Edgemoor's Quarterly Report

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January 2017

What a Year

The stock market rallied through the end of 2016, as investors appeared to express greater optimism about the U.S. economy and improving corporate earnings. Anticipation of the new administration's planned changes in tax and regulatory policy to support business activity and investment also boosted the market. In addition, as we have predicted for several quarters, value stocks outperformed growth stocks after several years of lagging.

The year began with a jolt, as oil prices continued their long slide to a low of $26 per barrel in February. Global stock markets followed and entered correction territory (down at least 10%) for the second time in six months. Then, after bottoming just before Valentine's Day, stocks began a long upward march to new highs with only temporary interruptions along the way.

The most notable pauses came around the two most significant votes during the year. First, the market swooned in the wake of British voters' surprise decision in June to leave the European Union, which threatened to potentially upend the European economy. Fears quickly eased, however, as investors concluded that the change might be less detrimental than initially feared, the U.K.'s exporting businesses should benefit from the weakening British pound, and the Brexit process would take several years to complete.

The second market pullback came as the U.S. presidential election neared and markets became jittery in the face of tightening polls. The consensus heading into this election was that a Clinton victory was likely and would be less disruptive to stocks than a Trump win. When Trump prevailed and Republicans retained their control of Congress, the immediate reaction in overnight markets confirmed these fears of a downturn.

However, the next day stocks began their post-election rally that has continued into early 2017. Investors concluded that the combination of President Trump and the Republican Congress, both committed to lowering tax rates and loosening regulations, should be good for the U.S. economy and businesses, resulting in rising corporate earnings and stock prices. In addition, a return to earnings growth in the third quarter, after six quarters of declines, likely played an important part in the rally.

Oil prices also surged in 2016 from their February low to about $53 per barrel at year end, providing a needed boost to the energy sector. In late September, the members of OPEC agreed to cut production for the first time in eight years, and energy stocks outperformed all other sectors during the year.

One event that surprised nobody was the U.S. Federal Reserve's decision to increase the federal funds rate by another 0.25% in December, a full year after the last hike. Stocks plowed ahead, but bonds fell as interest rates increased.

We were among the majority of observers who were surprised last year by the election results in the United Kingdom and United States. Nobody – not even professional pollsters or the often accurate election betting markets – can always know what the future will bring. What investors can do, however, is acknowledge that uncertainty always exists, follow a value investing strategy that has prevailed through many market conditions over long periods of time, and stick with this chosen plan.

Into the New Year

We enter 2017 optimistic that positive economic and market trends from last year will continue, yet wary of the many things we cannot predict. We believe the U.S. economy is healthy and expect it to continue its slow but steady expansion. Consumer confidence is at a 16-year high, and the most recent jobs report showed increases in wages. The transition to the Trump administration and new Congress is likely to result in moves toward less regulation, tax reform that reduces corporate and individual tax rates, increased investment in infrastructure, and other policies that should help to boost the economy. Inflation remains low, and business optimism should improve with the expected policy changes.

The Fed plans to hike rates three times in 2017, though Chair Yellen and her colleagues will remain focused on economic data and have clearly shown their willingness to adjust course as they see fit. Whatever moves the Fed makes, we believe that any increases in the federal funds rate will be small and gradual. Interest rates have risen since the Fed's December hike and Trump's election, due to the Fed's action and in anticipation of higher inflation resulting from his proposals, but rates are still low enough to promote economic growth.

One risk is that concern among lawmakers about issues such as the U.S. budget deficit and national debt, as well as potential differences in opinion between Trump and Congress on trade and immigration policy, may limit the extent of reform under the new administration. The stock market has largely brushed such concerns aside for now but may not always be as willing to do so.

Some sectors are likely to benefit more than others from Trump's proposed policies. For example, small capitalization stocks have surged since the presidential election, since they reap more rewards than larger multinational companies from policy changes that favor domestic businesses. Construction and other industrial sector companies have also risen in anticipation of increased infrastructure spending, and the financial sector should see profits improve if interest rates continue moving higher.

Retailers and technology companies are among those whose fortunes may dim if proposed tax, trade, and immigration policies go into effect, and healthcare companies face greater uncertainty given Republicans' plans to repeal the Affordable Care Act and Trump's pledge to negotiate lower drug prices. Also, a stronger dollar could hurt the competitiveness of U.S. exporters as their goods become relatively expensive around the world.

Beyond the United States, the European economy continues to expand, though more slowly than the U.S. economy, and the European Central Bank remains committed to low interest rates, bond purchases, and other monetary support. European government bond yields have returned to positive territory after being negative, a good sign for economic growth prospects. Among the risks to ongoing recovery is a wave of populism that could have negative economic impacts, and we will continue to monitor events for any significant changes.

In Asia, the Chinese government is fighting to stem an outflow of capital from China by attempting to strengthen the yuan, and a glut of apartments and other buildings after years of rapid infrastructure spending threatens the economy and financial system. However, both Chinese and Japanese exporters could benefit from a strengthening U.S. economy, and Japan's economy showed relatively strong growth in the third quarter of 2016, a positive sign after many years of stagnation.

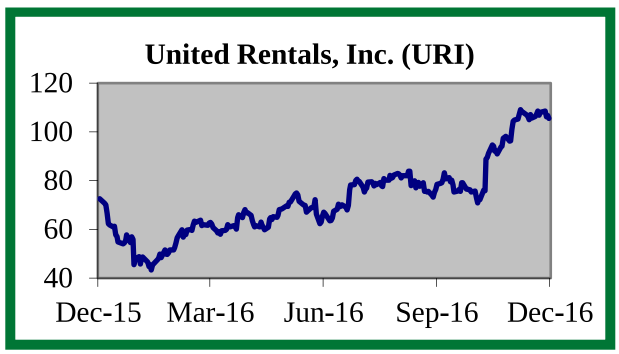
Overall, we are optimistic regarding stock market returns for the coming year. We believe valuations remain reasonable, even after the recent surge, and we are encouraged by the outperformance of value stocks over growth in 2016 and so far in 2017. The stocks we own currently trade, on average, at a significant discount to the broad market based on metrics such as price/earnings. We are optimistic that they will trade over time at prices closer to their higher intrinsic values, our estimate of their true values based on fundamental business measures.

For income investments, we continue to shun most bonds, given their low yields and our expectations of further rate increases, which would cause bond prices to drop. More attractive income holdings, in our opinion, include higher-yielding securities such as common shares of utilities, telecommunication companies, pipeline companies, and real estate investment trusts, as well as preferred stocks, convertible stocks, and closed-end funds.

Analysis of Selected Securities

Following is a discussion of three 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.

United Rentals, Inc. (URI)



Past performance is not indicative of future results. Please see disclosures on page 8.

Price (12/30/2016)	$ 105.58	Forward P/E	11.5
Market Cap ($B)	$ 9.3	Price/Book	6.0
Dividend Yield	0.0%	Price/Sales	1.7
Return on Equity	38.3%		

United Rentals is the largest rental equipment company in the world, with more than 880 rental locations across 49 states and 10 Canadian provinces. URI rents and sells a broad array of equipment, from heavy machinery to hand tools, to a diverse customer base that includes construction companies, contractors, industrial manufacturers, utilities, municipalities, and small businesses. The company generates total revenues of approximately $5.7 billion, with equipment rentals accounting for 85% of sales, rental equipment sales 9%, new equipment sales 3%, contractor supplies 1.5%, and services 1.5%.

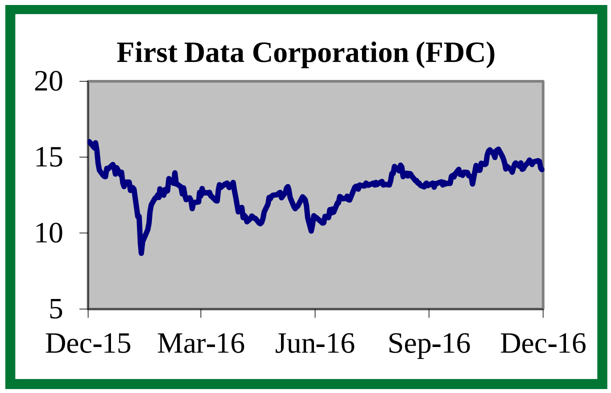
URI's size and scale afford it numerous competitive advantages, including greater purchasing power, the ability to provide a broad range of equipment and services, and flexibility to transfer equipment among locations to meet customer demand. The company is also able to focus on larger, more profitable customers, which tend to rent for longer periods and are more timely in payment.

URI is benefiting from a long-term industry trend for companies to rent heavy equipment rather than buy it. The advantages of renting include the avoidance of large capital investments for equipment purchases, a reduction in storage, maintenance and transportation costs, and the ability to access the latest technology. We expect this trend to continue and to drive increased demand for URI products and services.

The company is also benefiting from recent initiatives aimed at streamlining field operations, reducing operating costs, and improving fleet utilization, which have resulted in accelerating profitability for URI even amidst modest global economic growth. In July 2016, URI introduced a first of its kind online service that fully automates the equipment rental process, allowing customers to select, order, and pay for equipment online.

URI stock is attractively priced at 11.5 times 2017 earnings, which is well below the industrial sector average of 16.3 times. We believe management is shareholder friendly, having initiated a $1 billion share repurchase program that should be complete in 2017. With the forecasted upswing in U.S. construction activity in 2017 and beyond, we expect further upside for URI shareholders.

First Data Corporation (FDC)



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Price (12/30/2016)	$ 14.19	Forward P/E	9.1
Market Cap ($B)	$ 13.9	Price/Book	13.4
Dividend Yield	0.0%	Price/Sales	1.2

First Data Corporation (FDC) is a global leader in electronic commerce and the largest independent network services provider in the world. FDC's integrated commerce solutions enable businesses to accept electronic payments, help financial institutions issue credit, debit, and prepaid cards, and route secure transactions between businesses and financial institutions. FDC is headquartered in Atlanta, Georgia and operates in more than 118 countries, reaching approximately six million business locations and more than 4,000 financial institutions worldwide.

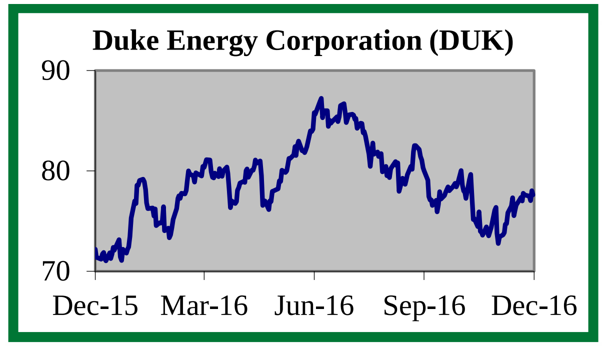
Founded in 1971, First Data was acquired by American Express in 1980 and spun off in an initial public offering in 1992. In 2007, private equity firm KKR took FDC private though a leveraged acquisition. In October 2015, KKR took the company public again but retained a majority of the voting shares, which the firm still holds today.

Since re-emerging as a public company in 2015, FDC has focused on growing each of its three business segments: Global Business Solutions (representing 58% of revenues), Global Financial Solutions (22%), and Network and Security Solutions (20%). Areas of particular growth include mobile commerce (using phones and tablets to transmit payments), ecommerce over the internet, and encryption and security of financial data. The company's core businesses processed 79 billion transactions globally last year, representing more than 28% of the world's electronic payment volume.

In addition to growth, FDC management has made a top priority the disciplined reduction of debt held over from the 2007 leveraged buyout, recently committing to pay down $1.3 billion per year for the next three years. Total debt stood at $18.3 billion on September 30, 2016, down from a high of $22.5 billion in 2008.

FDC stock is currently priced at 9.1 times forward earnings, below the broad market. We believe that management's disciplined growth and turnaround strategy will benefit shareholders as the company continues to repay debt, grow and diversify its global business, and eventually repurchase shares.

Duke Energy Corporation (DUK)



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Price (12/30/2016)	$ 77.62	Forward P/E	16.4
Market Cap ($B)	$ 53.5	Price/Book	1.3
Dividend Yield	4.3%	Price/Sales	2.3
Return on Equity	7.1%		

Duke Energy is the nation's largest electric power holding company with total assets of over $120 billion and a market capitalization of more than $53 billion. Duke's regulated utility business, which accounts for 90% of consolidated earnings, serves approximately 7.4 million electric customers in six states, primarily in the Southeast and Midwest. The company's nonregulated segments consist of renewable energy assets backed by long-term contracts with commercial and industrial customers nationwide.

Duke has been transitioning its business to primarily regulated operations for several years. Benefits of this strategy include service territory monopolies, efficient scale advantages, and an overall reduction of risk in its business, which are the primary sources of an economic moat for regulated utilities such as Duke. The company enjoys a favorable regulatory environment and an expanding rate base in its largest markets of North Carolina and Florida, where positive demographics and a healthy economy have contributed to solid earnings growth. Duke's utilities have consistently won rate increases from regulators that have translated into growing profits and dividends, and the company continues to invest strategically in new power generation, infrastructure, and environmental upgrades across its portfolio.

Duke has also made significant acquisitions, most recently of Piedmont Natural Gas for $5 billion in late 2016. This transaction presents significant growth and cost cutting opportunities, which we expect the company to realize in 2017 and beyond. Conversely, Duke has announced it will be selling most of its international operations in early 2017 as part of its continuing focus on expanding its electric and gas service in regulated U.S. markets.

In our view, Duke's financial position is strong and its dividend secure. With its current dividend yield of 4.3% and dividends projected to grow steadily with earnings over the next several years, we believe Duke is an attractive utility holding.

Source for charts and text: Morningstar, S&P, Schwab, Value Line, Black Diamond Performance Reporting, and Argus 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 $825 million as of December 31, 2016 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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