



Edgemoor's Quarterly Report

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

Summer 2010

It Don't Come Easy

During his recent 70th birthday celebration at Radio City Music Hall, Ringo Starr performed his first post-Beatles solo hit, "It Don't Come Easy." The song's title is an apt description of many investors' feelings during these times of turmoil and uncertainty in the market. Investing in the stock market can be challenging during periods such as the past quarter, a reminder that success requires patience, discipline, and a solid long-term strategy.

Following a 5.4% rise in the first quarter of this year and long recovery from the depths of March 2009, the S&P 500 continued to climb in April before stumbling, ultimately dropping 11.4% for the three months ended June 30th. The primary catalyst for this reversal was heightened concern regarding Greek debt issues, the risk of spillover into the rest of the Eurozone, and the potential for resulting credit market issues to disrupt the global economic recovery. In an echo of the U.S.-led financial crisis of a few years back, investors sought haven in the safety of Treasuries, pushing yields on the 10-year note down to just below 3% by the end of the quarter.

With this latest turmoil coming so close on the heels of the worst financial crisis in decades, it is not surprising that jittery investors fled stocks and caused prices to tumble. However, it is important to stay focused on fundamentals when evaluating the economy, markets, and prospects

for attractive returns on investments. As we noted in our analysis at the end of May (see www.edgemoorblog.com), a market correction such as the one in the second quarter is normal during a recovery. We expect continued volatility but remain optimistic that the economy will stay on the path to recovery and markets will rise.

Europe, China, and the Global Economy

The situation in Europe grabbed most of the headlines, but investors also heeded news that the Chinese government was taking steps to slow domestic economic growth. Disappointing reports on the U.S. housing market and the lethargic jobs market have raised concerns about slowing economic growth in the United States, as well.

As for Europe, we believe the credit issues there will slow the Eurozone economy but are unlikely to have a significant impact on other economies worldwide. The \$1 trillion relief package offered by the European Union and International Monetary Fund will buy time for those countries facing sovereign debt crises to enact financial austerity measures and rework their debts. Meanwhile, the fall in the Euro is actually proving beneficial to European exporters, whose products are now more attractively priced abroad. We recognize the political difficulty of implementing economic reforms, but we believe the situation will not impede the global recovery.



China faces challenges as well, namely the bubble in real estate and the potential for inflation. However, we are surprised at the alarm from some camps over economic growth forecasts of *only* 9.6% in 2011. Yes, this rate is slower than the 10.5% forecast by the I.M.F. for 2010, but 9.6% growth in China and high rates of economic expansion expected in other developing countries confirm our belief that the emerging markets are an important engine that will propel the global recovery.

The U.S. economic indicators we discussed in our last report remain supportive of our view that the domestic recovery is likely to continue. The Leading Economic Index has now risen for thirteen of the past fourteen months (it was flat in April) and points to further economic growth. The manufacturing sector continues to expand, business inventories are still at all-time lows, and restocking is likely to lead to additional increases in manufacturing and more jobs. Finally, personal incomes have risen and consumer spending has rebounded to record levels, providing important support to the economy.

The weak spots in the economic outlook include housing and employment. After benefiting from tax credits into the spring, housing activity has fallen. We think it is likely that the sector will continue to struggle for at least several more months before showing signs of improvement, although continued low mortgage loan rates should help to prevent further deterioration. The jobs outlook is mixed, with new job creation slow and politicians reluctant to extend jobless benefits to those who have been out of work the longest.

Taking all factors into consideration, we expect growth to moderate in the coming quarters, as is typical at this point in a recovery, but we believe the economy is not headed for a double dip recession. Companies are cautiously adding jobs and are showing signs of optimism, interest rates will remain low as long as inflation continues to be mild, and the economy should remain on a path of slow but steady recovery. Consistent with this view, the IMF recently raised its global growth forecast for 2010 to 4.6% and forecasts worldwide economic expansion of 4.3% in 2011 as governments withdraw stimulus.

It's All About the Earnings (or, "Show me the money!")

Earnings remain the linchpin of market valuations and will reclaim the headlines over the next several weeks, hopefully leading more investors to focus on fundamentals rather than the broad fear that has gripped the market for the past few months. We expect companies will again report strong improvement from the prior year, confirming the ongoing recovery. Analysts currently forecast year-over-year quarterly earnings gains of 27% for S&P 500 companies, and we would not be surprised to see earnings come in even stronger, as they have done the past few quarters. Investors will be particularly focused on companies' outlooks for the third quarter and beyond, which we expect to be cautiously optimistic.

The fundamentals support market valuations that are higher than current levels, and we are taking advantage of market uncertainty to buy companies that are available for significantly less than we think they are worth. We think the best opportunities continue to lie in large, well-



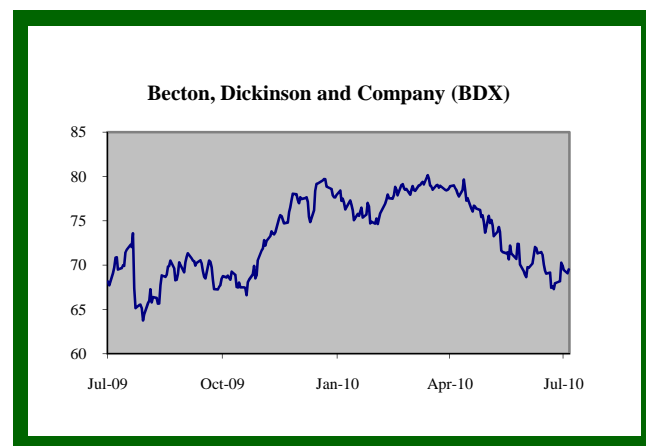
capitalized, multinational corporations with a strong presence both in the United States and abroad, particularly in emerging markets, and healthy cash flows that support rising dividend payments to shareholders. Corporations that have aggressively cut costs and positioned themselves to take advantage of renewed economic activity should see more quarters of impressive revenue and earnings growth, supporting further market gains.

Finally, yields on stocks are attractive relative to those on Treasuries. The earnings yield on the S&P 500 index (earnings/price) is more than twice the yield of the 10-year Treasury, an indication that stocks are undervalued. As investors regain their risk appetites and move back into stocks to participate in the economic recovery, the market should rise.

Analysis of Selected Stocks

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

Becton, Dickinson and Company (BDX)



Price (7/1/10)	\$67.29	Forward P/E	12.1
Market Cap.	\$15.7 B	Price / Sales	2.2
Dividend Yield	2.1%	Price / Book	3.0
Return on Equity	25.6%		

Founded in 1897 by Maxwell Becton and Fairleigh Dickinson, New Jersey-based Becton, Dickinson has long been a pioneer in the development of medical products. Today, the company offers a broad range of medical supplies, devices, laboratory equipment and diagnostic products to customers worldwide from offices in nearly fifty countries, and international sales represent 55% of the total business. Customers include healthcare institutions, life science researchers, and clinical laboratories.

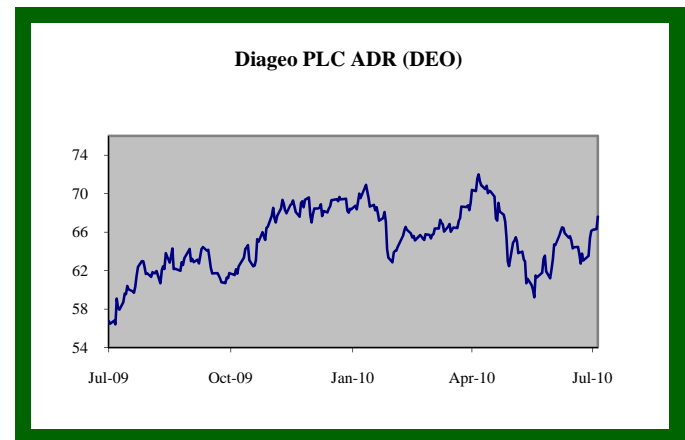
Becton started by manufacturing surgical instruments such as needles, syringes, and scalpels. In recent years, the company has developed products designed to prevent injuries and exposure to bloodborne pathogens, including safety-engineered sharps (needles) and blood collection devices. The European Union is in the process of enacting safety legislation that would mandate the use of products such as those produced by Becton, just one example of the increasing emphasis worldwide on medical safety. As hospitals and other healthcare institutions switch to safety-engineered products, particularly in developing countries where infectious diseases are more prevalent, Becton should continue to find increasing demand for these items.

Demand for regularly used products such as sharps is steady and represents about half of Becton's total sales. The company is able to invest the resulting cash flows in new products with higher growth prospects. A current area of focus is diagnostics. For example, Becton offers one of only two FDA-approved devices used to rapidly detect staph infections, reduction of which is a top priority of the Centers for Disease Control. Becton's biosciences unit, which produces research and clinical tools for cellular analysis, is another area of emphasis as Becton seeks opportunities to boost sales.

Becton's balance sheet is healthy, with cash of \$1.3 billion against debt of \$1.7 billion, and maturities of only \$200 million over the next five years. Profitability remained strong even in the face of a hospital spending freeze in 2009, which enabled the company to maintain its return on equity within the historical range of 20%-25% and commit to stock buybacks of \$450-\$550 million in the current fiscal year.

The dividend yield is 2.1%, and the forward price/earnings multiple is 12.1, below the S&P 500 multiple. We expect this excellent, well-managed business to do well as the economy recovers and are happy to buy the stock at such a reasonable valuation.

Diageo PLC ADR (DEO)



Price (7/1/10)	\$63.76	Forward P/E	13.0
Market Cap.	\$45.0 B	Price / Sales	2.8
Dividend Yield	3.7%	Price / Book	7.7
Return on Equity	39.5%		

U.K.-based Diageo is the world's largest producer of liquor, beer, and wine. Diageo's brands include Smirnoff vodka, Tanqueray gin, Baileys liqueur, Cuervo tequila, Captain Morgan rum, J&B and Johnnie Walker scotch, and Guinness beer. The company has eight of the top twenty spirits brands and a global reach, with 35% of fiscal 2009 sales coming from North America, 30% from Europe, and 35% from other countries.

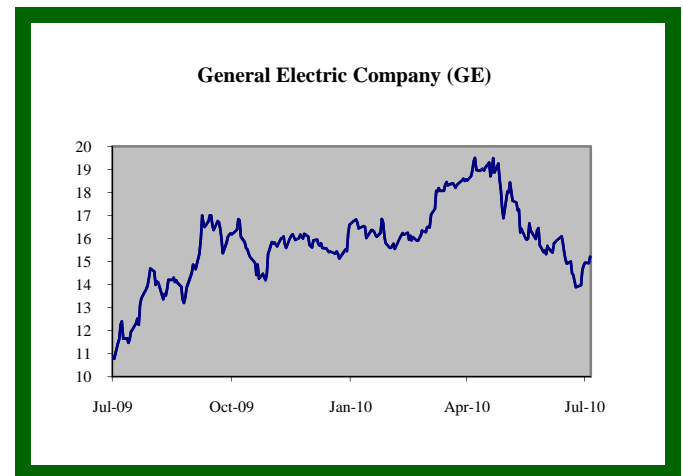
Diageo uses its scale and tremendous free cash flows to promote its brands heavily in 180

markets worldwide, a practice which has led to solid growth, particularly in international markets such as Brazil and China. The company's global distribution network is unmatched in the industry and is particularly strong in the U.S. market, the company's most profitable, where 80% of Diageo's volume is sold through exclusive distributors. The strength of the company's brands and distribution provides a wide competitive moat and strong pricing power that allows Diageo to raise its prices and increase profit margins.

Diageo has particular strength in the premium segment of the spirits market, which saw a surge in sales until the recent recession, when some price-conscious consumers traded down to less expensive brands. As the global economy rebounds, we expect Diageo's sales growth to accelerate, particularly as consumers with rising incomes in developing markets increase purchases of "aspirational" brands.

Diageo has made some shrewd financial and strategic moves, including the recent assignment of a portion of the company's Scotch whiskey inventory to its pension fund to cover a funding gap. Above all, management focuses on shareholder returns. The company uses free cash flow to pay a 3.7% dividend and repurchase shares, and Diageo generates returns on equity of approximately 40%. Diageo's stock currently trades at a forward P/E multiple of 13.0, roughly in line with the S&P 500 average multiple and below Diageo's historical levels. We expect the stock price to resume trading at a premium multiple due to the company's global reach, strong brands, steady growth, and high profitability, and we expect further appreciation in the shares.

General Electric Company (GE)



Price (7/1/10)	\$14.12	Forward P/E	10.7
Market Cap.	\$150.8 B	Price / Sales	1.0
Dividend Yield	2.8%	Price / Book	1.3
Return on Equity	9.1%		

With a market capitalization of \$151 billion and products ranging from home appliances to jet engines, General Electric is one of the world's largest and best known companies. GE does business in five segments – energy infrastructure, technology infrastructure, NBC Universal, GE Capital, and home and business solutions – and has operations across the globe.

We began buying shares of GE in early 2009 as many worried that its finance arm, GE Capital, had done irreparable harm to the company, driving its shares down to levels not seen in almost fifteen years. We believed GE would survive the problems at GE Capital and that the share price did not reflect the outstanding value and growth potential of its industrial businesses.

In the wake of the troubles at GE Capital, GE management has refocused the company on its



industrial businesses with positive results. In 2009 GE's industrial segments boosted earnings and margins and generated \$16.6 billion in free cash flow. In addition, GE stands to benefit from government stimulus programs that provide significant incentives for investment in areas in which GE has a leading presence, such as wind and solar technology and power infrastructure.

In December 2009, GE and cable giant Comcast announced a joint venture that combines GE's NBC Universal assets with Comcast's cable and other entertainment assets. We like this deal because it will generate cash that GE can invest in infrastructure growth, and it also frees management to devote more time to the company's infrastructure businesses.

Although GE Capital's exposure to commercial real estate and consumer loans remains problematic, the unit continues to post profits, and GE reduced leverage in this segment by 25% in 2009. GE still carries an AA credit rating, and management has worked hard to buttress the company's balance sheet and maintain financial flexibility.

A simplified, refocused GE is well positioned to take advantage of increased infrastructure spending both in the U.S. and globally. GE's size and finance capabilities provide it with competitive advantages as it seeks new customers and develops new products. GE's businesses and shareholders should prosper as the global economic recovery continues.

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 manage approximately \$380 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.

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

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
www.edgemoorblog.com