2nd Quarter 2002

EDMP, INC. Quarterly Review

The Perfect Market

The second quarter of 2002 is finally bringing us the “Perfect Market.” For some time now the prices of many of the common stocks of America’s leading businesses have been grossly inflated. Since stock prices are in a constant state of seeking equilibrium (intrinsic value), it was inevitable that valuations would come down. This process is currently in full bloom.

In plain English, the stock market is precisely that - a market. People (investors and speculators alike) go there to buy and sell. The stock market is a niche or specialty store that deals only in common stocks. Like all markets that people shop at, the stock market on occasion hosts huge and glorious blowout sales. However, for some curious reason that escapes us, people tend to behave in a completely opposite fashion when they patronize the stock market than they do in any other shopping experience.

The two most obvious strange behaviors are fascinating to watch. First of all, people who patronize the stock market seem strangely more attached to the store they bought the merchandise at than the merchandise itself. For example when I buy a car at the Auto Store, all my attention is focused on my shiny new toy. As I drive away from the store, I immerse myself in the magical new car aromas, the purring of my powerful new motor and all the pride I feel for its sleek new lines and its smooth ride. The store (market) becomes a distant memory, at least until something breaks or needs service. Otherwise the store is forgotten and the merchandise is focused on and enjoyed.

The point as it relates to EDMP clients, is that you do not own the stock market. Instead you own a carefully selected group of fine businesses that were merely purchased at the stock market store. Therefore what’s most important to you in the long run are the future operating results and the financial condition of these carefully selected businesses. Since we have already bought them, it matters not that the store is currently having a great sale. Unless, of course, you are interested in buying more merchandise, which is the logical point of view. Simply put the best time to shop (buy) is when things are on sale. Conversely, this is also the worst time to sell.

Second, again for some bizarre reason, when people go to the stock market (store) to shop and discover everything on sale, they become distressed. Quality merchandise that previously cost a great deal more, often way more than it’s worth, suddenly becomes unappealing. This behavior would make some sense if everything you wanted to buy went on sale when you had no money to buy. However, this behavior makes no sense when you have the money to spend, which, by the way, we do. Consequently, this great stock market blowout sale is a time to rejoice. This is why this quarter’s newsletter is titled ‘The Perfect Market.’ Stocks are going on sale, and we have cash.

The above metaphor is not offered to be glib, cute or trite. We believe the underlying rationale is vitally important and ultimately the key to long term investing success. As we have stated numerous times before, you make your money on the buy side. In truth when stocks are cheap, they are both safer to own and deliver better future results. Bear or bad markets are buyers markets, not sellers markets.

Regarding the stocks we already own, it’s important to remember that they were not bought to sell today. They were bought to hold or, if ever sold, only in some distant future. Therefore, as previously stated, what other people are willing to pay for them today matters very little because our businesses are currently not for sale. Unless of course, panic sets in and causes us to foolishly throw away valuable assets. No one is going to buy our stocks from us at prices less than they are worth; we encourage you to feel the same.

A few years ago, when the mood was different, conventional wisdom embraced some dangerous and fool hearted notions. There was this so called new paradigm with its new economy concept that proposed the business cycle had been repealed. Stocks would go forever up, the economy would continue to grow at a torrid pace, and there would be no more down cycles. This nonsensical view was embraced by the majority and attributed to the promise of technology. Then suddenly, and without apparent warning, everything changed.

Through the last three quarters of 2000, all of 2001 and so far through the second quarter of 2002, reality reared its ugly head. Clearly, the business cycle has not been repealed and the promise of technology is not infallible. What’s important in all of this however is to be very careful not to go from one extreme view to the other.

The promise of technology is real, and we might add, alive and well. Perhaps one could currently argue against the “well” part, but we would counter that it merely has a bug and certainly not a terminal illness. Technology has already created productivity enhancements that have in truth strengthened our economy. More importantly, research continues and future benefits are virtually certain to evolve.

This does not imply that the business cycle will ever be repealed, because it will not. However it is possible that future cycles will be less severe and protracted. On balance this is a very good thing and worthy of being generally optimistic about. Therefore, we are and have been accumulating technology stocks and, yes; telecommunication companies that we believe are sound and attractively priced today.

We realize that this last point is going to conjure up some "yeah buts" from many of you. For example: Yeah, but what about WorldCom, Peregrine and Enterasys, where corporate malfeasance has reared its ugly head. These are valid issues and warrant an honest response. However, rather than cover each specifically, for time and space constraints, we will cover these "yeah buts" more generally. For more specific answers we encourage you to contact us directly.

One of the great advantages of investing in great American businesses is the reliability and integrity of the information we rely on to make our decisions. Recent events (Enron, WorldCom etc.) have not destroyed this tremendous advantage; they have merely and temporarily only damaged it. On a more positive note, the shocking magnitude of this crooked behavior of a few has most assuredly made it less likely to occur in the future. Just as it's become more difficult for a terrorist action to be perpetrated upon us after September 11th, dishonest accounting has also become significantly less likely going forward. Dishonest accountants - who would have thunk?

In the same vein even though these outrageous actions have damaged our portfolios in the short run, thanks to our practice of proper diversification they have not destroyed them. On the other hand, in the long run we believe our future performance will actually be better. The pall that these events have placed on the market at large have created significant buying opportunities. In other words we are confident that the future returns of the many other holdings we own will more than make up for the losses we suffered from the few. As the old adage says, "In every cloud there lies a silver lining." Only this time we think the lining is gold.

In closing, we would like to highlight a human behavior tendency that we have observed as being very deleterious to long-term investor returns. Human beings seem to have a penchant towards projecting current events, attitudes and feelings as existing permanently into the foreseeable future. In other words, if things are bad today, they are forecast to remain bad forever and vice versa. This is a very dangerous trap to fall into because it's the exact opposite of reality. In fact this is exactly what the business cycle is all about and why free enterprise works so well. Booms and busts are extremes with either representing an unhealthy situation that needs to heal. When things become too good they will inevitably move towards normal tomorrow. When things become really bad, like today, they will inevitably become better (normal) tomorrow. This is reality.

During the last half of the 1990s, the Pollyanna period, we warned that optimism had gotten out of hand. We sold tech and everything else that had gotten ridiculously overpriced and thus both preserved and grew our clients' capital. Today, the gloom and doom period, is merely the mirror image of the 1990s. The great paradox of stock markets is profoundly important. The higher stock prices got during the great bull market of the 1990s, the greater the losses suffered by investors. Conversely, the lower stock prices get during this current bear market, the larger the gains for investors to harvest in the future. Currently our advice and posture is to be ready to buy while prices are on sale.

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

Sincerely,

Charles C. Carnevale
Chief Investment Officer