2nd Quarter 2004

EDMP, INC. Quarterly Review

Nature of the Beast

From EDMP's perspective, the 2nd quarter of 2004 was quite paradoxical. What was so unusual about the quarter was how dramatically our businesses on an operating basis outperformed their stock prices. In general our portfolio companies had exceptional quarters. Most exceeded consensus earnings expectations, and generated strong cash flows. With their businesses vibrant, it was common to see dividend increases, share buybacks, stock splits, and debt reductions. Yet, paradoxically it was also common to see their stock prices flat or down for the quarter.

Something is terribly wrong with this picture, and it is not bad news. Instead, it is just one more example of how irrational and downright silly the quote-unquote stock market can be in the short run. The economy is, as strong or perhaps, even stronger than it has ever been, interest rates are at historical lows, prospects for the future are exceptional, and the stock market is weak. This is the classical version of opportunity knocking loudly at the door while everybody is huddled, shivering inside, frightened by the loud noise. Meanwhile, EDMP is racing to answer the door, once again, out of synch with the rest of the world. Somehow, and a complete mystery to us, the investing world has found some bizarre reason to be pessimistic while surrounded by all this good economic news.

It is important to remember that these are the very same folks that faced the imminent danger of the 1995-2000 market insanity with irrational exuberance. Since they were so very wrong then, why should we believe they are correct today? The obvious answer is we should not, and the rest of this quarter's newsletter is dedicated to explaining why we should not.

To set the stage for what follows, we offer a quote from a 1997 best selling book Buffettology, co-authored by Mary Buffett, the venerable investor Warren Buffett's one time daughter-in-law. "Having a business perspective on investing is more about discipline than philosophy and once understood it demands absolute devotion. Stray from it, and you will wander the financial lunar landscape, forever, dancing to the folly called forth by fear and greed. Adhere to its wisdom, and the foolishness of others becomes the field in which you reap your harvest." In other words, people with a business perspective on investing exploit the foolish behavior of the emotionally driven crowd. Therefore, the crazy goings-on with current stock market behavior, offers a perfect backdrop to review the discipline of true prudent investing in contrast to the true **nature of the beast** we call the stock market.

As most of you know, our name EDMP is an acronym for Earnings Determine Market Price. We believe our name is a perfect metaphor for the true fundamental principles of sound long-term investing. Mainly, that as shareholders of a business, your long-term results are going to be a direct function of the long-term results of the specific businesses you own, independent of the stock market. However, we also acknowledge what we humorously refer to as the evil twin sister EDMP.

Specifically, in the short run, Emotions Determine Market Price. This evil twin, EDMP, represents the indisputable reality that the stock market has a penchant for often becoming terribly irrational for short periods of time. A key point here is that the true long-term EDMP is enduring and based on sound and relevant principles of business and mathematics. In contrast, the short term evil twin EDMP is always temporary and based on illusions and normally false pretense.

The immortal Ben Graham, the undisputed and recognized father of modern security analysis, summed this up nicely with the famous following quote: "In the short run, the market is a voting machine, reflecting a voter registration test that requires only money, not intelligence or emotional stability. But in the long run, the market is a weighing machine." Mr. Graham was merely pointing out that the daily buying and/or selling behavior (voting) of emotional entities, known as human beings, causes short term volatility in stock prices. While on the other hand, in the

longer run it is the assets, revenues, cash flows, earning, etc. (the weight) of the business that give it long-term value. Most importantly emotions are temporary and can suddenly change with the wind, while True Worth™ valuations are of lasting value.

The motivation for the above discussion comes from recent conversations we have had with many of you, our valued clients, and/or your professional financial advisors. It is quite clear that many of you are concerned about your money and your financial future in general. Please know that your concerns are important to us and we take them seriously. The objective of this quarter's letter is to ease your concerns through logic and reason. At EDMP, we believe that knowledge is power and the most potent antidote for fear. In truth we are quite optimistic regarding the future of your portfolios and confidently believe that our optimism is justified. For your sake, we sincerely hope that we can convey and thus transfer our optimism to you. We appreciate however, that this must be accomplished based on fact not fantasy. So, here are the facts as we hold them to be true and valid.

From the conversations we referred to in the above paragraph, there appears to be a commonly held fear that is rooted in the bear market of 2000-2002. Many of you, who were of course not EDMP clients at the time, suffered severe losses in that market and are quite fearful of a repeat occurrence. On the other hand, many of you that were EDMP clients saw friends and family that were financially devastated by the bear market and are thus fearful that you were just lucky last time and that your luck may run out the next time. Our goal is to prove through logic and analysis that although what happened in 2000-2002 was justified by the prevailing circumstances that existed then, they are not justified by the prevailing circumstances that exist today. In fact, it is quite the contrary.

By the fourth quarter of 1999, just before the collapse, stock market conditions could be summarized by the following: Optimism was at a ridiculous peak (irrational exuberance), the S&P 500 was capitalized at a P/E Ratio of 40 (12-15 being normal) and growth tech stocks like Oracle had a P/E ratio over 90 (25 being normal), and finally the economy was weakening to possible recessionary levels. In contrast today, pessimism is rampant, the S&P 500 trades at less than 20 times earnings, Oracle trades at just above 20 times earnings, and the economy is strong and accelerating.

As an important aside, we want to be very clear that we are not suggesting that the stock market cannot fall, even dramatically, from here. Previously in this newsletter, we pointed out that the stock market can be quite irrational for short periods of time, so a temporary fall in the market is certainly possible, but not inevitable. It is very important that you understand the profound difference between a highly overvalued market (1995-1999) falling to value, versus a fairly valued market that falls to being grossly undervalued. With the former, true risk is high and the time to recovery is unacceptably too long. With the latter, true risk is actually low, with opportunity being high and profit potential greatly enhanced. The principle to consider here is to not let emotions wreak havoc with your future. Instead, rely on prudent judgment and a level-headed assessment of the facts.

For perspective, we would like to present the essence of our prudent investment approach in order to illustrate the safety and opportunity we believe it provides you. Simultaneously, we hope to convince you beyond a shadow of a doubt that the so-called stock market has absolutely no bearing or anything at all to do with your portfolio's future potential. In short, with EDMP you are not invested in the stock market. Instead, you are positioned as shareholders in a select group of superior businesses that are currently financially strong, soundly valued, getting stronger, and poised for attractive, above stock market, future growth.

As an owner/investor in a business, you are buying the future earnings power of the specific company selected. Therefore, your attentions and concerns should logically be directed to how well the business is performing as an operating company and its potential to grow going forward. As prudent business owners, you leave the speculating on daily, monthly, quarterly, or even the yearly movement of stock prices to the stock market speculators (gamblers) where it belongs. Keep in mind, however, that these speculators are beneficial to you for the liquidity they provide if and when you need or desire it. The key point to keep in the forefront

of your mind is that investors take the long-term view while speculators chase the short-term.

The business perspective investing philosophy that EDMP employs on your behalf can be easily articulated through a very basic and simple mathematical analysis. Our objective is to position our clients as shareholders, long-term owners/investors in companies that we are confident can grow their earnings at the above average rate of 10% - 20% per year (8% - 12% is average). By definition this is precisely what makes them above average. Therefore, if you assume a 15% growth rate (the middle of our 10% - 20% objective), you will discover that it will take just slightly less than five years for the business to double its earnings at that rate of growth.

For further illustration, let's assume that today we paid a P/E ratio of 15 (the company's growth rate) to buy $1.00 worth of its earnings for a purchase price of $15.00 per share. Based on our forecast for 15% growth, we expect that $1.00 worth of earnings to grow to $2.00 worth of earnings in approximately 5 years. If we apply the same P/E ratio of 15 to our now $2.00 worth of earnings, our stock price, 5 years later, is $30.00 ($2 earnings times 15 = $30.00). Therefore, we have doubled our money in approximately 5 years, which translates into a compounded annual return of 15%.

From a risk perspective, we could also easily calculate that the company's P/E ratio could fall to 7.5 or half the P/E ratio of 15 we originally paid and we would still break even (7.5 times $2.00 = $15.00). Historically the stock market has rarely, if ever, capitalized a company growing at 15% per year at such a low P/E ratio. This explains a major part of the margin of safety we look for. However, if the market was really pessimistic five years later, it could be possible and has occurred occasionally, that the stock market might capitalize our $2.00 of earnings at a lower P/E ratio of 10. Under this bad case scenario, the stock we bought at $15.00 five years earlier would now be worth $20.00 (10 times $2.00 per share = $20.00). This translates into a compounded annual return of 7.5%, which is disappointingly half our target rate, but probably as good as any bond or CD type investment we could have chosen instead.

The critically important point behind all of this is that it takes the requisite five years for even superior (above average) companies to generate a doubling of your money. Equally as important is the recognition that companies only report earnings quarterly. To put this into perspective this implies that if our company is achieving our target forecast annual growth of 15% it is only growing by 3.75% (¼ of 15%) per quarter. In other words, the company we paid $15.00 for three months ago is mathematically now (three months later) worth $15.56 ($15.00 + 3.75%). True Worth™ investing results take the requisite time to manifest. However, the real value of your investment is truly increasing over time as long as the earnings continue to grow as forecast.

The above mathematical analysis represents the essence and reliability of true business perspective investing. This is what we meant in the opening paragraph of this newsletter where we stated that our companies were outperforming their stock prices. If we could get you to view your portfolios based on operating performance as we at EDMP do, instead of short-term price volatility, we are confident that you would be as excited and optimistic about the future as we are, and we are very excited.

Let's shift gears for a moment and talk a little bit about the evil twin, short-term, Emotions Determine Market Price, otherwise known as the stock market. While shareholder owners of businesses only receive factual information four times a year through quarterly and annual reports, the so-called stock market processes noise constantly. This evil twin emotional wreck suffers from bouts of hysteria and euphoria endlessly. Consequently, you can never rely on or predict what she might do next. There never seems to be any rhyme or reason to her actions. Owners of businesses invest their capital and allow it to grow in lock step with the growth of the company they own. Market timers, constantly in a state of agitation, trade their portfolios to oblivion.

True investors, and we might add the most successful investors, ignore the stock market. The following quote from the great investor Pete Lynch's best selling book, One Up On Wall Street summarizes our views nicely. "The stock market ought to be irrelevant. If I could convince you of this one thing, I'd feel this book has done its job. And if you don't believe me, believe Warren Buffett. 'As far as I'm concerned,' Buffett

has written, 'the stock market doesn't exist. It is only there as a reference to see if anybody is offering to do anything foolish.'"

For those of you who require hard evidence beyond wise words, we offer the following facts to validate our thesis. The track record of Home Depot, a superior business most of you own, compared to the track record of the S&P 500 (the market) clearly validates our argument. Had you invested $10,000 in both Home Depot and the S&P 500 (index fund) on December 31, 1984, and held them both through December 31, 2003, (20 years) you would have experienced the following results: The $10,000 invested in the S&P 500 (the market) would have grown to $66,493 representing a not too shabby 10.5% annual return, excluding dividends. In contrast, $10,000 invested in Home Depot at the same time would have grown to $909,999 representing a spectacular 27% annual return, excluding dividends. Remarkably, Home Depot would have made you just under fourteen times more money than the stock market would have. Clearly, the return enjoyed by the shareholders of Home Depot had nothing, absolutely nothing, to do with the stock market. Instead, it was the specific success of the company, independent of the stock market that enriched Home Depot shareholders.

In summary and conclusion, and in truth, we had a great second quarter of 2004. Unfortunately, it was not accurately reflected in stock price movement. However, an examination of operating results tells a very different story. As previously noted, most of your portfolio companies exceeded consensus earnings estimates, generated strong cash flows, and in general grew their businesses. Additionally, the overall economy is strong and robust, and is expected to continue to be into the distant future. Most importantly, our valuations are sound, and generally better than the stock market's. To us at least these are all ingredients for a bright and prosperous future.

There will always be things for the market to worry about, as there always has been. Consequently, the market will continue to be volatile, sometimes rationally, sometimes not. Volatility, however, is not risk. Volatility only represents risk if you react to it. Low stock prices only matter if you sell into them. The portfolio companies EDMP holds on your behalf are not for sale today. They were bought to hold for at least the next three to five years. Therefore, today's volatility means little to us. We are confident that our holdings possess the requisite characteristics for powerful operating growth over that time and beyond. The fact that the economy is so strong is a bonus, because we believe our companies would grow nicely in a weaker economy. Just because people are selling them currently has little to no relevance to the long-term business opportunities they possess. These are great companies run by honest and competent people that are leaders in growth industries. Inevitably, their growth will attract capital and their stock price will rise to reflect their True Worth™.

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

Sincerely,

Charles C. Carnevale
Chief Investment Officer