EDGEMOOR INVESTMENT ADVISORS

Edgemoor's Quarterly Report

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

Winter 2010

Ending the Year on a Positive Note

As we begin the second decade of the 21st century, we are relieved that 2009 helped move us along the road to recovery and are grateful for the partial rebound of the markets, following the recession and market collapse of the last couple of years. Weary investors are left pondering what just happened, and what is yet to come. The stock market still has a long way to go, but we are optimistic that it has turned the corner. Below we offer some observations and thoughts regarding the past year and future prospects for the global economy and markets.

2009 in Review

After tumbling to begin the year and then rising more than 15% in each of the second and third quarters, the S&P 500 index delivered a solid gain in the fourth as investors saw more evidence that the global economy is recovering and we have emerged from the financial crisis. As we predicted, the combination of fiscal stimulus and improved credit conditions boosted economic growth. The resulting increase in corporate earnings exceeded expectations and led to a surge in the U.S. stock market. The S&P 500 was up 65% from its March low and 26% for the year, its best performance since 2003.

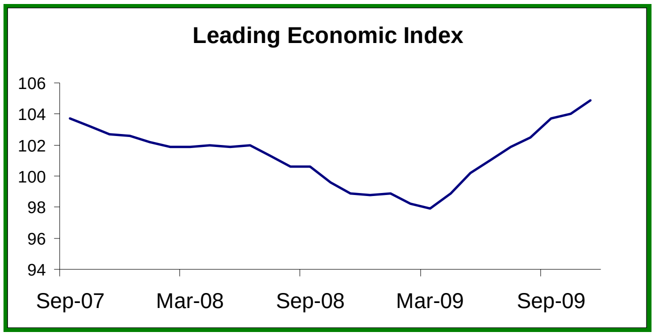
Foreign stock markets also soared on the evidence of an improving global economy. In Asia, massive Chinese government stimulus spurred domestic demand, and other Asian economies also grew at a more rapid pace than those in Western nations.

Long-term U.S. Treasurys declined nearly 13% in 2009, and overall Treasurys posted their worst performance since 1973. Just as stocks were oversold in 2008 and early 2009, Treasurys were overbought amidst the flight to safety, and 2009 was a year of reversion to the mean for both markets.

Outlook for 2010 and Beyond

In our Spring 2009 quarterly report, we listed reasons for optimism regarding market prospects, and we are still optimistic today. While it is not unreasonable to expect a temporary correction of 5% - 10% after the stock market's recent surge, there is good news portending continued economic recovery. Included in the positive news are strong corporate earnings reports for the third quarter, a dramatic decline in stock market volatility from the extremely high levels of early 2009, robust factory orders, increasing productivity, and the beginning of stabilization in the housing market.

One of the broadest measures of economic strength, the Conference Board's Leading Economic Index, was included in our last report and has now risen for eight straight months, as shown below.



Source: The Conference Board

Of course, there are still significant economic issues that the economy must overcome in order to continue on the path of recovery. First and foremost is the high unemployment rate, which is currently hovering at 10%. Recent reports, including a steady decline in initial jobless claims, indicate job growth is likely to resume in the next few quarters, a welcome reversal after eight quarters of job losses. Until we see a significant recovery in the job market, consumer spending is likely to remain constrained.

The residential and commercial real estate markets also face continued risks, and it remains to be seen exactly how and when the Federal Reserve, Treasury, and other government agencies worldwide will end the various stimulus programs that have fueled the economic recovery. Futures markets are currently predicting an increase in rates by mid-year, based on an assumption of steady GDP growth over the next few quarters. The Fed and others must carefully weigh the pros and cons of various exit strategies to ensure that, on the one hand, they do not choke the recovery by raising rates too soon while, on the other hand, they do not cause rapid inflation by keeping rates low for too long.

Weighing the good news versus the risks, we are optimistic that the global economic recovery will continue at a measured pace, one that will result in a gradual reduction of the unemployment rate and not lead to rampant inflation. Economic recovery, low interest rates, and the return of money to stocks from bonds and cash holdings should result in solid overall stock market performance in 2010, although we do not expect a repeat of 2009's dramatic rise.

High-quality, short-duration corporate bonds, which we added to our income portfolios in the fall of 2008 and the first half of 2009, rebounded from their depressed valuations as economic and credit market conditions improved. There are fewer opportunities to buy attractively priced corporate bonds today, so we are turning our income security focus back to the preferred stocks, master limited partnerships, public utilities, and other high yielding equities that have been the mainstays of our income portfolios for years and are more attractively priced than bonds today. As those bonds we bought in 2008 and 2009 mature over the next several years, we expect to redeploy the proceeds at higher rates of return.

Welcome to a New Decade

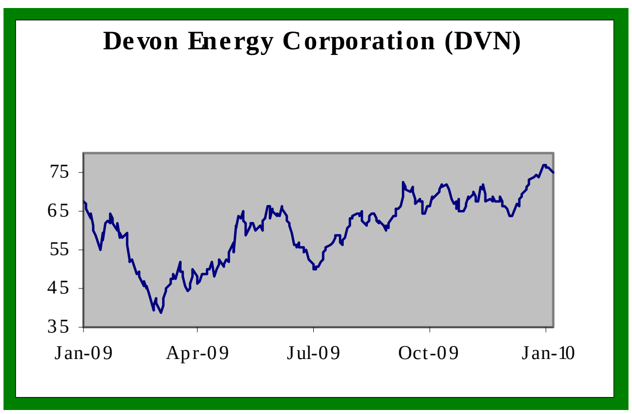
The market's huge bounce off the March lows has confirmed the virtues of patience and discipline, and we think investors who stick with sound holdings within an appropriate asset allocation framework will be rewarded. According to various measures of overall valuation, the stock market today is reasonably valued. Even so, we continue to find attractively priced shares of good companies that should benefit from the economic recovery and provide excellent long-term returns to patient investors. These opportunities still exist, particularly among high-quality, well-capitalized companies, as we discuss in the examples below.

On a final note, it is important to keep in mind that a decade of poor stock market performance has historically been followed by a decade of above-average returns. Here's to the next decade!

Analysis of Selected Stocks

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

Devon Energy Corporation (DVN)



Price (12/31/09)	$73.50	Forward P/E	12.2
Market Cap.	$32.6 B	Price / Sales	3.6
Dividend Yield	0.9%	Price / Book	2.2
Return on Equity	10.5%		

U.S.-based Devon Energy is one of the world's largest independent producers of oil and natural gas. Devon's production consists of 65% natural gas and 35% oil and natural gas liquids, with over 90% in North America. Much of the company's oil and natural gas is close to major gas markets, and Devon's pipelines facilitate fast and cost efficient delivery. Devon also operates treatment facilities, making it one of the largest processors of natural gas liquids in North America.

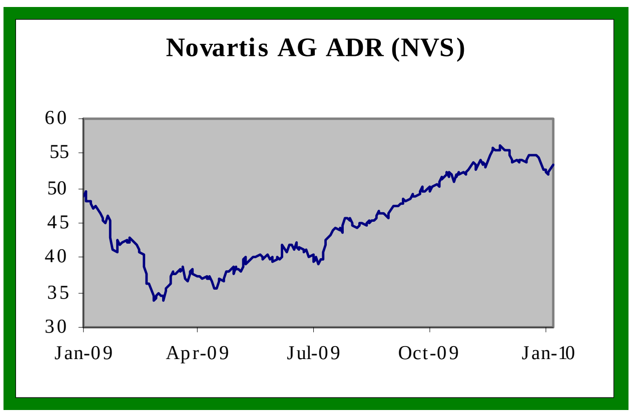
Devon recently announced plans to divest all of its non-Canadian foreign and Gulf of Mexico operations in order to focus on its onshore North American assets, which provide higher returns on invested capital. The properties Devon is selling account for 30% of the company's capital spending but only 12% of production. By selling the assets now, Devon should realize proceeds of $4.5 - $7.5 billion, which management will use to repay debt and accelerate growth from remaining fields.

One benefit of this enhanced focus on onshore North American production is that Devon may be more attractive as an acquisition target. Exxon's recently announced $41 billion deal to buy XTO Energy, one of Devon's peers, could portend more deals to come. While we are not counting on a takeout to generate attractive returns on our investment in Devon, we believe that a deal is more likely after the property divestitures.

Devon and other energy producers saw revenue and profits plummet in 2008 as energy prices tumbled from record highs due to oversupply, particularly of natural gas, and decreased demand amidst the global recession. Prices have since rebounded, and global demand should pick up as economic growth resumes. Devon is hedging 50% of its 2010 production to lock in favorable prices and reduce the risk posed by energy price volatility, resulting in more predictable revenue.

Devon's efficient operations help the company to remain profitable throughout energy price cycles, and the company generates solid returns on capital and cash flows. Management has used this cash to make strategic acquisitions, invest in production assets, repurchase shares, pay dividends to shareholders, and repay debt. Devon's stock currently trades at a forward P/E multiple of about 12, which represents a significant discount to the S&P 500 index.

Novartis AG ADR (NVS)



Price (12/31/09)	$54.43	Forward P/E	11.9
Market Cap.	$123.6 B	Price / Sales	2.9
Dividend Yield	3.2%	Price / Book	2.3
Return on Equity	14.8%		

One of several stocks we own in the health care sector, Swiss company Novartis is a global pharmaceutical and consumer health company. The company offers a broad range of products, including branded drugs (64% of sales), generic drugs (18%), consumer health products (14%), and vaccines (4%). Novartis sells its products around the world, with 44% of sales in Europe and 31% in the United States. The remainder includes sales to emerging markets, where rapid development provides promising growth prospects.

Novartis has strong positions in cancer and cardiovascular disease, one of the industry's best pipelines of new potential blockbuster drugs, and less exposure to patent expirations than most competitors. Novartis also benefits from the diversification of its business lines, including Sandoz, its large generics division. Most of the company's competitors focus exclusively on the highly profitable branded drug segment, but Novartis is able to extend the lifecycle of the drugs it develops by selling generics after patent expiration, while also offering generic versions of others' branded drugs. Billions of dollars of drugs face patent expirations over the next several years, presenting a large opportunity for Novartis.

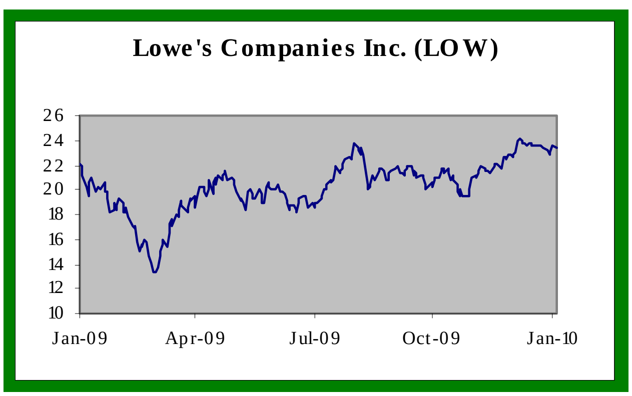
In addition to its strength in generics, the company's move into vaccines through the acquisition of Chiron in 2006 has positioned it as a leader in a sector with greater pricing power and less competition than the branded drug sector. Sales of the H1N1 vaccine, in particular, should provide a boost to earnings reported for the fourth quarter of 2009. Also, Novartis recently announced that it will purchase the remainder of eye-care products provider Alcon, in which Novartis already held a 25% stake, adding to its share of the rapidly growing eye-care market.

We like management's conservative style, reflected in the company's operating philosophy and solid balance sheet. Novartis generates strong cash flows and mid-teens returns on equity, and management uses all of cash flow after acquisitions and dividends to repurchase shares.

The stock currently trades at a forward price/earnings ratio of 11.9, a discount to its historical range, and also offers a dividend yield of 3.2%.

The removal of uncertainty regarding U.S. health care reform, which has kept a lid on stocks in the sector, should provide a boost to health care stocks. While Congress is still working on the final details of the reform plan, it appears that the resulting legislation will be less detrimental to drug producers and other health care firms than the market had feared. As a result of this added clarity on industry prospects, combined with Novartis's diversified portfolio of products, strong pipeline, conservative balance sheet, and reasonable valuation, we expect this stock to provide attractive returns.

Lowe's Companies Inc. (LOW)



Price (12/31/09)	$23.39	Forward P/E	17.4
Market Cap.	$34.4 B	Price / Sales	0.7
Dividend Yield	1.5%	Price / Book	1.8
Return on Equity	9.3%		

Lowe's is the second largest home improvement retailer in the world, with over 1,700 stores across the United States and Canada and plans to open stores in Mexico and Australia in 2010-2011. Headquartered in North Carolina, Lowe's has aggressively expanded its chain of large stores to successfully compete with Home Depot. Although we like both of these companies and think the prospects for the sector are bright as the housing sector stabilizes and begins to rebound, we currently favor Lowe's.

The entire home improvement sector suffered during the housing collapse and broader economic downturn, but we believe revenues and profits will rise significantly as conditions improve. The government's incentives to encourage home purchases and projects to improve energy efficiency, combined with aging homes and a relatively high level of home ownership, will help spur the recovery. We expect the home improvement market to expand at a rate of nearly 5% annually to reach about $365 billion in 2013.

The home improvement market is extremely fragmented, leaving Lowe's plenty of room to expand its share. Even though Lowe's and Home Depot are by far the largest competitors in the sector, 2008 market share for each was only 7% and 10%, respectively. We believe Lowe's will continue to gain share and increase profits, primarily at the expense of smaller competitors who cannot match the company's purchasing power, breadth of selection, and pricing.

Lowe's benefits from its tremendous scale, which provides purchasing power and a low-cost advantage over smaller competitors. Lowe's has a massive distribution network that would be difficult to replicate and, combined with its purchasing power, allows the company to offer lower prices than competitors. Lowe's also has advanced systems and logistics capabilities that enable automated management of most store inventory.

The company's balance sheet is healthy. Debt equals about 20% of capital, maturities are spread over many years, and earnings before interest and tax are more than 12 times interest expense. Lowe's also owns 88% of its stores, a high rate of ownership among retailers that provides a valuable asset. As the economy recovers, Lowe's should return to generating returns of capital in the low teens.

As a result of the pressures from the economic downturn, the company's stock fell sharply from the peak of the housing boom in 2006. The shares are now available at a price that reflects much worse conditions in the housing sector for the next several years than we think are likely. As the economy continues to improve, Lowe's should be able to increase profits and provide solid returns to shareholders. Buying the stock before the economy fully recovers should lead to the best returns – if we wait, the price will likely be much higher.

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

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