EDGEMOOR
INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Winter 2014

What a Run!

As we ring in the New Year, let us pause for a few moments to express our gratitude for 2013, which brought spectacular gains in the stock market. The S&P 500 had its best year since 1997 and ended December at an all-time high, the 52nd record close set during the year. These results came despite dysfunction in Washington, fears of withdrawal of the U.S. Federal Reserve's stimulus, and various other threats. While stocks soared, the Barclays U.S. Aggregate Bond Index returned -2% as interest rates rose and bond prices fell, confirming our predictions that the long rally in bonds was coming to an end.

Even though we entered the year bullish, we were admittedly surprised by the magnitude of the stock market gains. No complaints here, particularly since we believe stocks have more room to run and are adding to our positions in securities that we consider particularly undervalued. We continue to be bearish on bonds, however, and are focusing on other types of securities for our income investments.

2013 in Brief

The stock market's rise last year was remarkably smooth, with barely a pullback along the way. A primary catalyst was the Fed's efforts to boost the U.S. economy by keeping interest rates low through bond purchases and careful messaging. These actions combined with slow but steady economic growth and low inflation to create a nearly perfect environment for the rally in stocks.

Corporate profits are the foundation for stock valuations and provided support for the market's surge, rising 10% in 2013. Also contributing to the market's rise was an increase in price/earnings multiples during the year. Investors showed a willingness to pay more for each dollar of earnings, though price/earnings multiples still remain in line with long-term averages.

The United States was not the only major world market to perform well last year. European stocks also rose sharply as Eurozone financial and economic conditions continued to improve and investors took advantage of low valuations. Japanese stocks skyrocketed more than 50% as a result of the government's economic policies. On the other hand, emerging markets stocks disappointed, primarily due to concerns about the effect that slowing growth in China, combined with tepid economic expansion in the developed world, would have on developing economies, which tend to be more dependent on exports of natural resources to the rest of the world.

Outlook for the New Year

2014 should bring more gains to investors in stocks, though we do not expect a repeat of last year's blockbuster performance. Conditions remain favorable in the United States, Europe, and Japan, and we believe stocks in emerging markets, despite their recent underperformance, offer attractive opportunities for long-term investors and are an important component of a diversified portfolio.

Perhaps no institution has done more to fuel the stock market over the past several years than the U.S. Federal Reserve under outgoing Chairman Ben Bernanke. Janet Yellen will likely continue the Fed's accommodative policies when she succeeds Bernanke on February 1st. The speed and manner in which the Fed reduces stimulus will be critical. We think the transition will be gradual, but we also expect volatility along the way.

The U.S. economy is now strong enough that it should be able to continue its expansion even without the same level of Fed support. The manufacturing and housing sectors appear to be robust, the employment situation is slowly improving, consumer confidence is picking up, and corporate earnings should continue to improve. Natural gas prices rose in 2013 but are still low relative to those in other global markets, and increased supply and low U.S. energy costs resulting from the domestic exploration and production boom have reduced the U.S. trade deficit and provide our economy with a huge competitive advantage. Finally, unlike at the beginning of last year, there are no major tax increases to hinder consumer or business spending in 2014. We expect an ongoing combination of steady economic expansion, low interest rates, and tame inflation to create favorable conditions for U.S. stocks.

A risk to our outlook for the United States rests with our politicians in Washington, who have shown great ability to create uncertainty and have avoided making tough decisions to support our economy and address important fiscal issues. The latest agreement on the Federal budget was encouraging, as it provided some hope that Congress may be willing and able to reach compromise agreements to avoid another government shutdown, but it remains to be seen whether further deals are possible. Even so, it is noteworthy that in spite of all of the political gridlock of the past few years, the economy has continued to expand.

Turning to other areas of the world, Europe should make further progress on its slow road to recovery after the financial crisis. Even Spain, one of the countries hit hardest by sovereign debt issues a few years ago, is showing significant signs of improvement, and we are optimistic that the positive trends will continue. Prime Minister Abe's efforts to boost the economy should fuel further expansion in Japan, though the next steps in reform may be tougher than those already undertaken.

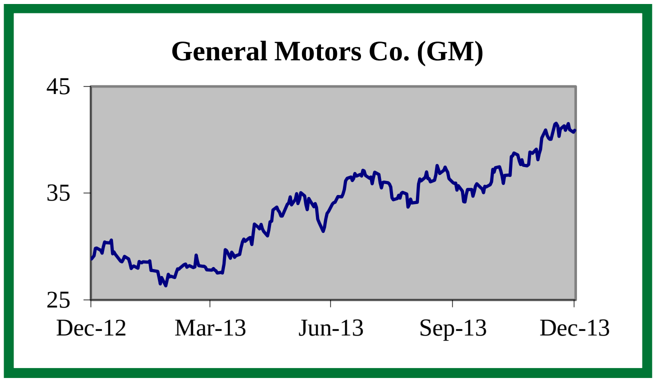
The Chinese government is wrestling with how best to provide support to economic expansion there without further exacerbating a potential real estate bubble and debt explosion. We are keeping a close eye on developments in this most important of emerging markets, as any changes in China's economic outlook can have a major impact on other countries' economies. As noted earlier, we continue to believe that direct exposure to emerging markets is appropriate and expect returns over time from these investments to be attractive.

Bonds are not likely to fare any better in 2014 than they did last year, since rates should rise further as the Fed reduces its bond purchases and the U.S. economy gains steam. Our focus for income investments remains on securities that have the potential to increase payouts as corporate earnings rise, such as master limited partnerships and high-yielding common stocks. Convertible securities also provide a hedge against rising interest rates through their exposure to the underlying common stocks, which should benefit from economic expansion. Finally, certain preferred stocks, with their higher yields, also remain attractive, though we are closely monitoring the impact of rising rates on these securities.

Analysis of Selected Securities

Following is a discussion of several of the securities we own and have been buying recently, including one income investment, Carlyle Group.

General Motors Co. (GM)



Price (12/31/13)	$	40.87	Forward P/E	7.2
Market Cap ($B)	$	55.0	Price/Book	1.9
Dividend Yield		0.0%	Price/Sales	0.4
Return on Equity		18.3%	Debt/Equity	0.7

General Motors is the largest automaker in the United States and the second largest worldwide. In June 2009, during the depths of the financial crisis, the company filed for Chapter 11 bankruptcy protection as part of a $49.5 billion government bailout package that gave the U.S. Treasury a 60.8% ownership stake in GM, earning it the moniker “Government Motors” at that time.

The bankruptcy filing allowed GM to shed billions of dollars in liabilities, sharply reduce its dealership count, and decrease its operating costs. Today, GM is once again a profitable business with streamlined operations, reduced pension obligations, and market-leading design and quality. The company 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.

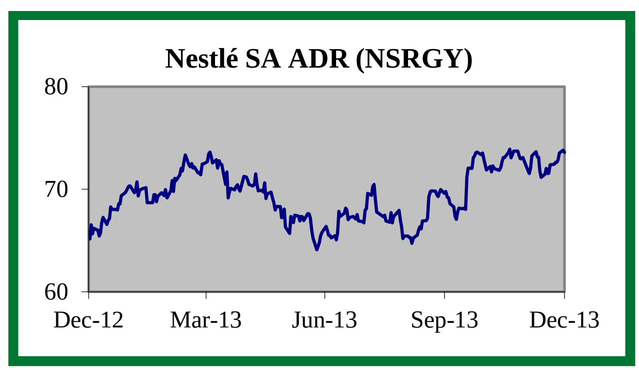
As a result of these successes, GM has steadily reduced the government's ownership stake, first through its return to the public markets in a November 2010 initial public offering and then with a $5.5 billion share repurchase in late 2012. In December 2013, the U.S. Treasury sold its last 30 million GM shares, sooner than originally planned.

GM's North American operations are healthy. The company has rationalized its product lineup by reducing the total number of brands from eight to just four. GM has also closed plants and spun off a voluntary benefit association for its retirees. These changes have drastically lowered the company's cost structure, enough that GM can now remain profitable even if total U.S. annual car sales drop back to recession era levels. Said another way, GM's estimated break-even point is now about 10.5 - 11 million total annual U.S. vehicle sales, much lower than total car sales in 2013 of 15.5 million and expected sales of more than 16 million in 2014. These trends point to significantly higher sales and profits for GM as the auto sector continues its recovery.

Elsewhere in the world, GM Europe has seen its losses narrow substantially to $200 million in the third quarter of 2013 from $500 million a year earlier. In South America, increased vehicle deliveries, higher pricing, and a better product mix all contributed to higher revenues and profits in 2013. And in China, the world's largest vehicle market, GM sales have continued on a solid upward trend. During 2013, the company sold over 3 million cars in China, 13% more than in the United States.

GM's valuation is compelling. At a 7.2x forward P/E, GM shares trade at the low end of its peer group and well below the S&P 500 average of 15x forward earnings. The stock also looks attractive based on other valuation metrics, including price/book value (1.9x) and price/sales (0.4x). Finally, now that the era of government ownership has ended, GM management will have the opportunity to reward shareholders by restoring dividend payments, which were suspended in 2008.

Nestlé SA ADR (NSRGY)



Price (12/31/13)	$	73.59	Forward P/E	16.5
Market Cap ($B)	$	236.6	Price/Book	3.3
Dividend Yield		2.5%	Price/Sales	2.2
Return on Equity		18.0%	Debt/Equity	0.2

Nestlé is the largest packaged food and beverage firm in the world by revenues, which last year topped $98 billion. Founded in 1866 by Henri Nestlé, the company today has a vast portfolio of nutritional, health, and wellness products, including such market-leading brands as Gerber baby food, Poland Spring water, Nescafe coffee, Purina pet food, and Stouffer's frozen meals. More than 20 of Nestlé's brands generate in excess of $1 billion of annual sales each.

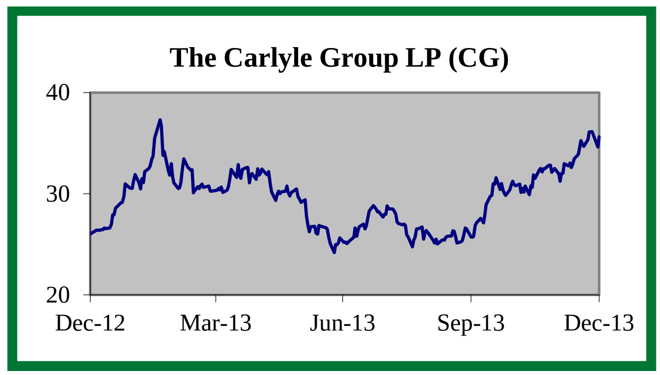
The company operates 461 factories in 83 countries worldwide, making it a core supplier to nearly every retail food chain around the globe. This competitive position enables Nestlé to command favorable shelf space and charge premium prices for many of its products, both factors that contribute to the company's wide economic moat.

Nestlé derives 45% of its global sales from emerging markets, where it has enjoyed near double-digit sales growth. Despite a cooling of growth in these regions recently, the broad penetration of Nestlé brands and the still-growing purchasing power of the emerging market consumer should drive steady, sustainable growth rates of 5-8% in the developing world.

Nestlé has been an active consolidator in the global consumer products industry, acquiring Pfizer's infant nutrition business last year and taking a 60% stake in the Chinese food company Yinlu Foods Group in 2012. Management has also made clear its strategic intent to dispose of underperforming or non-core brands, like the recently announced sale of its Jenny Craig weight-loss business, which demonstrates the company's renewed commitment to cost controls and efficiencies.

Nestlé's financial position is strong. The company generates significant free cash flow ($15 billion in 2013), has solid operating margins (15%+), and holds very little debt ($10.5 billion in long-term debt). Nestlé's stock also offers an attractive dividend yield of 2.5%, and dividend payments continued uninterrupted through the global financial crisis. Although the stock trades at a premium valuation of 16.5x forward earnings, this multiple is in line with historical averages for Nestlé and on par with valuations of its peers, including Unilever and Danone.

The Carlyle Group LP (CG)



Price (12/31/13)	$ 35.62		Forward P/E	10.1
Market Cap ($B)	$ 11.2		Price/Book	15.6
Dividend Yield	3.7%		Price/Sales	25.1
Return on Equity	4.7%		Debt/Equity	1.3

The Carlyle Group, based in Washington, DC, is among the largest alternative asset managers in the world, with $185 billion in assets under management across 122 actively managed funds and 81 funds-of-funds.

Carlyle invests across four primary segments: Corporate Private Equity (65% of total revenues), Global Market Strategies (18%), Real Assets (12%), and Solutions (5%). Its investments span multiple geographic regions, including Africa, Asia, Australia, Europe, the Middle East, North America, and South America, as well as a broad variety of industries. Carlyle has 34 offices across six continents, giving it truly global reach.

Carlyle invests on behalf of a wide array of investors in its funds, primarily public and private pension funds, endowments, sovereign wealth funds, and high net worth individuals. In 2012, Carlyle sold shares to the retail public for the first time, as part of its $700 million initial public offering. Since then, the firm has grown at an accelerated pace. In the first nine months of 2013, Carlyle raised $18.3 billion in new capital, more than in any year since 2007.

Carlyle generates revenues from both management fees on committed funds and performance fees on realized investment gains. Its strong fundraising capabilities, plus its nearly 30-year track record of generating consistent gains, will drive returns to shareholders. In 2013, strong performance in both of these areas increased net earnings available for distribution to shareholders by 26%. Distributions should jump another 30% in 2014 as fundraising continues to accelerate and Carlyle realizes further gains on its investments.

Carlyle's dividend policy is to pay out substantially all of its distributable earnings each year, paid in equal installments over the first three quarters (currently at a rate of $0.16 per share), followed by a year-end catch-up distribution in the fourth quarter ($0.85 per share for year-end 2012). Based on these current rates, Carlyle's effective yield is an attractive 3.7%, which we expect will increase as the firm's assets under management continue to expand.

Source for charts and text: Morningstar, S&P, Schwab, Value Line, Argus, and Credit Suisse 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 $700 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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