EDGEMOOR INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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Buckle Up!

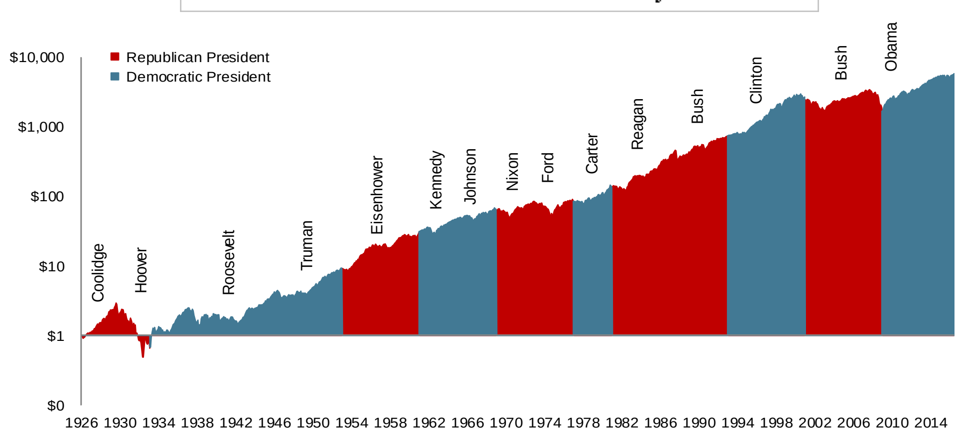
Following a good third quarter in the stock market, we are now rounding the final turn and heading into the homestretch toward year end, with plenty of excitement ahead. We are optimistic that the market will overcome the obstacles in its path to the finish line and emerge intact, but we are also bracing for more volatility over the next few months. Read on for our summary of the key issues affecting investments in the near term and our outlook through 2016 and beyond.

The Not-So-Presidential Election Campaign

While there have been bruising battles in the past, few have approached the nastiness of the current presidential campaign between Hillary Clinton and Donald Trump. Most current polls show Clinton leading in the race, though Trump has proven doubters wrong in the past. The Senate may also swing to Democratic control, though Republicans will likely maintain their majority in the House. Politics aside, the campaign is causing investors great angst, given the level of uncertainty about the potential outcome and market impact.

Like the rest of the nation and world, we are watching these events closely. However, we do not believe these elections will have significant long-term impacts on the markets or our portfolios, since other factors more directly and fundamentally impact investment returns. As shown in the chart below, markets have done well over the long term through many different political environments. The good news is that the election will be decided and over by November 8th, after which this uncertainty will no longer weigh on the markets.

Growth of a Dollar Invested in the S&P 500: January 1926–June 2016



Source: Dimensional Fund Advisors. Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. The S&P data is provided by Standard & Poor's Index Services Group.

Meanwhile, Over at the Fed

The rough Presidential campaign has stolen most headlines, but investors are still focusing on the U.S. Federal Reserve and its plans regarding interest rates. Having held off on further hikes since its last move at the end of 2015, the Fed is signaling an increase in the federal funds rate at its December meeting. Economic data seem to support this move, including continued strong hiring, low unemployment, and inflation (according to the Fed's preferred metric) of 1.7%, the highest level in two years and nearing the Fed's 2% inflation target.

We agree with the market consensus that the Fed will probably raise rates in December. As usual, changes in economic indicators between now and then could result in a delay, given the Fed's intense focus on the data. Any increase would likely be 1/4%, enough to signal the Fed's willingness to act to control inflation but not enough, in our opinion, to derail economic growth. Though it should not surprise anyone, this change could temporarily rattle markets.

U.S. Economy: Steady As She Goes

The U.S. economy remains on the course of slow, steady expansion that has brought the unemployment rate down from its financial crisis high of 10% to the current 5%. Economic growth rose to 1.4% in the second quarter and should pick up further in the second half of 2016, though forecasts are lower now than they were just a few months ago. GDP is increasing more slowly than last year, but we believe the near-term odds of a U.S. recession are still slight.

Oil prices, currently at about $50 per barrel, remain in the spotlight. After rising sharply in the second quarter from a bottom in February of about $26 per barrel, prices have hovered in the $40-$50 range since. This level is high enough to encourage drilling but low enough to keep energy firms cautious about hiring and spending, and the slowdown in the sector remains a drag on economic growth.

Elsewhere in the world, the economic picture is mixed but positive overall, and central bankers have maintained their stimulative policies. China's economic growth rate continues to slow but at 6%-7% still remains high relative to the developed world. The Bank of Japan is fighting hard to avoid an economic slowdown, as is the European Central Bank. So far, these efforts are succeeding. As the United Kingdom and European Union begin to negotiate the terms of their economic separation, there will likely be more volatility in markets there.

Investment Review and Outlook

The third quarter saw a reversal of many trends from the first half of the year. Technology and financial stocks went from lagging in the first half to outperforming in the third quarter. Meanwhile, several defensive asset classes that performed well in the first half, such as utilities, real estate investment trusts (REITs), and telecom companies, reversed course due to more positive economic data and increased odds of an interest rate hike by the Fed. Also, U.S. stocks outperformed in the first half but lagged foreign stocks in the third quarter. Since it is nearly impossible to predict all of these short-term changes in sentiment, these shifts emphasize the importance of a well-diversified, global portfolio similar to the ones we manage.

Analysts expect corporate earnings for the third quarter to decline for the sixth straight quarter; however, the tendency of analysts to underestimate results may indicate flat earnings this time. Either way, earnings will not provide much lift to the broad market until they pick up meaningfully from current levels. While we wait for earnings to improve, the discount at which our holdings trade relative to the market should provide potential for our stocks to rise due to higher multiples.

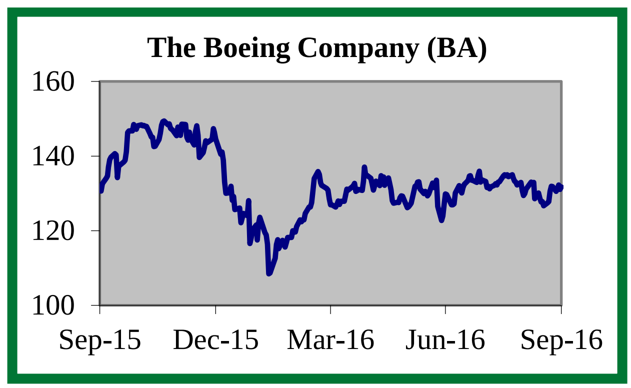
Particularly encouraging is the recent performance of value stocks, which are beating growth stocks for the first time in several years. In our last quarterly report, we discussed at length the advantages of owning value stocks over long periods of time, despite their recent underperformance, and we see signs of a shift back to the long-term trend. Value stocks typically trade for lower multiples of earnings than the broad market, and the stocks in our portfolios currently trade for an average of 12-13 times estimated earnings for the next year, a large discount to the S&P 500 index's multiple of 17 times. We remain confident that these stocks have the potential to perform well over the coming years.

With a rate hike likely in December and interest rates still at historically low levels, we continue to shun most bonds, since we believe they offer unappealing returns and expose investors to potential losses if interest rates rise. We reduced our utility sector exposure in the third quarter but still like those that we hold due to their long-term business prospects, solid fundamentals, attractive yields, and rising payouts. Other income classes such as preferred stocks, pipeline companies, and convertible securities also offer opportunities for attractive yields and total returns in the current low interest rate environment.

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.

The Boeing Company (BA)



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

Price (9/30/2016)	$ 131.74	Forward P/E	13.6
Market Cap ($B)	$ 84.0	Price/Sales	0.9
Dividend Yield	3.2%		
Return on Equity	108.4%		

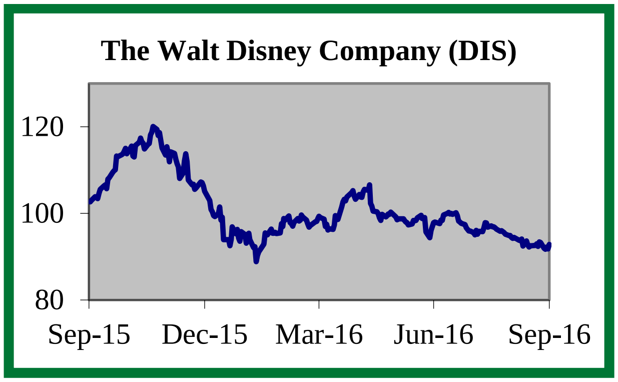
The Boeing Company is one of two dominant global aircraft manufacturers. The company designs, manufactures, services, and equips commercial and military aircraft sold to airlines, governments, and corporations throughout the world. In addition, Boeing makes helicopters, satellites, missiles, electronic systems, and communications equipment. Commercial aircraft sales and services account for approximately 70% of Boeing's total revenues, and defense accounts for about 30%, making Boeing less dependent on government contracts than most of its peers.

Boeing has benefited from strengthening demand for commercial aircraft worldwide due to increasing air travel, lower energy prices, and the accelerating replacement cycle for aging aircraft fleets. As a reflection of these trends, Boeing's backlog of commercial aircraft orders has grown to 5,700 planes worth over $400 billion, representing more than seven years' worth of production. The demand comes from both new aircraft orders in emerging markets and replacement demand in the United States and Europe, with all customers seeking more fuel-efficient and technologically-advanced planes.

To meet this robust demand, Boeing will be introducing several new models in the coming years, including the single-aisle 737MAX and the 777X, the largest twin-engine jet in the world. To prepare for this increase in production, the company made the controversial decision in early 2016 to curtail production of the older 777 and 787 wide-body planes, which dismayed some investors and sent Boeing shares to a 52-week low in mid-February. But shares have recovered nicely since, as investors recognize that the company is now well positioned to renew its growth in 2017 and beyond.

In our view, Boeing is financially sound, with strong earnings and cash flow, high returns on equity, and manageable debt levels. Total cash at June 30, 2016 was $9.3 billion, much of which will be returned to shareholders through a $14 billion share repurchase program approved last December and a dividend that was raised by 20% last quarter to yield 3.2%. With its shares trading at a below-market forward price-to-earnings ratio of 13.6 times, we believe Boeing represents a solid long-term investment.

The Walt Disney Company (DIS)



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Price (9/30/2016)	$ 92.86	Forward P/E	13.4
Market Cap ($B)	$ 149.0	Price/Book	3.4
Dividend Yield	1.5%	Price/Sales	2.7
Return on Equity	20.4%		

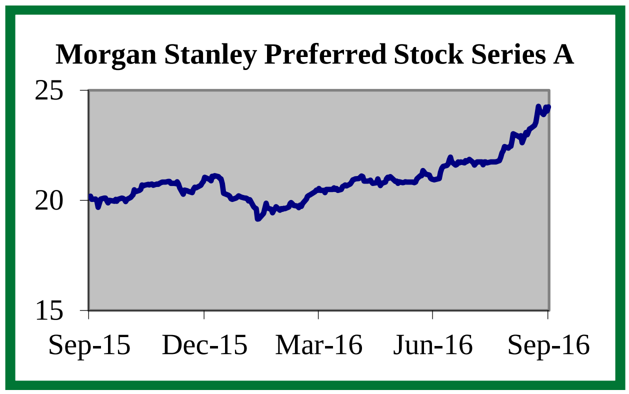
The Walt Disney Company is a global entertainment company founded in 1923 as one of the early animation studios. Today it operates in four diverse but interconnected business segments: Media Networks (including ABC and ESPN), Parks and Resorts (Disneyland, Magic Kingdom, Epcot), Studio Entertainment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

We believe the Disney brand stands out in the entertainment world and is the core driver of the company's parks, film, and consumer businesses. Over many decades, Disney has continuously demonstrated its ability to monetize its characters and franchises into long-lasting, profitable income streams from hits like Star Wars, Toy Story, and Frozen. From films and videos, to musicals and merchandise, Disney's interconnected businesses have the potential to generate enormous profits and solidify the strength and breadth of its world-class brand. Being able to produce and distribute valuable content through multiple channels is, in our opinion, a differentiator for Disney relative to its peers and is a source of the company's wide economic moat.

Disney's media network is marked by its crown jewel, ESPN. Arguably the dominant domestic sports television network, ESPN generates the highest affiliate fees per subscriber of any cable channel. It holds exclusive broadcast rights for both NFL and college football, which affords the network a second revenue stream from advertisers seeking to reach the coveted 18-49 age demographic. Despite significant changes underway in the cable TV industry, ESPN is positioning itself well for the future, recently announcing a $1 billion investment in video-streaming company BAMTech, with whom it expects to launch a multi-sport subscription streaming service. This move has been viewed favorably by investors who see Disney building a new, incremental revenue stream at ESPN to mitigate the risk of cord-cutters shifting from traditional cable subscriptions to internet-based streaming services.

We believe that Disney's financial position is strong, with steadily growing revenues, earnings, and cash flow. The company also enjoys high returns on equity and low levels of debt. Disney shares trade at a forward price-to-earnings ratio of 13.4 times, which is a discount relative to the market and to its peers. Although its dividend yield of 1.5% is slightly below the market average, its payout has increased steadily for the last ten years and is expected to continue to rise in line with the 9-10% earnings growth forecasted for the next 3-5 years.

Morgan Stanley Floating Rate Preferred Stock Series A (MSPRA)



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Price (9/30/2016)	$ 24.25	Current Yield	4.3%
Par Value	$ 25.00	Market Cap ($B)	$ 58.6
Preferred Coupon	Floating Rate w/ 4% floor		

Morgan Stanley's Floating Rate Preferred Stock Series A is an example of the kind of income investments we seek for our clients to generate safe, consistent, and attractive dividends in the current low interest rate environment. We consider the Morgan Stanley preferred shares particularly attractive because of several factors. First, they currently trade below their par value of $25, giving them potential upside upon redemption by the issuer. Second, unlike most preferred shares, which carry a fixed coupon rate, these shares pay a floating rate of interest based upon a benchmark rate plus 0.70%. With that benchmark rate currently yielding 0.85%, the calculated coupon on the shares would be just 1.55%. However, this preferred also carries a minimum coupon, or floor, of 4%. When calculated against a price of $24.25, the shares currently yield 4.3% to investors. Finally, dividends are paid quarterly and are eligible for the preferential income tax rate of 15% (up to 20% for some high income investors).

In addition to the specific traits of these preferred shares, the issuer, Morgan Stanley, is one of the largest global financial services firm in the world, with 1,300 offices in 24 countries and total assets under management of over $400 billion. Morgan Stanley operates in three main business segments: Institutional Securities (51% of revenues), Wealth Management (43%), and Investment Management (6%). Mitsubishi Financial Group, one of the largest banks in the world, owns 20% of Morgan Stanley.

Since the financial crisis, Morgan Stanley has focused its business more on wealth management and advisory services and less on sales and trading, creating a more stable business mix. Morgan Stanley also has strengthened its balance sheet, reporting Tier 1 capital of 15.8% at June 30, 2016, well above the required 10% ratio of the Basel III accord. We believe these factors combine to make Morgan Stanley's Floating Rate Preferred Stock Series A an attractive income alternative to low-rate, fixed-payout bonds.

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 $800 million as of September 30, 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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