1st Quarter 2002

EDMP, INC. Quarterly Review

Peace and Prosperity Through Diversification

The first quarter of 2002 can best be described as neither fish nor fowl, good nor bad. The broader markets appear to be marking time with each market segment taking its turn going up then down.

The economy is mirroring the market, or vice versa. Economists are even debating whether we actually had a mild recession or not. They generally agree, however that after an extended robust economy marked by a long bull market run, things have recently softened a bit and now appear to be strengthening again. Consequently the Federal Reserve has taken a neutral stance raising fears that interest rates may increase in the near future. This of course is a potential negative for the market, which would only occur if the economy began to overheat. On the other hand a robust economy would auger well for future corporate profit growth, which would be a plus for the market. Therefore, confusion reigns and the stock market is indecisive and volatile in the short run.

True long-term investors concern themselves with chunks of time spanning three to five years or longer. These more sensible time frames smooth out the nerve wracking and volatile short run, allowing the long run upward trend line to manifest itself. The biggest advantage that this more level headed perspective brings is the ability to exploit the folly of those more short sighted, with their knee jerk reaction to every little piece of news that crosses the wires, good or bad.

It is also quite important to recognize the fact that provocative news occurs literally on a daily basis. There exists a huge and powerful entity commonly known as the media whose very existence is predicated on disturbing us. As it relates to investing, it is this precise fact that validates the old adage that "Wall Street climbs a wall of worry". It seems there is always something to be concerned about.

One of my great teachers clarified this for me by pointing out a sad and tragic attribute of mankind. His observation was that unfortunately most people go through their daily lives looking for things to offend them. Surrounded by beauty, we will find one tiny insignificant piece of ugliness and focus on it, while ignoring the beauty that dominates. A current example of this phenomenon is today's reaction to the Enron scandal. Highly contagious "Enronitis" is spreading through the financial markets at epidemic proportions.

Regulatory agencies have become emboldened and the media is on a feeding frenzy. In the short run this witch-hunt is decimating capital for the guilty and innocent alike. Due to the evil and crooked acts of a few it has suddenly become almost shameful to be a CEO of a public company or, God forbid, a CPA. The honest, dedicated and competent actions of many have become forsaken because of a few bad apples. Yet, in truth, for every criminal action millions of ethical actions and good work goes ignored and unnoticed. The vast majority of public companies are not run by crooks and have good accounting. We should learn what we can from the bad or criminal actions then move on rather than obsess.

The important principle behind all this is irrefutable. It is impossible to time markets or forecast economies with precision, especially over the short run. The tops and bottoms of markets and economies are only seen in hindsight where everyone has 20-20 vision. Therefore the obvious lesson is, and should be, that there is little or no profit and large risk in attempting the impossible.

At EDMP we believe there is only one truth or reality that can be applied to thinking about stock markets and, more precisely, stock prices with certainty. History has proven, however, that this one principle makes all the difference in long-term gain or loss. This principle is simple, straightforward and also irrefutable. In the long run the value of a business will eventually and ultimately reflect its economic worth. It's only a matter of time, sometimes more and sometimes less, but it will and must always happen. One needs only go back a few years to the ridiculous valuations of technology stocks in 1999 and the spring of 2000 to see the principle at work. Technology stocks were not worth the prices they were fetching and this principle rained down with a vengeance. More than five years of irrational exuberance vanished in an instant.

The moral to this story is powerful and important. Equity portfolios should always (emphasize always) attempt to be constructed in such a way where time is on your side. This implies only buying companies (stocks) when your conviction is high that they are selling at or below their economic worth. This does not mean buying at the perfect bottom, because as previously stated, this is impossible. However, it does imply purchasing at values where conservative estimates of future earnings and cash flow generation make sound and attractive sense. This is the essence of the EDMP approach to investing.

Some additional general statements regarding the current state of the stock market are also in order. Even though the stock market has been broadly reconciling itself back to equilibrium for the past year or so, the process is hardly finished. Although valuations are better today than a year ago, they are still rather high based on historical standards and economic justification. Evidence of this is easily seen by examining the P/E ratios of most market indices such as the S&P 500, the Dow Jones Industrial Average, etc. Not only are the P/E ratios of these indices historically high, they are also significantly above their expected earnings growth rate estimates as well.

Some of this can be attributed to the absence of inflation and the currently low level of interest rates. Bonds do not compete as strongly with stocks when rates are low. Therefore, the demand for higher returns leads investors to buy stocks over low yielding bonds. This fact does justify some of the higher valuations of stocks today, but certainly not all of it.

It is vitally important to recognize that the above general statements, although true, do not apply universally to all stocks. As we have discussed in the past, every market, bull or bear, will contain over-priced, under-priced and fairly priced individual stocks. In summary, even though we are

clearly in a bear market today, the excesses of the great bull market of the nineties are not fully flushed out just yet. However, even though the market in general is not perfect today, it's better than it used to be. Today's problems to worry about create the opportunity for tomorrow's profits.

EDMP believes that the key element that defines a well-constructed investment portfolio is its ability to successfully navigate through stock market uncertainty. In order to accomplish this, a portfolio needs to be both safe and opportunistic. There are two primary factors that are crucial to safety; the first is valuation or soundness, the second is proper diversification.

With valuation extensively covered, we would like to emphasize the diversification principles that we believe are sound. At EDMP we believe, like most notable fundamental investment managers, that much of conventional wisdom today practices what Peter Lynch referred to as "di-worse-ification." In other words, if you spread your eggs over too many baskets you dilute your knowledge, results and safety. Therefore, at EDMP we believe that 20-30 holdings of above average businesses spread across various industries is ideal.

With 20-30 holdings, no one company can destroy the portfolio, and you can get to know these companies fairly well. Knowledge is truly power and in turn dramatically enhances safety. Your portfolio should follow the lead of the U.S. Marine Corp. and seek a few good stocks that you can trust. An added benefit is the increased profit potential that this strategy provides by minimizing dilution. The more stocks you own the closer you are going towards average rather than above average results. More directly stated, the more stocks you own, the more difficult it is to beat the market. This balance between safety and profitability is powerful and reliable.

When portfolios are properly diversified and valued, they will succeed over time. When these important elements are in place, the greatest risk to your portfolio is you, but more precisely, your ability to keep your emotions in check and your head on straight. To accomplish this it's helpful to emphasis a total portfolio perspective. Don't look at your portfolio only for things to offend you. Appreciate its balance and soundness. We have seen situations where people own twenty stocks, where five are down while fifteen are up and strongly up. Yes, you guessed it, they obsess about the few that are down and forget about the majority that are up.

The point is to be sensible and realistic in your evaluation. After all, the very reason you diversify is because you don't know which stocks will rise and which will fall in the short run. Stock markets or business sectors will always rotate. Some get hot or in favor, some get cold or out of favor. In the long run it all smoothes out with the price of each company's stock aligning itself with the success or failure of its operating results. In summary it's more useful to take a whole portfolio view and trust in the strength of the whole.

We would like to close this quarter's newsletter by reviewing the important points we covered relating to the status of your portfolios as they sit today. In short where we are, where we are going and importantly what we plan to do. Where we believe we are is sitting pretty. We have a great deal of confidence in the vast majority of the companies we have selected for you. As it usually is with portfolios, there are a few trouble spots that we are evaluating comprehensively, whether we go on to buy (add), sell or hold these positions is still to be determined. We do however promise to make these important decisions after careful study and analysis - no knee jerk reactions.

Where we see your portfolios going is towards long term above average results at below average real risk. Those of you who have been clients for more than three years might notice that yesterday's portfolio losers are today's biggest winners. We believe that tomorrow's biggest winners will be the telecommunication and technology holdings that we have acquired during this period of weakness. The rest of our portfolio holdings are reasonably priced and should contribute nicely as well.

What we plan to do is simple and consistent with the tenets of sound investing practices as well. What we have been and are buying, we believe is good. With the cash we still hold we will patiently wait for the values to come to us, as we know they will. We will not chase because there is no reason to. As the excesses of the market continue to reconcile, we will exploit each opportunity as it presents itself. When the valuations make sense, not if, but when, we will lay the money down.

We hope you appreciate and understand the difference between what we do based on valuations and market timing. We endeavor to only put money in front of opportunity based on conservative and realistic cash flows and earnings assumptions. We are not concerned if we are early, just never late. The primary reason behind this strategy is that most often when stocks begin to rise they run quickly. Therefore, it is imperative that the money is down before this movement occurs, not after. This is part of what we mean by putting time on your side. When you buy while stocks are cheap, your money is in front of the upside when it occurs and not left behind. Unfortunately they do not ring a bell at bottoms or tops. However the early bird gets the worm.

We are quite confident going forward and hope you are also.

God bless America! And, in matters of investing please remember; *Earnings Determine Market Price*, always have, always will.

Sincerely,

Charles C. Carnevale
Chief Investment Officer