4^{th} Quarter 1999
John Doe

EDMP, INC. Quarterly Review

PRESIDENT'S MESSAGE

Prudence Is Important

As we enter the new millennium, having successfully passed through the Y2K scare, we want to wish all of our clients a happy, healthy and prosperous New Year. Reflecting on the past 18 months, where sound investing was replaced by the madness of crowds, we are pleased that our portfolios overall returned an average annual return of 21%. While individual returns obviously varied due to the unique construction of each portfolio, these results far and away exceeded the results achieved by most managers who still believe that a stock price should bear some resemblance to the underlying fundamentals of the company it represents. In fact many of the best managers, with outstanding long-term track records, who dared to be associated with the word "value," suffered portfolio losses for 1999.

Wall Street will soon publish the new and abridged financial and investing lexicon for the new millennium. As professional financial advisors, we were given the privilege of receiving an advance sneak preview edition. This new financial dictionary has been significantly revised to accommodate the new paradigm of investing. According to current conventional wisdom several tried and true principles have become obsolete and therefore omitted.

Nowhere in the new reference book will you find any of the old-fashioned concepts or definitions. Gone is the word risk at least as it relates to stocks. The hot new book Dow 36,000 clearly points out that stocks no longer warrant a risk premium. The words prudence and fiduciary responsibility have also been deleted. In the new paradigm of investing, safety and prudence are for sissies. After all, everyone now knows that stocks go never-endingly up, regardless of fundamentals or sound economics. By the way you won't find words like fundamentals or sound practices in the new book either.

EDMP, Inc. will especially miss the elimination of the words value and diversification. After all, these have been the cornerstones of our disciplined philosophy since our inception. Even concepts like sensible PE ratios in line with future growth rates have been thrown out.

The new investor credo, "damn the torpedoes, full speed ahead" may be exhilarating, but also fraught with danger--real danger. With the excitement of going fast it is all too easy to ignore the consequences of a mishap. Extreme velocity can give the illusion of an early arrival while the pavement is smooth, but hit one little pothole and it often turns into terminal velocity.

Dear valued clients, the point of all this is quite simple. Regarding investing practices and long-term financial security, **prudence is important**. Most of you have spent your lifetime accumulating assets that are necessary to provide and preserve the lifestyle and future needs of you and your family. Preserving those assets are profoundly more important than doubling them. This has always been the guiding principle at EDMP and always will be.

The old Wall Street adage "sometimes the bulls win, sometimes the bears win, but the pigs never do" seems most appropriate. During more benign and normal times, investors find it easier to think clearly. People can accept the reality that in the short run either fear or greed can dominate the markets, but in the long run sound economics will rule. More importantly greed and fear are chameleons that without warning can change from one to the other instantaneously. Although greed currently prevails on Wall Street, it is important to realize that of the two, fear is ultimately the most powerful. When greed turns to fear, the consequences are usually swift, brutal and disastrous.

During calendar year 1999 there was a tremendous media buzz over the performance of the NASDAQ. It seemed like new records were achieved almost every day, and in fact, many of you asked us why you weren't enjoying the same results. The truth is you were. The NASDAQ is heavily weighted in technology stocks, which last year was the only game in town. If you were to analyze only the tech holdings in your own portfolios you will find results equal to or better than the NASDAQ on this portion of your properly diversified portfolios. More importantly, we invested in these fine companies when they were reasonably priced and therefore had lower risk. Great companies like ATMEL, C-Cube Microsystems, Computer Associates, Intel, Applied Materials, Analog Devices, Electronic Data Systems, Hewlett Packard, Motorola, 3COM, Cabletron, Cisco, EMC and Oracle were all purchased when they were cheap and out of favor. In many cases these stocks fell precipitously immediately after we first bought them.

Oracle is a classic example. It initially fell approximately 25-30% after we bought it in late 1997 making most of you angry with us. After suffering through most of 1998 with poor price performance Oracle took off and rose to an unprecedented price and valuation. We prudently sold one-third of your holdings essentially taking nearly our entire cost basis out, thereby reducing our risk to nearly zero. Once again you were mad at us for selling some of the very company you were mad at us for buying in the first place. Oracle continued its meteoric ascent and we, undaunted by your previous anger, sold a third of your remaining shares thereby pocketing a handsome profit. Yes, you were mad at us once again, but we fear not for the last time. A quick glance at your Oracle chart should convince each of you that current prices are insanely high beyond any possible economic reality. Consequently, sometime in the not so distant future you will be mad at us again for not selling it all. Portfolio management is often a thankless vocation. If the chart doesn't convince you, then try what we call the acid test.

Prudent investors know that a good investment has the ability to generate enough future cash flows and earnings to provide a return of and on original capital invested. Staying with our Oracle example, as of this writing it trades at approximately $100 per share and had $.88 per share of profit or earnings. There are 32 analysts following Oracle whose consensus forecast is for earnings to be $1.10 per share in 2000 and grow by a whopping 25% per year. The following table illustrates Oracle's optimistically expected earnings for ten years out.

Oracle

Year	**Earnings**
2000	$1.10
2001	$1.38
2002	$1.72
2003	$2.15
2004	$2.69
2005	$3.36
2006	$4.20
2007	$5.25
2008	$6.56
2009	$8.20

Total 10 yr. Earnings	$36.61

Therefore, if you pay $100 to buy a share of Oracle, you are optimistically expecting that share to only generate a total of $36.61 of cumulative profit return over ten years. This is only slightly more than one-third of today's investment. Oracle, today fails the acid test. Interestingly, our original average cost basis is approximately $16 per share which means that given the same $36.61 in future earnings, we would get over twice our original purchase price from future profits.

A second example that passes the acid test is Clayton Homes. This superb company is significantly out-performing its stock price. Clayton Homes can be bought today at approximately $9 per share and has current earnings of $1.16 per share. The consensus forecast for future earnings growth is 15% per year, only three-fifths as fast as Oracle's forecast. The following table illustrates Clayton Homes expected future earnings stream.

Clayton Homes

Year	**Earnings**
2000	$1.16
2001	$1.33
2002	$1.53
2003	$1.76
2004	$2.02
2005	$2.32
2006	$2.67
2007	$3.07
2008	$3.53
2009	$4.06

Total 10 yr. Earnings	$23.45

Therefore, if you pay $9 per share today you can reasonably expect Clayton Homes to generate $23.45 of future earnings, or more than two and one-half times today's investment. This is obviously a sound long-term purchase regardless of whether or not people are currently buying the stock.

When you have a sound economic foundation under your holdings, you enjoy the safety and luxury of being able to wait out stock market volatility. In contrast, if you bought Oracle today and it did fall to value, the devastation to long-term results would be staggering. There is a significant difference in risk between an overpriced company that falls from unjustified values and a soundly valued company that becomes undervalued. With the former, if the company's price follows future earnings, as it normally will, it can take years and years to recover. On the other hand, a truly inexpensive company can and inevitability will recover relatively quickly.

To summarize, a sound long-term investment is only accomplished through buying the right company at the right price or value. The right company is defined by its potential to successfully generate future growth of earnings and cash flows. The right price or value is where the businesses' expected future cash flows and earnings will exceed your original investment outlay. In other words, the business is capable of providing both a return of and a return on your investment.

Perhaps our greatest challenge as financial advisors and managers is to somehow get our valued clients to focus more on the fundamentals and future potentials of the businesses you own and less on current stock prices which may or may not reflect the company's true worth. This is not easy to do at times, but is precisely what differentiates long-term success from long-term failure. The remainder of this quarter's letter will be geared toward trying to get you to see your portfolios as we see them. We like what we see very much, and we are quite confident that you will too if we can paint the picture properly.

In recent newsletters we covered many of the individual companies that you currently hold, in this letter we would like to talk more generally about your portfolios' structure and position. The three primary areas we want to focus on are 1. diversity 2. balance 3. valuation.

It is our philosophy and discipline to spread our risk in a reasonably diversified manner. This strategy is about protecting your money, not maximizing returns. As Will Rogers so aptly put it, "I am much more concerned with the return of my capital than the return on it." Proper diversification does protect our money, but is also a key to achieving a superior long-term return. The debacle caused by our government's recent health care reforms is a case in point. We are currently experiencing paper losses for example in Genesis Health Ventures, but it has not destroyed our portfolios. This is a true testament to the importance and power of proper diversification. Furthermore, at current values if Genesis went to zero, the effect on our portfolios would be negligible from here. On the other hand, if Genesis recovers (which we expect), the upside will be extraordinary. In other words from here we have little or no downside and enormous upside. This is a very comfortable position to be in.

Balance is a close cousin to diversification with important differences. It is highly unlikely that all companies in a well-balanced and prudently diversified portfolio will move in tandem. Normally, some will rise, some will fall and some will remain the same. For illustration purposes let's assume that all portfolio companies were purchased at perfect intrinsic value. Let's further assume that short-term market mania doubled the price of company A and cut company B's price in half. Therefore company A is now 100% overpriced and due to this overvaluation is now a disproportionately large holding with high risk. Company B on the other hand is now 50% undervalued and a disproportionately small holding with low risk and higher return potential. The sensible action is to sell 1/2 of company A, thereby taking out our original investment which cuts our risk to zero and use the proceeds to double up on company B, assuming its long-term growth prospects are still intact. This rebalances our portfolio, lowers our risk and leverages our long-term upside.

This strategy, although prudent and powerful, normally distresses clients. Human nature is a funny thing. Without thinking most people would sell company B, the so-called loser, and invest the proceeds into company A, the so-called winner. This may actually work in the short-term because company A has momentum and company B does not. However, in the longer run, momentum will eventually wane, while sound economic value will endure.
This brings us to the third and final point, valuation. If it took company A three or four years to double, its valuation would more than likely still be sound and reasonably priced. The growth of earnings and assets now support the higher price. On the other hand, if the doubling in price occurs in a year or less, then ceteris paribus, the valuation has likely become excessive.

The point is simply this. Judging a portfolio solely on short-term market price valuation can be misleading and potentially long-term dangerous. As we have constantly pointed out, it is far more important to know a company's true worth first, and then measure current price against this yardstick. If higher than true value, then avoid; if lower, then buy and add more. This strategy does not always generate instant performance, but will almost always generate sound and superior long-term performance.

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

Sincerely,

Charles C. Carnevale
President

PORTFOLIO REVIEW