2nd Quarter 2001

EDMP, INC. Quarterly Review

President's Message

Return to Normalcy?

Can you believe it? The first half of 2001 is over. I guess time flies when you are having fun. We are having fun at EDMP because as the stock market **slowly but surely returns to normal**, the credibility of practitioners of prudent investing, like us, grows stronger. Sound strategies, based on realistic economic principles, are not trendy or flashes in the pan. Fundamental, business perspective investing based on solid valuations stands the test of time. Value investors are vindicated once again. YAHOO!

We are also quite happy for you, our valued clients, for the excellent performance our disciplined and prudent approach produced for you last quarter. With the S&P 500 down over 7%, and the broader NASDAQ down 13% year-to-date, our solidly positive results taste even sweeter. Furthermore, with the S&P still near record high valuations and the majority of large cap blue chip tech stocks commanding PE ratios 50-100% greater than their growth rates, our current portfolio characteristics appear most promising for the long-term. In other words, based on current valuations and reasonable future expectations for growth, we believe your portfolios are poised to grow with the risks moderate to low. In short, when the numbers make sense, the investment makes sense and the appropriate solid performance will surely follow; again long-term.

When investing, it's important to look to the future and weigh the now. When you intelligently base your decisions on attractive fundamentals, it is true that you can get temporarily bit by short-term volatility. Your prudence, however, places you in the enviable position of being empowered to wait the market out.

Normally, your wait is short and at worst moderate in length, due to the real worth of the businesses you own. All great and successful investors know that inevitably, over and over again, stock prices will reflect economic value.

On the other hand, those who recklessly pay too much during exuberant periods are doomed to a wait too long to tolerate. Also, these uninitiated can be devastated by a bite so powerful as to be financially fatal. This is much too high a price to pay, and is therefore the prime impetus behind our dedication to educating current and future clients to the benefits of sound investing. It's simply our duty to share our knowledge and perspective with all who will listen.

Superior and safe long-term performance is more a function of common sense than genius. It's about discipline applied intelligently, and based on straightforward realities. One such reality is short-term price volatility in the stock market. This is an unavoidable reality that will never change. Consequently, you cannot invest without both facing it and dealing with it.

Many believe that volatility is risk. Some now famous academics with PhD's even won the Nobel Prize on this premise. Over the course of the past thirty years, this erroneous notion has dominated the thinking and practices of the vast majority of mainstream Wall Street and most institutional investors as well. Literally trillions of dollars were lost in the recent past because people imprudently, out of ignorance, believed you could relegate the complexities of true risk to mere statistical references such as beta, standard deviation and R^2. Volatility is not risk. True risk is much more complex and must be dealt with intelligently to succeed in investing.

In truth, volatility is but a small and relatively unimportant element of true risk. It is also benign, because once understood for its true relevance and nature can be easily dealt with and its danger eliminated. Volatility can only hurt you if you fear it. Once you recognize volatility for the toothless tiger it truly is you make it harmless. The risky part of volatility is how you deal with it, not the volatility itself.

One of the great ironies of this prevalent thinking about risk is that it flourished by ignoring true investing greatness. Academic research showed that very few professional money mangers beat the market averages on a consistent basis over time. Therefore, they reasoned, that the market was perfectly efficient and that all knowledge that could be known is priced in. Therefore, price and its movement is placed on a pedestal with economic valuation all but ignored. Since nobody bothered to study the ideas, practices and strategies of those few great investors that did constantly produce superior results, their voices and influence are lost. Conventional modern portfolio thinking, commonly known as Modern Portfolio Theory, or MPT, did not study our greatest investors.

Had they taken this simple step, they would have discovered that sound investing practices do in fact exist. The academics and their followers would have learned that the majority of professional managers that under-perform do not follow sound investing practices. Instead, they speculate on guessing price movements. More profoundly, they would also have seen that those rare few that do reliably outperform almost universally do invest prudently. The great investors have much more in common than different. They are not clones, but they are philosophically aligned. The most prominent belief they all share is the undeniable fact and reality that the markets often mis-price stocks. In simple terms, they understand that price and value are not the same.

What this all has to do with risk is vital. True risk is complex, containing numerous elements and magnitudes. To repeat, it cannot be statistically defined. At best, the conventional and prevalent view of risk is only dealing with a small and rather unimportant aspect of risk. The most important element of risk, valuation risk, or more precisely overvaluation risk is not even factored into their fancy mathematical formulas. This is folly because measuring price performance without comparing its relative valuation is both a job half done and highly dangerous to your long-term financial health.

Fundamental investors, like us, see this as the primary reason people lost over four

trillion dollars in the recent dot.com and tech stock fiasco. As the prices of these, some great, some not so great companies, rose to stratospheric levels, everyone felt great. Dumb and happy, they forgot to evaluate the economic worth of these businesses and held to oblivion.

Sadly, this expensive lesson that valuation truly does matter has still not been learned by many. Unfortunately, they cling to their enormous assumptions and continue to ask their flawed models for answers. This is analogous to a primitive tribe passionately dancing around idols representing rain gods during the Monsoon season. They connect their dance to the cause of rain and when the drought comes, believe the gods are angry with them. Their primitive minds are so conditioned to the notion that dance and rain are correlated that they are blocked from considering otherwise. Life goes on and they are condemned to repeat the same tragic mistakes over and over again.

In the modern world of investing there is no place or room for primitive thinking. We are intelligent beings capable of reason and analysis. Ignorance is not stupidity; it is the lack of knowledge. Ignorance becomes stupidity when knowledge is obtained but not applied. Modern Portfolio Theory is not without merit. It is merely a piece of knowledge that can have practical applications regarding investing. However, it is not the end all answer, rather it is one piece of a large complex puzzle.

For example, the concept of an efficient market is not completely devoid of truth. In fact, for the vast majority of the time stock prices trade within a reasonable variation and correlation to intrinsic value based on cash flow principles. Since there is always uncertainly in forecasting the future, reasonable volatility in price movements are to be expected. During these prominent periods of normalcy, statistical references like beta and standard deviation provide an incremental piece of knowledge that can be useful in making proper long-term decisions. They do not, however, define total risk; they only measure a small component of it.

To succeed safely and reliably investors must be thorough, and complete all the analysis necessary to making a sound decision. Fundamental business and accounting principles are conspicuously absent from conventional wisdom. This must and will change, but, alas, progress always seems to happen slowly. But in the end the truth will set us free.

At EDMP we recognize that since the middle 1990's the stock market has not been normal. This period will go down in investing history as one of the longest anomalies or bubbles on record. However, it was not unique in the sense that it never occurred before, because it has – many times. Furthermore, it will not be the last, and we must remember that for each exuberant anomaly that happened before there were also anomalies of fear and panic as well. The power of acknowledging the existence and possibilities of anomalies, like we do, renders them harmless. Only those who foolishly deny their existence are vulnerable to falling into their traps. It's kind of like poisonous snakes; if you see them, you can avoid getting bit. Snakes only bite you when you don't see them before encountering them, or if you behave recklessly when you do. Investing in the stock market is just like that. The ability to see and recognize an anomaly when it occurs, for what it truly is, leads to safe and superior profits over time.

This brings us to what matters most to you, our valued clients; our past, present and future actions on your behalf. In the recent past we sold overvalued tech and large cap blue chip growth stocks to harvest the excess profit we had, and to protect you from the inevitable loss. Then, because we believed in and practice proper diversification principles we re-deployed some of our harvest into sound and growing so called "old economy" businesses at better valuations. Names like: Jacobs Engineering, Lancaster Colony, Clayton Homes, Superior Industries, Invacare, Mattel, Johnson Controls, Illinois Tool Works, Diebold, and others have subsequently rewarded us with safe and attractive profits.

More recently we have been, and expect to continue, accumulating superb blue chip companies in the technology and the telecommunications industries. It's important to note that had we not done this, our current performance would be even more stellar than it is. As Yogi Berra put it, we see this as "deja vous all over again." Those companies cited in the last paragraphs were yesterday's drag on performance and today's generators. There is little doubt in our minds that both technology and telecommunications are growth industries far into the foreseeable future. With current prices based on temporarily depressed earnings, these industries and the companies in them are too compelling to ignore. Although it's impossible to time their purchase perfectly, we believe it's more dangerous to be out of them at these low valuations then in them.

The moral of the story is that the stock market is constantly seeking equilibrium based on intrinsic value or simply said - **normalcy**. When the occasional anomalies occur, intelligent investors recognize them for what they are and behave appropriately. We believe we do this as well as anybody. Measured according to the realities of whatever market condition we find ourselves in, we always strive to buy growing businesses at sensible prices. Money is truly made on the buy side, because the beauty of a growing business bought right is that the longer you own it, the more valuable it gets. Measure current price against current valuation and sound, superior and reliable performance will surely follow.

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

Sincerely,

Charles C. Carnevale
President