4th Quarter 2000

EDMP, INC. Quarterly Review

PRESIDENT'S MESSAGE

The Real Paradigm
The Original Paradigm

All of us at EDMP wish our clients and friends a happy and prosperous New Year. More than likely, most of us started the New Year singing Robert Burns' classic "Auld Lang Syne" (the old long ago). In light of what occurred in the financial markets in the year 2000 the first verse seems most relevant. "Should auld acquaintance be forgot and never brought to mind? Should auld acquaintance be forgot and days of auld lang syne (and the old long ago)?"

Most investors started the year 2000 forgetting the old acquaintance's prudence and sound judgment. This was a new paradigm they argued and therefore they ignored the real paradigm. Sound economic principles they ultimately learned were not an old paradigm but in truth the real paradigm.

The consequences of rejecting truth in 2000 were significant. The high flying NASDAQ ended down nearly 40% for the year and 50% from its March highs. Not only was this the greatest decline in its 29-year history, but it was also the largest decline for an index since the 47% drop for the S&P 500 during the depth of the depression in 1931. Even though NASDAQ was up 85% in 1999, people were shocked when they realized that this 40% drop in 2000 nearly erased the entire 85% gain. This old tried and true principle should never be forgotten and should always be brought to mind by investors. Investing, and the power of compounding that it is based upon, are geometric principles not arithmetic ones. This principle is easily explained and understood as follows: To take a dollar to two dollars requires a 100% gain; conversely to take two dollars to one dollar requires a mere 50% fall. This is why protecting money is so much more important than making it.

At EDMP, we are dedicated to following the old tried and true real paradigm. Sensible practices like proper diversification and only investing on sound economic valuations gave our clients relative out-performance last year, with an overall 6% gain. True we didn't make a bundle for you last year, but we didn't bet the farm on one horse and lose it all either. More importantly we currently hold a basket of excellent companies, most of which now have a cost basis below the economic value of the business. This gives us, and we hope you, a great deal of comfort and much to look forward to.

With these principles in mind we would now like to comment on the recent past, current and near future behavior and portfolio strategies we have and are implementing. For part of 1999 and most of the year 2000 we gradually pared back our tech holdings, thus selling into the height of investor irrational exuberance. Since we prudently purchased these fine tech companies at sensible values, we enjoyed significant profits in excess of what prudence would dictate. We didn't always hit the exact top but did come pretty close on numerous occasions.

With the market totally possessed with technology we found excellent value in many high quality "old economy" names that had become cheap due to investor neglect. Great established growing and profitable businesses such as ConAgra Foods, Clayton Homes, Jacobs Engineering, Carnival Cruise Lines, Illinois Tool Works, Sherwin Williams, Lancaster Colony and Diebold to name a few, have either gone up or held their value since purchased. Meanwhile, the tech stocks we sold have generally been decimated. This is a primary reason we outperformed most others during this volatile period.

There was a tax consequence of this heavy selling; it created huge capital gains for our taxable accounts. As a normal part of our customized service, we made every effort to reduce this liability through tax loss selling to offset as much of these gains as reasonably possible. Since there was no escaping the bear market in technology for even reasonably priced companies, several of our recently purchased technology companies got crushed by the selling wave. These would include WorldCom, Adaptec, Computer Associates and Compaq.

What's important here is that we did not lose our confidence in these fine companies, nor did we feel we paid more than their economic worth in the first place. We are simply taking advantage of our tax code for our clients' benefit. Some examples of our thinking will hopefully prove helpful. We executed a planned double down on WorldCom in taxable accounts, waited the appropriate time, then we sold the high priced half for realized losses, and kept the low priced half for future profit. Please note that in non-taxable accounts we kept it all using the double down to lower our cost. In another example we sold Compaq and immediately replaced it with Motorola. Adaptec was sold and will either be repurchased after 31 days or replaced with an equivalent company depending on what the market gives us.

The beginning of a new year is traditionally a time for reflecting on the past and contemplating the future. More often than not this exercise can cause people to make a classic error, especially regarding investing. Human beings tend to get so caught up in the present (or recent past) that they project it into the future. In other words if things are currently good they simplistically project good times ahead and vice versa. This explains the classic investor behavior where value funds were sold in 1999 when they were cheap to buy technology funds at the top. Yes, they bought what should have been sold and sold what should have been bought. For example the Janus Twenty fund, which everyone bought at the top, was down 45% last year, while the value funds rose or held value.

This is a prime reason why investing based on sound economic principles is so important. It's all about thinking things through to their logical conclusion. When technology stocks got so high in 1999 and the first half of 2000 all you had to do was run the numbers to see the danger and folly. Even if you used the highest expectations of future earnings growth, the numbers were not good enough to give an acceptable long-term return on investment. The parabolic advance in the stock prices, however, clouded judgment. The future for technology was and is extraordinary, only the prices of their stocks were out of line, not their future business prospects.

What all this means for EDMP and our clients' portfolios is most exciting. Those reckless investors that believed that technology stock prices would never endingly rise, now believe that they will never endingly fall and are therefore selling.

Thus, some of the worlds greatest technology companies are becoming reasonable or even cheap. Log onto our website and run a chart on Intel to see what we are referring to. We don't believe anyone would argue that Intel is a better buy today than it was in September of 2000. One caveat is in order, when a bubble bursts it usually requires an extended healing time before the next advance. Additionally, many if not most of the Dot Coms with no real business prospects may never recover. The good companies like Intel, however, most certainly will; it's only a matter of time.

We would like to caution our clients that there often is a recurring psychological pattern to bear markets such as we are currently experiencing, particularly with regard to NASDAQ. The first phase is disbelief, which we saw in March after the first sharp decline. Many saw this as an opportunity to buy more, especially those who felt they had missed the huge gains the first time. One look at our charts showed that even with this decline, valuations were still way too high and many techs should have been avoided. The second phase is acceptance, which we believe we are currently experiencing. People feel disappointed and upset that the staggering gains vanished, and accept the losses as a painful reality. This gnawing feeling, in many cases, can lead to the third and final phase of the bear. People begin to assume that the bad times will continue and succumb to a sense of fear of much greater losses. This fear can lead to panic selling where their brains succumb to their emotions. This is the most dangerous phase to investors because you sell your stock at the very bottom before the next bull phase. Hopefully, we will not experience this final stage, but if we do, remember to resist the temptation to give away your cheap holdings in a blind panic. This is the worst thing you can do for your long-term financial well-being. Remember, that bull markets always follow bear interruptions. More importantly, remember that we protected you as best we could by never chasing over valued stocks in the first place, so we have solid fundamental values to begin the next bull run.

The point, and it is an important one, is this: The world is not coming to an end, at least economically speaking. Technology and the many solid old economy companies alike will prosper and grow in the long-term future. Bad stock markets are great opportunities to buy good businesses cheap. This reduces your long-term risk and increases your profit potential. It has been a long time since we have had so many great companies priced so reasonably. We are salivating, you should be too.

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

Sincerely,

Charles C. Carnevale
President