EDGEMOOR
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Edgemoor's Quarterly Report

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From the Edge of the Cliff to Record Highs

The first quarter of 2013 began with a compromise on the fiscal cliff issues and ended with record highs in the U.S. stock market, thanks to a combination of support from the Federal Reserve, an improving economy, and solid corporate earnings. Investors responded to the largely positive news by returning money to stocks after several years of selling.

Even after the market's recent surge, we believe fundamentals support prices higher than current levels and expect stocks to continue their run. As always, there are reasons to be cautious, but we are still finding opportunities to own shares of outstanding companies at discount prices.

First Quarter in Review - What's Different from Previous Peaks

As noted in our last quarterly report, the American Taxpayer Relief Act addressed many of the issues related to the fiscal cliff at the end of 2012, and the stock market resumed its climb in January. The deal preserved the automatic spending cuts that were scheduled to take effect at the beginning of the year, but when the sequester did hit on March 1st, the markets shrugged off the cuts and rolled on.

The Fed maintained its support of the economy during the quarter, primarily through its continued monthly purchases of $85 billion of bonds to keep interest rates low. U.S. economic growth remained slow but steady, the jobs market continued to gradually improve, and the housing sector further rebounded.

Major indexes, including the S&P 500 index and Dow Jones Industrial Average, ended the quarter at all-time highs, cheering investors and providing headlines for the financial media. Unlike some pundits, however, we do not assume that we should sell our stocks just because of the market's recent strong performance.

It is important to note some key fundamentals in the market today compared to 2007 and 2000, the times of previous market peaks. First and foremost, the earnings of the S&P 500 have nearly doubled since 2000 and have also risen 10% since 2007, providing greater support to current market levels. Earnings for the S&P 500 index for the past 12 months are currently about $98, compared to $89 in the fall of 2007 and $54 in early 2000. Consequently, the S&P 500 index trailing price/earnings ratio is 16 today compared to 17 in the fall of 2007 and ***28*** in early 2000. We expect S&P 500 index earnings of about $110 for the full year 2013, which implies a forward price/earnings multiple of 14, lower than historical averages.

In addition to strong earnings, corporate balance sheets are healthier, with businesses holding record levels of cash and S&P 500 book value per share up nearly 30% since the fall of 2007. Interest rates are also significantly lower, supporting economic growth and making stocks more attractive relative to bonds. Finally, the global financial system is more stable now than at the time of the 2007 peak, as central banks around the world have stepped in to keep the markets calm.

Market Outlook

We remain optimistic that the stock market will continue its run over the coming quarters, though likely at a slower pace than the first quarter's 10.6% rise. Yes, there will be pullbacks along the way, but we believe the fundamentals in the markets and global economy support further gains over the long term.

The markets remain focused on conditions in the United States, Europe, China, and Japan. Here at home, the Fed's support has been important, and we expect it to continue. Though economic reports have been mostly positive, the March jobs numbers point to an economy that is still struggling to break out of its current state of steady but slow expansion. Having committed to maintaining interest rates at their current low levels as long as unemployment is greater than 6.5% and core inflation below 2.5%, the Fed will not be changing course anytime soon.

The U.S. housing sector has been a bright spot and should improve further throughout the year. Prices of existing homes increased in all 20 markets covered by the S&P/Case-Shiller Home Price Indices in the most recent data, single family home permits and housing starts increased at double-digit rates, and the home building industry has been hiring steadily. Home improvement retailers and others have benefited from housing activity, and the sector's rebound will ripple through the economy even more over time. Rising home values support consumer spending, which is critical to economic growth. As homeowners see the values of their homes increase, they are more willing to spend savings or even tap into their home equity to borrow money to spend.

As in recent quarters, we have some approaching deadlines for political decisions that will impact the economy and markets. Next up is a debate over the debt ceiling, which Congress suspended only until May 19th. We are confident that lawmakers will reach a compromise solution, but we also expect some market volatility as they debate the alternatives. Investors seem to have resigned themselves to a high level of political dysfunction, though each battle does result in a bit of progress toward a long-term solution and removes some uncertainty. Meanwhile, as the economy strengthens it is better able to weather the political storms and other shocks that may come along.

Political and economic issues in Europe flared toward the end of the first quarter. Elections in Italy cast a spotlight on the difficulties of implementing austerity measures on the electorate, and a banking crisis in Cyprus spooked investors who worry about the implications for dealing with similar issues in larger European countries. The European economy has stabilized somewhat but is still struggling to recover in the face of high debt loads, austerity measures, and political turmoil.

The European Central Bank and other government agencies are providing support where possible and trying to resolve specific crises quickly and effectively. The challenges in Europe will continue, but we see some improvement and do not expect the issues there to cause a global recession.

China's economy has been picking up steam, due in large part to government stimulus. The resulting uptick in Chinese demand for raw materials and other goods has helped to boost other nations' economies. We are keeping a close eye on a potential property bubble there and government efforts to rein in skyrocketing housing prices, which could slow the broader Chinese economy.

Japan has significantly devalued its currency over the past several months in an effort to boost exports and its economy. These efforts should succeed in rejuvenating the Japanese economy and are creating some opportunities for investment in Japan, but we are also keeping our eyes open for any signs of broader currency wars.

Overall, we see a slowly improving global economy, and we find stock market valuations reasonable. We purchase about 30-35 stocks for our equity portfolios and a select group of income securities for our income portfolios. Though there are not as many bargains available today as there have been in the past several years, we are still finding securities that trade below our estimates of fair value, and we expect attractive long-term returns from our portfolios.

While we like stocks, we believe that bonds are significantly overvalued. Boosted by investors' flight to safety over the past several years and the Fed's efforts to keep interest rates artificially low, bond prices are destined to fall as the economy improves and interest rates rise. For income investments, we continue to favor preferred stocks, master limited partnerships, utilities, and other high-yielding equities. The yield on the income portions of our portfolios is currently about 5%-6%, significantly higher than the yields on most bonds, particularly Treasurys.

Before moving to a few of our current investments, we offer the following excerpt from Warren Buffett's most recent letter to Berkshire Hathaway shareholders. These words of wisdom are important to remember whenever short-term market challenges cause anxiety:

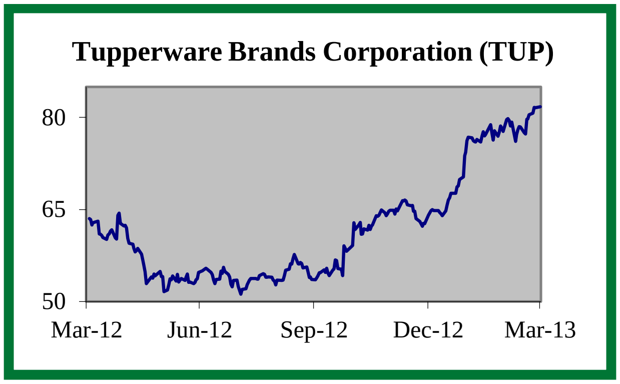
As owners of, say, Coca-Cola or American Express shares, we think of Berkshire as being a non-managing partner in two extraordinary businesses, in which we measure our success by the long-term progress of the companies rather than by the month-to-month movements of their stocks....If we have good long-term expectations, short-term price changes are meaningless for us except to the extent they offer us an opportunity to increase our ownership at an attractive price.

Of course, we enjoy rising markets more than falling, and we are pleased with results so far in 2013. Nevertheless, we will maintain our focus on the long term in the face of any upcoming challenges.

Analysis of Selected Stocks

Following is a discussion of several of the securities we own and have been buying recently.

Tupperware Brands Corporation (TUP)



Price (03/28/2013)	$ 81.74	Forward P/E	14.2
Market Cap ($B)	$ 4.4	Price/Book	8.9
Dividend Yield	3.1%	Price/Sales	1.7
Return on Equity	58.6%		

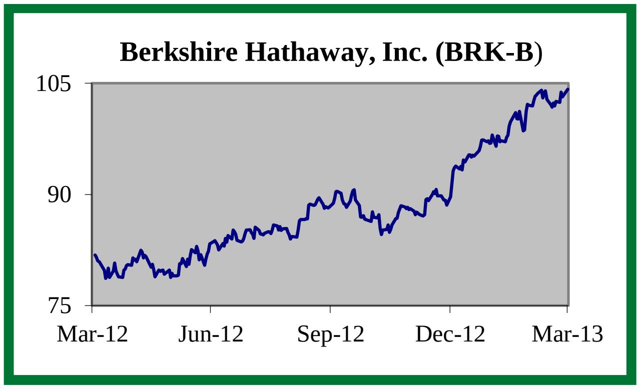
Tupperware Brands, based in Orlando, FL, is one of the world's leading direct sellers of consumer products, including food storage, preparation, and serving items, as well as skin care, cosmetics, and other beauty products. Its independent sales force consists of over 2.8 million consultants spread across 100 countries worldwide. Tupperware pioneered the in-home direct-sales approach in the United States back in the 1950s, and today the company's reps reach customers worldwide through a variety of channels including online sales, retail kiosks, and traditional home parties.

TUP derives more than 80% of its revenues from outside the United States, with emerging markets alone contributing nearly 60% of the company's top line. Sales in these emerging economies, from Mexico to the Philippines to India and South Africa, are growing at double digit rates as demand for consumer products, particularly beauty products, is soaring among the expanding middle class. The company is also able to recruit very high quality reps in these markets, many of whom are well-educated school teachers, because of its relatively high-commission pay scale and flexible work hours. We expect TUP to continue to generate above-average growth and profits from these largely under-penetrated markets, given its low-cost business model and strong reputation for high quality goods at fair prices. Growth in established markets like the United States and Europe is likely to remain flat over the near term.

TUP has a solid track record of returning capital to shareholders. The company boosted its dividend 72% in the fourth quarter of 2012 to $0.62, or $2.48 annually, for a current yield of 3.1%. We expect dividends to rise further as management has vowed to maintain a 50% payout ratio of its growing earnings base. TUP also recently increased its share repurchase authorization from $1.2 billion to $2 billion through February 2017.

Based on its prospects for solid growth, additional dividend increases, share repurchases, and positive earnings momentum, we consider TUP an attractive long-term holding.

Berkshire Hathaway, Inc. (BRK-B)



Price (03/28/2013)	$104.20	Forward P/E	18.3
Book Value/Share	$80.32	Price/Book	1.3
Market Cap ($B)	$244.9	Price/Sales	1.5
Dividend Yield	0.0%	Return on Equity	8.4%

Berkshire Hathaway, one of Edgemoor's largest and longest-held investments, performed solidly in 2012. The company's book value per share increased 14.4% to $80.32 for the Class B shares, and operating earnings of the underlying non-insurance businesses, a critical component of measuring performance and intrinsic value according to Chairman and CEO Warren Buffett, grew nearly 16% per share.

The market responded, sending Berkshire Class B shares up 18% last year and another 17% year-to-date in 2013. At 1.3 times book value, below their historical median value of 1.4 times, we view the shares to be reasonably priced. We consider price-to-book value to be the best valuation metric for Berkshire stock, as the more traditional price-to-earnings ratio fails to capture the significant earnings of Berkshire's unconsolidated investments that are not included in its reported earnings. If these were included, the forward P/E ratio would be notably lower than the 18.3 stated ratio, reflecting better value.

Operationally, Berkshire's business units performed well in 2012, with its largest insurance segment (consisting of GEICO, General Re, and Berkshire Reinsurance) generating another record $73 billion in float, which is essentially free money consisting of premiums collected net of unpaid claim reserves. This low cost capital has always been one of the most compelling advantages of Berkshire's business model. When combined with the operating cash flow of its 70 other, non-insurance businesses, this float provides Buffett with the capital and the clout to make large, opportunistic deals such as the preferred investments in Goldman Sachs, Bank of America, and General Electric struck during the 2008-2009 credit crisis that have proven very lucrative to shareholders.

But Warren Buffett's favorite business is still buying companies that meet his criteria of having consistent earnings power, above-average returns on invested capital, little to no debt, and a strong management team. Oddly, he was unable to find a major acquisition in 2012 that met these simple standards. To paraphrase his words, he pursued a lot of elephants but came up empty-handed.

Luckily, this disappointment did not last long. In February 2013, Berkshire announced a $28 billion deal to buy H.J. Heinz in partnership with Brazilian investment group 3G Capital. Berkshire's investment will consist of $4 billion of common equity and $8 billion of 9% preferred equity, following a similar structure of the earlier Goldman and Bank of America investments. Hence, we are quite optimistic about this one.

The well-publicized challenges facing Berkshire – namely growth and succession – are not of great concern to us. We do expect the company to continue making selective acquisitions, but even absent more elephants, the growth of its underlying companies will serve to increase shareholder value over time. As far as the succession risk, we have already seen the successful integration of two new investment managers, Todd Combs and Ted Weschler, each of whom beat the S&P 500 in 2012 by double-digit margins. Consequently, Buffett increased the funds managed by each to nearly $5 billion, up from an initial $2 billion. Buffett commented in his most recent annual shareholder letter that "we hit the jackpot with these two."

Indeed, we recognize that the day will come when Warren Buffett (82) steps aside from Berkshire's operations, and that he may be largely irreplaceable in terms of capital allocation and deal-making skills. But, we expect to continue to hold Berkshire stock, which at today's prices we consider to be under-valued, as long as the company is managed according to his time-tested principles of value investing that have served his investor-partners so well.

FelCor Lodging Trust Inc.
Series A Cumulative Convertible Preferred Shares (FCHPRA)

Price (03/28/2013)	$ 24.90	Market Cap ($B)	$ 699.0
Par Value	$ 25.00		
Preferred Coupon	7.8%		
Current Yield	7.9%		

FelCor Lodging Trust (NYSE: FCH) is a real estate investment trust that went public in 1994. Today, FelCor owns a diversified portfolio of 66 primarily upscale and luxury hotels that are located in 30 major cities and resort markets. Most are operated under well-recognized brands such as Doubletree, Embassy Suites, Hilton, Marriott, and Sheraton. The company recently added upscale flags Westin, Royalton, and Morgan Hotels to its portfolio. We have followed FelCor for many years and are once again buying its Preferred A shares, whose dividend appears to us to be secure after a period of instability over the last few years.

FelCor's hotel business suffered during the Great Recession, and the company was forced to suspend dividends on its preferred shares in March 2009. FelCor then embarked on a major restructuring of its operations and business strategy, including the sale of non-strategic assets (primarily limited service and midscale hotels located in secondary and tertiary markets), the selective acquisition of superior hotels in major markets (New York and Boston), and the redevelopment of its core properties.

The company has made great progress on this plan. As of year-end 2012, FelCor has sold 19 of its 39 non-strategic hotels for total proceeds of $429 million. Of the 20 remaining, 11 were brought to market in March 2013, and two of these are already under contract. The company expects it will generate close to $1 billion of cash from asset sales by the time they are completed in 2014.

The successful realignment of its portfolio allowed FelCor to reinstate its quarterly preferred dividends in 2011, and by July 2012 it had repaid in full the $76 million of suspended dividends on these shares. The company has also repaid approximately $100 million in long-term debt outstanding and funded $200 million in capital expenditures to upgrade its core hotel holdings. Most recently, FelCor was able to refinance more than $500 million of debt outstanding and lower its cost of capital to 6.6%, reduce its annual interest expense by $30 million, and extend the average maturity of its debt out to 2020.

While still a work in progress, the success so far of FelCor's strategic repositioning makes these preferred shares once again an attractive income investment with a stable yield profile.

Source for charts and text: Morningstar, Value Line, S&P, company reports, EIA estimates.

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 $625 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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