June 1995 **Volume 3.2**
John Doe

EDMP INC. Quarterly Review

PRESIDENT'S MESSAGE

The Dilemma of our Sell Discipline

The year is half over and the bull rages on as we gleefully watch our portfolios grow. Alas, however, runaway markets create a good news, bad news scenario for EDMP portfolio managers. The good news is we are making money, and we are beating the old market nemeses the Dow Jones and the S&P 500. Our clients are happy (at least we hope you are) and life is good.

Unfortunately, a reality check is in order. At EDMP we pride ourselves on thinking logically and keeping a sensible perspective. Our elegant discipline really helps us maintain our balance. When prices rise as dramatically as they have over the past six months, the old "sell discipline" rears its ugly head. In short, many of our best companies now appear dangerously overvalued. Therefore, they must be flagged for possible sale in order to protect your precious money. Remember, though, that at EDMP, we custom design each portfolio as we become responsible for them. Consequently, depending on when you hired us, your portfolios may not be the same as someone who came to us at a different time. As a result, this letter will prove more timely for accounts we have managed for two years or more. Nevertheless, the principles we are discussing are valuable and important for us all.

My purpose for this June 1995 quarterly review is to clarify and explain our important "Sell Discipline". Perhaps the appropriate starting point is to state our general attitude regarding the selling of great businesses we own. The most important thing that can be said of EDMP's sell discipline is that we really wish we didn't have one. Our position is that the long-term ownership of great growing businesses is the surest most powerful and prudent investment strategy to follow. As you all know, history supports the logic of ignoring markets and short-term fluctuations in favor of concentrating on the operating results and future potential of the "Great American Companies" we invest in. Sometimes, however, the market just takes hype and hysteria to extremes that simply cannot be ignored. There is mounting evidence that regarding some of our best companies, the market may have done just that. For those of you who own them, I am specifically referring to the following: Diagnostic Products, Johnson and Johnson, Merck, Microsoft, PepsiCo, Pfizer, and St. Jude Medical. Ironically, it seems like such a short time ago that most of these companies were being avoided like the plague. This brings to mind the humorous definition of appreciation: appreciation occurs when others appreciate what you own more than you do. When this happens, the only sensible course of action is to let them have it and find something else of equal quality at more reasonable valuations. It is possible that we may be on the verge of just that with many of the above listed companies. Newer clients can at least be confident that these names won't be soon showing up in their portfolios.

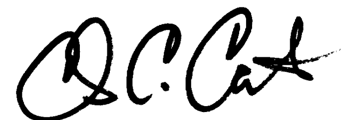
Having pointed all this out, here is the dilemma. The one investing principle that we are most certain of is that Earnings Determine Market Price in the long-run. The subtle point is that what actually and ultimately happens to earnings will be the driving determinant of price. In other words, actual results may prove to be quite different than the forecast results (plus or minus) that we utilize to assist us in the buying decision. Therefore, if a company significantly exceeds the analysts' estimates, then what appears overvalued may not actually be and vice-versa. Thus, our job is one of continuously analyzing and revalidating the original forecast to stay current. In summary, if we conclude that earnings results will be better than forecast, we can continue to hold, if not, we must sell and protect your money. Making these tough decisions is one of the most important reasons you pay us, and we believe we are up to the task. Naturally, we cannot promise to be correct every time we make a decision, but we do promise to try.

All things being equal, there remains a few other sell issues that I would like to briefly mention. The easiest to talk about is deteriorating fundamentals. If, in our judgment, a company's fundamentals fail, then we sell as soon as we make that determination regardless of price. Our purpose would be to move the money to a better opportunity.

Keeping your portfolios properly balanced and prudently diversified is the final sell discipline issue. From my twenty-five years experience in this industry, it is always hard and painful to sell companies that have made us a lot of money. Yet, as we review your portfolios, we see some rather disturbing imbalances. In several cases, due to exceptional and rapid increases in price, several of you own companies that represent 10%-15% or more of your total portfolios' holdings. Our policy is to only invest 5% of your money in any company or business. When exceptional growth happens, our portfolios get out of whack. Selling winners is always painful, but prudence dictates that we must. In these extreme cases we may pare back to 5% (sell part of the holding) regardless of valuation. It is important to remember that we believe that in any market there are always at least a few good or equivalent companies to invest in.

In summary, we hate to sell good companies. Sometimes, however, we must. First to protect your money and next to keep your portfolios properly balanced. At EDMP, we do not treat the sale of a great business lightly; they are just too hard to find at value. Perhaps the old adage, "no pain, no gain" is appropriate. Thank you once again for your trust in us, we appreciate it very much. And as always remember: Earnings Determine Market Price, always have, always will.

Sincerely,



Charles C. Carnevale
President