Edgemoor's Quarterly Report

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Winter 2016

A Year to Forget

The stock market paused in 2015, finishing the year near its starting level, but the journey felt worse. After steadily rising from its low point in March 2009 and delivering above-average returns through 2014, the S&P 500 index disappointed investors in 2015 by finally stopping to catch its breath. More specifically, earnings growth slowed, primarily due to the struggles of the energy sector.

Now 2016 has gotten off to a rocky start, with China's currency moves and related concerns about this largest of emerging economies rattling markets. Another concern is that oil prices remain low, which is good for consumers but bad for energy producers, and the ultimate impact on the global economy of energy sector woes remains to be seen.

Patience and discipline remain virtues and are keys to successful long-term investing, particularly in an uncertain environment. Notwithstanding market setbacks, we are confident that our stocks and income investments will continue to provide attractive long-term returns and help our clients achieve their financial goals. We believe that our value-oriented approach to investing is the best way to succeed through market cycles, and we keep finding what we consider good opportunities to invest. The coming months may try investors' patience, however, and it is important to remain committed to the investment strategy that has worked over the long term and in similarly volatile times.

2015 in Review

The U.S. Federal Reserve, energy, and China provided the major themes for 2015. After holding the federal funds rate at near zero since late 2008, the Fed seemed on the verge of raising throughout 2015 and finally did so, modestly, in December. Much speculation about the Fed's pending action caused market swings throughout the year, but the reaction was muted when the Fed finally increased the rate by 0.25%.

Perhaps the biggest drag on U.S. stocks was the dramatic fall in the prices of oil, natural gas, and other energy-related commodities throughout the year. Prices for other commodities also dropped, primarily due to slowing economic growth in China. The earnings of energy and other commodities producers plunged as a result, causing overall S&P 500 earnings to decline more than 5% for the year despite an increase in all other sectors.

China rattled markets in August with a surprise devaluation of its currency and has shaken markets with a similar move in early 2016. Concerned about slowing growth, the Chinese government took actions to encourage domestic consumption and encourage stock market investment. As China moves away from its spending on infrastructure toward a more sustainable, consumer-based economy, Chinese demand for commodities and other goods has dropped, causing economic pain elsewhere in the world, particularly among other developing countries dependent upon commodity exports.

Other issues also moved the stock market in 2015, including geopolitical conflicts, record mergers and acquisitions activity, and the surge of a relatively small group of technology and consumer goods companies that reflected a preference for growth stocks over value that has persisted for longer than typical in this business cycle. Positive employment reports and other data provided evidence of slow but steady improvement in the U.S. economy, and the Fed's tightening in December was a vote of confidence.

Outlook for 2016

We are modestly bullish on prospects for 2016 and expect continued support for stocks from improving economic conditions in the United States, worldwide central bank policies that will encourage further economic growth globally, and reasonable equity valuations. Risks and concerns in 2016 will echo those from last year, namely the path of interest rates, the direction of oil prices, economic conditions in China, and geopolitical issues in the Middle East.

We expect the U.S. economy to continue on its path of slow, steady GDP expansion in the range of 2%-3% per year as it moves through the middle phase of the business cycle, typically characterized by economic growth and strong profitability. The U.S. economy added 2.7 million new jobs last year, after an increase of 3.1 million in 2014, the most new hires over two years since the late 1990s. As a result, the unemployment rate decreased from 5.6% to 5% during 2015, and a tightening labor market should lead to increases in wages this year. Rising earnings and low gas prices will likely result in increased consumer spending, which has been the primary source of economic growth for the past several years and has offset reduced business investment, which we believe will remain sluggish. We expect inflation to pick up as energy prices level out, but we think it will stay low enough to support further economic expansion.

Having finally raised rates, the Fed appears to be on course to do so two to four more times this year, depending on economic conditions. We see the Fed's actions as a positive sign of confidence in the economy, and we expect further increases will be small and gradual. We also believe the Fed will adjust its course if economic data here or abroad indicate weakness that would justify holding rates steady. Foreign central banks are more likely to continue to provide stimulus, as seen over the past months in Europe, Japan, and China.

The net result of the central bank actions will most likely be to support the currently strong U.S. dollar. Dollar strength will continue to pressure U.S. exporters, but the negative impact on earnings compared to the previous year should not be as great as in 2015.

We expect oil and natural gas prices to remain relatively low in 2016, bad news for the energy sector, and we have reduced our exposure to energy shares. Reduced spending on drilling will eventually cause a drop in production, but additional oil supplies from Iran and elsewhere will limit that impact and help keep prices low.

China may pose the greatest risk to the markets this year, given its slowing economic growth and the ripple effect on much of the world. However, exports to China represent less than 1% of U.S. GDP, and we do not expect issues there to cause a global recession or widespread market disruptions.

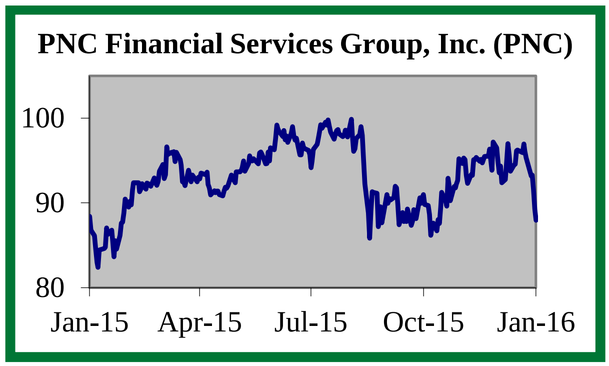
Finally, we believe stock valuations are reasonable and particularly attractive for the shares we own. The S&P 500 index currently trades for a multiple of about 16 times estimated earnings for the coming year, close to its historical average. The stocks in our portfolios trade for an average price/earnings multiple of about 12, a significant discount to the market that provides a margin of safety in our investments. We believe that patiently holding these positions and looking for new opportunities to add similarly undervalued shares to our portfolios will result in solid long-term returns.

Given today's historically low interest rates, we still favor other income investments over bonds. We are currently invested in preferred stocks, convertible securities, utilities, real estate investment trusts, and other securities with higher yields for the income portions of our portfolios.

Analysis of Selected Securities

Following is a discussion of several of the 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.

PNC Financial Services Group, Inc. (PNC)



Past performance is not indicative of future results. Please see disclosures on page 9.

Price (1/8/2016)	$ 87.96	Forward P/E	10.9
Market Cap ($B)	$ 44.7	Price/Book	1.0
Dividend Yield	2.3%	Price/Sales	3.1
Return on Equity	8.8%		

Since the financial crisis, PNC has emerged as one of the largest and best-capitalized banks in the United States with several key competitive advantages, including a low-cost deposit base, strong underwriting culture, and large fee-based business. With an expansive network of 2,800 branches serving 6 million consumers and small businesses across 19 states throughout the Midwest, Mid-Atlantic, and Southeast, PNC generates low-cost deposits that fund more than 80% of its loans. This source of cheap capital has allowed the bank to competitively price its loan products, which has led to 6-8% average loan growth over the last several years, even as many of its competitors have had to shrink their loan portfolios in the wake of increased regulatory requirements.

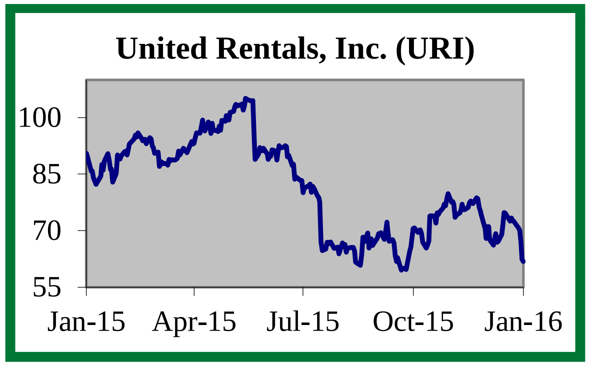
PNC's strict attention to underwriting standards has also contributed to the bank's superior credit quality and steadily improving profitability. In addition, through its efforts to reduce expenses and improve efficiency, the bank has achieved cost savings of more than $1 billion over the last two years.

PNC is also distinguished among its banking peers by its focus on generating asset management fees. Through a strategic investment in BlackRock, the world's largest asset manager with over $4.5 trillion in assets under management, PNC controls a 21% voting interest in BlackRock's common shares and received $285 million in cash dividends last year.

As a result of all of these factors, PNC is now among the best capitalized banks in its peer group, with a common equity Tier 1 capital ratio of 10.6%, well ahead of its Basel III requirement of 9%. This balance sheet strength allowed PNC to adopt a $2.9 billion share repurchase program in the second quarter of 2015 (without any objection from the Federal Reserve), as well as raise its dividend 6% during the year.

As we have tracked the recovery of the banking sector over the last several years, we have been continuously impressed by the results at PNC. Management has maintained strict discipline in its pursuit of growth, in its core underwriting and balance sheet management, and in overall expense controls, all of which are reasons we chose PNC as the first bank stock to add back to our core equity portfolio after the financial crisis.

United Rentals, Inc. (URI)



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Price (1/8/2016)	$ 61.81	Forward P/E	6.1
Market Cap ($B)	$ 5.8	Price/Book	3.9
Dividend Yield	0.0%	Price/Sales	1.1
Return on Equity	36.9%		

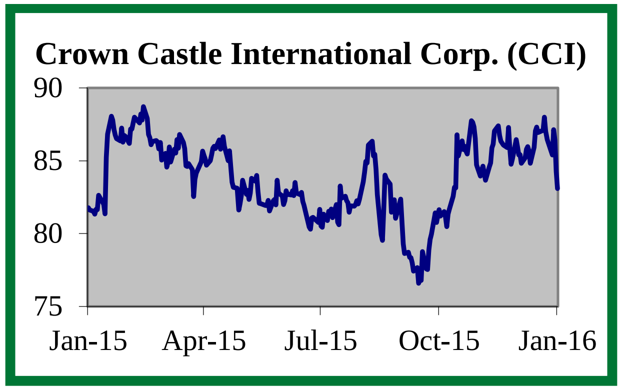
United Rentals, Inc. (URI) is the largest equipment rental company in the world, operating 900 locations throughout the United States and Canada. Its fleet of over 430,000 rental units serves the construction, corporate, municipal, and industrial markets. The company's number one share of the U.S. market stands at only 12%, leaving ample room for growth and consolidation in this fragmented industry.

Given the still fragile recovery of the U.S. economy, many companies are opting to rent equipment rather than buy it. The advantages of renting include a lower capital outlay, lower ongoing maintenance costs, and access to newer technologies. URI has benefited from these trends with revenues rising solidly for the last several years. In addition, the company's focus on larger customers, who tend to rent for longer periods and make more timely payments, has led to better overall profitability and utilization of URI's fleet. The company has also streamlined its cost structure over the past several years, which we believe bodes well for its continued earnings power, even in a slow-growth economy.

One challenge for URI in the past year has been its energy market exposure, which accounts for approximately 11% of total revenues. Offsetting this weakness is the longer-term growth expected in nonresidential and industrial construction, which represents 50% of total revenues and should benefit as the economy continues to expand. We estimate URI's earnings will increase by 15% in 2015 and by double digits again in 2016.

We believe URI is an example of a company whose shares are worth far more than their current market price. Given the company's high return on equity of 36.9% and low valuation at 6.1 times forward earnings, we expect solid long-term returns from URI shares.

Crown Castle International Corp. (CCI)



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Price (1/8/2016)	$ 83.06	Price/AFFO*	20.1
Market Cap ($B)	$ 27.7	Price/Book	3.9
Dividend Yield	4.2%	Price/Sales	7.4
Return on Equity	21.1%		

*Price-to-adjusted funds from operations

Crown Castle International Corp. is one of the largest owners and operators of cell towers and other wireless infrastructure in the United States. Organized for tax purposes as a real estate investment trust (REIT), Crown Castle is one of three companies that together control over 70% of the U.S. cell tower market.

U.S. mobile data usage has surged in recent years with the explosive growth of smartphone and other wireless device usage and is projected to increase another seven-fold by 2019. To keep up with this growth, carriers like AT&T, Verizon, and T-Mobile need to constantly add network capacity, which has translated into increasing demand for tower space and use.

Crown Castle has benefitted from these trends by focusing its business almost exclusively on the U.S. market, where towers generate a reliable income stream and demand for mobile data is growing rapidly. The company owns, leases, and manages 40,000 cell towers across the country, which it leases to major wireless carriers typically under long-term contracts (usually ten years or more) with annual rent escalation clauses of 2%-4%. The leases provide strong and predictable cash flows that can rise further as Crown Castle attracts new tenants to its towers and adds more equipment from existing tenants. High switching costs also mean that once equipment is placed on a tower, it is rarely removed.

In our view, the company's focus on increasing revenue per tower will be the source of continued organic growth. Crown Castle has also made select acquisitions to add to its fiber, small cell, and distributed antenna system assets, which positions it well to benefit from growing carrier needs for diverse wireless infrastructure.

Crown Castle recently raised its dividend by 8% to yield an attractive 4.2%. In addition, its shares are reasonably valued at approximately 20 times adjusted funds from operations (AFFO), which is comparable to its competitors. We believe Crown Castle's positive operational momentum can continue and will support dividend growth and positive returns for shareholders.

Source for charts and text: Morningstar, S&P, Schwab, Value Line, and Argus research reports.

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