



Edgemoor's Quarterly Report

Suite 315
7250 Woodmont Avenue
Bethesda, MD 20814
301-543-8881
www.edgemoorinv.com

Spring 2009

Are we there yet?

By “there” we mean “at the bottom,” and investors today are eager to know whether we have reached that point and are now on the road to recovery. There is no way to be certain until we can look back on this recession after the rebound is well underway. In the meantime, however, we offer the following **reasons for optimism**:

- Stocks are attractive relative to Treasuries: the S&P 500 earnings yield is nearly 8% - about 2.5x the 10-year Treasury yield – and the S&P 500 dividend yield is greater than the yield on the 10-year Treasury.
- In all recessions since World War II, stocks have risen sharply in advance of the economic turnaround.
- The equities markets are oversold and valuations are very reasonable.
- Credit is available for high-quality companies, and banks are lending to each other again.
- Orders for manufactured goods rose 1.8% in February, reversing six straight monthly declines, and inventories are declining.
- New home sales were up 4.7% in February and mortgage refinancings are surging.
- Consumer confidence rose in March, and retail sales are stabilizing.

- Deflation fears have decreased, and inflation is unlikely in the near term.
- Lower oil prices provide massive stimulus to the economy.
- The U.S. Treasury has committed to purchasing \$300 billion in long-term government bonds over the next few months and also plans to buy a total of \$1.45 trillion of mortgage debt from Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Banks.
- Treasury and private investors are joining to purchase up to \$1 trillion of toxic assets from banks.
- The European Central Bank cut a key interest rate to an all-time low of 1.25%.

These and other signs that the economy may be stabilizing led markets to rebound sharply over the last several weeks of March. The S&P 500 index rose 17% from its bottom, ending down 11% for the quarter, and has extended its run into April.

The primary catalyst for the recent surge in equities markets around the world has been the extraordinary measures taken by the U.S. and other governments to boost the global economy and prevent a deeper recession. These programs include a combination of traditional monetary policy (lowering interest rates, for example) and rarely used tactics such as the U.S. Treasury's decision to repurchase government bonds in another effort to increase money supply, thereby



keeping residential mortgage rates low to help the housing market recover. We are optimistic that these actions will lead to a more rapid recovery, and the economy and markets are beginning to reflect the benefits of governments' efforts. All this stimulus money may lead to inflation in the future, but we believe the U.S. Treasury and Federal Reserve have been right to move aggressively.

Economies around the world must still overcome serious issues to emerge from this difficult period and are likely to struggle into 2010. Unemployment is high and will rise further, and cash-strapped consumers are unlikely to resume their robust spending ways anytime soon. In the face of current headwinds, corporations will post at least another quarter of poor earnings, but analysts project earnings to resume growth beginning in the fourth quarter.

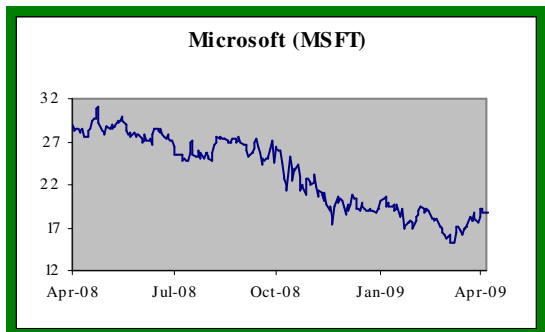
Most investors have seen these negative headlines yet are not as aware of the increasing amount of positive news that is sometimes lost beneath the surface. We offer our list of reasons for optimism as a reminder that all is not gloom and doom.

Perhaps the best news of all is that, amidst all of the turmoil and panic in the markets, we are finding some of the best opportunities we have ever seen to invest in stocks and bonds that are trading well below intrinsic value. Despondent over their losses, many individual investors have given up on the stock market at what we believe is the exact wrong time, when prices seem to be close to bottoming. Also, hedge funds and mutual funds have had to sell in order to meet client redemptions.

With so many investors racing to the exits over the past several months, we are able to buy stakes in high quality companies with strong competitive positions and earnings power selling at significant discounts. We cannot predict what will happen in the short term. However, we are confident that the companies in our portfolios will have much greater earnings several years from now and will increase their dividend payments. Consequently, the prices of the securities we hold today should rise, rewarding us as patient, disciplined investors. As Warren Buffett often says, a key to investment success is to be "fearful when others are greedy and greedy when others are fearful."

Analysis of Selected Stocks

Microsoft Corporation (MSFT)



Price (4/09/09)	\$19.67	Forward P/E	10.1
Market Cap.	\$174.8 B	Price / Sales	2.9
Dividend Yield	2.6%	Price / Book	5.1
Return on Equity	50.1%		

Microsoft is the world's largest software company, and its flagship Windows operating system and Office suite of business applications run on 90% of all personal computers. Windows and Office generate about 60% of Microsoft's sales, and server software provides another 23%. The remainder comes from entertainment and devices, such as Xbox and Zune, and from online services, primarily MSN. 40% of Microsoft's sales come from abroad.

Microsoft has established a wide moat through its dominance of the personal computer operating system and business application markets. Users of the software are reluctant to switch, and the company spends 14% of revenue - \$9 billion over the past four quarters - on research and development efforts related to new offerings and improvements to existing products. Microsoft plans to launch Windows 7, the newest edition of its Windows operating

system, in early 2010, and reviews of the test versions have been very favorable.

In addition to this momentum in its core products and ongoing development efforts, Microsoft has expanded through acquisitions. We are relieved that the company did not purchase Yahoo! at the premium price offered, but we would not be surprised to see some type of agreement between the companies related to online search and advertising as Microsoft attempts to boost its ability to compete with Google.

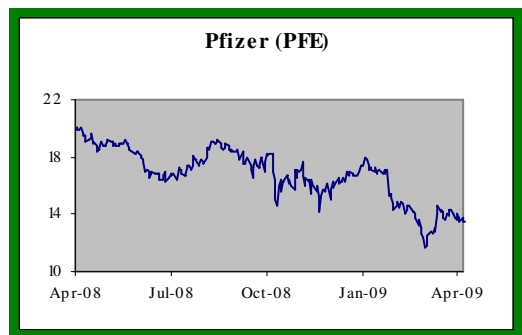
Microsoft's business is exceptionally profitable, particularly its Windows and Office segments. These products together generate operating margins of greater than 70% and account for more than 85% of the company's operating profit. Return on equity has steadily increased for the past several years and is now above 40%, and the company produces cash flow of more than \$1 billion each month. This cash flow will support continued investment in marketing, research and development, share repurchases, and dividend payments. Microsoft has only \$2 billion in debt and, even after the payment of over \$125 billion in dividends and for stock repurchases since the beginning of fiscal 2004, still has \$24.6 billion of cash and investments on its balance sheet.

Despite its competitive advantages, Microsoft currently trades at a multiple of only 10.1x projected earnings, which is lower than the multiple for the S&P 500 index. Adjusting for the large amount of cash on Microsoft's balance sheet, the stock trades for only 9.0x projected earnings. The market has pushed the share price down due to slowing sales of the Windows

operating system amidst the struggling economy. The potential threat from Internet-based applications that compete with Microsoft's products has also weighed on the stock.

In order to address these issues and preserve margins, Microsoft is adapting its strategic focus, reducing costs, and investing heavily to secure its competitive position. We believe Microsoft's dominance of the personal computer applications market and huge embedded user base will enable the company to generate tremendous cash flows for many years to come. At the current price and with a dividend yield of 2.6%, the shares of this outstanding company offer great long-term potential for investors.

Pfizer Inc. (PFE)



Price (4/09/09)	\$13.55	Forward P/E	6.5
Market Cap.	\$91.4 B	Price / Sales	1.9
Dividend Yield	4.7%	Price / Book	1.6
Return on Equity	17.0%		

Founded in 1849, Pfizer is the world's largest research-based biomedical and pharmaceutical company. The company generated \$48.3 billion in revenue and invested \$7.9 billion in research and development in 2008. Pfizer has over 80,000 employees in more than 90 countries,

and 57% of sales come from abroad. Key brand names include Lipitor, Celebrex, Lyrica, Viagra, and Norvasc.

Pfizer's management is focused on continuing the company's success in developing and marketing prescription drugs and also on increasing international sales, particularly in emerging markets. 90% of Pfizer's sales are from prescription drugs since the divestiture of the consumer products division for \$16 billion in 2006. Management has also established a separate division to manufacture and market generic drugs and has reduced operating costs dramatically, achieving \$2.8 billion of savings since 2006.

Pfizer has many strengths that give it the wide moat, or protection from competition, that we look for in our investments. Pfizer has a broad range of patent-protected drugs, and its scale enables the company to spend enormous sums on R&D to keep drugs in development pipeline, which currently includes over 100 products. Pfizer also benefits from the largest sales force in the industry, which facilitates the speedy rollout of new drugs. Pfizer's cash hoard facilitates acquisitions of drugs once they are proven by other companies that lack Pfizer's sales and distribution capabilities. Finally, we like the defensive nature of the company's products. Even in the face of a slowing economy, people are unlikely to cut prescription drug spending, particularly for branded drugs with no generic equivalents.

Pfizer recently announced the acquisition of competitor Wyeth for \$68 billion, a deal slated to close later this year. The biggest concern regarding Pfizer for the past several years has been the company's dependence upon blockbuster drug Lipitor, which accounts for



25% of sales and generates high margins. The Wyeth acquisition addresses this concern by broadening the product offering significantly and preparing Pfizer for Lipitor's patent expiration in 2011. This deal also strengthens Pfizer's position in key geographic and product areas, and it should add to earnings per share within two years of closing.

Pfizer generates steady profits, with return on equity averaging over 20% per year and operating margins approaching 50%. Management expects the company to have about \$25 billion in net debt (debt less cash) after the merger with Wyeth, a reasonable amount given projected cash flows, and plans to reduce annual operating expenses by \$6 billion by 2012.

The stock's dividend yield is 4.7%, and the forward price/earnings ratio is only 6.5, about half that of the S&P 500 index. Pfizer is likely to continue to play a leading role in the recession-resistant pharmaceuticals industry for many years, and we believe the stock is a great long-term investment at the current valuation.

Transocean Ltd. Bonds

As discussed in our last report, we have been buying corporate bonds for our income portfolios. Amidst the current financial and economic turmoil, borrowing costs for corporations have increased significantly. As a result, we have found multiple bonds with low risk of default, relatively short duration, and a yield to maturity of 7% or better. Since we believe inflation and interest rates are likely to go much higher as a result of the increased money supply, particularly as the economy recovers, we are limiting our purchases to bonds payable over the next few years.

Examples of these securities include corporate bonds offered by Transocean Ltd., the world's largest offshore drilling contractor. Transocean operates a fleet of 136 drilling rigs located in major oil fields around the world, including the Gulf of Mexico, the North Sea, the waters of the Middle East, and off the coasts of Brazil and West Africa. The company's fleet includes jackup rigs, designed for use in shallow waters, and floaters, which can drill in water depths of 10,000 feet. These deepwater drilling platforms are in particularly high demand and command rates of \$500,000 per day or higher, and Transocean has about one-third of the total number of these rigs worldwide.

Almost all of Transocean's deepwater rigs are booked for this year, 89% for 2010, and 70% for 2011. At nearly \$39 billion, Transocean's backlog is formidable, and cash flows from this existing backlog should be adequate to cover debt payments through at least 2013. Over 90% of this backlog is with large, well-capitalized companies, which minimizes the risk that they will cancel contracts.

We are currently buying two Transocean bonds. The maturity dates and coupon rates of these bonds would typically lead us to look elsewhere - both bonds mature in 2037, and they carry coupon rates of 1.65% and 1.5%, respectively. A closer review, however, reveals that the bonds have a put feature that allows bondholders to return them to the company for full payment at par value (\$1,000 per bond) in December of 2010 and 2011, depending on which of the two issues we purchase. When we are able to buy them at a significant discount to their par value



these bonds offer a yield, or return, to their put date of approximately 7%.

We have been thrilled to buy these investment grade bonds in our portfolios at such attractive prices. Transocean's business prospects are robust, particularly if energy prices continue to rebound from their recent lows, and the company's deepwater rigs are in high demand. We are confident that the company will have

adequate cash to redeem these bonds when we exercise our put options in 2010 and 2011. Meanwhile, investors holding these bonds will receive the income from semi-annual interest payments.

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



Edgemoor Investment Advisors is an independent wealth management firm providing investment advice to individuals, retirement plans, trusts, family foundations, and an equity mutual fund. We 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.

Thomas P. Meehan – President

(301) 543-8881

tmeehan@edgemoorinv.com

Timothy C. Coughlin, CFP® – Managing Director

(301) 543-8371

tcoughlin@edgemoorinv.com

R. Jordan Smyth, Jr., CFA – Managing Director

(301) 543-8370

jsmyth@edgemoorinv.com

Paul P. Meehan, CFA – Managing Director

(301) 543-8373

pmeehan@edgemoorinv.com

Michael J. Leasure, CFP® – Vice President

(301) 543-8375

mleasure@edgemoorinv.com

Christine J. Potts – Associate Vice President

(301) 543-8365

cpotts@edgemoorinv.com

Sara R. Parker – Associate Vice President

(301) 543-8363

sparker@edgemoorinv.com

Anne Baker – Executive Assistant

(301) 543-8366

abaker@edgemoorinv.com

Suite 315

7250 Woodmont Avenue

Bethesda, MD 20814

(301) 543-8358 fax

www.edgemoorinv.com