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INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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January 2019

Sit Tight

After rising to record highs in September, the U.S. stock market plunged in the fourth quarter of 2018 before rebounding sharply in the last several days of the year. The volatility rattled investors, who entered 2019 nervous about the outlook for the global economy, corporate earnings, the markets, and their portfolios.

The prospect of an end to the longest-ever U.S. bull market is daunting, and we understand the angst caused by falling portfolio values. However, we think the U.S. economy and stocks still have room to run, and we are encouraged by the market's recovery so far in early 2019. We may not yet have seen the short-term bottom for stocks, but we believe market history tells us that the best thing to do is hunker down, avoid selling attractively-valued securities when their prices are down, seize opportunities as they present themselves, and await the recovery that has always followed market pullbacks.

What Happened?

A litany of concerns, including slowing global economic growth, rising interest rates, trade wars, and geopolitical issues, combined to cause stocks to decline around the world beginning in October. In the United States, the S&P 500 index fell 19.8% from its September peak to its low point for the year in December, barely missing the 20% drop that would have officially put the index into bear market territory for the first time since 2009. After a bounce at year end, the S&P 500 index's total return, including dividends, for the full year was -4.4%. Foreign stocks fared worse, broadly falling about 14%. Investors flocked to the safety of bonds in December, but bond prices still declined over the full year as interest rates rose. The yield on the 10-Year Treasury is currently 2.7%, up slightly from 2.4% at the end of 2017.

Investors again closely watched the actions and statements of the U.S. Federal Reserve Board for clues to its plans for further interest rate increases, and Fed Chair Jerome Powell rattled markets in mid-December with a statement that investors saw as a signal for more rate hikes even in the face of indications of a slowing global economy. Changes in yields led briefly to an inverted yield curve, a situation in which certain short-term Treasury bonds have higher yields than longer-term bonds. An inverted yield curve has reliably preceded recessions in the past, though the recent inversion was for a different set of bonds than typically cited in studies of past recessions. Even though yields on the bonds more commonly used for attempting to forecast recessions do not currently indicate an inversion, the relationship between short- and long-term bond yields signals concerns about future economic growth.

Finally, a partial government shutdown stemming from disagreement over funding for a border wall began on December 22nd, capping a year of unusually sharp political discord. As we write this report, the shutdown is now the longest in history, is adversely impacting workers and businesses across the country, and has added more uncertainty to the economy and markets.

Don't Forget the Good News

Fortunately, there has been much good news to offset the challenges facing the economy and markets. Most important, economic expansion continues in the United States and in many other important economies around the world. Here at home, unemployment is very low and jobs growth remains strong; in fact, the current 99-month streak of hiring is the longest on record. Consumer spending is robust, with the just-concluded holiday season marking the best retail sales growth in six years. Consumer confidence points to ongoing economic growth in at least the short term, and the Conference Board Leading Economic Index® also indicates solid GDP growth in 2019, though growth is likely to taper in the second half.

Because of the strong economy and the boost from tax law changes enacted for 2018, corporate earnings growth has been spectacular. Fourth quarter earnings should increase close to 15%, following three quarters of earnings growth above 20%. Companies have been using the additional cash flows to fund dividends, repurchase shares, and reinvest in their businesses.

Even after four rate increases by the Fed in 2018, interest rates remain historically low, providing inexpensive capital for investment and for stock dividends and buybacks. Mortgage rates have dropped back to the levels of early 2018, making purchase loans and refinancings more attractive than in recent months and providing a potential boost to the housing market.

What We See and Expect

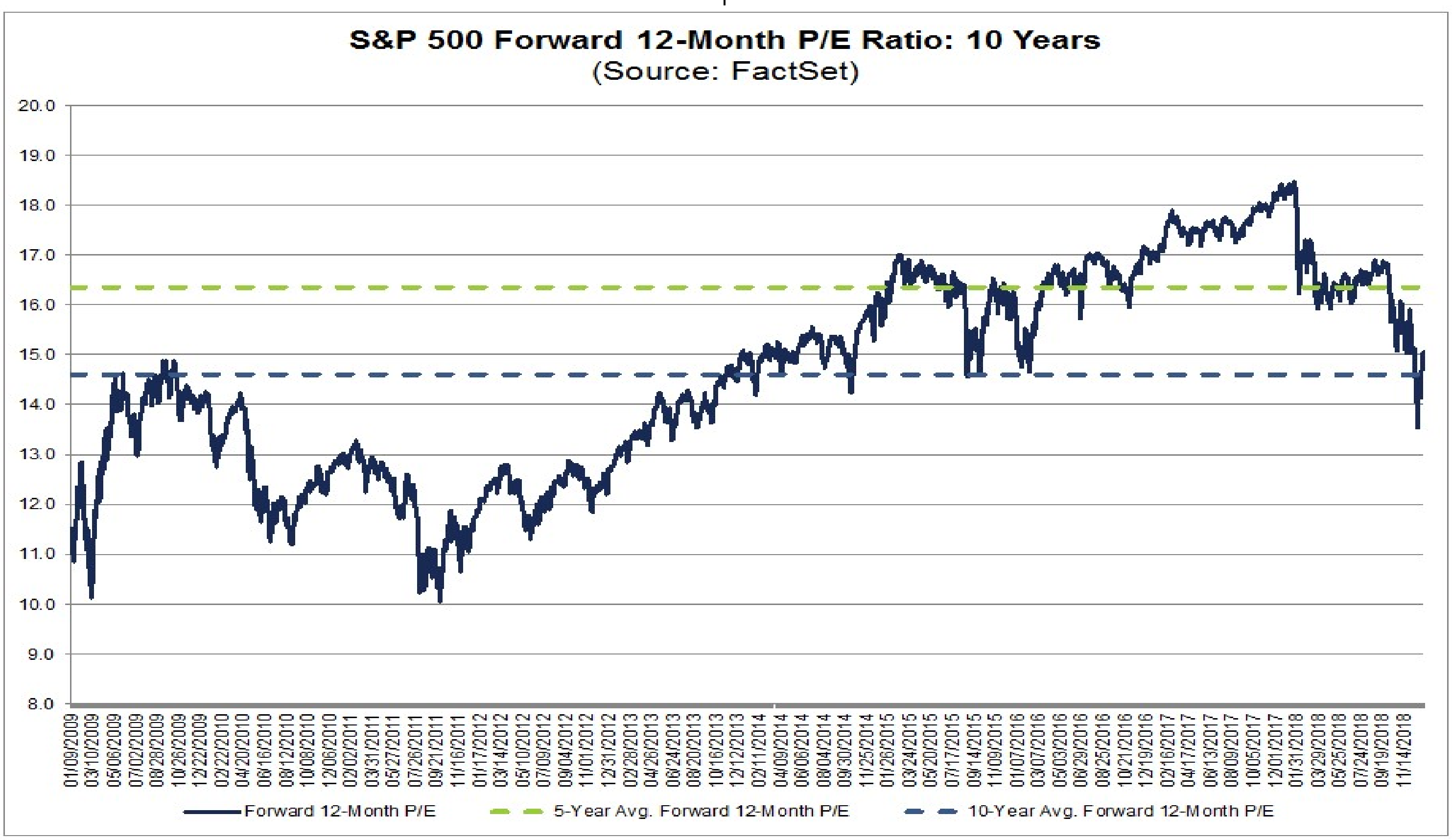
First, we believe the economic expansion will continue and currently do not expect the U.S. economy to enter a recession in 2019. Interest rates remain low, inflation is tame, and corporations should be able to further increase their sales and hire more workers. GDP growth should be about 2.5% in 2019, and analysts currently expect corporate earnings to increase about 7%. Both of these growth rates are lower than in 2018, largely due to the absence of another boost from tax cuts, but are still strong. We think economic fundamentals are currently too healthy for a recession to be likely this year and expect the Fed to move cautiously on raising rates further to avoid stalling the economy and rattling markets.

Second, we expect mixed economic trends elsewhere in the world. The European Central Bank seems determined to remove stimulus even as the European economy is slowing, and Great Britain's planned exit from the European Union (Brexit) will probably hurt economic growth. The Chinese economy is likely to continue to expand at a lower rate than in recent years. Any resulting decrease in Chinese demand for raw materials and other goods would slow the global economy.

Third, one of the biggest economic risks is the potential for harmful trade wars, as threatened by the Trump administration. We are optimistic that ongoing negotiations will lead to agreements to avoid the worst outcomes, but we are keeping a watchful eye on progress.

Fourth, we believe stock valuations are attractive after the recent pullback. As shown in the chart below, the S&P 500 index's price/earnings ratio, one of the most widely followed measures of market valuation, has dropped from above 18 at the beginning of 2018 to 15.1 now, below its 5-year average of 16.4 and the 25-year average of about 16. As we have noted before, the stocks we own trade on average for lower price/earnings ratios than the stock market as a whole, and we believe they will deliver solid long-term returns.

Fifth, we see good opportunities to invest in high-yielding equities for the income portion of our portfolios. While we have added some bonds to our portfolios to help provide stability in times of market uncertainty, we continue to invest a larger portion of our income portfolios in utilities, pipeline companies, preferred stocks, and other equities with higher yields than currently offered by bonds. In our opinion, many of these securities should also be able to increase their payouts over time, providing a hedge against inflation and the potential for price appreciation.



Finally, the stock market has always bounced back sharply from corrections (drops of 10%-20%) and bear markets (drops of more than 20%) in the past, and we see no reason to expect anything different now. The reversal is often swift, though patience is one of the most important virtues for investors.

What to Do

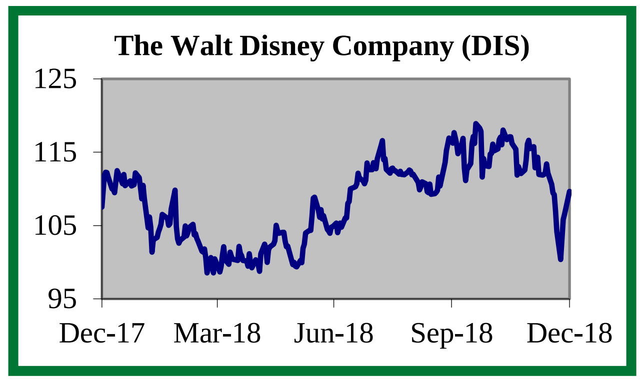
We know that recent volatility has caused anxiety, particularly for investors whose retirement spending and other financial needs depend on their portfolios' performance. We believe our experience through multiple past market cycles enables us to be more objective and stay focused on the long term, but we know rapid and large market swings are unnerving.

We believe the best course of action in the face of current opportunities and challenges is to stick with a diversified portfolio designed, as are the ones we manage, to weather the periodic market storms that inevitably come and wait for stocks to rebound. At times like now, it is tempting to think that certain outcomes are obvious and easily predictable; the reality is that they are neither, and past attempts by both professional and amateur investors to invest based on short-term predictions of market moves have proven that point over and over. We see potential for attractive long-term returns from the securities we own, we continue to look for new opportunities to take advantage of lower valuations, and we appreciate your confidence in our approach and patience through difficult times in the market.

Analysis of Selected Securities

Following is a discussion of three securities we own and have bought recently. Due to factors specific to each company, these stocks are, in our opinion, priced attractively in the markets today.

The Walt Disney Company (DIS)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 10.

Price (12/31/2018)	$109.65	Forward P/E	14.4
Market Cap ($B)	$162.8	Price/Book	3.3
Dividend Yield	1.7%	Price/Sales	2.7
Return on Equity	28.0%		

The Walt Disney Company (DIS) is a global entertainment company founded in 1923 as one of the early animation studios. Today it operates in four diverse but interconnected business segments: Media Networks (including ABC, ESPN, and The Disney Channel), Parks and Resorts (Disneyland, Magic Kingdom, and Epcot), Studio Entertainment (Pixar and Lucas Films), and Consumer Products and Interactive Media (Marvel Comics and Disney Interactive). As the market leader in many of these segments, Disney has built a diverse stream of revenue, franchising, and merchandising opportunities that spans multiple platforms including movies, cable television, theme parks, publishing, video games, and music.

The world-class Disney brand is unmatched in the entertainment industry. Over many decades, Disney has continuously demonstrated its ability to generate profits from its characters and franchises across multiple platforms. Being able to produce and distribute valuable content through multiple channels is a huge differentiator for Disney relative to its peers and is a source of the company's wide economic moat, a term we use to denote sustainable competitive advantages.

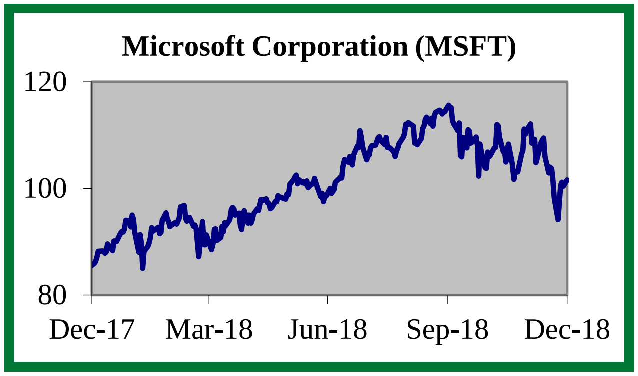
Disney's media network is marked by its crown jewel, ESPN. As the dominant domestic sports television network, ESPN generates the highest affiliate fees per subscriber of any cable channel. Partly due to its exclusive broadcast rights for both the NFL and college football, ESPN also receives revenues from advertisers seeking to reach the coveted 18-49 age demographic. This dual stream of revenues from affiliate fees and advertisers is a significant advantage not shared by traditional broadcast networks and should provide Disney with some offset to projected declines in affiliate fees as viewers shift to new platforms like internet streaming services.

In the face of such industry shifts, Disney has been investing heavily in new streaming services, direct-to-consumer offerings, and unique and proprietary content. The company recently launched ESPN+, a subscription streaming service, to leverage its $1 billion investment in Major League Baseball's BamTech platform last year. Since the April 2018 launch, ESPN+ has brought in over 1 million subscribers. Disney also expects to launch a Disney+ streaming service in late 2019 to expand distribution of its Pixar, Marvel, and Star Wars film and television content.

Finally, and most significantly, Disney announced its acquisition of much of Twenty-First Century Fox in July 2018 for $71 billion plus the assumption of $14 billion of debt, beating out Comcast in a hotly-contested bidding war. The Fox media assets being acquired include valuable film and television studios (producers of X-Men, Avatar, and The Simpsons), cable entertainment networks (FX networks and National Geographic), and a vast international television business (Star India and Tata Sky). The Fox merger will also give Disney a 60% controlling interest in television streaming service Hulu. Analysts expect the Disney/Fox merger to generate $2 billion in annual cost savings by 2021 and to add to Disney's earnings in the second year after closing. The combination of the two media giants should drive long-term growth in revenues, earnings, and market share worldwide.

Disney's financial position is strong, with steadily growing revenues, earnings, and cash flow. The company enjoys high returns on equity and low levels of debt. Disney shares trade at an attractive forward price-to-earnings ratio of 14.4 times, which is a discount relative to the market and to its 5-year historical average of 18 times. Although the dividend yield of 1.7% is slightly below the market average, Disney has increased the payout at a 17.5% compounded annual rate over the last five years and is expected to continue to raise it in line with the company's 9%-10% earnings growth forecasted for the next 3-5 years.

Microsoft Corporation (MSFT)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 10.

Price (12/31/2018)	$101.57	Forward P/E	23.3
Market Cap ($B)	$754.5	Price/Book	9.0
Dividend Yield	1.8%	Price/Sales	6.9
Return on Equity	21.4%		

CEO Satya Nadella took the helm of software and computer services giant Microsoft in 2014 and quickly adopted a new vision for the company, beginning the process of transforming the business from a personal computer (PC)-based model to one focused on mobile, cloud-based products and services that enable users to access, share, and store their work on the internet rather than on desktop computers and servers. Nadella's "cloud-first, mobile-first" strategy has taken hold and accelerated the company's growth in notable new areas like cloud services, artificial intelligence, and internet services.

Microsoft operates in three primary segments: Productivity and Business Processes (32% of 2018 revenues, 36% of operating income), Intelligent Cloud (29%, 33%), and Personal Computing (38%, 30%). All three segments have been growing at double-digit rates, led by core offerings like Office 365 (revenues up 36% year-over-year), Azure cloud (up 76%), and LinkedIn (up 33%).

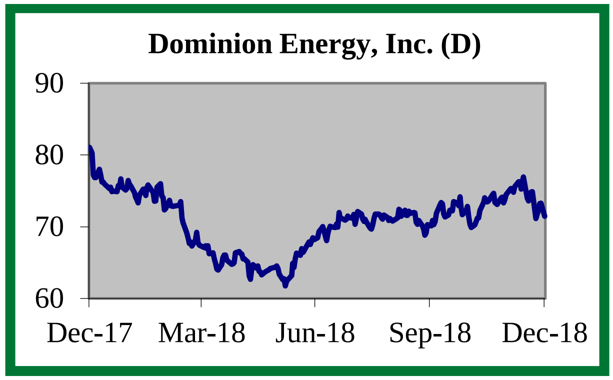
Under CEO Nadella's leadership, Microsoft has quickly emerged as the second-largest provider of public cloud services behind market leader Amazon Web Services. Microsoft's Azure cloud platform has experienced significant user growth due to the fast pace of adoption by both commercial and consumer markets of internet-based services. By leveraging Azure-hosted software packages like Office 365 and Dynamics 365, Microsoft's Intelligent Cloud division has grown revenues to more than $32 billion annually, or nearly one-third of total company revenues. The Productivity and Business Processes division is also experiencing strong growth driven by the successful roll-out of the Windows 10 operating system, now running on over 700 million devices including PCs, tablets, smartphones, and consoles and fast approaching its goal of 1 billion installed users.

Microsoft has also pursued its growth-oriented strategy by making some significant acquisitions. The company acquired professional services platform LinkedIn in December 2016 for $26 billion, bringing LinkedIn's 500 million users into the Microsoft ecosystem of products and services. Microsoft also bought open-source software development platform GitHub in June 2018 for $7.5 billion, connecting GitHub's 28 million developer-users with Microsoft's global cloud infrastructure, partner channels, and developer tools and services. The GitHub acquisition is expected to add to Microsoft's earnings by 2020.

Microsoft enjoys a wide economic moat due to its large enterprise footprint across a multitude of products and services that creates a network effect around its applications and operating systems and results in high switching costs for its customers. In addition, the company's huge commercial user base, strong customer relationships, and massive amounts of customer data inherent in products like Windows, Office, and LinkedIn position the company well to continue growing revenues and earnings globally as the process of digital enterprise transformation continues to accelerate.

Microsoft's current financial position is strong. The company generates $32 billion of free cash flow annually, has $136 billion of cash on its balance sheet compared to $76 billion of long-term debt, and enjoys a triple-A credit rating. The company is also shareholder friendly, increasing its dividend 9.5% in November 2018 and buying back $10.7 billion of its stock in 2018, on top of $11.8 billion in 2017 and $16 billion in 2016.

Dominion Energy, Inc. (D)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 10.

Price (12/31/2018)	$71.46	Forward P/E	16.7
Market Cap ($B)	$55.4	Price/Book	3.0
Dividend Yield	4.7%	Price/Sales	3.5
Return on Equity	18.0%		

Dominion Energy, which we currently buy for our income portfolios, is one of the nation's largest producers and transporters of energy, serving more than six million utility and retail energy customers in fourteen states. The company's portfolio of assets includes 26,200 megawatts of electricity generation, 15,000 miles of natural gas transmission, 6,600 miles of electric transmission lines, and 1 trillion cubic feet of natural gas storage capacity.

Dominion operates in three major segments: Power Generation (42% of operating earnings), Gas Infrastructure (39%), and Power Delivery (19%). Since 2010, the company has made a strategic shift to focus its business on utility projects and infrastructure, while retiring merchant energy plants and exiting its exploration and production business.

Specifically, Dominion has been investing in what it terms foundational projects like distribution and transmission lines and natural gas-fired power plants, as well as transformational projects like solar installations, large-scale pipelines, and natural gas liquification plants. These projects should support average earnings growth of 6%-8% through 2020 and 5% thereafter. Analysts expect these wide-moat projects to generate half of Dominion's earnings by 2022, with the balance coming from steady, regulated gas and electric utility operations in attractive growth and regulatory environments.

On January 1, 2019 Dominion acquired South Carolina utility SCANA for $7.9 billion, adding 1.5 million customers in North Carolina, South Carolina, and Georgia. The acquisition adds scale in adjacent states to Dominion's existing operations that should improve efficiencies, reduce costs, and add to earnings in the near term.

Dominion is currently financially stable, with good earnings growth and strong cash flows. Dominion's focus on wide-moat utility and infrastructure projects supports its strong and growing dividend. Currently yielding 4.7%, Dominion's dividend is a full percentage point above the utility average, and the company has increased its payout at an annual rate of 7.8% over the past five years. Though we expect future increases to moderate from that level, the company's consistent earnings growth should continue to drive the dividend higher in coming years.

Dominion has also been working to deleverage its balance sheet by selling off assets to repay debt. Long-term debt stood at $18 billion in September 30, 2018, down from $30 billion at year-end 2017. We believe Dominion shares represent good value and steady income for long-term investors.

We Welcome Christine Xu to Edgemoor

We are pleased to announce the newest addition to our team, Christine Xu. Christine joins us as an Assistant Relationship Manager after two years at Pricewaterhouse Coopers. She graduated magna cum laude from the University of Illinois, where she also earned a master's degree in accounting science.

Source for text: Morningstar, S&P, Schwab, ValueLine, Black Diamond Performance Reporting, Yahoo Finance, and Argus 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 $872 million as of December 31, 2018 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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