U.S. natural gas storage capacity. Spectra's valuable infrastructure assets in transportation, storage, and distribution provide critical links for natural gas supplies to reach high-volume end markets throughout the United States and Canada.

Spectra operates like a toll collector, generating 80% of its revenues from fees collected for transporting, storing, and distributing natural gas to end users, a model that makes it less vulnerable to commodity price swings. In addition, its core strategy has been to concentrate its assets within a local monopoly, controlling both the first and last mile of the distribution system, which provides a huge competitive advantage in its markets.

The company has successfully employed a drop-down asset strategy for several years, by which it sells assets to its master limited partnership, Spectra Energy Partners (SEP), to lower its overall cost of capital and tax efficiently distribute cash flows through partnership distributions from SEP. In June 2013, Spectra announced that it will drop down its U.S. storage and transmission assets to SEP in a transaction valued at $10.9 billion. Not only will this deal accelerate the value recognition of these assets for Spectra, but it will also fund annual dividend increases of $0.12 per share for SE shareholders through 2015. In addition, the transaction will shift capital raising costs for future projects to SEP, improve Spectra's financial flexibility, and likely raise its market valuation multiple.

Overall, we like Spectra Energy for its wide economic moat, well-positioned asset footprint, fee-based revenue model, and good long-term growth prospects. We expect management to continue its focus on building the business for the long term, with $25 billion of growth projects planned for the next decade. These investments should drive continued dividend growth, which has averaged 7% annually since 2010, well into the future.

Express Scripts Holding Company (ESRX)



Price (9/30/2013)	$ 61.80	Forward P/E	12.0
Market Cap ($B)	$ 50.1	Price/Book	1.2
Dividend Yield	0.0%	Price/Sales	0.5
Return on Equity	14.6%		

Express Scripts is the largest pharmacy benefits manager (PBM) in the United States. The company processes and administers more than 1.5 billion prescriptions annually through its vast network of retail and mail order pharmacies, equating to a commanding 40% market share. It provides these services to a huge array of customer groups, including managed care companies, insurance carriers, employers, public sector employees, third-party administrators, and union-sponsored benefit plans.

Express Scripts acquired rival Medco in 2012 in a $30 billion acquisition that catapulted the company into its dominant position in the PBM market and also solidified its position as the low-cost provider of drugs for customers and insurers. The company has successfully realized nearly $1 billion in cost savings from the acquisition while maintaining greater than a 90% customer

retention rate, which is a testament to management's strong acquisition track record.
The PBM industry is highly competitive, but Express Scripts' size and scale afford it numerous advantages. These include the ability to extract better rebates from brand name drug makers, the financial leverage to efficiently cover the fixed operating costs of its large mail order facilities, and the enjoyment of solid profit margins on generic drugs, which are the fastest growing segment of the drug market.

Regulatory changes represent both a risk and an opportunity for Express Scripts. On balance, however, the Affordable Care Act aims to add approximately 37 million uninsured Americans to the health insurance rolls, which will in turn increase demand for the company's services, whatever the success rate of the healthcare exchanges. Moreover, the added focus on controlling prescription drug costs will also favor players like Express Scripts, whose business model is already based on lowering pharmaceutical costs for both consumers and insurers.

Overall, Express Scripts' size, scale, and low-cost operating structure make it one of the only wide moat companies in the entire healthcare industry. And with its attractive valuation of just 12x forward earnings and good growth prospects, Express Scripts is our favored long-term holding in the sector.

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

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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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