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EDMP INC. Quarterly Review

PRESIDENT'S MESSAGE

The Many Faces of Value

The third quarter of 1996 was quite eventful as the world gave investors a lot to worry about. First, came the assumed end of the computer age; chip prices were falling almost as fast as the prices of technology stocks. Then Saddem Hussein was back, and finally the Federal Reserve teased us with the threat of raising interest rates. Yet, the bull raged on despite the occasional bout of volatility.

For most investors, large and fast variations in stock prices are most unnerving. As discussed before, volatility elicits emotional responses (fear & greed) which invariably cause many investors to make mistakes. Greed takes over at the top causing them to pay too much, and fear turns into panic at the bottom, causing them to sell too cheap. The stock market is the only store in existence where shoppers flood the premises when prices rise and leave in droves when everything goes on sale.

Then there are the eccentrics of the investing world, like EDMP, called Value/Growth investors. We, mavericks that we are, avoid the herd instincts and prefer to calmly and rationally think through each situation. This is not to imply that value investors are androids completely void of emotion. In truth, we can get quite excited when we see a great business suddenly being rejected by the herd. In contrast, we can also become quite nervous when we see a feeding frenzy driving prices to incredulous heights. Our apparent calm stems from the fact that we are usually on the other side of the dementia. In other words, we are buying when the majority is selling and vice versa.

This is why value growth investing is such a powerful and reliable strategy for successful and prudent long-term investing. What separates value investors from the pack is our willingness to do the work and think things through.

The concept of value growth investing is both simple and logical. First, search out the best companies we can find that possess superior track records as well as bright futures. Then, as carefully as possible, validate the forecasts, and diversify among at least twenty choices to diminish the effects of error. Finally, and perhaps most importantly, exercise extreme patience to buy only when reasonable business valuations exist.

In other words, don't pay too much for even the best of companies. This final concept should not be confused with trying to find the bottom. Short-term price movements are often irrational and unknowable, therefore, finding the bottom is mostly a matter of luck. However, it's interesting to note that it's value investors that tend to actually find bottoms the most; perhaps validating the axiom that luck is when preparation meets opportunity.

The benefits of value growth investing are both extraordinary and reliable. Common sense dictates that by paying reasonable prices (values) the investors place themselves on solid ground. Value investors enjoy the double barreled benefits of lower downside and greater upside. This is in stark contrast to the momentum investors whose portfolios are comprised of false profits. How bizarre it is to see investors content to own companies that are trading at prices and values that are higher than logic or history would indicate. Ignorance may be bliss, but only until reality eventually rears its ugly head.

The task of finding value can vary from slam dunk to gigantically difficult. Yet we have never seen a market environment where finding value was impossible. In every market there are companies that are over-priced, fairly priced, and under-priced. The value investor need only learn to recognize **the many faces of value.**

The recognition of value is most easily achieved once we hold a clear perspective of what value means. At EDMP we define value as when a business is capitalized rationally in relation to its fundamentals, both past and future. Our rule of thumb is generally to pay only a price earnings ratio that is equal to or less than its growth rate. More comprehensively, we evaluate all the fundamentals: free cash flow, debt levels, profit margins, market share, sales, etc. Our objective is to identify a quality company that is reasonably priced today and, we believe, will grow its business in the future. Obviously, this implies a long-term view, because it takes time for a company to grow its business.

The following real world scenarios will hopefully clarify this process and reveal **the many faces of value:**

1. CLASSIC REASONABLY VALUED MARKETS: A rational market where stocks are generally reasonably valued in relation to their fundamentals or intrinsic value. Sample companies which we purchased in the past under this scenario include Aflac, American International Group, Conagra, Circuit City, Carnival Corp., Columbia Healthcare.

2. MAJOR MARKET CORRECTIONS: The October 1987 crash and the more recent correction triggered by the Gulf War in October 1990. The vast majority of our master list companies were at or below value.

3. SECTOR MARKET CORRECTIONS: Isolated corrections limited to specific industry groups typically occurring in a bull market. Health care reform brought us Merck, Pfizer, St. Jude Medical, Johnson & Johnson, Amgen, etc. Technology industry fears brought us Intel, Microsoft, Cisco Systems, and more recently Applied Materials, Cabletron, Motorola, Hewlett-Packard. Finally the recent retail industry correction brought us Home Depot, Walmart, Price Costco, and the restaurants Cracker Barrel, Outback Steakhouse, and Brinkers.

4. COMPANY SPECIFIC EVENTS: Occasionally issues or problems will occur uniquely to a certain company that are either one time non-recurring events or temporary in nature such as weather related, product transitions or other anomalies. This scenario brought us Echlin, Sensormatic, Stewart & Stevenson, United HealthCare, Forest Labs, Mylan Labs, Michaels Stores, Superior Industries, Shaw Industries.

We believe the most important point that we are presenting relates to the power of value. Each company mentioned above, as well as all the companies in your respective portfolios are, in our view, great businesses that we bought at either sensible or very low values. In reality, there may eventually prove to be a few companies among our universe that do not live up to our expectations. At this moment in time, however, we don't see any. More interestingly, we believe that the current underperformers are in actuality the best positioned for future growth. On balance, we believe your portfolio holdings represent significant long term opportunities and the added benefit of reasonable or even low risk.

In closing, I would like to comment on what we feel is the only potential negative regarding value/growth investing. Being a value investor is analogous to the fable of the tortoise and the hare. Sometimes, and perhaps often the value investor is not the quickest out of the blocks. Also, when fishing near the bottom it often turns out to be deeper than you first thought. It's interesting that our best performing companies (Intel, Merck, St. Jude Medical, Amgen, etc.) initially fell in price after we first bought them. The investing race is a marathon not a sprint. What matters most is where you finish, not how fast you start. Marathons are won by those in the best condition who pace themselves properly and possess the staying power to persevere.

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

Sincerely,

Charles C. Carnevale
President