EDGEMOOR
INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Waiting for Action

Summer is well underway, America just celebrated its 241st birthday, and people are enjoying or looking forward to vacations. Markets have been calm and friendly for most of the year, with the most recent corporate earnings reports supporting the generally bullish mood. Amid this calm, however, we still await the policy reforms and infrastructure spending promised by the new administration, and investors are growing more skeptical of the ultimate results to come from Washington as time marches on.

Will the reforms that pass Congress provide the boost to earnings and the economy that the markets are anticipating? Will earnings growth continue, with or without significant policy changes? These are the questions on investors' minds in the summer of 2017, and following are our thoughts on these and other topics.

So Far, So Good

The markets performed well during the first half of the year, with the S&P 500 index returning 9.3% through June 30th. Despite ongoing threats of rising interest rates, bonds also provided positive returns, 2.3% as measured by the Bloomberg Barclays U.S. Aggregate Bond Index.

Corporate earnings rose 15% in the first quarter, the best showing in six years. As we have said many times in these reports, we believe earnings are the linchpin of stock valuations, and these gains provide critical support for current stock prices.

Economic growth continued and was enough to lead the Fed to boost the federal funds rate by 0.25% in June, following a similar increase in March. The U.S. Bureau of Economic Analysis raised its estimate of first quarter GDP growth to 1.4%, and we expect the figure for the second quarter to be higher at 2%-3%. Unemployment is low at 4.4% due to the monthly addition of 180,000 jobs on average this year, only slightly below last year's monthly pace of 187,000.

The energy sector benefited from a rebound in oil prices earlier this year and favorable comparisons to last year's depressed earnings. However, some gloom entered the sector when oil prices retreated late in the second quarter as higher output from shale oil producers more than offset attempts by OPEC to curtail production and prop up prices.

Housing prices rose across the country, and household debt stayed below historical averages, trends that increased consumer confidence and spending. The manufacturing and services sectors remained robust, and the dollar decreased about 6% against a basket of foreign currencies in the first half of the year, the most in two quarters since 2011 and a boon to U.S. exporters, whose goods are now more competitively priced abroad.

In June, all thirty-four of the largest U.S. banks passed the latest stress test intended to gauge their ability to survive another financial crisis without government support. As a result, the Fed lifted restrictions on dividend payments and buybacks, and several banks immediately announced plans to increase their payouts to shareholders. Bank balance sheets and capital levels currently appear strong, which could lead to more lending and a spillover of confidence into other sectors of the economy.

What to Expect

The U.S. Fed's deliberations, statements, and actions remain critical to the economy and markets. The Fed plans to lift rates at least once more this year if economic growth continues. Stubbornly low inflation and paltry increases in wages could derail the Fed's plans, though the strong June jobs report provided support for another rate move. Even if the Fed does not act on rates again this year, we believe it will probably begin to shrink its inventory of Treasurys and federal government agency bonds as another way to unwind the massive stimulus it has provided to the economy since the financial crisis.

Foreign central banks are also influencing markets. The rate of economic expansion in Europe is now about the same as in the United States, thanks largely to the stimulus provided over the past several years by the European Central Bank. European stocks have slightly outperformed U.S. stocks this year but still trade at a lower average multiple of earnings.

The S&P 500 index currently trades for 19x estimated earnings for 2017, above the long-term average of about 16x but far below the level of nearly 30x at the peak of the tech boom in 2000. Because interest rates are near all-time lows, the S&P 500's earnings yield (earnings/price) of 5.3% is much higher than the interest yield on the 10-Year Treasury bond, currently 2.4%. This premium offered to stock investors, which is higher than its historical average, attracts investors to stocks rather than bonds, is unlikely to shrink dramatically in the near term, and is one of the reasons we believe current valuations are sustainable.

Of course, there are reasons to be cautious about the markets, starting with the observation that the stock market is overdue for a correction. Anyone invested in stocks should expect corrections (declines of 10% or more) and bear markets (declines of 20% or more), which occur more frequently than most realize (about once per year for corrections, once every 3 ½ years for bear markets). However, with the economy slowly expanding, interest rates low, and inflation tame, we do not currently see a fundamental reason for the market to drop sharply in the near future.

The pace of policy change coming from Congress has been slower than many investors had hoped, and the struggle to replace the Affordable Care Act raises questions about Congress's ability to pass comprehensive tax reform and agree on an infrastructure spending plan. Anticipation of progress on both fronts is reflected in current market prices and the relatively high multiple of earnings at which the S&P 500 index now trades. Failure to enact significant legislation in the second half of the year would likely disappoint investors and put pressure on stock prices. While there remains much work to be done, we expect some version of tax reform from Congress later this year, though it may be difficult to enact anything that takes effect before 2018. Major infrastructure spending will probably not come until 2018 at the earliest.

Any attempts by the administration to restrict trade, including significant changes to the North American Free Trade Agreement (NAFTA), could also rattle investors. Geopolitical issues are back on the forefront following North Korea's launch of an intercontinental missile, disagreement between the United States and Europe on key issues including climate change, and the beginning of negotiations related to the United Kingdom's exit from the European Union. A further decline in oil prices could upend energy companies just as their earnings recover from last year's price shock.

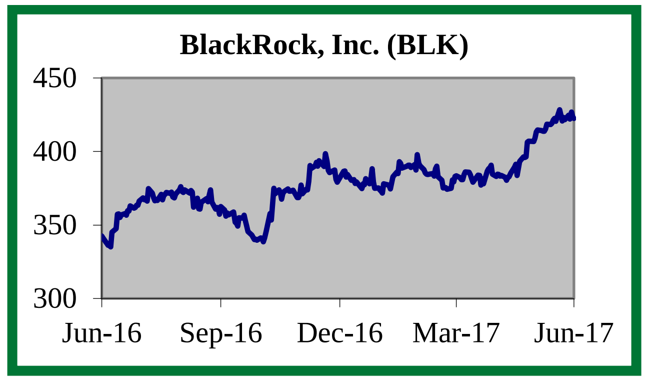
We are still waiting for opportunities to buy bonds as rates rise but continue to prefer other high-yielding securities for our income holdings. Bonds' current low yields make them vulnerable to sharp price swings on small movements in interest rates, a risk that we do not think is worth taking.

We believe markets will continue to trade near their current all-time highs as we await further action from the administration and Congress. Whether or not policy changes meet expectations, we foresee ongoing economic growth and further improvement in corporate earnings. While you enjoy the summer, we will keep a close eye on events as they unfold, and we remain optimistic that the markets will continue to reward patient, disciplined investors.

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.

BlackRock, Inc. (BLK)



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

Price (06/30/2017)	$ 422.41	Forward P/E	17.3
Market Cap ($B)	$ 69.3	Price/Book	2.4
Dividend Yield	2.2%	Price/Sales	6.3
Return on Equity	11.7%		

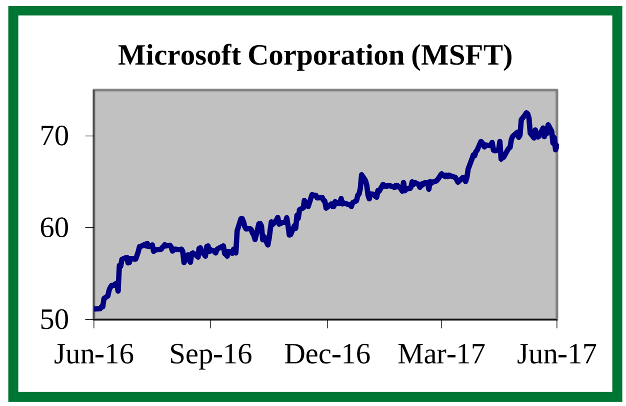
BlackRock is the largest asset manager in the world, with $5.4 trillion in total assets under management (AUM) and clients in more than 100 countries. BlackRock provides investment management, risk management, and advisory services to institutional and retail clients worldwide. Its range of offerings spans both actively managed and passive investment products, including mutual funds, exchange traded funds (ETFs), separately managed accounts, and other pooled investment vehicles. BlackRock has demonstrated its ability to retain a high proportion of assets through investment cycles due to its broad array of low-cost fixed income, equity, international, and alternative asset products.

With $1.4 trillion in ETF assets under management, BlackRock's iShares platform is the largest domestic and global provider of ETFs with an estimated 37% global market share, double the share of second-place Vanguard. BlackRock has benefited from the rise over the last two decades of passive investment products, which are designed to track a benchmark index and offer lower costs. Passive products account for roughly two-thirds of BlackRock's assets under management and nearly half of its revenues. About 80% of iShares' $1.4 billion of AUM is accounted for by institutional clients, who tend to trade in and out of funds less frequently than individual retail investors and therefore allow BlackRock to generate higher and more stable levels of growth than many of its peers. Continued flows of assets into passive investment products are currently expected to drive iShares' growth rate of 5% annually for the foreseeable future.

BlackRock also currently manages $1.5 trillion in actively managed equity and fixed income funds for institutional and retail clients. The higher fees associated with actively managed portfolios allow this business to generate 48% of the firm's total base management fees while accounting for only 28% of long-term AUM.

We believe BlackRock is financially strong and shareholder friendly. The firm's operating profit margin of 44% and return on equity of 11.7% are currently among the highest in the industry. Its balance sheet has modest leverage, and its cash flow generation is high at over $3 billion annually. Dividends have grown at a rate of 18% compounded annually over the last five years, and the company has an active share buyback program with 9 million shares currently authorized. At 17.3x forward earnings, the stock is in our view attractively valued given its above-average growth and profitability, stable long-term asset inflows, and history of client retention and product innovation.

Microsoft Corporation (MSFT)



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Price (06/30/2017)	$ 68.93	Forward P/E	18.5
Market Cap ($B)	$ 534.1	Price/Book	7.5
Dividend Yield	2.2%	Price/Sales	6.1
Return on Equity	24.7%		

The world of computing is in a rapid phase of change. The shift to mobile devices and web-based applications is affecting how businesses and consumers alike utilize technology for everything from communications to productivity to e-commerce and entertainment.

Microsoft, the world's largest software developer, is likewise changing the way it does business. Microsoft has been steadily shifting its strategy from a model based on personal computers (PCs) to one focused on a mobile, cloud-based computing platform though which users access, share, and store their work on the internet rather than on their desktop computers and servers. The "Cloud-first, Mobile-first" vision adopted for the company by CEO Satya Nadella several years ago is taking hold.

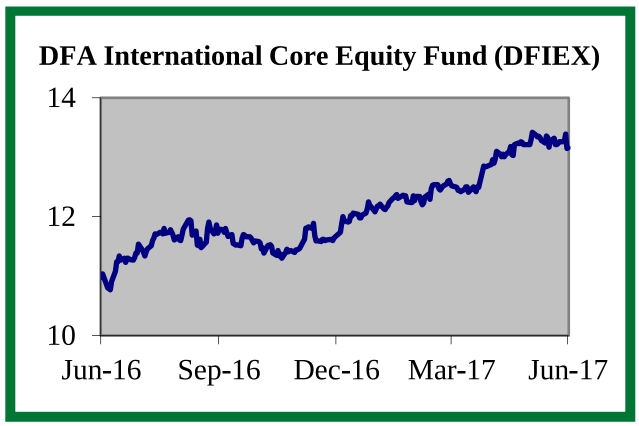
Microsoft enjoys a wide economic moat, or protection from competition, due to its massive enterprise footprint across a multitude of products and services that creates a network effect around its applications and operating systems and results in high switching costs for its customers. Azure, Microsoft's public cloud service, has quickly emerged as the number two player in the space behind Amazon Web Services. The platform is experiencing significant user growth as Microsoft expands Azure-hosted software packages like Office 365 and Dynamics 365. The fast pace of adoption by both commercial and consumer markets of internet-based services has quickly driven revenues of the company's Intelligent Cloud division to more than $25 billion in 2016, or 29% of total company revenues of $85 billion.

Microsoft's Productivity and Business Processes division, which represents 29% of total revenues, is also experiencing strong growth driven by the successful rollout of the Windows 10 operating system, now running on over 350 million devices across the company's large installed base of commercial customers. While the sluggish PC market has shrunk Microsoft's Personal Computing business to 44% of total company revenues, the highly profitable and growing enterprise cloud and commercial services businesses have more than made up for the lost sales.

In December 2016, Microsoft closed on its largest-ever acquisition, purchasing the professional social networking website LinkedIn for $26.2 billion in cash. Management believes that LinkedIn will expand Microsoft's total addressable market to more than $300 billion from $115 billion today, as LinkedIn's 500 million users are brought into the Microsoft ecosystem of products and services. The acquisition is also currently expected to realize $150 million in annual cost savings this year and to be accretive to earnings within two years.

Microsoft's current financial position appears strong. Although the company took on $31 billion of incremental debt to finance the LinkedIn acquisition last year, it now generates $28.5 billion of free cash flow annually, has $126 billion of cash on its balance sheet, and enjoys a triple-A credit rating. The company is also shareholder friendly, paying a current dividend of $1.56 per year to yield 2.2% and buying back $10 billion of its stock in the first nine months of the current fiscal year on top of the $16 billion it repurchased last year.

DFA International Core Equity Fund (DFIEX)



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Price (06/30/2017)	$ 13.16	Expense Ratio	0.3%
Total Assets ($B)	$ 22.4	Turnover	2.0%
Dividend Yield	2.3%		

The DFA International Core Equity Fund (DFIEX) offers broad exposure to international equities in foreign developed markets, like Europe and Asia, in a low-cost and tax-efficient manner. The fund uses a distinct approach to portfolio construction that emphasizes value, profitability, and size of the companies in its target universe, factors which empirical data show have historically resulted in higher expected returns. As a result, the fund tends to favor companies with lower valuations, smaller market capitalizations, and higher profitability than the broad market.

The fund's holdings are broadly diversified across about 5,000 stocks listed in non-U.S. developed markets. Its largest geographic exposures are in Europe (57%) and Asia-Pacific (35%), including Japan and Australia. DFIEX has a strong track record, outperforming the MSCI ACWI ex USA Index in the each of the past 1-year, 3-year, 5-year, and 10-year time periods. The fund also has exceptionally low turnover with just 2% of holdings being traded during any year, which reduces transaction costs and keeps its expense ratio at a low 0.30%.

DFIEX is managed by Dimensional Fund Advisors (DFA), a global investment firm founded in 1981 that today manages nearly $500 billion for investors worldwide. DFA takes a unique approach to investment management, viewing it as a science by which investment strategies are developed based on large bodies of empirical research and subject to rigorous review and testing. This disciplined approach allows DFA to avoid chasing trendy investment themes and ultimately to generate higher returns than passive index funds. DFA also limits the distribution of its funds such that individual investors can gain access to them only through an approved advisor like Edgemoor.

We began investing in select DFA funds in 2014 to gain broad, multi-capitalization, international exposure and to complement the individual foreign stocks in our portfolios. We chose DFA as a manager after a lengthy review of its investment philosophy, procedures, and performance, as well as meetings with its portfolio managers and academic advisors. We like DFA's value orientation, disciplined process, and low cost.

We believe international exposure is an important component of diversified portfolios and currently presents one of the most attractive market opportunities for investors. Accordingly, our investment in DFIEX represents a core allocation in our client portfolios.

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

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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 $875 million as of June 30, 2017 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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The S&P 500 index is an unmanaged market-capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. The MSCI ACWI ex USA Index is an unmanaged market-capitalization-weighted index of 1,866 stocks representing 85% of the global equity opportunity set outside the United States. The S&P 500 index and MSCI ACWI ex USA Index are discussed for comparative purposes only. The comparisons have limitations because the indexes have volatility, investment, and other characteristics that differ from the investment strategies of Edgemoor. Further, it is not possible to invest directly in the indexes.

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