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John Doe

EDMP, INC. Quarterly Review

PRESIDENT'S MESSAGE

RUNNING WITH THE HERD

The second quarter of 1999 was very good to EDMP and our client portfolios. The majority of your portfolios demonstrated rather dramatic out-performance relative to the standard benchmarks the S&P 500 and the Dow Jones Industrial Average. Many would argue this to be a function of a changing trend and market broadening away from the 20-30 companies that have dominated for the last few years. While we would concede this to be a short-term factor, we do not see it as the root cause.

We have steadfastly asserted the strategy of investing in sound and growing businesses bought at reasonable, or even better, low valuations is both powerful and safe. This sound and proven approach positions your portfolios for reliable and exceptional long-term performance at relatively low risk.

In the long run stock prices will potentially reflect the operating results of the business. In the short run, markets can move to excess, up or down. There is a natural tendency for people to follow the crowd, often referred to as running with the herd. The stark reality of running with the herd is your ultimate destination is the slaughterhouse. People need to be smarter than cows.

For the past five years we have witnessed one of the most bizarre stock markets in recorded history. Norms, based on sound principles of business economics and even common sense, established over the entire history of investing have been summarily rejected. This marks the third time this has occurred this century with each of the prior two ending in disaster for those investors embracing the insanity. Recently behavioral finance experts are warning that investor psychology becomes more compelling during market extremes. This explains why people sell after the market falls when they should be buying and why they rush in with reckless abandon at market tops.

The recent bull market is causing many investors to lose their sense of perspective leading them to expect returns of 25% to 30% per year. At their peril they ignore the reality that stocks have historically returned 9-10% a year. More importantly they forget why this is true. Stocks have historically returned 9-10% per year, precisely because 9-10% per year has been the operating growth rates of the businesses behind these stocks. This is an economic reality that will not change. There is a limit to how big and fast a company can grow, and the bigger the company, the more limited its growth potential.

What all this means is markets will ultimately revert to the mean or become normal again. Normal is what sound investors believe in, because normal is based on economic realities. The advantage to understanding this is the very profitable ability to recognize anomalies and exploit them to your long-term benefit. Fads are after all fads, and will eventually run their course. Sound principles are based on economic realities and will persevere. Fads are short-lived, sound principles are permanent. Chasing performance can and will work for awhile, but is totally unpredictable and based on luck. Who in their right minds would trust their long-term financial security to chance? Not I, and I hope not you.

This extreme thinking is highlighted by reviewing several recent articles on Warren Buffett. Many have been quick to point out Warren's track record since the summer of 1998 has been a minus 15-20%. Once again we hear the question, has Warren Buffett lost his touch? The truth is his record based on the last 8 or 9 months is a function of markets out of whack. This is also true of his record for the last 4 or 5 years, exceptional even by his standards, again based on a zany market. Remember he has major holdings in big cap icons like Coke and Gillette, that have performed above fundamentals for the past four or five years, but have fallen more recently from unprecedented lofty valuations. On the other hand his record since 1958 exceeds 25% per year, more than double the markets and has nothing to do with luck or fads. Warren Buffett practices sound investing and ignores the stock market. He simply invests in great companies when they are reasonably priced and holds them permanently. Warren recognizes market prices will fluctuate, often irrationally, but is more concerned with the businesses he owns.

This is precisely the point we have been stressing since April of 1998, and actually since we have been in business. In contrast to a raging big cap bull market this has been difficult to convey, especially to our newer clients (less than three years). Perhaps with performance beginning to manifest it will be easier to focus more on what is important and less on lying stock prices. Volatility is a reality of owning common stocks and can be either unnerving or worse bring complacency. On the other hand the operating results of a sound business are more predictable, less erratic and of paramount importance to the true investor. Speculators chase performance and stock prices and rarely catch either. Investors pay more attention to the actual businesses they own, and enjoy superior long-term results and lower risk.

As I hope you all know, EDMP our firm's name is an abbreviation for Earnings Determine Market Price. We contend this to be both logical and factual. Our fundamental charts clearly illustrate the validity of this axiom. They are profound and powerful tools for the long term, serious investor and should not be ignored. Once you understand this truth you will be empowered to focus on what is relevant to investing and ignore what is not. Stock prices move randomly and therefore are unpredictable, at least in the short run. Earnings and operating results, though difficult to predict, can be forecast much more reliably than prices. Future operating results are a function of measurable factors that can be rationally analyzed. We can examine a company's management, its balance sheet, its competitive position, its cash flows, its profit margins etc. We can determine whether these fundamentals are strengthening or weakening. We can also forecast important factors such as trends, demographics, market size and share, etc., in order to ascertain future probabilities. Most importantly we can apply this information to evaluate whether at current prices or values the company is cheap or expensive. This is the process intelligent investors use to make sound long term decisions.

Admittedly, the process is not easy. However, through critical thinking applied analytically it can be accomplished with a high enough degree of accuracy to generate the necessary returns to meet your future financial needs. On the other hand, market timing, performance chasing and predicting short-term stock prices simply does not work.

Forecasting future earnings and exercising the judgment to only buy those earnings at sensible prices are major keys to investing success. The most significant points are future earnings and the price you pay to buy them. Unfortunately many investors only get this half right. They often identify the right company and even make correct assessments of its future potential. Where they err is with the price or valuation they pay. They fail to realize even the best of companies with the brightest of futures can be dangerously overpriced. The irony is investors usually get attracted to the stock (company) after it has already gone up. On the other hand, the most successful investors with the best long-term records make their money by buying right.

Even more befuddling is how investors react to low prices or valuations. When a company's stock price is low or down investors avoid it like the plague even if the company's long term prospects are bright. Actually, if the price is low many people will refuse to even look at it, even though this defies logic.

This leads me to the most important point of this quarter's report. Never underestimate the power and potential of accumulating a sound business at fire-sale prices. In a generally overvalued market like we have today, a falling stock price is usually caused by an issue that scares people into selling. Sometimes the reason or reasons are temporary or a function of management making a sound long-term decision that may have a short run negative impact on current results. A great example that many of you own is Atmel. We identified this superbly managed tech company as they were transitioning from commodity memory chips to proprietary logic chips. The transition caused a short-term interruption in earnings growth but positioned them for powerful future earnings power. The "stock market" took the price down from $42 to $6. We started accumulating in the twenties and continued as the price fell. At six dollars per share, clients were irate, many suggesting we sell. As of this writing, Atmel trades at approximately $28 per share rising just under 500% in 8 months.

When the price of a good company falls, shareholders often become despondent focusing only on price. They think there is no way to get their money back, or fear losing it all, and will panic and sell. Yet, if they could fight their price bias and look more carefully at the underlying company they would see the remarkable opportunity. To repeat, the best time to buy is when prices are low. We believe your current portfolios are generally comprised of excellent businesses with extraordinary bright futures and cheap prices. Therefore, we are confident that our risk is low and our upside high, regardless of what the stock market may do. Look closely at the twenty or so businesses you own, use your charts and you will surely see this too.

It remains our privilege to serve you. And, as always, remember; Earnings Determine Market Price, always have, always will.

Sincerely,

Charles C. Carnevale
President

PORTFOLIO REVIEW