EDGEMOOR
INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Now what?

We've gone over the fiscal cliff and quickly rebounded, thanks to a deal that left many issues unresolved. The classic compromise includes something for everyone to hate, but we are grateful that our lawmakers finally did something to avoid the worst-case scenario.

In the wake of the not-so-grand bargaining just concluded, it is tempting to lament what could have been. However, it is more constructive to consider the deal and the outlook for the global economy and markets, and we are happy to contribute our thoughts. The stock market delivered solid returns in 2012, despite the many uncertainties here in the United States and around the world, and we are optimistic that 2013 will deliver more good performance.

The deal, in brief

The American Taxpayer Relief Act makes permanent the so-called Bush tax cuts for most Americans and also provides for federal estate taxes that are within the range of what we had expected. The Act raised rates on upper income taxpayers and eliminated some breaks that were previously available, but the vast majority of taxpayers will owe less than they would have in the absence of any Congressional action.

Much to the chagrin of many of us, Congress delayed for two months the automatic spending cuts that were scheduled to take place on January 1st. Consequently, we can look forward to another round of painful negotiations to address these cuts and the looming debt ceiling.

The American Taxpayer Relief Act and other tax provisions that were already scheduled to take effect in 2013 have important implications for investors and the markets. In addition to the institution of a 39.6% federal tax rate on single taxpayers earning at least $400,000 per year and joint filers earning $450,000 or more, significant changes include the following:

- The Act maintains the policy of taxing both dividends and long-term capital gains equally and at lower rates than personal income. However, individuals in the top income tax bracket will now pay 20% federal tax on long-term capital gains and dividends, up from 15% before. Many observers had feared a more drastic hike in taxes on dividends to the same rates as on ordinary income. Consequently, dividend stocks remain attractive alternatives to other income sources, especially after considering taxes.

- An extra 3.8% Medicare tax on investment income for single taxpayers earning $200,000 or more per year and joint filers earning at least $250,000, a change that was already scheduled to take effect in 2013, adds more complexity to the calculation of taxes owed and will raise to 23.8% the total federal rate paid on long-term capital gains and dividend income by many of our clients.

- For higher-income taxpayers, the Act phases out personal exemptions and reduces itemized deductions.

- The Act sets the federal estate tax rate at 40% on estates over $5.12 million (2012 level), an amount that will be indexed for inflation. Many pundits had predicted a combination of a higher rate and lower exemption amount. Spouses also retain the ability to benefit from a deceased spouse's unused exemption, which effectively increases the exemption to $10.24 million per couple.

- Social Security payroll taxes paid by employees revert to 6.2% of applicable wages, their level prior to the temporary cut to 4.2% in 2011. Discretionary income and consumer spending may decline as a result.

This list covers only several highlights, and readers should consult with their tax advisors for specific guidance. We will incorporate these new provisions into our investment strategies and financial planning, but we do not anticipate significant changes for most clients.

And now, back to our regularly scheduled programming...

Predictably, global stock markets reacted favorably to the compromise. Now investors are returning their focus to other market opportunities and challenges, and we are cautiously optimistic that markets can add to their gains in 2013.

The U.S. economy continues to chug along at a slow and steady pace, and we expect GDP growth of about 2% in 2013. Signals continue to be mixed but largely positive. The housing market rebound is directly impacting homebuilders and other construction firms and also indirectly boosting related businesses such as home improvement retailers. Corporate hiring is gradually reducing the unemployment rate, thus helping to increase personal incomes and support further consumer spending. Consumer confidence dipped in the face of the fiscal cliff, but we expect a rebound in future surveys now that we avoided the worst-case scenario.

Corporate earnings should continue their rise, though at rates lower than in the past few years. Key to the ongoing recovery will be an increase in business spending to offset the negative impact of any federal spending cuts and tax hikes. Clarification of tax policy resulting from the fiscal cliff negotiations and specification of spending cuts later this year should free corporations to spend some of their enormous cash hoards.

The U.S. Federal Reserve and other central banks remain committed to providing more stimulus and support to global economies. The U.S. Fed announced that it will maintain currently low interest rates as long as unemployment is greater than 6.5% and core inflation below 2.5%.

Despite these favorable trends, we are not yet out of the woods here at home. Next up for Congress is another debate about limits on the federal debt and spending cuts. The U.S. Treasury will likely run out of room under the debt ceiling sometime in February or early March, and Congress must approve an increase in borrowing limits in order to prevent a default. We expect a resolution, but only after another nasty battle that could rattle markets temporarily.

Also, some significant global issues have returned to the headlines now that Congress has acted. Europe's economy remains weak as the continent struggles to address lingering sovereign debt problems and as austerity measures slow spending. Reassurances by the European Central Bank that it would prevent a widespread banking collapse have bought some time for the weakest countries, such as Greece, Spain, and Portugal, to implement changes and shore up their finances, but structural problems remain. Despite these headwinds, European stocks performed well in 2012 - in line with U.S. stocks - and could climb further as the situation there stabilizes.

China and other emerging markets saw their economic growth rates slow in 2012, which reduced global demand for commodities and other goods and had the ripple effect of hurting economies in the developed world that are dependent on the Chinese export market. Having taken measures to contain inflation, particularly in housing, the Chinese government is now providing stimulus to its economy, which should expand at a higher rate of about 8% in 2013 and help to boost other nations' economies, as well.

Equity valuations remain reasonable both at home and abroad, and we expect to add positions to our portfolios that will give us exposure to a strengthening U.S. economy and more rapidly expanding emerging markets. We continue to find attractive investment opportunities in large, multinational companies with strong balance sheets and robust cash flows that are trading at significant discounts to their intrinsic values, similar to the three discussed below.

Some of these investments, like National Oilwell Varco, are available at attractive prices due to a drop in 2012 in energy prices, which we expect to rise over time. Others, like AIG, experienced severe problems in the financial crisis, but we see potential for more gains as the company emerges from government ownership and continues to recover. We are happy to take advantage of these and other similar opportunities and are confident that our portfolios can generate healthy long-term returns, despite near-term volatility.

While bullish on equities, we remain bearish on most bonds, particularly Treasurys. Investors' flight to safety and the Fed's actions to keep interest rates artificially low have boosted Treasury prices for several years, and we think Treasurys are not attractive investments currently. We believe these and other bonds that have risen in recent years are destined to fall when interest rates eventually rise, which will occur as the economy continues to recover.

Analysis of Selected Stocks

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

American International Group Inc. (AIG)

Price (12/31/2012)	$ 35.30	Forward P/E	9.1
Market Cap ($B)	$ 53.0	Price/Book	0.5
Dividend Yield	0.0%	Price/Sales	0.9
Return on Equity	27.8%		

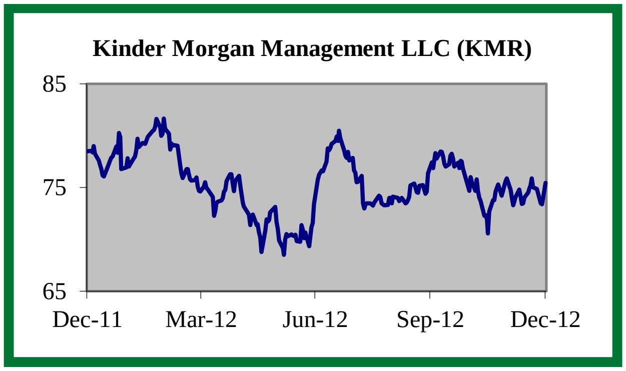
American International Group (AIG) is one of the largest insurance and financial services firms in the world. After suffering massive losses during the financial crisis of 2007-2009 and since then shedding large portions of its business assets to repay the $182 billion of bailout aid it received from the U.S. Treasury, AIG now has three core operating units. Chartis, its property and casualty (P&C) insurance unit, accounts for approximately 50% of total revenues. SunAmerica, the life insurance unit, represents 20% of revenues, and the financial services (mortgage insurance) unit comprises the remainder.

Veteran insurance CEO Robert Benmosche, whom the board hired to lead turnaround efforts, has been repositioning AIG to focus more on P&C insurance and less on commodity life insurance, a shift that should improve profitability and growth over time. Management has sold most of AIG's Asian life insurance subsidiaries as well as the International Lease Finance Group, its aircraft leasing arm. Chartis now represents AIG's best growth area globally and saw net written premiums rise 10% last year, driven by growth in Asia and Latin America.

In December 2012, the U.S. Treasury sold its remaining shares of AIG in a public offering, officially ending government ownership of the insurer, which amounted to a 92% control position at its highpoint. For shareholders, this change marks an end to the uncertainty of government ownership and puts the future of AIG entirely in the hands of its new management team.

Although AIG's turnaround remains in the early stages, we believe management is steering the company in the right direction. At a price of roughly 50% of book value, a steep discount to valuations of AIG's peers, the shares represent a compelling value for the patient investor.

Kinder Morgan Management LLC (KMR)



Price (12/31/2012)	$ 75.46	Price/Distributable CF	14.7
Market Cap ($B)	$ 9.1	Price/Book	2.7
Dividend Yield	6.4%		
Return on Equity	24.0%		

Kinder Morgan operates the largest energy transportation network in the United States. Its operations span the entire midstream energy sector, with a nationwide network of pipeline and storage assets that crosses the continent and transports and stores natural gas, natural gas liquids, crude oil, refined product, ethanol, and coal. Acquisitions have fueled Kinder Morgan's expansion over the years, and the 2012 purchase of El Paso Corporation for $38 billion increases prospects for long-term growth.

Kinder Morgan operates like a toll road, with revenues tied to the volumes, rather than the price, of the oil and gas pumped through its pipelines. Hence, its cash flows are steadier and more predictable than those of most energy production companies, and they support distributions to shareholders that should continue to rise.

The Kinder Morgan corporate structure offers investors a variety of ways to participate in the business. We currently consider Kinder Morgan Management LLC (KMR) to offer the best combination of yield and valuation. Investors in KMR receive distributions in the form of new KMR stock, rather than cash, essentially creating an automatic dividend reinvestment plan for investors. The value of these stock distributions currently equates to an attractive 6.4% yield on KMR's stock price, and management has targeted annual distribution growth of 8% through 2014, a rate it has achieved every year since 2004.

Kinder Morgan's outstanding assets and market leading position across its business segments give it a wide economic moat. The management team is exemplary, led by founder and CEO Rich Kinder, whose salary and bonus amount to $1 annually. His 24% ownership of the business, however, fully aligns his interests with shareholders and keeps him and his team focused on maximizing growth, operating efficiencies, and profitability. All of these factors combine to make Kinder Morgan a core, long-term holding with continuing upside.

National Oilwell Varco, Inc. (NOV)

Price (12/31/2012)	$ 68.35	Forward P/E	9.6
Market Cap ($B)	$ 30.5	Price/Book	1.6
Dividend Yield	0.7%	Price/Sales	1.6
Return on Equity	13.1%		

National Oilwell Varco (NOV) is among the largest equipment suppliers to the oil and gas drilling industry. The company provides a comprehensive line of equipment, components, consumables, and maintenance and repair services for drilling operations. More than 90% of the mobile offshore rig fleet and the majority of the world's land rigs use parts and components manufactured by NOV.

As an industry leader, National Oilwell Varco has benefited from positive industry trends. Energy companies are retooling their aging fleets of drilling rigs, as well as ordering new rigs for the first time in nearly three decades. In addition, technological advances in both offshore deepwater drilling and onshore shale drilling are increasing demand for NOV's products and services.

National Oilwell Varco is the best and often only source of rig equipment to support the deepwater operations needed to economically drill deeper and more complex wells. Similarly, NOV supplies onshore drillers with the advanced technology required to exploit unconventional shale reservoirs. The boom in demand for such oilfield equipment is expected to continue for the foreseeable future, with NOV being a prime beneficiary.

The company has positioned itself well in a consolidating industry, completing fourteen acquisitions in 2012 valued at more than $4.7 billion. National Oilwell Varco's CEO, Pete Miller, is credited with having the extraordinary vision to identify industry trends early and capitalize on them quickly. He was most recently named Morningstar's CEO of the Year for 2012. With the stock trading at just 9.6 times estimated 2013 earnings, we believe NOV has significant upside for shareholders.

Source for charts and text: Morningstar, Value Line, S&P, 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 $585 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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