Edgemoor's Quarterly Report

Suite 315
7250 Woodmont Avenue
Bethesda, MD 20814
301-543-8881
www.edgemoorinv.com
www.edgemoorblog.com

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All Eyes *Still* on the Fed

Careful readers will note that we just repeated a headline from last quarter's report, with the addition of one word. Our excuse is that the markets are hanging on every hint coming from the U.S. Federal Reserve related to the timing of any future actions, and we expect this obsession to continue. We forecast ongoing support from Fed policies and solid third quarter corporate earnings, which should combine to boost markets through the end of the year, barring extraordinarily adverse international economic or armed conflict developments. In the meantime, investors should brace themselves for more volatility similar to what we have seen recently.

Volatility Returns

In the first weeks of the fourth quarter, we have experienced some of the biggest daily moves in the stock market in many months. Stocks have whipsawed due to global issues and the impact on the markets of potential Fed reaction. One day, the markets view Fed concerns about the economy as good news, a sign that any action to raise rates will be later rather than sooner. The next, the markets view the Fed's comments as reasons to be worried about corporate earnings. Up and down the stock market has gone, mostly down. Meanwhile, investors have bid up Treasury bonds, causing yields to plummet to the lowest level since June 2013.

The Fed has clearly stated its commitment to keeping interest rates at their extreme low levels for as long as necessary to support economic growth and prevent the United States from slipping back into recession. At the same time, the Fed has made clear its intention to end bond purchases in October as planned, thus removing some of the stimulus it has been providing for the past several years.

Markets have been struggling to predict the exact timing of any other Fed moves, and nobody knows exactly what the impact will be. As a result, volatility has picked up. Based on current market information, it appears that the Fed will not hike rates until late 2015, and we expect the increase to be gradual. Any signs that rates will rise sooner or more rapidly would no doubt add to volatility.

U.S. Versus Global Economies

Recent data support the Fed's view that the U.S. economy remains healthy. The latest employment report confirmed that the job market continues to improve, with 248,000 jobs added in September and an average monthly increase of over 200,000 jobs for the past year. The unemployment rate has dropped to 5.9%, but stagnant wages indicate that employers still have the upper hand in setting pay. As a result of these labor conditions and falling commodity prices, inflation remains tame, an important condition for the Fed's ongoing support of low interest rates.

The housing sector is one area of particular focus and concern, and recent data have been mixed, with housing starts and sales of existing homes declining but new home sales rising. We expect the housing market to continue to improve, fueled by low interest rates.

Even though growth has been slower than in past recoveries, the current U.S. economic recovery has been an extended one, and the United States should continue leading the world's major economies. Europe is still struggling to escape from its doldrums, exacerbated by extreme cuts in spending. Uneven economic growth in China has also contributed to the decline in demand for commodities and hurt exporters that depend on Asia for sales.

Concerned about slowing economies, the Japan Central Bank and European Central Bank have made it clear that they will keep rates low indefinitely to boost growth. As a result, even the paltry yields offered in the United States are better than those abroad, a situation that has caused investors to flock to the U.S. bond market. Given its relative economic strength and higher interest rates, the United States should remain attractive relative to foreign markets for a while.

The strength of the dollar, which has risen about 5% so far this year, presents a bit of a conundrum. The appreciation of the dollar has contributed to falling prices of commodities and reduced the cost of U.S. imports, both trends that boost the purchasing power of U.S. consumers. For example, oil prices have fallen to about $85 per barrel, more than 20% below their recent peak, good news for consumers and companies with high energy costs.

However, the stronger dollar makes U.S. exports less attractively priced relative to goods produced abroad, putting pressure on U.S. companies to keep costs, including wages, low to remain competitive. Some large U.S. companies and other exporters will likely see a net reduction of earnings over the coming quarters as a result of the currency trends. Also, lower oil prices are bad news for oil producers, whose profits suffer when prices fall.

Geopolitical issues remain a concern. Unrest throughout the Middle East, Russian aggression in Ukraine, and financial troubles in Argentina are among the recent issues around the world. While specific regions and companies will no doubt suffer until these conflicts and problems end, we do not think the impact on the global economy and markets will be severe.

Earnings Season and Midterm Elections

Forecasts call for third quarter corporate earnings increases averaging about 5%, which should alleviate some concerns about economic strength. Investors will pay careful attention to the outlooks voiced by management teams as earnings season unfolds. We will be watching for confirmation that the companies we own are optimistic about their long-term prospects, as well as for occasions to buy shares of others that express short-term concerns and become available at prices below fair value.

In addition to earnings, another bullish sign is that the stock market has consistently performed well following midterm elections, which we will have in early November. A recent article in *Barron's* cited a study showing that following each of the 17 midterm elections since 1945, stocks have closed higher one year later, rising an average of 17.5%. We will not rely blindly on this amazingly consistent cycle to continue, but the trend is interesting and somewhat reassuring, nonetheless.

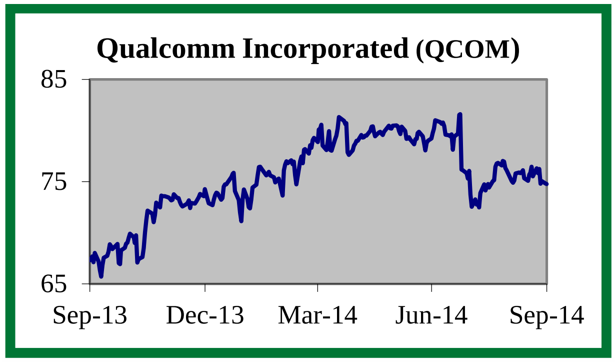
Steady As She Goes

With the recent pullback in prices, the S&P 500 index trades close to its fair value and its historical average of about 15 times forward earnings. Within the broad market, we continue to find opportunities to buy and hold stocks trading for less than fair value. Though emotionally difficult, pullbacks are healthy for the markets and present us with buying opportunities. The S&P 500 index is down about 7% from its peak, and we will likely see a larger drop at some point in the near future. If so, we will take advantage where we can, and we remain optimistic about the long-term prospects for our portfolios.

Analysis of Selected Securities

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

Qualcomm Incorporated (QCOM)



Price (9/30/14)	$ 74.77	Forward P/E	13.8
Market Cap ($B)	$ 125.0	Price/Book	3.2
Dividend Yield	2.1%	Price/Sales	4.9
Return on Equity	19.8%		

Qualcomm is a world leader in 3G, 4G, and next-generation wireless technologies. Its innovative CDMA technology is the core of all 3G wireless networks, enabling mobile devices to send and receive voice and data.

Qualcomm licenses its technology to virtually every major handset maker in the world, including Samsung, LG Electronics, and Motorola, and collects a 3-5% royalty fee on each device sold. Qualcomm's exclusive patent on this essential technology is the source of the company's wide economic moat.

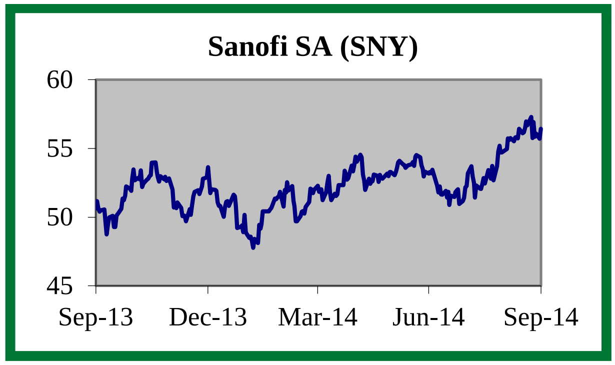
Qualcomm's licensing and royalty fee segment accounts for 38% of total sales and enjoys unrivaled 87% operating margins. Rapid growth in the smartphone market has increased licensing revenue for Qualcomm by more than 30% in each of the last three years. While this pace may slow, we still expect solid growth as Qualcomm's dominant 3G and emerging 4G technologies continue to set the standard for wireless connectivity. We do not expect an ongoing dispute about the collectability of certain royalty fees in China to have a meaningful impact on Qualcomm's long-term earnings power.

Qualcomm also manufactures high-end semiconductor chips for the mobile smartphone market. The company's chip business is a robust operation with solid growth potential and a stable market position. Qualcomm is the sole chip supplier for Apple's iPhones and iPad, has a strong share of high-end Android devices, and supplies chips for all Windows phones.

Qualcomm's financial position is strong, and its shareholder practices are friendly. The company has stated publicly its intention to distribute 75% of free cash flow to shareholders and raised its dividend 20% in the second quarter of 2014, the 12th consecutive year it has increased its payout. In March 2014, the Qualcomm board boosted its share repurchase authorization by $5 billion, bringing the total to $7.8 billion, of which $3.5 billion has been repurchased so far this year.

At a reasonable 13.8x forward price/earnings ratio and with a healthy 2.1% dividend yield, Qualcomm shares offer an attractive way to participate in the growing global smartphone market.

Sanofi SA (SNY)



Price (9/30/14)	$ 56.43	Forward P/E	7.2
Market Cap ($B)	$ 147.0	Price/Book	2.2
Dividend Yield	3.5%	Price/Sales	3.5
Return on Equity	7.7%		

Sanofi is the largest pharmaceutical company in continental Europe and the fifth largest in the world. Backed by a world-class research and development organization, Sanofi has developed leading drugs and vaccines in seven major therapeutic areas, including diabetes, oncology, thrombosis, and cardiovascular disease.

Sanofi's blockbuster drug Lantus is the largest selling insulin drug in the United States and is at the core of the company's well-entrenched diabetes franchise. The drug's best-in-class status and ability to last throughout an entire day set it apart from other insulin drugs, including the better-known but now unpatented Plavix.

Sanofi's wide line-up of branded drugs and vaccines produces strong earnings and cash flows and, together with its robust pipeline of new drugs, is the source of the company's wide economic moat. After an extended period of patent run-offs over the last decade, the company appears to be at an inflection point of new growth as patent losses fade. We expect steady gains over the next three to five years from launches of the next generation of insulin drugs, as well as growth in vaccines, consumer products, and animal health treatments.

Sanofi's sales are global and diverse, with emerging markets accounting for 32% of sales, the United States 31%, Western Europe 24%, and Asia/other 13%. Growth in emerging markets is expected to top 15% per year through 2016, driven by rising standards of living and increased government spending on healthcare.

Financially, the company is strong and sound. It enjoys high margins, consistent cash flow, and low debt. Sanofi has a history of making prudent acquisitions that have generated strong returns and enhanced the company's competitive position. Management also has a good track record of returning cash to shareholders through steadily increasing dividends.

Trading at an attractive 7.2x forward price/earnings ratio and offering a healthy 3.5% dividend yield, Sanofi shares are a good value play in the global pharmaceutical market.

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 $750 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.

Thomas P. Meehan – President
(301) 543-8881
tmeehan@edgemoorinv.com

Timothy C. Coughlin, CFP® – Managing Director
(301) 543-8371
tcoughlin@edgemoorinv.com

R. Jordan Smyth, Jr., CFA – Managing Director
(301) 543-8370
jsmyth@edgemoorinv.com

Paul P. Meehan, CFA – Managing Director
(301) 543-8373
pmeehan@edgemoorinv.com

Gay S. Truscott, CFP® – Senior Vice President
(301) 543-8375
gtruscott@edgemoorinv.com

Christine J. Potts – Vice President
(301) 543-8365
cpotts@edgemoorinv.com

Sara R. Parker – Vice President
(301) 543-8363
sparker@edgemoorinv.com

Anne Baker – Executive Assistant
(301) 543-8366
abaker@edgemoorinv.com

Suite 315
7250 Woodmont Avenue
Bethesda, MD 20814
(301) 543-8358 fax

www.edgemoorinv.com
www.edgemoorblog.com