Edgemoor's Quarterly Report

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Second Quarter Surge

The stock market just had its best quarter since 1998, after its sharp fall in the first quarter. The S&P 500 index rose 20.5% on aggressive actions by the U. S. Federal Reserve and Congress and signs of an economic rebound, most notably the robust rehiring of workers in May and June. The market's move coincided with a steady decrease in reported cases of COVID-19 until mid-June, but then cases in the United States began to increase sharply.

Of course, we have been hoping for a quick rebound in economic activity after the shutdowns around the world in March. Also, we remain optimistic that over the long term the U.S. and global economies will survive the current challenges and return to steady expansion. However, our near- to intermediate-term outlook is more muted due to our concerns about the ongoing effect of the pandemic, including the potential for a second wave in the fall, depressed consumer purchasing, and delayed rehiring of the remaining workers furloughed or laid off earlier this year.

Quarter in Review

Stocks' recovery from their March lows was remarkable for its speed and magnitude. Having plunged 34% from its high in February to its low point on March 23rd, the S&P 500 index gained almost 39% through the end of June, with over half of that increase coming in the second quarter. The sectors with the best performance during the quarter included consumer cyclical, energy, and technology, each up more than 30%. Hard hit during the downturn, consumer cyclical stocks bounced back partly due to fiscal relief provided by Congress that offered some support to consumer spending and businesses in the sector. Energy stocks benefited from the rebound in oil prices, which had plunged in the first quarter. Tech stocks, which had held up much better than others during the first quarter downturn, showed their ongoing resilience and ability to provide for the needs of their customers in the face of economic shutdowns. The S&P 500 index ended June down only 3.1% for the first six months, a performance we consider impressive given the severity of the challenges.

The global spread of COVID-19 and resulting shutdowns of economic activity remained the primary issues facing the markets in the second quarter. China and Europe reduced the number of new COVID-19 cases, but the United States and Brazil have had more difficulty controlling its spread. Cases also began rising in India and other developing countries. The slowdown in economies elsewhere in the world limited demand for goods from reopened factories, such as in China. Until all countries around the world can control the disease, global economic growth will not fully recover.

Past performance is not indicative of future results.

Reports during the quarter confirmed that U.S. gross domestic product (GDP) declined during the first quarter at a 5% annual rate, and expectations are for an even more severe decline in GDP in the second quarter despite the employment gains. Following the loss of 22.2 million jobs during March and April due to shutdowns, U.S. employers added 7.5 million jobs in May and June, with the leisure and hospitality sector seeing the biggest gains after suffering the most losses earlier. As a result of this hiring, the unemployment rate dropped from 14.7% in April to 11.1% in June; this substantial improvement still leaves the rate higher than its peak during the 2008-2009 financial crisis. Corporate earnings declined 15% during the first quarter, hurt by the pandemic-related shutdowns in March. Current estimates project an earnings decline of 45% for S&P 500 companies in the second quarter, when the shutdowns affected the entire period.

Powerful support from the U.S. Fed and foreign central banks, combined with government fiscal support in the United States and abroad, was critical to the global economy's ability to dampen the economic blow from the pandemic. These organizations used tools from the financial crisis as well as new ones, and they acted even more quickly and decisively this time. We applaud the Fed's aggressive actions to provide relief and maintain liquidity in the markets, and we are confident that Chair Powell and his colleagues will continue to take necessary steps to help our economy.

Our Current Outlook

We are pleased to see the stock market's resilience in the face of the significant challenges presented by the pandemic. Stocks were trading only 7% below their all-time highs at the end of June, despite the severe downturn in the economy and corporate earnings. We are optimistic that, over the long term, there will be a vaccine to prevent COVID-19, economies around the world will resume their expansion, corporate earnings will rise, and stocks will follow.

However, we have concerns about the market's prospects for the coming quarters and are being cautious with our portfolios. While we expect the securities we own to perform well over the coming years and decades, we believe there is a greater than usual risk in the market as the impact of the pandemic on the timing of an economic recovery becomes clearer.

The United States clearly is having difficulty controlling the spread of COVID-19, and we are concerned that our economic recovery will take longer, and securities will remain volatile, as a result. Much uncertainty remains regarding the economic outlook, including the reopening of schools over the next few months that is a prerequisite for many workers to return to their jobs. The improvement in the employment picture is encouraging, but getting the remaining sidelined workers back to their jobs may be slower than the initial burst of hiring we saw as many businesses reopened. We are also wary of rising tensions with other nations, China in particular, and the impact they might have on economic recovery.

Also unknown is whether our political leaders will provide another round of relief to workers and households still hurt by loss of jobs and closure of much of our economy. We are hopeful that further relief will be forthcoming and are confident the Fed will do what it can to help, but we are wary of the political squabbles ahead as Congress and the

White House work out the details of any additional relief measures.

Even with additional relief and support, economic data and corporate earnings will likely be weak over the coming quarters. Yes, we expect to see improvement from the second quarter, but results will still likely lag significantly behind the pre-pandemic course.

Rather than try to value stocks based on current or near-term results, we are focusing more on prospects for 2021 and beyond, when we believe the economy will be back on a path closer to what we were expecting at the beginning of this year. The S&P 500 index now trades at a multiple of about 22x projected earnings for the next twelve months, higher than its historical average. As we have noted before, extremely low current interest rates justify a premium to historical earnings multiples, and we also believe today's higher price/earnings ratio is less troublesome than it might otherwise be, since we expect the downturn in earnings to be temporary.

We continue to believe the best course of action for investors is to stick with our long-term investment strategy, which focuses on shares of high-quality companies with durable business models and sustainable competitive advantages that will survive this temporary threat. As noted in earlier reports, we have sold certain holdings that we believed were most directly exposed to the impact of the pandemic and built up cash reserves in the process. While we intend to generally hold current cash levels until we get more certainty regarding the pandemic and economy, we expect to take advantage of opportunities to purchase individual securities that become available at attractive prices, particularly if the market drops again over the coming months. For the income portion of our portfolios, we are also being cautious and currently favor less volatile securities such as bonds and preferred stocks.

We know recent conditions have been stressful on many fronts, and we appreciate your ongoing patience and confidence in our investment approach and stewardship of your assets. While we do not know how long this economic disruption will last, we are confident that the economy and markets will bounce back once conditions improve, as has happened after every other downturn. We remain optimistic that the United States will get through these tough times and that our clients' portfolios will perform well over the long term.

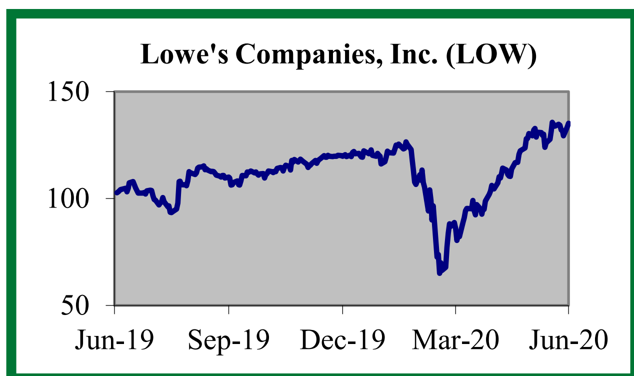
Remote Office Operations

We have been working remotely since March 16th (almost four months, but who's counting?) and are pleased to report that the transition has been smooth. While we miss being together in our office and meeting with you in person, we have been able to carry on with our work fully and are readily available by phone or email. Our investment committee has been meeting regularly via Zoom to review our investments, and we will continue to work remotely until being together is clearly safe for all of us. If you need to send anything to us by mail, FedEx, or UPS, please contact Anne at 301-543-8881 or abaker@edgemoorinv.com for instructions. Stay safe and healthy.

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 market today.

Lowe's Companies, Inc. (LOW)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 9.

Price (06/30/2020)	$ 135.12	Forward P/E	21.3
Market Cap ($B)	$ 102.7	Price/Sales	1.4
Dividend Yield	1.6%		
Return on Equity	184%		

Lowe's is the world's second largest home improvement retailer, generating $72 billion in annual sales and operating 1,977 stores throughout the United States and Canada. The states with the highest concentration of Lowe's stores are Texas, Florida, North Carolina, and California. The company sells products and services to both do-it-yourself retail customers (about 75% of sales) and to professional contractors (25%) for the maintenance, repair, remodeling, rebuilding, and decorating of homes and businesses. Home Décor (appliances and paints) is the company's largest segment at 36% of total sales, followed closely by Building Products at 32% and Hardlines (tools, hardware, and lawn and garden) at 29%.

Its enormous size and scale afford Lowe's numerous competitive advantages, including purchasing power, operational efficiencies, and a low-cost position tied to its automated distribution network that links vendors, distribution centers, and stores on one technology platform. This logistical system has allowed Lowe's to improve inventory flow, channel fulfillment, and delivery strategies and is a source of the company's wide economic moat.

Most recently, Lowe's has benefited from shelter-in-place orders associated with the coronavirus pandemic, as it was one of the few brick-and-mortar retailers to be deemed essential and allowed to remain open. First quarter 2020 results handily beat analysts' expectations, with revenues rising 11%, same-store-sales growing 11.2%, and operating profit margins expanding by 2 percentage points to top 10% for the first time in more than a decade. E-commerce sales grew more than 80% during the quarter, as more customers shopped online and the company's previous efforts to redesign its website paid off generously.

Lowe's is also well-positioned to deliver long-term earnings growth, projected to average 14% annually over the next five years. CEO Marvin Ellison joined the company in 2018 (from Home Depot and JC Penney) and has worked with urgency to improve merchandising efforts, supply-chain efficiencies, inventory control procedures, and customer engagement. In addition, with about two-thirds of homes in the U.S. now more than 25 years old, the upgrade

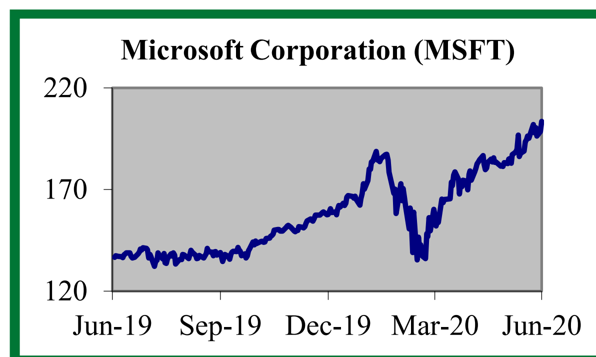
cycle for home improvements is still in the early stages. Finally, Lowe's and Home Depot together account for only about 20% of the total retail home improvement market, leaving significant room for growth and consolidation in most major markets.

Lowe's is financially strong, with a high return on equity, strong cash flow, and manageable debt. At the end 2020's first quarter, the company had $6 billion of cash, $3 billion of undrawn credit availability, and interest coverage of 9.5 times. Cash flow from operations has been consistently positive for more than ten years and topped $4.3 billion in fiscal 2020.

The company owns more than 85% of its stores, which makes its real estate a significant asset that is carried on its balance sheet at an estimated 60% of non-depreciated value. Lowe's is also friendly to shareholders, having boosted its dividend at an annual rate of 19.6% over the last five years to its current payout of $2.13 per share, resulting in a 1.6% dividend yield.

Lowe's shares currently trade at about 21x fiscal 2021 earnings, which is a slight premium to its 5-year historical average as well as to the overall market. We believe Lowe's deserves a premium valuation due to its strong growth prospects, dominant market position, and durable earnings and cash flow.

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 9.

Price (06/30/2020)	$203.51	Forward P/E	33.6
Market Cap ($T)	$ 1.6	Price/Book	14.0
Dividend Yield	1.0%	Price/Sales	11.7
Return on Equity	44.2%		

Since CEO Satya Nadella took the helm of Microsoft in 2014, he has transformed the company from a personal computer-based software business to one focused on high-value commercial and 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 accelerated the company's growth, profitability, and market share as Microsoft has become a leader in high-growth areas like cloud services, internet applications, and artificial intelligence.

Microsoft operates in three primary segments: Productivity and Business Processes (33% of 2019 revenues, 38% of operating income), Intelligent Cloud (33%, 32%), and Personal Computing (34%, 30%). All three segments have been growing at double-digit rates, led by core offerings like Office 365 (revenues up 25% year-

over-year in the quarter ended March 31, 2020), Azure cloud services (up 59%), and LinkedIn (up 21%).

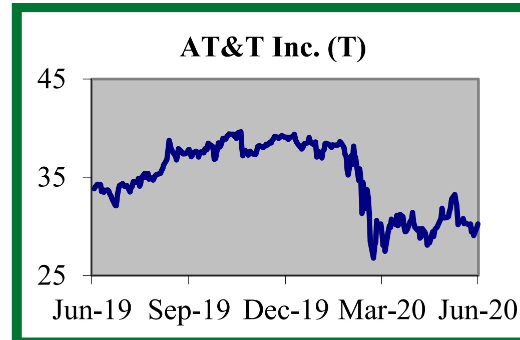
Under CEO Nadella's leadership, Microsoft has quickly emerged as the second largest public cloud services provider behind market leader Amazon Web Services. Microsoft's Azure cloud platform has doubled its market share to 17% of the public cloud infrastructure market in just a few short years, and the Intelligent Cloud segment surpassed Microsoft's other two business segments in the quarter ended March 31, 2020 with annual run-rate revenues of $50 billion.

Microsoft's diversified portfolio, durable business model, and differentiated technology platform has positioned the company well to continue to prosper through the coronavirus pandemic. The company has leveraged its huge installed base of customers to move them quickly and seamlessly to hybrid, cloud-based operations to meet their remote working and learning needs. In addition, Microsoft's business model is not advertising-dependent, like tech rivals Google and Facebook, which has made the company less vulnerable to the pandemic-driven drop in advertising sales.

Microsoft enjoys a wide economic moat due to its large enterprise footprint across a multitude of products and services. This breadth 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 10, Office 365, and LinkedIn position the company well to continue growing revenues and earnings in both its core businesses as well as in emerging technologies like artificial intelligence and Internet-of-Things.

Microsoft's financial position is strong. The company generates $43 billion of free cash flow annually, had $136 billion of cash on its balance sheet at March 31, 2020 compared to $63 billion of long-term debt, and enjoys a triple-A credit rating from Standard and Poor's. Microsoft shares trade at a premium to the overall market at 33.6 times forward earnings, but we believe this premium is warranted by the company's strong growth prospects, robust earnings and cash flow-generating power, and dominant and defensible market position.

AT&T Inc. (T)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 9.

Price (06/30/2020)	$ 30.23	Forward P/E	9.6
Market Cap ($B)	$ 217.0	Price/Book	1.2
Dividend Yield	6.8%	Price/Sales	1.2
Return on Equity	7.9%		

AT&T is one of the largest media and telecom companies in the world, with global revenues of nearly $180 billion and a market capitalization of $217 billion. AT&T provides a wide array telecommunications and digital entertainment

services to consumers in the United States and Latin America and to businesses worldwide. The company's two primary businesses are Communications (wireless and wireline telecom, video and broadband services – 77% of 2019 operating revenues) and Warner Media (Turner, HBO, Warner Brothers - 18% of revenues).

AT&T has built a diversified media and telecom business made up of distinct but interrelated businesses that together reach over 170 million customers worldwide. AT&T Mobility, its wireless business, is the company's largest business segment and a dominant player, along with Verizon, in the U.S. wireless industry. It benefits from enormous size and scale, a large and loyal customer base, and a broad network of infrastructure assets that allow the company to deliver a wide range of telecom services to its customers.

During the coronavirus pandemic, AT&T's wireless business has also proved to be durable and resilient, as work-at-home restrictions have made reliable communications services and connectivity more vital than ever. In addition, the deployment of 5G networks should further differentiate AT&T from its wireless competitors, as it continues to focus on speed, reliability, and data usage offerings.

Warner Media, the company's second largest business segment, also has several competitive advantages with a deep content library and ability to reach audiences across a variety of platforms. Although the pandemic curtailed much of Warner Brothers TV and film production studios, AT&T's other cable and network channels like HBO, CNN and Turner Classic Movies have continued to prosper. Warner Media also launched in May its new HBO Max streaming service, which is expected to garner a large share of the growing video streaming market. Overall, the full integration of Time Warner is expected to yield $1.5 billion in annual cost savings and $1 billion of annual revenue gains by June 2021.

AT&T's financial position is strong, even as it increased its long-term debt load as a result of the Time Warner acquisition. The company generates $27 billion in annual free cash flow and had $10 billion of cash and $20 billion of borrowing capacity as of March 31, 2020. It pays out a generous and sustainable 50% of free cash flow in dividends to shareholders, and shares are valued at a below-market 9.6 times forward earnings. AT&T's current dividend yield of 6.8% and its record of steady dividend increases also make it an attractive income holding.

Source for text and charts: 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 $971 million as of June 30, 2020 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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