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INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Economic Recovery Solid but Slowing

The third quarter of 2021 began with renewed hope for the return to some "normalcy," but the rise of the highly contagious Delta variant of COVID-19 over the summer created some setbacks. Still, the economic recovery from the lows of the pandemic has been faster and more pronounced than many expected. U.S. real GDP growth surged in the first two quarters of 2021, at 6.3% and 6.6%, respectively. Although GDP is expected to slow to 5.5% in the third quarter and 3.9% in the fourth, the rate of economic growth in the United States remains strong.

The U.S. unemployment rate, which peaked at 13.1% in the second quarter of 2020, has fallen steadily to 4.8% in September 2021 and is projected to decline further to 4.0% in 2022. Wage growth is also at its highest in two decades, as employers have had to compete for fewer workers due to pandemic-related retirements and work disincentives from Federal relief payments, among other factors. The August manufacturing output level was its highest since early 2019 and capacity utilization hit 76.7%, a rate seen only once since the 2008-2009 recession.

Still, there are economic headwinds which accelerated during the third quarter. Supply chain disruptions, particularly in the semiconductor and energy sectors, continue to ripple through the economy. The surge in demand over the last year, for everything from homes to cars to appliances, has resulted in logistical bottlenecks and supply shortages around the globe. Although we expect these supply chain disruptions to ease in the coming months, they have already led to a noticeable spike in inflation in many sectors. Core CPI, which strips out more volatile food and energy prices, rose to 4.0% year-over-year in September, though it is expected to decline to a more moderate 2.5% in 2022 as supply-demand metrics come more into balance.

Markets Take a Pause

After surging 103% from its pandemic low point 18 months ago, investors saw the S&P 500 take a pause in the third quarter of 2021. The total return for the S&P in the third quarter was just 0.6%, compared to 6.2% in the second quarter. For the month of September, the index declined 4.7%, the first negative return month in 2021. Despite the pullback in September, the S&P 500 was still up an impressive 15.9% year-to-date, reflecting the fundamental strength of corporate earnings and the overall economy.

Investors also had to contend with a sharp increase in volatility in September, particularly among high-flying tech sector names. Two darlings of the pandemic, Zoom and Peloton, are each off more than 50% from their 52-week highs. Overall market volatility, as measured by the CBOE Volatility Index, or VIX, hit a high of 25.7 in mid-September, its highest level since March of 2021. Driven largely by fears of higher interest rates and rising inflation, market volatility seems likely to stick around for the near term.

All Eyes on the Fed

The Federal Reserve signaled in September that it will likely begin tapering its $120 billion monthly bond purchasing program by the end of 2021, rather than in early 2022. This accelerated timetable, though widely expected, boosted Treasury yields back above 1.6% for the first time since May 2021.

However, Fed Chairman Jerome Powell also made it clear that the Fed is in no hurry to raise the short-term fed funds rate from its current near-zero level. Most expect that will not happen until early 2023. This subtle but important distinction between "tapering" (slowing asset purchases) and "tightening" (increasing short-term interest rates) made by Chairman Powell suggests to us that accommodative monetary policy will continue through this year and next, which we believe should be positive for equity markets.

All Eyes on Congress too

In addition to monetary policy, fiscal policy has been a key feature of the economic recovery in the United States. From the massive fiscal stimulus measures passed by U.S. lawmakers during the pandemic, to the current proposed infrastructure legislation being debated in Congress, U.S. consumers and U.S. businesses have benefited greatly from increased government spending.

Where fiscal policy goes from here remains unclear. While the bipartisan $1 trillion infrastructure bill seems likely to pass, the larger $3.5 trillion human infrastructure bill seems destined for significant cuts, due to concerns over exploding government deficits and debt.

The Biden tax proposals, which are designed to raise revenue to pay for his infrastructure bills, also face great uncertainty. However, all signs point to higher taxes for high income earners. An increase in the long-term capital gains rate from 20% to 25% and a reduction in the individual Federal estate tax exemption from $11.7 million to $6.2 million seem likely. However, the good news is that the current proposal does not include an elimination of the step-up in cost basis, which protects inherited appreciated assets from capital gains taxes.

All in all, we are hopeful that a compromise on both infrastructure spending and tax legislation will be reached. Recent agreements on extending both government funding and the debt ceiling until December were important first steps. So, all eyes will remain on Congress through the end of the year.

Outlook

In our view, the outlook for U.S. equities remains positive. Stock valuations are elevated but not unreasonable given a backdrop of low interest rates and strong corporate earnings. A continuation of economic expansion should underpin stocks as we move through the rest of this year and into 2022. Improving economic performance in the Eurozone is also encouraging.

Recent dips in consumer confidence and retail sales due to the Delta variant suggest we could experience a near-term speed bump in economic activity. But we expect the consumer to work through these temporary headwinds as more pentup demand is released into the economy and virus concerns subside.

Portfolio Implications and Actions

We continue to manage client portfolios with a cautious eye toward rising rates and inflation. We also continue to look for pockets of value in an otherwise fully valued market. Fortunately, we are still able to find both equity and income investments that we believe will provide solid returns over the long term.

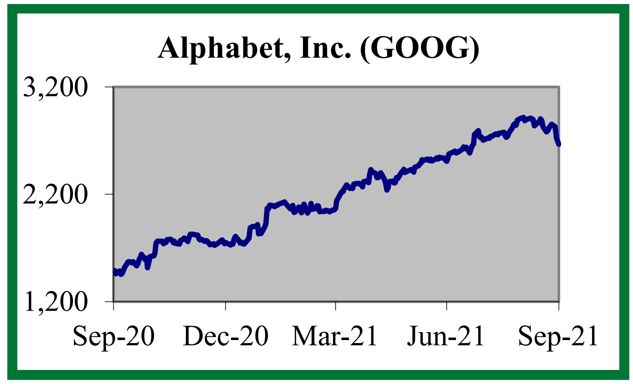
New Hire

We are pleased to announce that Steve LaRosa, CFA, has joined Edgemoor as a Director and Senior Portfolio Manager. Steve has more than 20 years of experience as an investment advisor. Most recently, Steve was a Senior Portfolio Manager at Bank of America Private Bank, where he was responsible for managing over $1 billion in client assets. Steve holds a B.S. from the Boston College Carroll School of Management and an MBA from Columbia Business School, where he was selected to participate in the Applied Value Investing curriculum. Please join us in welcoming Steve to the Edgemoor team.

Analysis of Selected Securities

Following is a discussion of three securities we own and have bought recently. Due to factors specific to each company, these stocks are, in our opinion, priced attractively in the markets today.

Alphabet, Inc. (GOOG)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 8.

Price (09/30/2021)	$ 2,665.31	Forward P/E	26.0
Market Cap ($T)	$ 1.8	Price/Book	7.7
Dividend Yield	0.0%	Price/Sales	8.5
Return on Equity	28.3%		

Alphabet, Inc. is a global technology company best known for its dominant internet search engine, Google, which controls more than 80% of the market for online searches. In addition, Alphabet's array of other services and applications includes Gmail, YouTube, Google Maps, Google Earth, and Google Play. The company also owns the Android mobile operating system, which powered roughly 73% of smartphones globally as of June 2021. Together, these core assets provide a cohesive, end-to-end experience for consumers and, most importantly, drive advertisers to Alphabet's platforms.

Alphabet benefits from a few particularly strong secular trends, including the continued migration of advertising spending to digital/online platforms, the growth of the cloud, and the shift away from traditional cable television. Most of the company's revenue is derived from advertising, where they are the dominant online presence. However, as digital ad spending accounts for less than 60% of the total, there is a long runway for continued growth.

In the rapidly growing enterprise cloud market, Google Cloud is currently the number three player, trailing only Amazon Web Services and Microsoft Azure. With projected worldwide annual spending of more than $800 billion on cloud services by 2025, Google Cloud may grow into one of Alphabet's largest business segments.

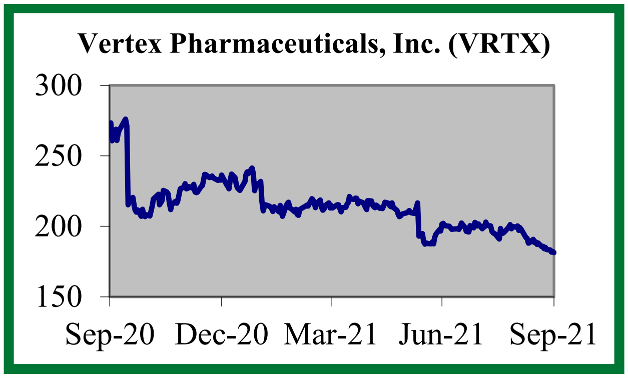
Lastly, Alphabet stands to benefit from the ongoing shift away from cable television. As of 2020, there were more than 2 billion active YouTube users, many of whom are in the 18-49 year-old demographic and don't watch traditional network TV. Most importantly, individual YouTube channels appeal to specific audiences, which is extremely valuable to advertisers seeking to target specific customers. Over time, we think this should enable Alphabet to extract higher fees from advertisers than traditional networks can command.

In addition to the company's current operating businesses, Alphabet also invests heavily in emerging technologies, which they categorize as "moonshot investments". The most notable of these businesses is Waymo, an autonomous driving technology company most recently valued at $30 billion. While most of these investments currently generate losses, they could become substantial money-making businesses within Alphabet and diversify the company's revenue sources.

In our view, Alphabet is financially strong. The company has grown its revenues at a compounded annual rate of 19% since 2011, and it is projected to deliver annual earnings growth of nearly 20% over the next five years. Additionally, the company's balance sheet is solid, with $136 billion of cash and marketable securities and only $14 billion of long-term debt as of June 30, 2021.

At approximately 26 times forward earnings, Alphabet stock trades at a premium to the S&P 500 average price/earnings ratio of 21.5 times, but we believe Alphabet's higher-than-average growth prospects and strong competitive advantages justify the premium.

Vertex Pharmaceuticals, Inc. (VRTX)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 8.

Price (09/30/2021)	$	181.39	Forward P/E	14.0
Market Cap ($T)	$	46.3	Price/Book	5.1
Dividend Yield		0.0%	Price/Sales	7.1
Return on Equity		23.8%		

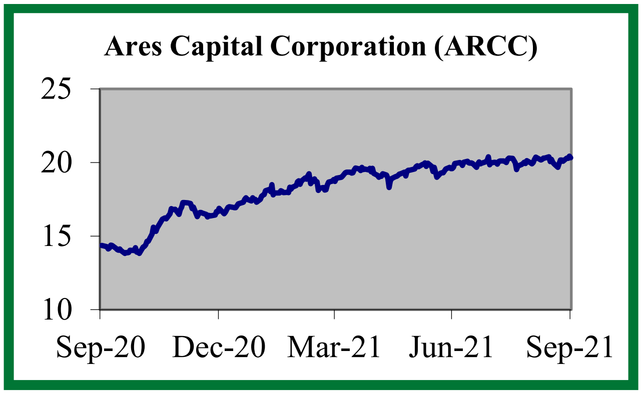
Biotechnology company Vertex Pharmaceuticals dominates the market for the treatment of cystic fibrosis (CF), a rare genetic disease for which the company's therapies are the standard of care. Sales of Vertex's four therapies for cystic fibrosis, headlined by Trikafta, generate substantial cash flows that are reinvested into the research and development of the company's drug pipeline. Trikafta's patents in the United States and Europe run through 2037 and have limited competition due to the rarity of the disease and the complexity of developing a new, more efficient therapy.

There is substantial runway for growth in the CF franchise as they are currently only treating 50% of the global population afflicted with the disease. The company also recently received regulatory approval and reimbursement authorization in several countries outside of the United States. These developments have allowed Vertex to increase revenue projections for 2021 to over $7 billion, an increase of 17% over the previous year. Consensus estimates are for revenue growth of 10% in 2022 to nearly $8 billion.

Meanwhile, the company's pipeline includes a late-stage clinical program with CRSPR Therapeutics to develop a one-time cure for two blood diseases, sickle cell disease and beta thalassemia. Other promising developments in their pipeline include APOL1, a drug that can prevent a certain type of kidney disease, and a recently inked deal with Arbor Technologies to explore gene-editing technologies for a host of disorders, including Type-1 diabetes.

Vertex shares are currently trading at 14 times projected 2022 earnings, compared to a three-year average of 31 times forward earnings. The stock has sold off this year due to setbacks related to a treatment for anti-trypsin deficiency, a genetic disease that can damage the liver and lungs. As a result, the stock has fallen from a high of $300 down to its current share price near $180, presenting a buying opportunity. In our estimation, the value of their CF franchise alone is worth north of $200 per share. The company generates nearly $3 billion in free cash flow and should end the year with close to $8 billion in cash on their balance sheet and no debt. We think there are multiple avenues for upside in the stock, and the current price represents a compelling value for long-term investors.

Ares Capital Corporation (ARCC)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 8.

Price (09/30/2021)	$	20.33	Forward P/E	11.6
Market Cap. ($B)	$	9.5	Price/Book	1.2
Dividend Yield		8.0%	Debt/Equity	1.2
Return on Equity		22.6%		

Ares Capital Corporation is a specialty finance company that provides debt and equity financing primarily to private, middle-market companies in the United States. The company invests in various industries, such as automotive services, business services, consumer products, and containers and packaging. With a market capitalization of $9.5 billion, Ares Capital is the largest business development company regulated under the Investment Company Act of 1940.

Ares's investment objective is to generate current income and capital appreciation by investing principally in first and second lien senior secured loans and mezzanine debt, which in some cases includes an equity component. As a regulated business development company, Ares 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, Ares Capital pays an attractive and growing dividend, currently yielding 8.0%. The company recently increased the quarterly dividend by 2.5% to $0.41 per share.

Since its initial public offering in 2004, Ares Capital has invested approximately $70 billion in more than 1,540 transactions and generated an average annual return to shareholders of 13%. The company's current investment portfolio totals $17.1 billion, invested across 365 companies in 23 diverse industries. Largely comprised of senior secured, floating-rate loans, we consider the portfolio well positioned to lift earnings as interest rates rise.

In addition to organic growth, Ares has made several well-timed, opportunistic acquisitions to grow its business and market share. The company's 2010 acquisition of competitor Allied Capital 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. In January 2017, Ares Capital acquired another large competitor, American Capital, boosting its total assets under management to more than $12 billion and making it by far the largest publicly traded business development company.

With cash and investments at fair value of approximately $17.5 billion and debt and operating leases of $9.4 billion, Ares Capital's balance sheet has ample liquidity and relatively low leverage. Ares also enjoys an investment grade debt rating from all three credit rating agencies.

We believe Ares Capital is an attractive, long-term income investment due to the company's leading market position, conservative investment philosophy, and attractive and growing dividend.

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 $1.1 billion as of September 30, 2021 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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