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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Rising Waters

The stock market rose steadily in the third quarter, and major indexes have already hit new highs early in the fourth. Neither severe storms in the United States and Caribbean, nor geopolitical tensions in North Korea, nor angst over the U.S. Federal Reserve's plans to tighten monetary policy, nor political turmoil in the United States caused stocks to diverge from their upward path. Another round of strong earnings reports fueled the rally, and market volatility remained historically low.

We are currently optimistic that the combination of low interest rates and inflation, steady economic growth around the world, and solid earnings will continue to support stock prices. Passage of a bill reducing U.S. corporate income taxes could provide an additional boost to earnings and stocks. Balanced against these positive trends and opportunities, valuations are high relative to historical levels, threats lurk in many places, and a market reversal at some time in the future is inevitable. In our view, confidence in a proven long-term strategy and careful selection of securities will be the keys to weathering any approaching storm.

Third Quarter in Review

The S&P 500 index returned 4.5% in the third quarter and even climbed in September, a month that usually brings declines. U.S. market volatility has been subdued for almost the entire year and during the third quarter was the lowest since 1968. Foreign stocks also rose, led by emerging markets' nearly 7% jump.

S&P 500 index companies reported that earnings increased about 10% in the second quarter, following an even higher rise in the first, as the economy steadily expanded. The Bureau of Economic Analysis measured GDP growth of 3.1% for the second quarter, up from 1.2% in the first. The U.S. economy has added an average of 176,000 jobs per month in 2017 (before the hurricane-affected results for September), only slightly below the 187,000 pace in 2016, and unemployment is low at 4.2%. The most recent PMI reports show that the manufacturing and services sectors expanded in September at the highest rates since 2004-2005.

Wage growth has hovered around 2.5% annually, lower than during past recoveries. However, with inflation struggling to reach the Fed's target of 2%, real (inflation-adjusted) wages are still rising. Some companies have recently announced wage hikes heading into the holidays, and the tightening employment market could lead to higher labor costs and some pressure on corporate profit margins.

The dollar has declined over 7% since the beginning of the year, though it has stabilized recently. This drop is good for U.S. exporters, whose goods have become less expensive in foreign currencies. The weaker dollar has also boosted demand and prices for commodities, which are typically priced in dollars around the world. Oil rebounded sharply from June lows to nearly $52 per barrel as demand increased, but most forecasts call for oil prices to remain at or below their current levels.

Our Outlook

We expect the U.S. economy to continue its steady expansion, even as the Fed removes some of the monetary stimulus it has provided since the Great Recession. Current expectations are for one more Fed rate increase of 0.25% this year, most likely in December. Low inflation due to a combination of technological improvements, globalization, and demographics gives the Fed reason to move slowly with rates. We believe the markets will most likely take any slight increase in stride, as with other recent Fed moves.

The Fed has also announced plans to trim its bond holdings by no longer reinvesting proceeds it receives from maturing bonds. We believe this gradual reduction will also have minimal impact on economic growth or the markets. U.S. interest rates will be even more attractive relative to other countries' if the Fed proceeds with its plans, and foreign capital should find its way to the United States in search of higher yields. Because of these inflows and the Fed's plans to move deliberately, we believe interest rates will remain low for the foreseeable future.

We think the near-term risk of a U.S. recession is modest, despite the current expansion's relatively long tenure. Consumer confidence is currently high, leading indicators point to ongoing GDP growth, and rebuilding efforts should make up for lost economic output from recent hurricanes. There may be some degree of tax reform, which could help increase corporate profits. Even if broad tax reform does not pass – certainly a possibility amidst the current political turmoil in Washington – a reduction of taxes on corporate cash brought home from abroad could boost domestic business spending and stock repurchases.

Also, low interest rates provide capital to fund consumer spending and business investment, and we do not believe current yields point to a recession. Each recession since the 1960s was preceded by an inverted yield curve, a situation in which short-term interest rates are higher than long-term rates that indicates pessimism about the economy. The current yield on the 10-Year Treasury is 2.4%, comfortably above the 1.1% yield on the 3-Month Treasury.

Global economies are expanding together for the first time since the Great Recession, and we expect this trend to continue. The Chinese government has taken steps to rein in economic growth, but the rate of expansion in China is still high relative to the rest of the world. Europe's expansion looks sustainable for the near term, despite pressures from Brexit and secessionist movements in Spain and elsewhere.

Overall, we see a benign environment that should support further increases in stocks, and we continue to prefer those that trade for multiples of earnings that are below the market's average. Due to current low interest rates and expectations for their gradual rise, we continue to favor preferred stocks, pipeline companies, utilities, and other higher yielding securities over bonds for most of our income investments.

While we are rooting for more gains, we do expect a correction in the markets at some point. However, the timing of any pullback is unpredictable, and the catalyst may be an event that few could foresee now. We believe the best course is to stick with our value-oriented investment strategy through the current good times and any tough times to come.

Analysis of Selected Securities

Following is a discussion of three 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.

Affiliated Managers Group, Inc. (AMG)

Past performance is not indicative of future results. Please see disclosures on page 8.

Price (09/30/2017)	$189.83	Forward P/E	13.2
Market Cap ($B)	$10.8	Price/Book	3.0
Dividend Yield	0.3%	Price/Sales	5.1
Return on Equity	15.6%	Debt/Equity	0.6

Affiliated Managers Group, Inc. (AMG) is an asset management company that owns equity interests in small and mid-size boutique investment managers around the world. AMG's affiliate model provides it with a diverse mix of assets under management (AUM) and earnings, as well as exposure to a variety of asset classes and investment styles, including value and growth equity strategies, emerging markets equities, fixed-income products, and alternative investments.

AMG is selective in the firms it acquires and typically buys only a 50%-60% stake in order to leave plenty of equity with the selling managers to keep them motivated and engaged. Over several decades, AMG has built a portfolio of highly-regarded affiliate firms, including Yacktman (global equities), Tweedy Browne (value equities), AQR Capital Management (equities, fixed income, alternatives), and Blue Mountain (hedge funds).

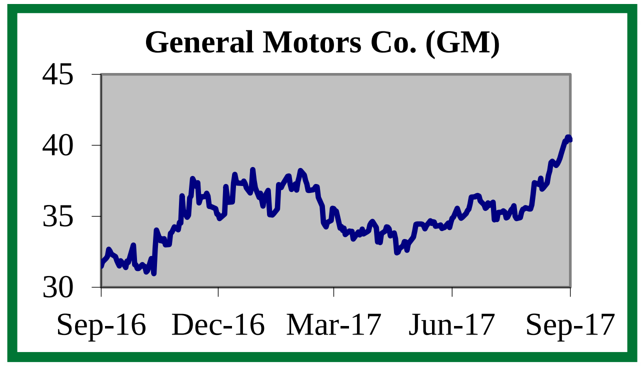
Assets under management totaled a record $772 billion at June 30, 2017, representing 20% year-over-year growth. Institutional clients represent 58% of AUM and 40% of revenues, mutual fund clients stand at 27% and 47%, respectively, and high net worth individuals account for 15% and 13%, respectively.

AMG's diverse platform limits its dependence on any one market or distribution channel. With nearly 60% of its AUM coming from clients outside of the United States, AMG is more global in scope than many of its peers. We believe the company's focus on institutional and high net worth clients (73% of AUM) gives AMG more long-term, relationship-based clients than retail oriented managers. And finally, with 38% of AUM dedicated to alternative strategies (hedge funds, private equity, etc.) and 13% to multi-asset products, we believe AMG is less exposed to the competitive threat that passive investment strategies pose to many active managers.

AMG's business model also sets it apart from most traditional asset managers. The company allows its affiliates to continue to operate independently and does not involve itself directly in the management of investments. Instead, it provides strategic, operational, marketing, product development, and distribution support in exchange for a fixed percentage of revenues. For much of the last three decades, this hands-off approach has made AMG the buyer of choice for many boutique investment managers seeking liquidity but not loss of control.

We consider AMG stock attractively valued currently at 13.2 times estimated 2018 earnings, which are expected to grow by 3% according to consensus forecasts. In February 2017, the firm initiated a dividend that we predict will increase as AMG continues to generate significant free cash flow to use for strategic investments, share repurchases, and dividends.

General Motors Co. (GM)



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Price (09/30/2017)	$ 40.38		Forward P/E	7.1
Market Cap ($B)	$ 63.3		Price/Book	1.4
Dividend Yield	3.5%		Price/Sales	0.4
Return on Equity	19.9%		Debt/Equity	1.3

General Motors Co. (GM) is the largest automaker in the United States and the second largest worldwide. GM enjoys a commanding 18.3% share of the U.S. car and truck market, ahead of both of its Big Three competitors, Ford and Fiat/Chrysler. The company is also among the largest auto sellers in China, the world's largest car market.

GM has transformed its operations since its bankruptcy filing in June 2009 during the depths of the financial crisis. The filing allowed GM to shed billions of dollars in liabilities, sharply reduce its dealership count, and decrease its production footprint and operating costs. These actions have drastically lowered the company's cost structure such that it has the potential to remain profitable even if total U.S. annual car sales drop back to recession era levels. GM's break-even point is now 10.5 - 11 million total annual U.S. vehicle sales, compared to an estimated 17 million U.S. auto sales projected for 2017.

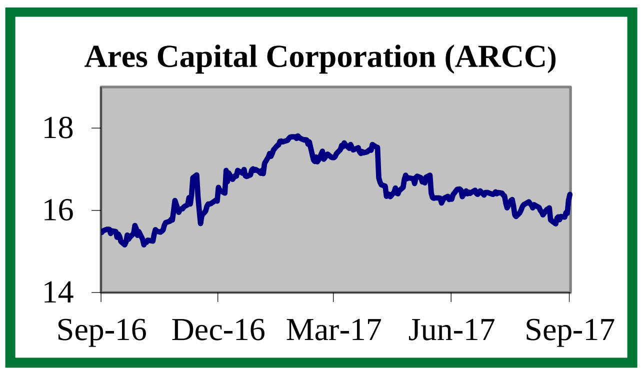
GM has reduced manufacturing complexities by moving rapidly toward a goal of producing 96% of its vehicles on global platforms by 2018, compared to just 39% in 2010. GM has also refocused on its customers by emphasizing style, reliability, and value in its vehicles. The company has rationalized its product lineup by reducing the total number of brands from eight to four, closed redundant or inefficient manufacturing plants, and spun-off a voluntary benefit association for its retirees.

In early 2017, GM announced the sale of its unprofitable European brands, Opel and Vauxhall, to the PSA Group for $2.3 billion. The sale should improve operating margins and reduce annual capital spending by an estimated $1 billion, freeing up cash for share repurchases and other investments.

North American total vehicle sales may have peaked in mid-2017, but light truck and crossover vehicle sales are up sharply this year. In addition, the impact of Hurricanes Harvey and Irma is expected to boost replacement auto sales significantly through the end of the year, as those storms damaged or destroyed an estimated 1 million vehicles in Texas and Florida. GM sales jumped 12% in September, led by a 10% increase in pickup trucks and a 43% surge in crossover sales.

GM's stock valuation remains compelling, even with its strong run-up this year. At a 7.1x forward P/E, GM trades within its peer group range and well below the S&P average of 19x forward earnings. The stock also looks attractive based on other valuation metrics, including price/book value (1.4x) and price/sales (0.4x). GM has completed more than $9 billion of share repurchases since 2015 and announced in January 2017 plans to repurchase another $5 billion of stock in the coming year. The company reinstated its dividend in 2014 and currently pays $1.52 per share to yield 3.5%, which compares favorably to the S&P average of 2%. We applaud management's pledge to return all available free cash flow to shareholders after maintaining its investment-grade balance sheet and at least $18 billion of cash to reinvest in the business.

Ares Capital Corporation (ARCC)



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Price (9/30/2017)	$ 16.39	Forward P/E	11.2
Market Cap. ($B)	$ 7.0	Price / Sales	5.6
Dividend Yield	9.3%	Price / Book	1.0
Return on Equity	7.8%	Debt/Equity	0.7

One of our long-term income holdings, Ares Capital Corporation (ARCC) is a specialty finance company that provides debt and equity financing to private, mid-size companies across diverse industries. With a market capitalization of $7.0 billion, Ares is the largest regulated business development company (BDC) under the Investment Company Act of 1940.

Ares Capital's acquisition of competitor Allied Capital in 2010 in the aftermath of the financial crisis roughly doubled the assets of the company and, at 60% of Allied Capital's book value, was attractively priced and highly accretive to shareholders. In January 2017, Ares Capital purchased another large competitor, American Capital Ltd., boosting its total assets under management to more than $12.3 billion, making it by far the largest publicly-traded BDC.

Ares Capital'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. As a regulated business development company, Ares Capital is required to pay out 90% of its taxable income in the form of dividends to its shareholders to avoid corporate-level taxation. As a result, the shares currently yield an attractive 9.3%.

The dividend is strong and sustainable in our opinion, with current coverage from earnings per share a comfortable 1.1x. In addition, Ares currently has a backlog of undistributed earnings equal to more than two years of future dividends.

Ares Capital's balance sheet has ample liquidity and low leverage, and we believe its portfolio of largely senior secured, floating-rate loans is well positioned to boost earnings as interest rates rise. In summary, we like Ares for our income portfolios because of its leading market position, conservative investment philosophy, and strong and stable dividend.

Source for charts and text: Morningstar, S&P, Schwab, Value Line, Black Diamond Performance Reporting, Yahoo Finance, 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 $897 million as of September 30, 2017 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

Robert H. Roane – Analyst and Assistant Trader
(301) 543-8364
rroane@edgemoorinv.com

Christine J. Potts – Vice President
(301) 543-8881
cpotts@edgemoorinv.com

Sara R. Parker – Vice President
(301) 543-8881
sparker@edgemoorinv.com

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

Suite 315
7250 Woodmont Avenue
Bethesda, MD 20814
(301) 543-8881
(301) 543-8358 fax

www.edgemoorinv.com
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