THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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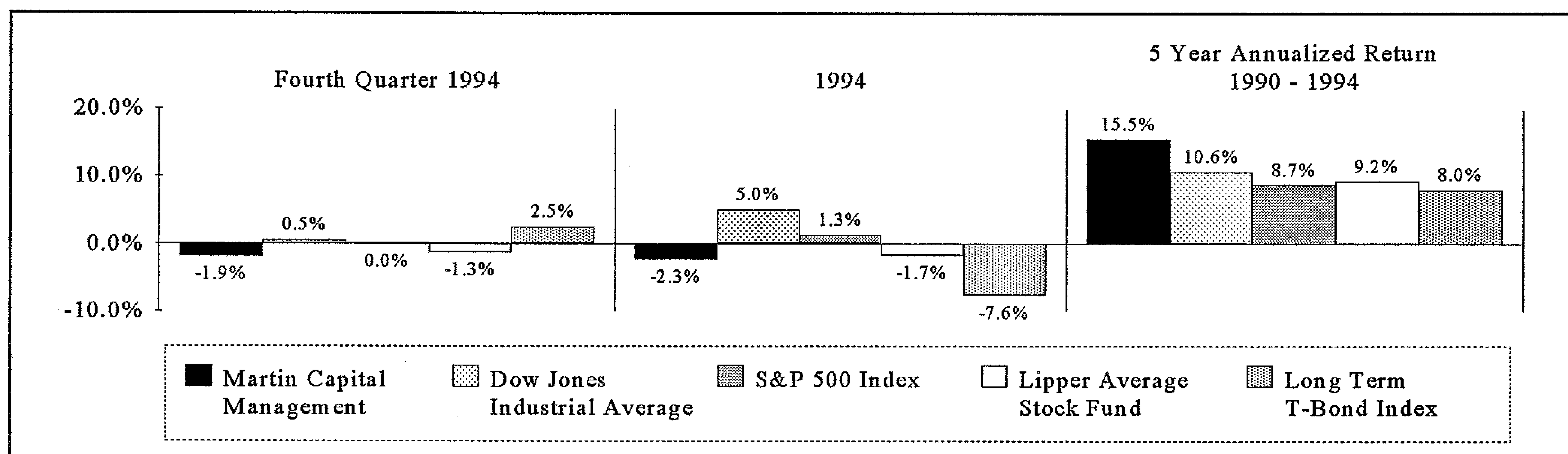
January 1, 1995

DJIA 3834.44 / S&P500 459.27 / NASDAQ Comp. 751.96 / Wilshire 5000 4540.62 / Long T-Bond Index 7.98% (5130.02)
3 month T-Bill rate 5.53% / Federal Funds Rate 5.5% / Discount Rate 4.75% / Prime Rate 8.5% / Inflation (CPI) 2.7%
Federal Reserve Dollar Index 88.72 / Oil $17.75 / Gold $383.10 / GDP (3Q) 4.0%

Investment Results



Investment Perspective

1994 proved to be a difficult year for the financial markets. Despite inflation actually falling since the end of last year, the bond market and the Federal Reserve Board chose to ignore fundamental disinflationary influences in the economy, and instead focused on the notion that any growth has to be inflationary. Fixed income instruments suffered their worst performance in many years - with some securities, such as 5 year notes, having their worst performance on record. On the surface, the stock market managed to hold up rather well considering the huge increase in interest rates. Although many of the indexes were fairly flat for the year, it was an extremely treacherous market, as most stocks were individually far more volatile than indicated by the neutral net performance of the indexes. Considering the investment carnage that many money managers experienced, we were fairly relieved to finish the year with only slight losses in most portfolios.

The first quarter of 1995 should show a substantial improvement for both stocks and bonds. Contrary to most analysts expectations, we believe short-term interest rates will not rise much further from current levels, and may even start to back down by the end of the quarter. Long treasury bond rates should also fall below 7.5% as the economy slows toward a sustainable 3% rate of growth and inflation remains in check. Sometime during the first half of the year, instead of the inverted yield curve most economists predict, accelerating reductions in short-term rates should put the yield curve on a positive slope as the economy moves toward a successful "touch and go landing". U.S. monetary stability and high real rates of return will stimulate a shift from foreign to domestic assets as the year progresses, thus strengthening the dollar and enhancing the performance of U.S. financial markets.

The way the bears growl you would think 1994 was a total disaster and 1995 is going to be even worse. Sure, the fixed income markets were savaged, but as we have repeated more than once, *investors* should be diversified, and not be surprised when "safe" investments turn out to be not as safe as they appeared. Risk can be managed, but it can not be avoided. While we were disappointed with the performance of the financial markets in 1994, we believe that the case for the secular bull market remains intact. As the financial markets begin to accept the fact that we are on the downhill slope of the 1970's/80's inflationary mountain, higher levels of growth will be tolerated without assuming high inflationary consequences in the pricing of stocks and bonds. Just as a stock with a sustainable high rate of growth justifies a higher valuation, higher economic growth with low inflation, which should prevail for at least the next ten to twenty years, justifies higher market valuations. For a long time into the future the positive macro-economic impact of baby-boom demographics, technological innovation, and global economic expansion will more than compensate for the correctable and transitory problems on which the bears have made their case for many years without vindication.

Recommended Asset Allocation

Stocks	95%	(Δ +05%)
Bonds	15%	(Δ +05%)
Cash	-10%	(Δ -10%)

Market Timing Viewpoint

	Three Month Performance Expectation January 1, 1995 to March 31, 1995					
	Optimistic		Most Likely		Pessimistic	
DJIA/S&P500:	4200/510	(+10.0%)	4000/485	(+05.0%)	3650/440	(-05.0%)
T-Bond Index rate:	7.2%	(+10.0%)	7.5%	(+05.0%)	8.3%	(-05.0%)

	One Year Performance Expectation January 1, 1995 to December 31, 1995					
	Optimistic		Most Likely		Pessimistic	
DJIA/S&P500:	4800/575	(+25.0%)	4400/535	(+15.0%)	4200/510	(+10.0%)
T-Bond Index rate:	6.4%	(+20.0%)	6.8%	(+15.0%)	7.5%	(+05.0%)

20 Largest Common Stock Positions

(Prices as of December 31, 1994)

Apple Computer	39.00	Electronic Arts	19.25	Michaels Stores	34.75	Southwest Airlines	16.75
Applied Materials	42.25	Hewlett-Packard	99.875	Microsoft Corp.	61.125	Taco Cabana	9.00
Best Buy	31.25	Home Depot	46.00	Motorola	58.00	Texas Instruments	74.875
Dell Computer	41.00	Intel	63.875	Office Depot	23.5313	Waterhouse Invest.	12.25
Egghead, Inc.	11.75	Lotus Development	41.00	Schwab (Chas)	34.875	Williams-Sonoma	30.0625

Investment Philosophy

Our investment approach focuses on the reality that in order to achieve long-term superior performance there must be an acceptance of some amount of short-term risk. With this in mind, we pursue an investment allocation strategy emphasizing a diversified mix of stocks and bonds - structuring our clients' portfolios according to their ability to withstand short-term volatility in the pursuit of long-term investment performance.

Both fundamental and technical factors are taken into account in determining a prospective investment's risk-reward ratio. Socially responsible issues, such as environmental policies and employee relations, are evaluated as part of our investment risk assessment.

Overall market risk is considered in the timing of investment decisions and the implementation of hedging strategies. The reduction of investment exposure during periods of high market risk, and the complementary increase of investment commitment during periods of low risk, should normally reduce volatility and enhance portfolio performance.

Our general goal, which will vary depending on market conditions and individual client risk tolerance, is a 15% to 20% average annual return over the course of a five year period or market cycle. We expect this goal can be achieved with minimized volatility through our combination of risk-reward analysis and market timing strategies.

Comparison of Investment Results

		Performance of Relevant Indexes					
	Martin Capital* Management	Dow Jones Industrial Average	S&P 500 Index	Wilshire 5000 Index	Long-Term T-Bond Index	Money Market Avg. Yld.	Consumer Price Index
1989	+ 37.9%	+ 32.4%	+ 31.5%	+ 29.2%	+ 18.9%	+ 6.5%	+ 4.8%
1990	+ 5.8%	- 0.5%	- 3.2%	- 6.2%	+ 6.3%	+ 5.9%	+ 6.1%
1991	+ 38.2%	+ 24.5%	+ 30.6%	+ 34.2%	+ 18.5%	+ 5.2%	+ 3.1%
1992	+ 27.1%	+ 8.0%	+ 7.7%	+ 9.0%	+ 8.0%	+ 3.3%	+ 3.0%
1993	+ 13.2%	+ 18.1%	+ 10.0%	+ 11.3%	+ 16.9%	+ 2.5%	+ 2.7%
1994	- 2.3%	+ 5.9%	+ 1.3%	- 0.1%	+ 1.5%	+ 2.4%	+ 2.7%
Total**	+183.3%	+119.5%	+ 99.5%	+ 97.1%	+ 74.7%	+ 28.6%	+ 24.5%
Avg. ***	+ 19.0%	+ 14.0%	+ 12.2%	+ 12.0%	+ 9.7%	+ 4.3%	+ 3.7%

* Total annual performance, net of commissions, fees, and expenses, of all discretionary investment portfolios.
** Total compounded return, including reinvestment of dividends and interest.
*** 6 year annualized return (1989 - 1994).

(Past performance does not guarantee future results.)

Martin Capital Management is a registered investment advisor, managing discretionary investment portfolios on a percentage fee basis for individuals, trusts, and pension plans.