4th Quarter 2004

EDMP, INC. Quarterly Review

Back to Normal

Calendar year 2004 completed what could only be described as one of the most anomalous 10 year periods in stock market history. Starting in 1995, the stock market soared to irrationally exuberant levels that culminated in the spring of 2000. From these lofty unsustainable levels the market had no choice but to correct itself to more reasonable valuations over the next several years. These extreme market conditions created much investor concern and confusion as well as several challenges for professional portfolio managers like EDMP, Inc. However, it's important to remember that within every challenge lies the seed of an equivalent or greater benefit. Consequently, we at EDMP enter 2005 with our eyes on the opportunity ahead.

The rationale for reflecting on the past ten years is vitally important for investors. First of all, having a clear perspective on where we have been and where we are now is the only way we can effectively plan for where we need to go. Unfortunately, many investors have been so traumatized by the past ten years that they have lost a clear perspective. Therefore, they are engaging in extreme behavior which we fear is risky and potentially ruinous. For example, so called alternate investments (Hedge Funds), have recently become popular. Typically these are market timing vehicles, which we believe is impossible to do, or worse yet highly leveraged (risky) investment vehicles. Taking on greater risk to avoid perceived risk is not in our view a prudent way to plan for the future.

In essence, what is happening is that people have lost confidence in the quote unquote "stock market." This is somewhat humorous to us at EDMP, since we have never believed in the stock market in the first place. However, we understand that most investors think in stock market terms which therefore make their confidence in it rather important, at least in the short run. Aberrant behavior can and often does lead to aberrant short-term results and therefore cannot be totally ignored. Instead, aberrant behavior can be exploited to your extreme benefit if your thinking is clear.

The important question here is, if the stock market is not important what is? EDMP, believes that the answer is the future earnings growth of the businesses you own and the valuation the market places on them. The true explanation of what has been going on for the past ten years is simple and straightforward. During the first five years (1995-1999), the stock market overvalued earnings to extremes rarely seen before, which led to the necessity to bring valuations back to normal over the last five years (2000-2004). The first five years made investors overconfident and the last five years have now scared them to death. Greed and fear are not rational principles upon which to base investing decisions. Sound business principles on the other hand are, which is why EDMP focuses on business operating results in lieu of the stock market.

The most important reason for sharing this perspective with you is to clarify EDMP's behavior relative to the positioning of your portfolios going forward. As previously mentioned, these anomalous stock market conditions presented us several challenges that had to be dealt with. The first five years, the overvaluation period, forced us to sell many of our favorite holdings which had become dangerously overvalued as our discipline dictated. As hard as that was to do, it was nowhere near as hard as finding attractively valued businesses to replace them with. Fortunately, through diligent effort we were successful; unfortunately the advances were so powerful they did not stay in value long. As a result, a portfolio that came to us in January, for example, could be made up of significantly different names than a newer portfolio that came in April. This behavior was consistent with our sacred principle of only buying at value and therefore was the right thing to do for each client. It is a great testament to EDMP's philosophy that it is flexible enough to accommodate the unique goals and objectives of each respective client regardless of general market conditions. In fact, it was this very flexibility that enabled us to preserve client capital during the severe bear market of 2000 through 2002. In short, we didn't lose our clients' capital as so many of our peers did. We are quite proud of that.

As the stock market has now begun to rationalize itself back to near normal levels, another important EDMP investing principle has come to the forefront. EDMP has always held that each of our clients deserved to benefit from our best practices and thinking. Just as the stock market had to re-calibrate itself, EDMP has to now re-calibrate your portfolios as well. Please understand that this does not imply correcting past mistakes, quite the contrary. In our humble opinion, EDMP superbly navigated, on your behalf, through one of the most treacherous and aberrant stock market periods of all time.

In plainer English, what we are talking about is resetting your portfolios **back to normal**. This means that you will temporarily experience more turnover (buying and selling) than you are accustomed to seeing with us. On the sell side there are various reasons for our action. In some cases, we will be selling companies we still like, but have become overvalued (CCL, DBD, SHW, CAG). In other cases we will be selling companies that can be replaced by better opportunities in similar industries. In a few cases we will be selling companies where the fundamentals no longer support our capital commitment. However, in all cases, we will be selling so we can buy more attractive names. This is the part we are most excited about.

To clarify even further, during the overvaluation period, EDMP, through our disciplined valuation procedures, clearly recognized the associated high risk. Therefore, based on our prime directive, to first protect your money, we positioned your portfolios more defensively than we would under normal circumstances. Consequently, by preserving capital we now have the capital to take advantage of the significant opportunities that the market's correcting process has manifested. Therefore we are quite excited regarding these opportunities that the market is now presenting us. This has been a long time in coming, but we believe it will prove to be worth the wait.

It is important to also point out that the stock market in general is still rather richly valued based on historic standards. In other words, the correcting process continues but is not yet finished. This is important because we do not expect your portfolios to correlate to the general stock market. Frankly, in the longer run we expect them to strongly outperform. The reasoning behind this confidence is simple and straight forward. The companies that we own and are keeping, in conjunction with the newer names we are adding, are forecast to grow earnings faster than the market and carry PE ratios at or below the market. Therefore, we believe your portfolios are properly valued to harvest the opportunity their future earnings growth offers, even though the market is not.

We would like to close this quarter's letter by sharing an excerpt from last, year's Berkshire Hathaways annual meeting courtesy of "Outstanding Investor Digest." A shareholder made the following comments and asked the following question: "In view of the Iraq war, increasing consumer debt, declining job growth, declining pay in the jobs that are growing, prospects of increased interest rates, he has this view that the next five to 10 years are going to be very difficult. What would your view be about the investment future for the next five to 10 years in view of all these negative factors going on?"

Mr. Buffett's response: "Well, I would say that at any given point in history-including when stocks were their cheapest-you could find an equally impressive number of negative factors. I mean, you could've sat down in 1974, when stocks were screaming bargains, and you could've written down all kinds of things that would've caused you to say the future was just going to be terrible. And similarly, at the top, or any time, you could write down a large list of things that would cause you to be quite bullish."

The importance of what Mr. Buffett is addressing here can not be emphasized enough. Neither worrying about the future (fear) nor having a Pollyanna outlook (greed) has ever made investors money. Instead what is needed is a practical, realistic, and level-headed approach and outlook. Mr. Buffett accentuated this point as he continued answering his shareholder's question. "There have always been problems and opportunities. We really don't pay any attention to that sort of thing. You might say that our underlying premise- and I think it's a pretty sound underlying premise- is that this country will do very well. And then particularly, it will do well for business. Business has done very well. The Dow went from 66 to 10,000+ during the 100 years of the 20th century. And we had two world wars, nuclear bombs, flu epidemics, the Cold War- you name it. There will always be problems- and there will always be opportunities in the future. But in this country, the opportunities have won out over the problems over time."

The moral of the story is to think specifically about what you own, rather than more generally about things you do not (the stock market). Our goal is to generate above average long-term performance at below average long-term risk. We believe the best way to accomplish that goal is to buy above average or superior businesses. However, the most important thing to get right is valuation.

Most of the turnover EDMP has ever generated was based on valuation, rarely has it been based on a mistake, and never on an opinion about market timing. We believe the turnover you are seeing now is based on enlightened opportunism. When this process is complete, we believe your portfolios will possess the following exciting characteristics: Historical Earnings growth, significantly higher than the market, in general with the accompanying track record significantly higher as well. More importantly, forecast earnings growth significantly higher than the market in general and current PE ratios either lower than the market or at least less than or equal to their respective growth rates. Consequently, we envision superior future performance at lower real risk.

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