Edgemoor's Quarterly Report

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Winter 2012

Getting By

Ask the average person on the street what happened in the stock market in 2011, and you may hear a tale of angst and suffering. In reality, although there was plenty of bad news in 2011, the market managed to deliver a positive return to investors. The S&P 500 rallied 11.8% in the fourth quarter and returned 2.1% for the year, including dividends.

Because of significant economic concerns, the year felt much worse than it actually was. While we are not suggesting that earning 2% annually over time would enable investors to achieve their long-term goals, we find the market's performance in the face of so many issues reassuring. If the market can avoid losses even amidst the myriad problems in 2011, investors should do well if conditions improve as we expect in the new year.

2011 in Review

We will spare you a detailed review of the many dispiriting events over the past year, including the European sovereign debt crisis, rancorous political debates, the downgrade of the U.S. government debt, and natural disasters in Japan and Thailand. Instead, following are a few market observations that will help set the stage for our current year outlook.

One of the primary reasons that participating in the market felt so bad was heightened volatility. The S&P 500 moved 2% or more on 14 days in the fourth quarter, following such moves on 19 days in the third. To put this volatility in perspective, the S&P 500 experienced no days with moves greater than 2% in 2005 and only two days in 2006. Correlation among stocks was also much higher than normal. As a result, even stocks of companies with no change in their fundamental business prospects were whipsawed with the broader market.

Despite its low return, the U.S. stock market was the year's best performer among major markets. European markets, including Germany (down 15%) and France (down 17%), fared much worse. In Asia, Japan's market dropped 17%, and government efforts to rein in the Chinese economy contributed to a 22% decline in the Shanghai Composite Index. Slowing global economic growth and falling commodities prices led to an 18% decline in emerging markets equities.

What's Next?

Alas, we expect more volatility and uncertainty in the markets in 2012. The European debt situation remains the thorniest issue threatening the global economy and markets. It appears the European Central Bank will provide needed liquidity to the European banking system, preventing a financial meltdown. However, the

European Union will have difficulties in resolving the sovereign debt crises of its problem countries, and we do not believe there will be an elegant solution to the EU's problems anytime soon. Europe appears likely to experience a recession, but only a shallow one as long as the ECB supports the banks.

Emerging markets present a more positive picture. Returns suffered in 2011 due primarily to falling commodity prices and continued economic weakness in developed countries, which purchase emerging market exports. Despite this stall, we see no change in the overall trend of more rapid economic growth in emerging markets than in the developed world.

Turning to the United States, we are encouraged by signs of an improving economy here. Recent reports confirm an acceleration of growth in the manufacturing sector, an increase in consumer confidence, and another uptick in The Conference Board Leading Economic Index®. Overall GDP growth has risen through the year from its slow start and should reach 3% or more for the fourth quarter, resulting in an increase of 2% for the full year. Inflation is low, which frees the Federal Reserve to take further measures to stimulate the economy, if necessary.

U.S. consumers have increased their spending for nine straight quarters. Consumers are also borrowing again after a few years of trimming debt, a potentially encouraging sign of confidence. Partly as a result of consumers' resilience, the U.S. economy is now larger than it has ever been, and we expect more support from businesses and consumers as they replace aging equipment, cars, and other durable goods.

The major trouble spots in the United States have been employment and housing. Unemployment is still too high at 8.5%, and the housing market remains under pressure, but both appear to be improving. After the addition of 200,000 jobs in December, U.S. payrolls have increased by 1.6 million jobs over the past year. The housing market appears to be bottoming, though banks and regulators continue to struggle to find a solution for the many homeowners whose homes are worth less than the debt they carry.

Consistent with the broad economic trends, corporate earnings remain strong, and we expect further increases in the fourth quarter and in 2012 as the economy continues to improve. Companies have kept inventories low, they hold record levels of cash (approximately $2 trillion), and profit margins are at all-time highs.

Political wrangling will be even more prevalent in this U.S. presidential election year. We do not expect the results of the election to have a major influence on the markets, but November will at least bring some clarity and certainty that should calm investors.

What to Do?

We continue to favor stocks of large capitalization, multinational, dividend-paying corporations with strong balance sheets, and stock market valuations remain particularly attractive for these companies. The S&P 500 index currently trades at about 12 times forward earnings, well below its historical price/earnings ratio of 15. Many of the equities we are buying trade at even lower P/E ratios.

Historically higher than the ratio for the S&P 500, P/E ratios in emerging markets are now about 20% lower, presenting another attractive long-term investment opportunity. We participate in the emerging markets through an exchange traded fund oriented toward dividend-paying companies in the developing world. We also benefit from the higher economic growth rates in these markets through ownership of multinational corporations with operations in developing countries.

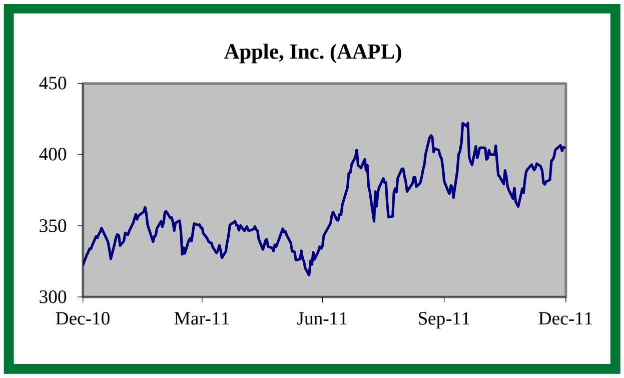
Given the uncertainty in the world and the gut-wrenching experience of staying invested through 2011, some investors may be tempted to shift even more money to Treasurys and other assets perceived to be safer. We consider Treasurys unappealing, with their extremely low yields relative to historical levels and the current yields offered by dividend-paying stocks. The 1.9% yield on the 10-year Treasury is lower than inflation, resulting in a negative real return, and when interest rates rise, long-term Treasurys will get crushed. We expect investors to return to equities as economic and financial market conditions improve and investors seek greater returns.

By holding undervalued securities of sound companies with prospects for earnings and dividend growth, we endeavor to achieve a margin of safety that provides protection from a slow economic recovery or precipitous drops in the broad market while offering the potential for attractive long-term gains. In our opinion, the best protection from market uncertainty is this margin of safety, and we remain confident that our holdings will perform well over time.

Analysis of Selected Stocks

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

Apple, Inc. (AAPL)



Price (1/10/12)	$ 423.00	Price/Earnings (Fwd)	10.7
Market Cap	$392.5B	Price/Book	5.1
Dividend Yield	0.0%	Price/Sales	3.6
Return on Equity	41.7%		

Apple Inc., the iconic maker of the iPhone, iPad, iPod, and maybe soon the iTV, has become *the* standard for consumer electronics. Founded in 1976 in Steve Jobs' garage, Apple today is a computer company, a software company (iOS), a digital media company (iTunes), a networking business, and a provider of third-party digital content and applications.

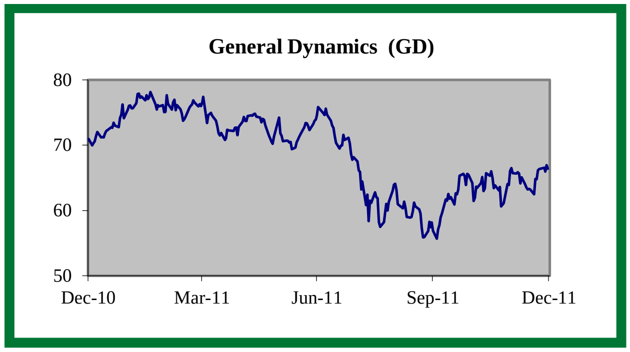
Apple has overcome the classic product cycle risk of many once-great consumer electronics companies by using its proprietary iOS software to connect users to an ecosystem of content and applications spanning multiple devices. This approach makes switching to another device or system cumbersome, if not costly, resulting in brand loyalty that is designed to last from one generation of devices to the next.

Apple's financial position is just as strong as its market position. The company has $82 billion in cash and investments on its balance sheet, generates $33 billion in annual free cash flow, and has no debt. Apple's revenues have more than doubled in the last three years to over $100 billion, while the company has maintained a hefty operating margin of 31% and return on equity of nearly 42%.

We believe the outlook for Apple remains strong, despite the death of Steve Jobs in October 2011. Apple has a deep pool of able managers, most of whom were put in place by Jobs and have worked together for many years. The company also has a full pipeline of Jobs-approved new product launches, which bodes well for continued success in both customer acquisition and customer retention. Finally, the continued proliferation of smartphones and trend toward cloud computing should keep Apple's revenues and cash flows growing at a robust rate.

Overall, we see Apple as a core holding with strong growth prospects. The stock also offers the possibility of income if new CEO Tim Cook moves to pay out some of Apple's massive cash hoard to shareholders in the form of a dividend, as Microsoft and Intel have done.

General Dynamics (GD)



Price (1/10/12)	$ 69.93	Price/Earnings (Fwd)	9.2
Market Cap	$24.4B	Price/Book	1.8
Dividend Yield	2.7%	Price/Sales	0.8
Return on Equity	20.4%		

Virginia-based General Dynamics manufactures ships, armored vehicles, information technology systems, and business jets. The company operates in four primary business lines: Aerospace (16% of revenues), Combat (27%), Marine (21%), and Information Systems (36%). GD derives approximately 72% of its revenues from the U.S. Department of Defense, with the remainder from foreign sales and Gulfstream business jets.

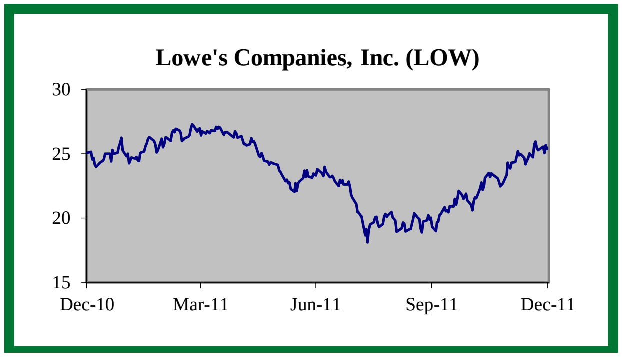
Diversified platforms and well-entrenched product offerings put GD in a strong position even in light of today's defense budget constraints. Products like its M1 Abrams tank and Virginia-class nuclear submarines form the backbone of U.S. defense superiority and give GD an incumbency advantage in a tightening market for new contracts. In addition, the firm enjoys a current backlog of $58.5 billion representing more than two years' worth of sales.

GD's non-defense businesses are where the most opportunity lies. Its fast-growing Gulfstream Aerospace division (16% of sales) offers the premium brand in business jets and enjoys a 30% share of the market, with Asia being the strongest driver of recent growth. While a global economic slowdown would certainly impact jet sales, analysts still project total earnings from the aerospace division to double over the next five years to 35-40% from 20% currently.

GD's financial health is solid. It generates approximately $3 billion of operating cash flow on $32 billion of sales, boasts a return on equity of over 20%, and is leveraged just 0.3x debt-to-equity. We also like management's shareholder-friendly practices of repurchasing shares (10% over the last five years) and paying out healthy and consistent dividends, which have risen 14 years in a row.

The stock currently yields 2.7% and is attractively valued at 9.2 times 2012 earnings. We view this valuation as a great opportunity to buy a top-tier company at a discount multiple.

Lowe's Companies, Inc. (LOW)



Price (1/10/12)	$ 26.43	Price/Earnings (Fwd)	14.8
Market Cap	$32.7B	Price/Book	2.0
Dividend Yield	2.1%	Price/Sales	0.7
Return on Equity	10.8%		

Lowe's is the second largest home improvement retailer in the world, generating close to $50 billion in annual sales and operating 1,725 stores in the United States, Canada, and Mexico. The company sells products and services that target retail do-it-yourself and do-it-for-me customers for the maintenance, repair, remodeling, and decorating of their homes and businesses.

Lowe's has developed a low-cost edge in the competitive retail industry, in large part because of its highly automated and efficient distribution network that links vendors, distribution centers, and stores on one information technology platform. This competitive advantage over chief rival Home Depot has bolstered the company's returns and supported its wide economic moat even during the economic downturn.

Lowe's fared comparatively well during the recession, staying profitable throughout by closing underperforming stores and aggressively reducing costs. Management remains focused on store and company profitability, and we see revenue and margin upside in the recently announced acquisition of online home improvement retailer ATG Stores. Management called this deal a strategic step towards the stated goal of "providing an endless aisle of products."

The company also remains very friendly to shareholders, aggressively buying back shares over the last several years (about $2.5 billion annually) and boosting the dividend every year since 2003, even during the 2008-2009 recession. Financially, the company is healthy, with modest leverage of 0.36x debt-to-equity, manageable debt maturities, and strong interest coverage of 12x.

We believe that the outlook for Lowe's is favorable as consumer spending, consumer confidence, and employment trends return to normal levels. Lowe's is well positioned to increase its share of the highly fragmented home improvement market and to continue rewarding shareholders along the way.

Source for charts and text: Morningstar, Value Line, S&P, Credit Suisse, 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 $500 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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