THE COMPASS

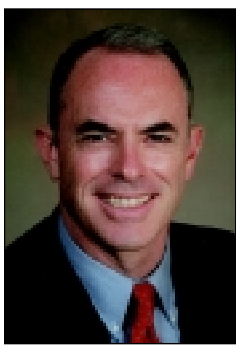
Third Quarter, 2001 A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stock market stabilizes in anticipation of economic recovery

July 8, 2001

The stock market advanced during the second quarter in anticipation of an economic rebound later this year. Bonds prices fell due to the concern that faster economic growth may fuel inflation. We maintained our bullish stock market posture throughout the quarter, but sold all bond positions for flexible portfolios in April.

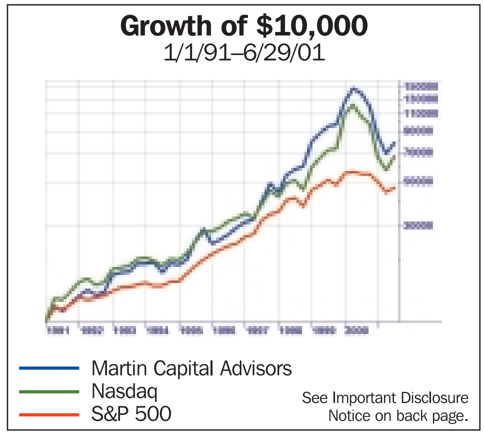


The Federal Reserve Board cut rates three times in the second quarter, lowering the Fed Funds rate to 3.75%. Short-term interest rates are now low enough for the economy to start to recover and the stock and bond markets have begun to sense this recovery. Volatility, however, has continued to be a disruptive factor as various economic indicators continue to generate mixed signals. This confusion about where the economy is going is always present at cyclical troughs. By the end of the third quarter the economic recovery should be better established. This should result in a further improvement in stock market performance and a continuation of lackluster bond market returns. Accordingly, we will maintain much higher than normal stock market positions and no bond positions for flexible portfolios.

The past year has been extremely difficult for growth oriented investment portfolios. Now that the worst is most likely behind us, the next several months may prove to be the most frustrating. Even as the stock market continues to rebound many investors may lose patience with erratic economic data and inconsistent corporate earnings reports. Every stock market decline will renew concerns about losses already suffered. Rallies will be seen as opportunities to take profits and adjust portfolio positions in preparation for further declines. The best approach to this period of uncertainty is to maintain consistent investment positions and not lose sight of the positive long-term U.S. and global economic fundamentals.

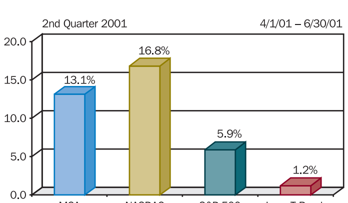
There is a high probability that the second quarter's positive stock market performance may prove to have marked the beginning of a new cyclical bull market. The U.S. economy, and hence the stock market, should rebound significantly over the next several years. Although there will be many ups and downs as the new bull market unfolds, I believe that investors owning shares at today's prices in good quality, high growth companies will be well rewarded for their patience as the U.S. economy returns to above average growth.

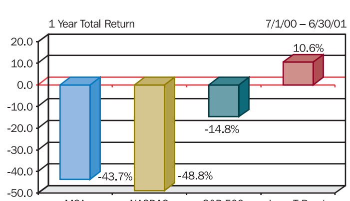
MCA Flexible Portfolios
12-month Tax Efficiency: 95.1%
(After Tax Return divided by Before Tax Return)

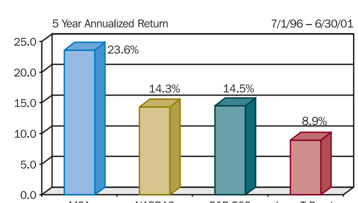


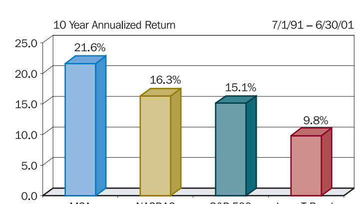
INVESTMENT RESULTS

Martin Capital Advisors Flexible Portfolios vs. NASDAQ Composite, the S&P 500 Index and the Lehman Brothers Long Treasury Bond Index









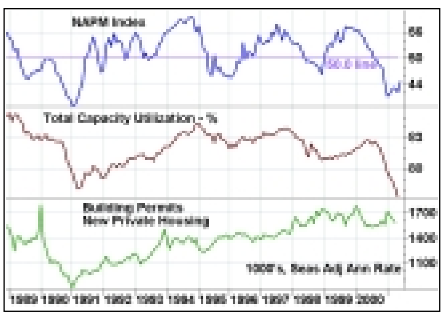
—— See Important Disclosure Notice on back page. ——

QUARTERLY ECONOMIC REVIEW by Alston Boyd, Economic Director

Economic growth has slowed dramatically in the past year as a result of the Fed's tightening of monetary policy in 1999 and 2000. The attached table of Market and Economic Statistics shows the extent of the decline. The Fed reversed its tight monetary policy this year by cutting rates sharply in an effort to stop the decline. The Fed Funds target has dropped 25% in the last quarter and 45.8% in 12 months. This effort to speed up the economy will eventually succeed and some signs have recently appeared that hint at the beginning of a recovery. As these positive signs are only tentative so far, negativity about corporate earnings still dominates the financial markets today.

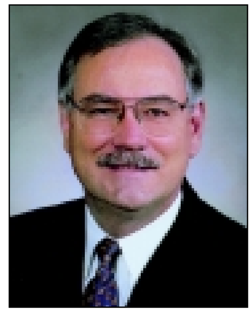
MANUFACTURING

The manufacturing sector continues to be the hardest hit in this slowdown. The North American Purchasing Managers Index (top chart at right)



rose slightly in June to 44.7, though still remaining below the 50.0 line separating growth from contraction. June was the 11th straight month of contraction measured by that index. The Industrial Production Index, another important manufacturing indicator, was down 0.8% in May and down 2.8% in 12 months, the largest 12-month decline since the last recession. Total capacity utilization fell to 77.4% and capacity utilization in manufacturing to 76.0% in May, the lowest levels since 1983. Hopefully, the slight upturn in the NAPM Index registered since the January low is the beginning of a return to more normal conditions. This index led on the way down and it may well be the leader on the way back up.

Housing has remained a relatively bright spot in the economic picture, avoiding a severe decline like the one in 1990. The relative resilience of this sector has resulted from a combination of low mortgage rates and relatively high consumer confidence. Though consumers have been shaken by the downturn in the economy, the drop in confidence has not been as extreme as in previous cycles and it has actually rebounded off the low.



SALES

Though the rate of growth in retail sales over 12 months slackened in 2000 and 2001, it did not turn negative and now shows a tentative reversal to the upside. Auto and light truck sales have remained strong over the past year, with sales of 17.1 million units in June being roughly equal to the average of the past two years. Sales of both existing and new homes have remained strong all during the current economic slowdown. The relative strength of sales of these big-ticket items in the face of the current downturn is due to several factors. Relatively high consumer confidence and low interest rates have been important. Even more important, however, is the fact that most workers in this country are still employed, earning wages that they turn around and spend. As consumer spending makes up two-thirds of our economy, these issues of confidence and income are critical. Strength in sales of these items points to the fact that the current economic slowdown has not been caused by consumers cutting back, but rather by businesses cutting capital spending.

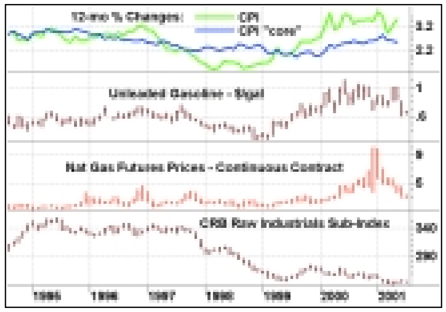
LABOR

Conditions in the labor market worsened with a net loss of 114,000 jobs in June. The unemployment rate rose from 4.4% to 4.5%, though such a low rate would have seemed impossible as little as five years ago. In spite of the loss of jobs and negative emphasis by commentators, underlying conditions don't seem to be getting much worse. The unemployment rate is a distinctly lagging indicator and the monthly change in the number of non-farm jobs, though important, is volatile (see chart at right). An important indicator that is coincident with the economy rather than lagging it is the number of initial unemployment claims filed each week, a measure of the number of people losing their jobs. The past three monthly averages are just over 400,000, high compared to the low of 263,000 in March 2000. The middle chart at right shows a different way of looking at those unemployment claims: dividing them by the total number of non-farm jobs shows them as a percentage of the workforce. The resulting curve shows that this percentage is now about equal to the average of 1993-1995, a level that is relatively mild rather than shocking. The percentage has been virtually flat at 0.31% over the past three months, so we may be seeing a plateau. Also, people out of work found new jobs in less time during June than previously, another positive note. The average number of hours worked per week is another coincident indicator that is often ignored. The figure for June was 34.3, roughly the average since late last year. Employers are ordinarily reluctant to hire or fire people, so they increase or decrease the number of hours their employees work according to their needs. Likewise, average hours of overtime, which seem to have bottomed out at 3.9 per week, rose to 4.0 in June. Some economists predict massive layoffs by businesses desper-

ately trying to cut losses, but these predictions make no allowances for an improvement in the economy during the second half of this year. The job market and unemployment rate follow the economy, they don't lead it.

INFLATION

The current inflation rate in our economy indicated by the 12-month change in the Consumer Price Index is 3.5%. Roughly 2/3 of the half-percent increase in May was due to energy. The "core" rate of inflation, which excludes the volatile food and energy sectors, is 2.5%. Two categories, housing and medical care, rose 4.6% in 12 months, but the primary source of inflation in our economy today is energy. Oil prices rose sharply throughout 1999 into 2000, and then stabilized. Today's price of roughly $26/bbl is already lower than a year ago. The chart at right shows that gasoline prices at the wholesale level are near a two-year low. Natural gas made the news last winter, when shortages developed and prices vaulted to $10/mcf. Now they are near $3. Consumers evidently decided to drive less and the economic slowdown has helped cut consumption of gasoline, causing prices to fall. These lower energy prices presage a drop in our overall inflation rate. Looking elsewhere, the CRB Sub-Index of raw



industrial materials prices (bottom chart) is close to a 15-year low. Most companies with products to sell in the marketplace today are stuck with no pricing power. Purchasers refuse to pay more so even if costs go up, product prices have to stay the same. Therefore, margins shrink and earnings decline. Worldwide competition today is tough, holding down prices, inflation and profits all at the same time – a strongly deflationary factor. The strong US dollar has made it harder to sell our products by making them more expensive in other countries. On the other hand, it has also held down inflation in this country by making imports cheaper.

SUMMARY AND OUTLOOK

The current economic slowdown will probably not extend to two consecutive quarters of negative GDP growth, the benchmark for a recession. Nevertheless, the severity of the slowdown, from an annualized rate of 8.3% in the last quarter of 1999 to 1.0% a year later, means that we have experienced the equivalent of a recession, whether we have reached the official definition or not. Manufacturing has been hardest hit because of the big cuts in business capital spending. Consumer spending has not declined, a factor that has kept the economic situation from becoming even worse. The Fed started aggressively easing monetary policy in early January and six months have now gone by since the first rate cut. It normally takes six to nine months for a change in fed policy to begin to affect the economy and I believe we are close to the threshold of a turnaround. Consumer confidence and the North American Purchasing Managers Manufacturing and Non-Manufacturing Indexes may be the first indicators to show that economic growth is beginning to quicken instead of slow. Recent labor market data is ambiguous, though negative news about lagging economic data has been far more accentuated in the media. If we see the average of initial unemployment claims begin to ease, it will lend more weight to the idea of an upturn. The recovery will come – the only uncertainty is when. I believe we will start to see clear signs at least by late August that economic growth is beginning to accelerate.

MARKET AND ECONOMIC STATISTICS

as of Market Close June 29, 2001, with 3-month and 12-month changes

1st Quarter '01	Final	3 mo	12 mo
GDP-Bil$	9423	1.2% apr	2.5%
GDP Deflator	108.5	3.2% apr	2.3%
Empl Cost Index	152.3	1.1%	4.0%
NF Productivity	119.1	–1.2% apr	2.5%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10502	6.3%	0.5%
S&P 500	1224	5.5%	–15.8%
NASDAQ Comp	2161	17.4%	–45.5%
NASDAQ 100	1833	16.5%	–51.3%
NYSE Comp	622	4.4%	– 3.5%
Wilshire 5000	11407	7.2%	–16.2%
Russell 2000	513	13.9%	– 0.8%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	3.45%	–17.7%	–40.9%
30-yr T-Bond Yld	5.76%	5.7%	– 2.2%
FNMA 30yr mortg	7.23%	3.4%	–12.2%
Prime Rate	6.75%	–15.6%	–28.9%
Fed Funds Trgt	3.75%	–25.0%	–42.3%
Fed Disc Rate	3.25%	–27.8%	–45.8%
S/L Long T-Bnd Ind	9517	– 1.6%	10.1%

PRICES, INFLATION		3 mo	12 mo
CPI, May	177.5	0.7%	3.5%
PPI, May	142.2	0.3%	3.7%
Gold, cash	270.6	5.0%	–6.6%
W Tx Int Cr Oil	26.24	–0.8%	–17.5%
Copper, cash	0.71	–6.7%	–13.2%
CRB Futures Ind	205.6	–2.2%	–8.2%
CRB Raw Indust	246.2	1.8%	–4.6%

MONEY			
M2, Bil Curr$, May	5167	2.5%	8.4%
Free Reserves	1047	–21.0%	64.1%
Money Mkts - Bil$	2105	1.3%	25.0%
US $$$ Index	119.4	1.7%	9.2%

INDUSTRY			
NAPM Index, Jun	44.7	1.6	–7.4
Indus Prod Ind, May	143.1	–1.6%	–2.8%
Cap Utiliz, May	77.4%	–2.2%	–6.4%
Bldg Permits, May	1621K	–2.5%	5.3%

LABOR – Jun. '01			
Unemployment Rate	4.5%	0.2%	0.5%
New Non-Farm Jobs	–114K	–271K	+414K
Avg Hourly Wages	14.29	0.8%	4.2%
Avg Init Unempl Clms	413K	+36K	+113K

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

Stocks	135%	Δ	0%
Bonds	0%	Δ	0%
Cash	–35%	Δ	0%

Performance Expectation

	July 2002		*July 2006*	
	Target	Total Return	Target	Total Return
S&P 500	1650	+35%	3700	+200%
NASDAQ	3600	+65%	8400	+290%
30-Yr. T-Bond	5.5%	+ 5%	4.7%	+ 40%

MARTIN CAPITAL

U.S. OPPORTUNITY FUND

	NAV	YTD	Annual-ized	Since Inception
U.S. Opportunity Fund-MCUSX*	$8.14	–15.03%	–8.44%	–18.01%

*Inception Date was 4/1/99. Obtain a prospectus and read carefully before investing. Call 1-877-477-7036 for a copy. Mutual funds are subject to investment risks, including possible loss of the principle amount invested. Distributed by Unified Financial Services, Inc. Past performance is no guarantee of future results.

Net Asset Value per Share as of 6/30/01

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Computer	26.15	6	Charles Schwab	15.30	11	Tiffany	36.22	16	Whole Foods Market	27.10
2	Nasdaq 100	45.70	7	Oracle Systems	19.00	12	Intel	29.25	17	Citigroup	52.84
3	SPDR Trust	122.60	8	Advent Software	63.50	13	Cisco Systems	18.20	18	Electronic Arts	57.90
4	Enzon	62.50	9	Texas Instruments	31.50	14	Home Depot	46.55	19	LAM Research	29.65
5	Applied Materials	49.10	10	Microsoft	73.00	15	Advanced Micro Dev.	28.88	20	Starbucks	23.00

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	Dow Jones Industrial Avg.	S&P 500 Index	NASDAQ[2]	Wilshire 5000 Index	Long-Term T-Bond Index	Money Market Avg. Yld.	Consumer Price Index
1991	+33.9%	+24.5%	+30.6%	+56.9%	+34.2%	+18.5%	+5.2%	+3.1%
1992	+26.8%	+8.0%	+7.7%	+15.5%	+9.0%	+8.0%	+3.3%	+2.9%
1993	+14.5%	+18.1%	+10.0%	+14.8%	+11.3%	+17.3%	+2.7%	+2.7%
1994	–2.1%	+5.9%	+1.3%	–3.2%	–0.1%	–6.9%	+3.8%	+2.7%
1995	+27.5%	+36.9%	+37.6%	+40.0%	+36.5%	+30.7%	+5.5%	+2.5%
1996	+29.4%	+29.1%	+23.0%	+22.7%	+21.2%	–0.8%	+5.0%	+3.3%
1997	+41.4%	+24.9%	+33.4%	+21.6%	+31.3%	+15.1%	+5.1%	+1.7%
1998	+78.8%	+18.1%	+28.7%	+39.6%	+23.4%	+13.5%	+5.0%	+1.5%
1999	+58.2%	+27.2%	+21.0%	+85.6%	+23.6%	–8.7%	+4.9%	+2.6%
2000	–33.0%	–4.9%	–9.1%	–39.3%	–10.9%	+20.1%	+5.8%	+3.2%
2001 YTD	–6.8%	–1.8%	–6.7%	–13.0%	–5.8%	+0.5%	+1.8%	+1.8%
Total[3]	+684.3%	+421.4%	+373.3%	+474.8%	+352.2%	+160.6%	+59.8%	+32.0%
Avg.[4]	+21.7%	+17.0%	+16.0%	+18.1%	+15.5%	+9.6%	+4.6%	+2.7%

[1]Total Annual Performance, net of commissions, fees, and expenses, of all Martin Capital Advisors flexible investment portfolios. Audited 1991-99 by Carpenter & Langford, P.C., Certified Public Accountants. [2]Without dividends. [3]Total compounded return, including reinvestment of dividends and interest. [4]1991-2001 annualized return.

IMPORTANT DISCLOSURE NOTICE: Past performance does not guarantee future results. Figures include the reinvestment of all dividends received and reflect cash and cash equivalents. The volatility of the Flexible Portfolios may differ from that of the benchmark. From time to time, portfolio performance may reflect the use of margin investing as well as material investments in bonds or cash. The manager will utilize stocks, bonds and cash in an attempt to enhance returns. The Flexible Portfolio average represents 64 individual portfolios and 44.8% of all funds under management by MCA on 6/29/00. Clients explicitly elect this management style on their personal data form. The Flexible Portfolios are tactical asset allocation investment accounts containing stocks and bonds that are managed with a view toward capital appreciation.

INVESTMENT PHILOSOPHY

Our investment approach recognizes that to achieve long-term, superior performance, there must be an acceptance of some short-term risk. We pursue an investment allocation strategy that emphasizes diversification to manage short-term volatility in pursuit of long-term performance.

We then consider fundamental and technical factors in determining a prospective investment's risk-reward ratio. We also evaluate social issues, such as environmental policies and employee relations, as part of our investment assessment.

Overall market risk is considered in the timing of investments and implementation of hedging strategies. We seek to maximize portfolio performance and manage volatility by reducing investment exposure during high market risk, while increasing investment commitment during periods of lower risk.

THE COMPASS

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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios, mutual funds and hedge funds. Independent CPA performance review available on request.