3rd Quarter 2002

EDMP, INC. Quarterly Review

A True Story

The third quarter of 2002 is over and investors find themselves in the throes of one of the worst bear markets in history. Bear markets scare investors to a point that fear over comes reason. Fear is an extremely powerful, if not the most powerful, emotion of all. When people are gripped with fear, regardless of why, they are likely to behave in totally unpredictable ways. Consequently, I find this to be one of the most difficult quarterly reports I have ever written. How do you reason when reason is clouded by fear? However, reason we must, for it is our responsibility to provide sound counsel to you, our valued clients.

Perhaps the best way to start is with some incontrovertible truths. Truth number one: both bear markets and bull markets are facts of economic life. Truth number two: both bear markets and bull markets will begin and they will end. The end of one always, without fail, leads to the beginning of the other. Truth number three: although the occurrence of both bear and bull markets is predictable, the precise timing of either is not. Truth number four: the terms bear and bull markets are mere adjectives describing the highs and lows of normal market cycles. Truth number five: market cycles are normal functions of the working of supply and demand. Truth number six: supply and demand are the market mechanisms that empower the markets to function efficiently. Truth number seven: the long-term trend line of the market is up. This is of paramount importance and worthy of repeating. The long-term trend line of the market is up.

The primary point that we want to emphasize in this quarter's report is as follows: you have complete and total power over bear markets and they cannot hurt you unless you let them. Any self respecting park ranger will corroborate this sage advice; never run from a bear. In other words, if you sell your businesses in the teeth of a bear market, you will lose money. In essence this practice is one of self-fulfilled prophecy. The unrealized losses in your portfolio, which are for the most part temporary, become real losses and for the entire part permanent.

When scared or nervous the normal human emotional reaction is to want to do something. Regarding bear markets, there is a powerful action available to you that has always worked for those with the insight and courage to avail themselves of it. The best course of action in a bear market, or a bear in the woods, is to calmly sit tight. When you ignore the bear it will eventually go away and no harm is done. Attack it or run from it and the consequences are severe.

In order to muster the courage to stare down a bear, one must possess the knowledge of the true nature of a bear or bull market. Knowledge is power and will protect you from making foolish mistakes. Regarding investing, the true nature of a bear market is the mirror image of a bull market. At their troughs or peaks, both are classic examples of a market's tendency to mis-price companies as it seeks equilibrium. Intrinsic value or true economic worth is the market's version of equilibrium. Most importantly, intrinsic value or true worth will always manifest itself given enough time.

Perhaps the following analogy will help provide perspective. The bull market that ran from approximately 1995-2000 was a fairytale. In this fable, stocks would go forever up and all the princesses and princes would live happily ever after. The current bear market is a horror story. In this grim fairy tale the monsters (that don't really exist) are going to devour the world. Sound investing and behavior, on the other hand, is **a true story**. In reality the outcome of this non-fiction account of business principles deals with real world events. There are no ghouls or magic wands to fantasize about. Valid mathematical formulas and sound principles produce real and actual answers. So please, we encourage each of you not to make critical judgments about something as vital as your long-term financial security on fantasy. Make these judgments instead on real facts.

The real facts regarding the portfolios we manage for you are, at least as we see them, both sound and opportunistic. The majority of your holdings are industry leading, mostly blue chip companies that pay growing dividends and are performing well for us. This is true regarding stock price performance, and more importantly operating results as well. These represent a solid foundation underneath us and the potential for attractive long-term returns.

The remainder of the companies we hold are industry-leading growth companies doing business in the various areas of the broadly defined technology or telecommunications industries. These recently highflying companies are now being taken out to the woods to be shot by many investors. Therefore, their prices are down, some dramatically others more modestly. Clearly many of these companies are also suffering real operating weakness as well. However, most are financially strong with little or no debt and have cash in the bank. Therefore, we believe that the majority of the companies we own will survive this nuclear winter and once again enjoy a reemergence of a rapid growth cycle in their businesses leading to large advances in future stock prices. Therefore, our strategy is to continue to take advantage of their temporary weakness to accumulate more while this temporary opportunity is available.

Last, but not least, we have adequate cash reserves on hand to exploit this carnage. This is a most powerful advantage that we have. It is true that most of your portfolios are down this year due mostly to these technology and telecommunication holdings. It is also true that a few blue chips are down as well. However, closer scrutiny will show that this is generally only true of the blue chips we have recently been accumulating. For those of you who have been clients for 5 years or longer this is not something new. Short-term weakness is generally how we find bargains and the bottom is impossible to predict.

We remain quite confident in the future potential of the portfolios we have built for you. How successfully we allocate the remaining capital we have (the cash) will be a primary determinant of how profitable these portfolios will ultimately be. Remember, money is made by buying low, not selling low.

The most insidious attribute of the stock market is that when it changes direction, as it always does, it does so without warning and usually in advance of the fundamentals changing. This is why the recent bear market caught most investors off guard. This will surely happen when the next bull market begins, and therefore we believe it is actually more dangerous to be out of the market than in it. History bears this out.

There have only been three other times before the current bear market when the S&P has been down two or more years in a row. The first and worst was during the great depression and lasted 4 years from 1929-1932. Those investors that panicked and sold out lost 78% of their money. Those more level headed that held recovered their losses in four years and four months. The smart ones who bought more (we have the cash to do this) recovered in **three months**. The second was during World War II and lasted for three years from 1939-1941. Those investors that panicked and sold out lost 31% of their money. Those more level headed that held recovered their losses in 9 months. The smart ones who bought more (again, we have the cash to do this) recovered in **four months**. The third was the recession caused by the oil crisis and lasted two years from 1973-1974. Those investors that panicked and sold out lost 44% of their money. Those more level headed that held recovered their losses in one year eight months. The smart ones who bought more (that's right, we have the cash to do this) recovered their losses in **five months**. When stocks are low, time is on your side, trust it.

In each of these previous bear markets lasting two years or more, the recovery one year from the final bottom was huge. The depression bottom was June 1, 1932 and by June of 1933 prices rose 138%. The World War II bottom was April 28, 1942. One year later prices rose 64.3%. The oil crisis bottom was October 3, 1974 and by October of 1975 prices rose 44.4%. The point is that if we use our cash reserves wisely and buy more of our good companies at or near this bottom, and if history is any guide at all, the imminent recovery will not only recoup our losses, but

generate high profits as well. Buy low, sell high, and never the other way around. Your common sense will tell you that this is the time to buy stocks not sell them, listen to it!

The final point we would like to make regarding all this can help alleviate the fear. Even though our portfolios are down and real money appears to have vanished, it is not as dire as it looks. In market environments like we are currently in, it is not uncommon to experience high volatility. Literally on any given day the price of a company's stock can move 10-20% in either direction. This does exacerbate the apparent loss when they are falling, but it also works as powerfully in the reverse.

Atmel, a widely held tech holding, is a case in point. We started buying this company in March of 1997 at a split-adjusted cost of $6.32. We continued to add to our position for the next year and a half or so culminating in our final purchase at $2.34 in December of 1998. This process ended with our selling in March of 2000 at $20.08. The result was we, on average, quadrupled our money. Therefore, we turned what appeared to be a bad situation into an awesome one. True, this hasn't happened in every case, but it only takes a few of these to obliterate several bad ones.

Therefore, our plan going forward is to use our cash reserves to buy more shares of those companies that the bear market is unduly punishing. With this strategy we will have more shares to profit from when they advance again, than we had while the prices were falling. This will leverage our upside thereby not only recouping our unrealized losses, but enhancing our total profits as well. Naturally, we will only do this after careful analysis and research has been completed. Of course, we will continue to monitor all portfolio holdings as we always have, to be on the look out for mis-pricing and changes in fundamentals.

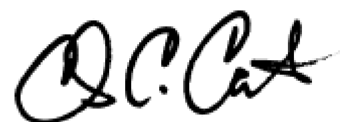
As professional portfolio managers we have trained ourselves to judge our companies based on their fundamentals rather than short term price movements. We never see a portfolio of stocks, but instead a group of real operating companies. We evaluate them based on real attributes not illusionary prices.

We are concerned with things like the thousands of productive and dedicated employees they employ, the factories and stores that produce and sell their goods and services, and the R&D departments full of scientists and future discovery. We evaluate their balance sheets and income statements, cash flows and earnings past, present and future. In short we see real businesses, run by real people, with real assets and real income streams. The market thankfully, does not always price these tangibles accurately. It is our job to exploit the market when it mis-prices. Never try to guess when the markets may zig or zag next, it's more profitable and reliable to focus instead on the future prospects of the businesses you own. Stock prices will take care of themselves in the long run.

In order to more fully illustrate the above important point we have added to this newsletter an addendum on seven broadly held stocks (companies) we currently own. Not all of you will own all of them, but all of you should own some of them. Read about them all or just the ones you own. We are confident that focusing more on the businesses and their future prospects is more important, reliable and ultimately profitable than reacting to erratic price volatility. Technology and telecommunication companies were worth a lot less than they traded at in 1999; today we believe they are worth a lot more. In short don't throw the baby out with the bath water, nurture it instead.

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

ADDENDUM

Adaptec (ADPT) is a market leader that designs and markets storage access solutions that reliably move, manage and protect critical data and digital content. The company's storage solutions are used in high performance networks. We are especially interested in this company as it is involved in a number of emerging technologies, including the current leader in developing next generation Internet Protocol storage. The company has $480 million in debt, but more than $800 million in cash, and none of the debt matures before 2007. The company is currently generating positive earnings and cash flows and we expect strong performance when technology spending resumes. We plan to add to our holdings.

Altera (ALTR) is a market leader in the design of high performance programmable logic devices (PLDs). These are semiconductors which enable customers to program them using Altera's proprietary software, and avoids the need to replace circuitry when an upgrade is made. The company continues to provide cutting edge new products that increase performance and lower overall cost of ownership. The stock price has been weak since 35% of its customers are in the currently depressed telecommunications sector. However, it continues to generate positive earnings and cash flow during the technology downturn and has no debt. We expect a strong recovery when technology spending resumes. We plan to add to our holdings.

Andrew (ANDW) is a leading supplier to the wireless communications industry whose products include coaxial cables, connectors, microwave and special purpose antennas, and power amplifiers. The company maintains leading market share, but industry fundamentals are currently very weak. Long-term prospects are excellent given that less than half the world's population has ever made a phone call, and Andrew has leading market share in developing countries, including China. The company has maintained positive earnings and cash flow during the downturn and holds only a nominal amount of debt. We plan to add to our holdings.

Dycom (DY) is the leading provider of construction, engineering, installation and maintenance services to the telecommunications and cable industries. Although its customer base includes the largest players in this industry, including Bell South, Verizon, Comcast and Cox, capital spending by these companies remains weak as the industry continues to absorb excess capacity created during the bubble period. Dycom, however, has the strongest balance sheet in the industry, with positive cash flow and no debt. In the meantime, the company has readily responded to industry weakness by lowering its cost structure, which will provide leverage to its earnings when spending resumes. The company's strong balance sheet will not only enable it to survive the downturn but also permit it to take market share from weaker players. We plan to add to our holdings.

Electronic Data Systems (EDS) is the second largest provider of information technology outsourcing. The investment thesis for this holding is that companies are continuing to seek ways to reduce their costs, and outsourcing provides an excellent vehicle to accomplish this task. With an A+ rating, and strong earnings continuing during the technology downturn, EDS looked inexpensive in the low 40s at 15 times expected earnings. The company's stock has been under pressure due to a build-up in receivables not yet collected on major contracts, causing limited positive cash conversion. However, the two primary contracts responsible for this slow cash cycle are the U.S. Navy and the government of the United Kingdom, so the quality of the payers is not an issue and free cash flow is expected to be over $1 billion in 2003. More recently, EDS announced a substantial short fall in earnings for the remainder of 2002. This surprise announcement, after confirming guidance as recently as August, caused institutional investors to dump the stock, and the opening price was at $17 down from $37. We are hard pressed to liquidate the position in the mid-teens since this represents a multiple of only 6 times our lowered earnings estimate. We do have management credibility concerns when the size of the earnings short-fall is so large, but we need to weigh the current situation to the price the market is offering us here, and we elect to hold at these prices. EDS still maintains its A credit rating and we would prefer to see more information from the company in October before acting rashly.

Safeway (SWY) is a large food and drug retailer, primarily operating in the Midwest and West. It has an extensive network of distribution, manufacturing and food processing facilities. Safeway offers its customers an extensive selection of superior quality perishables, including meat, seafood, vegetables, flowers, baked goods and a growing assortment of natural foods. We are interested in Safeway because, at time of purchase, the stock was already off 35% due to fears of Wal-Mart encroachment in the food retailing business. Although Wal-Mart has strong pricing power, we believe the two companies serve a different demographic, and Safeway has the highest industry gross margins, making it the best situated to defend its franchise. Food retailing is still highly fragmented, and it is, we believe, the smaller players who will bend under the increased competition. In the interim, Safeway did cause a temporary self-inflicted wound by instituting a shrink reduction program, which caused an unexpected sales decline due to poor execution. This is clearly fixable. The weaker economy is also causing some shoppers to trade down, but this is clearly cyclical and not secular in nature. The company trades at a P/E of 8, will generate $600 million in free cash flow this year and is aggressively buying back its stock. The company's management has a proven track record, and we intend to add to our holdings.

Duke Energy (DUK) provides physical delivery for both electricity and natural gas throughout the United States. Our investment thesis is that Duke's strong balance sheet and earnings from its regulated utility (which are stable and recurring, accounting for 70% of total profits) would provide an anchor for the company to capture market share in the unregulated energy and power trading businesses, as weaker players fall by the wayside after the Enron debacle. Although we still believe this to be true, the weakening economy has hurt electricity demand causing a power glut, and thus lower prices. At the same time, other energy traders essentially imploded, leaving no quality counter parties for Duke to trade with. The company has also been under a cloud due to industry concerns regarding bogus power trades and the California energy debacle. Management of Duke has a long tenure and is highly respected in the industry, and we would be surprised if anything amiss would have occurred at the company. The company now trades at 8 times earnings with a 6% dividend yield. With a strong balance sheet, a recent successful stock offering, and plans to be self-funded in 2003, we do not foresee any liquidity issues. Although we think Duke is the "class act" in the group, industry conditions may stay depressed until 2004. We would consider replacement if a compelling opportunity becomes available. In the meantime there appears to be limited downside risk above and beyond any further general market weakness.