1st Quarter 2004

EDMP, INC. Quarterly Review

Real Risk

The first quarter of 2004 ended on a positive note, after a lot of volatility in the middle. Once again EDMP portfolios outperformed the general stock markets. After a very strong 2003, it would be naïve to expect a repeat of the same magnitude. However, that does not mean we should necessarily expect a bad year either. In truth, your dedicated professionals at EDMP expect a good year in 2004, when all is said and done.

There are many valid reasons for our optimistic view for your portfolios, none of which are predicated on a prediction for the stock market. Instead, our rosy view is based on the sound and attractive characteristics of the superior businesses we own on your behalf. The stock market represents an average of the thousands of publicly traded corporations in the United States. Your portfolios, on the other hand, are made up of what we confidently believe to be above average (superior) businesses.

In most cases your portfolio companies have historical track records, which are significantly greater than the market averages. This does not only apply to the long-term superior movement of their stock prices, but also to the growth of their businesses as well. You see, the two go hand in hand, or as often stated in statistical terms, are correlated. Yes, that is right, in the long run Earnings Determine Market Price. More precisely, the rate of change or velocity of the growth rate of earnings creates superior performance. In simpler terms, faster growing businesses generate greater future returns than slower or average companies do.

Of greater importance than historical results are future results. At EDMP, we hold high confidence that your portfolio companies possess the necessary characteristics and qualities to grow faster than the average company going forward. This is the primary reason that you own them, and why we believe they are high quality, and better than average.

What is even more interesting is a logical fact that defies conventional wisdom. It is commonly held that to get higher returns, you must take higher risks. Yet common sense would indicate that superior, faster growing companies are simultaneously the safer companies to own as well. As an aside, this is true as long as you are careful not to pay too much when you buy them, and we are.

The underlying basis for this opinion regarding safety is very straight-forward. An above average growing company generates above average revenues, cash flows, earnings and (if paying one) dividends. These powerful income streams create strong balance sheets and superior financial strength. Therefore, faster growing companies are stronger and consequently safer. In the long run, this leads to higher returns at a lower risk. Yes we are saying that your portfolio companies are safer and will generate better returns in the long run than the average business (the stock market).

All you need to do to substantiate this claim is to review the commonly measured financial metrics of your portfolio holdings to the stock market's. What you will discover is that the majority of our businesses have higher historical earnings, growth rates, higher forecast future earnings growth rates, and lower current PE ratios than the S&P 500 or the Russell 1000. In the long run, this spells more opportunity and lower risk. This represents the most potent combination an investor can ask for.

Unfortunately, this potent combination is hidden from most investors due to the stock market's greatest advantage and greatest disadvantage at the same time. This blind spot is liquidity. The advantage of a liquid stock market is the ability to turn all or any portion of your portfolio holdings into cash in an instant. The disadvantage of a liquid stock market is the ability to turn all or any portion of your portfolio into cash in an instant. This is due to the volatility that accompanies this benefit.

What is unfortunate about this conundrum is the fact that most investors equate volatility with risk. The evidence for this statement is the ubiquitous reliance of most professional investors on statistical references such as beta, R^2, or Standard Deviation in order to measure or judge risk. In truth, these statistical references measure volatility, which we at EDMP, at least, do not equate to risk. At EDMP we view **real risk** as the loss of your capital or poor performance on your investments.

The truth about the risk of volatility is that in the long run it won't hurt you unless you react to it in the short run. The long-term upward trend of stock market valuations supports this thesis. At EDMP we refer to short-term volatility as the evil twin sister EDMP-Emotions Determine Market Price, (fear & greed), and as you all hopefully know by now Earnings Determine Market Price, in the long run. In summary, volatility is merely the cross investors must bear for the benefit it provides.

To clarify this volatility issue it is important to note that investors do not mind volatility even a little bit as long as it is on the upside. In fact it was the volatile rise in stock prices during the 1998 & 1999 bubble periods that fostered investor overconfidence, which lead to the crash in 2000. Investors are only concerned with volatile stock price movements when they are falling. From this perspective volatility is a chameleon; it is considered risk when prices are falling and opportunity when they are rising. Ironically, it is actually the opposite. Falling prices lead to cheaper stocks, which hold more promise and opportunity than rising prices, which often lead to excessive valuations, which create risk.

This leads to what we at EDMP view as the greatest true risk investors in common stocks face. True risk is inflated stock prices where the income stream the businesses you own do not support your investment. In a word it's over-valuation. This is what we mean at EDMP when we state that measuring performance without simultaneously measuring valuation is a job half done. Great short-term performance can often be a harbinger of large losses when the valuations become excessive. Great long-term performance always comes from getting the valuations right, especially on the buy side.

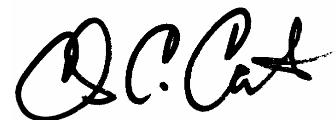
A final point on volatility is most important. In the shorter run, the movement of the stock market functions with a take no prisoner's attitude. Stronger and weaker companies alike will rise and fall at approximately the same magnitude as the market in general. This is due to the auction nature of the stock market coupled with the fact that it takes time for superior businesses to distinguish themselves.

As previously stated, it is the rate of change of earnings growth that drives prices in the longer run. Publicly traded businesses only report earnings quarterly. Consequently for approximately 90 days (one quarter), stocks trade predominately on old news, or the last quarter's reported number. In between reporting periods there is some speculation about the next quarter's numbers, but few real facts. The power of compounding is a formidable force that takes time to manifest. In other words, superior businesses require time, usually a 3-5 year business cycle in order to separate themselves from the pack. Successful investors are rewarded by the larger than average earnings power that superior businesses build over future time.

In closing, we are very confident about the future growth potential of your portfolios and the superior businesses they hold. We believe they possess the quality characteristics to grow their earnings and dividends (if paying one) at above average rates. Thanks to the recent recession, they are entering this improving economic environment with significant earnings leverage. Leaner and meaner than ever, most are poised to take more normalized revenue growth straight to the bottom line. Higher earnings eventually lead to higher stock prices and attractive returns.

And, as we hope you all agree: in the long run ***Earnings Determine Market Price***. Always have, and always will.

Sincerely,



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