THE COMPASS

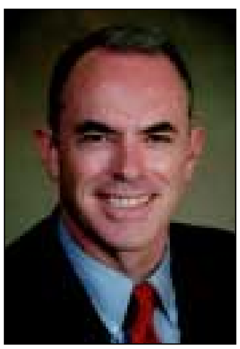
First Quarter, 2002 — A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Fourth quarter stock market rally signals economic recovery

January 10, 2002

The stock market rallied during the fourth quarter in anticipation of improving economic conditions in 2002. Despite anthrax attacks and continuing government warnings of further terrorist attacks, the stock market chose to focus on the embryonic signs of underlying economic strength and the prospect that monetary and fiscal stimuli already in place would eventually result in a return to economic growth. Although short interest rates continued to decline significantly, bond yields rose slightly in a tug of war between short-term lower inflation expectations and the long-term higher inflation potential of an economic recovery.

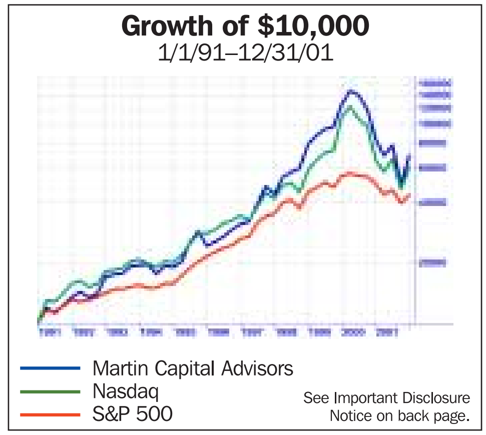


As we enter the first quarter of 2002, the signs of economic recovery are becoming more apparent. While the stock market has already begun to factor in better times ahead there is still the potential for much greater returns as the economic recovery unfolds. I believe that the recovery may prove to be stronger than the consensus expectation, in which case corporate earnings will rebound better than current forecasts and the stock market will work its way significantly higher over the next twelve months. Whether or not I'm right, it's becoming more and more difficult for anyone to argue against the likelihood of a better economy as the year progresses. Of course, there will be occasional corrections from time to time, especially if there are further cataclysmic events, but their negative impact should be temporary, as is proving to be the case with the September 11th terrorist attacks. Bond yields should be stable to lower over the next year as the debate between lower inflation and higher economic growth continues.

The challenge for 2002 will be to ride through periodic stock market corrections and stay onboard for the significant returns that may be achieved over the course of the year and for the long run. Unfortunately, the past year and a half has been so negative that it may be difficult to accept normal corrections as short-term events and not as the beginning of another bear market. One of the most common sayings on Wall Street is "Bull markets climb a wall of worry." Even as the economy improves and the stock market moves higher an underlying sense of fear may prevail.

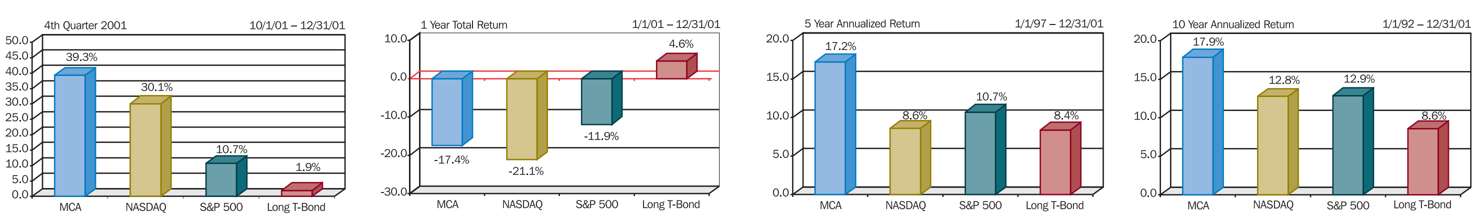
One of the greatest risks to the financial markets over the next several years is that the economy may be overstimulated and quickly surge to an unsustainable rate of growth. The question then will be whether the Federal Reserve Board has learned the lesson of its 2000 - 2001 tight monetary policy. The odds are that, at least for the next economic cycle, the Fed will be more careful to not hit the brakes too hard, but the Fed's actions and the response of the yield curve should be closely monitored.

MCA Flexible Portfolios
12-month Tax Efficiency: 101.6%
(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

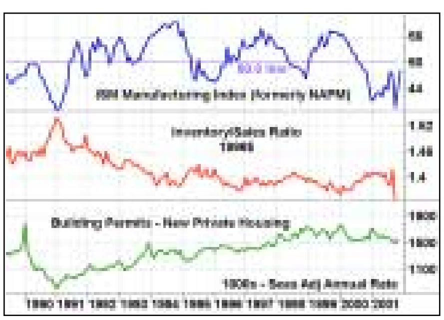


See Important Disclosure Notice on back page.

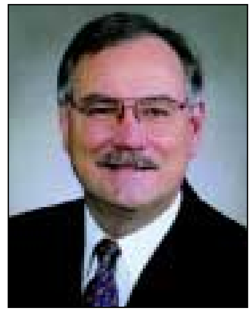
The U.S. economy, already slowing before September, spent most of the fourth quarter reacting to and recovering from the terrorist attacks. The table of statistics below shows unusual volatility, with one stock index up as much as 35% in the last quarter. Short interest rates have dropped sharply over both three and 12 months, as the Fed has loosened monetary policy. Commodity prices are showing evidence of disinflation in a weak economic environment that extends around the world. Industrial activity has been showing considerable weakness, though signs of recovery have appeared. The labor market is also weak, as our economy lost 1.1 million jobs in the last quarter. We are now officially in a recession, as these figures show.

MANUFACTURING

The manufacturing sector of our economy, which has been hit the hardest in the current economic downturn, shows signs of improvement. The Manufacturing Index of the Institute for Supply Management (formerly the NAPM) moved up to 48.2 in December, just below the 50.0 figure separating expansion from contraction. Though still showing contraction, this is the highest reading since October 2000. It appeared to be showing signs of a recovery before the terrorist attacks, but plunged after September 11, as shown by the sharp V on the top chart. Total capacity utilization of industry has fallen to 74.7%, the lowest since May 1983, reflecting the current sad state of manufacturing in general. A big slowdown in business spending occurred that was directly reflected in slower sales. Inventories on hand proved to be much larger than needed for the slower rate of



sales, so production was cut back. A couple of good signs have appeared with regard to this situation. First, the manufacturers' inventory/sales ratio has fallen precipitously (middle chart), meaning that inventories are no longer outsized in relation to the rate of sales. A similar sharp drop occurred at the end of the last recession. Second, the new orders component of the ISM manufacturing index rose to 54.9, the highest since April 2000. Orders have risen in recognition of the fact that inventories have fallen to levels that are too low. Further confirmation of this improvement in the outlook of the economy as a whole is found in the ISM Non-Manufacturing Index, which rose sharply to 54.2 in December.



Single-family home construction has remained strong during this economic downturn, largely due to low mortgage rates. Virtually all other downturns over the past 40 years have been accompanied by rising mortgage rates that had the effect of pricing monthly mortgage payments for homes out of reach of most buyers. This time, mortgage rates have remained relatively low, allowing this industry to retain its strength while much of the rest of the economy became weaker.

SALES

Deep cuts in business spending have been largely responsible for the economic slowdown. Consumer spending, on the other hand, has remained relatively strong compared to similar downturns in the past. The 12-month change in retail sales has remained positive over the past year, and is currently up 3.5%, though month-to-month changes have showed declines, particularly right after the terrorist attacks. Home sales have remained much stronger than during most previous recessions, supported to a large extent by low mortgage rates. Auto and light truck sales, which had remained relatively flat during the economic slowdown, jumped to an all-time high annual rate of 21.1 million units last October, stimulated by strong industry incentives like zero-interest loans. Sales dropped back to a rate of 16.5 million by December, a figure roughly equal to the average of the past two years. As noted above, inflated manufacturing inventories were drawn down over the past year until they were more in line with the slower rate of sales to businesses. As sales pick up, more products will need to be manufactured in order to meet increased demand.

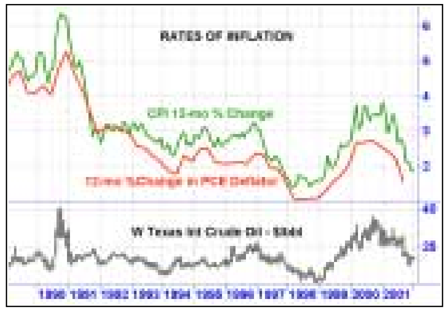
LABOR

Though the unemployment rate reached 5.8% in December, the highest since April 1995, signs are appearing that the end of the economic slowdown is probably not far ahead. Weekly initial unemployment claims are a measure of the number of workers losing their jobs. The weekly rate peaked in October, following the terrorist attacks, at an average of 496,000, then tapered off to 410,000 in December (middle chart at right). A net total of 448,000 jobs were lost in our economy during October, though this situation has

rapidly improved so that only 124,000 jobs were lost in December. The average number of hours worked per week in manufacturing (bottom chart at right) increased from 40.3 to 40.7 in December. As manufacturing has been the epicenter of our economic slowdown, this is an important positive sign. The average numbers of hours worked throughout the economy increased from 34.1 to 34.2, and the number of overtime hours increased from 3.7 to 3.9 hours. These increases in hours worked per week may seem small, but when multiplied through the entire economy, they are large and important in terms of paychecks and dollars flowing back into the economy. The numbers of initial unemployment claims and the numbers of hours worked per week in manufacturing are two of ten indicators used by the Conference Board in its Index of Leading Indicators. These measurements are much more indicative of future conditions than the unemployment rate, which is a lagging indicator.

INFLATION

The rate of inflation in our economy subsided during 2001. A number of gauges of inflation show this decline, starting with the 12-month change in the Consumer Price Index, the most widely watched and accepted measurement, in the top chart at right. That now points to an inflation rate of 1.9%. Also shown is the 12-month change in the Personal Consumption Expenditure Deflator, not often mentioned, but important because it affects consumer purchases and is closely watched by Alan Greenspan. It currently shows a 1.6% rate of increase. The decline in oil prices has contributed significantly to these current low rates. The overall rate



of inflation usually continues to decline for six to 12 months after a recession, so we may expect inflation to continue to drop in 2002. Small increases have been registered in some industrial metals like copper and nickel, no doubt in anticipation of the resumption of economic growth. Heavy scrap steel, on the other hand, is selling at the lowest price since 1983.

SUMMARY AND OUTLOOK

Regardless of how grim the figures in the table below may appear, they are representative of the past and not necessarily of the future. We were experiencing a mild economic slowdown of the overall economy until the terrorist attacks occurred, though some sectors were having a harder time than others. At that time, some indications had appeared that the economy had probably bottomed and was at the point of beginning to recover. The attacks had the effect of sharply deepening and extending the economic downturn. Now that the effects of the attacks are fading, the economy is beginning to show signs of turning up again, and the evidence of a turnaround is stronger now than it was in early September. That positive evidence is found in the upswing in the ISM (NAPM) Indexes, the sharp drop in the inventory/sales ratio, the drop in initial unemployment claims and the increase in the average numbers of hours worked in manufacturing. In addition, the financial markets are pointing to a recovery: the stock market is up sharply and long interest rates have risen. Long rates tend to rise primarily in response to two things: inflation expectations and anticipation of a greater need for investment capital that comes with increased economic activity. As inflation is projected to fall still further, the increase must be due to the latter. Some of these indications can be misleading by themselves, but the combined weight of all of them points strongly to an economic recovery soon. The economy is being pulled along toward a recovery by extraordinarily low short interest rates, low mortgage rates, a huge increase in liquidity and improved consumer confidence. These positive factors will overcome any lagging increase in unemployment. Provided that we do not experience any further significant terrorist attacks, the recovery should begin in the first quarter of 2002.

MARKET AND ECONOMIC STATISTICS

as of Market Close December 31, 2001, with 3-month and 12-month changes

3rd Quarter '01	Final	3 mo	12 mo
GDP-Bil$	9310	–1.3% apr	0.5%
GDP Deflator	109.8	2.2% apr	2.3%
Empl Cost Index	155.3	1.0%	4.1%
NF Productivity	118.8	2.7% apr	1.8%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10022	13.3%	– 7.1%
S&P 500	1148	10.3%	–13.0%
NASDAQ Comp	1950	30.1%	–21.1%
NASDAQ 100	1577	35.0%	–32.7%
NYSE Comp	590	8.5%	–10.2%
Wilshire 5000	10727	12.2%	–11.9%
Russell 2000	489	20.7%	1.0%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	1.71%	–27.8%	–71.1%
30-yr T-Bond Yld	5.46%	0.6%	0.0%
FNMA 30yr mortg	7.01%	9.2%	– 4.1%
Prime Rate	4.75%	–20.8%	–50.0%
Fed Funds Trgt	1.75%	–41.7%	–73.1%
Fed Disc Rate	1.25%	–50.0%	–79.2%
S/L Long T-Bnd Ind	9948	– 1.9%	4.6%

PRICES, INFLATION		3 mo	12 mo
CPI, Nov	177.6	0.1%	1.9%
PPI, Nov	138.3	– 1.8%	– 1.1%
Gold, cash	278.7	– 4.7%	2.9%
W Tx Int Cr Oil	19.84	–15.3%	–23.0%
Copper, cash	0.65	1.1%	–23.4%
CRB Futures Ind	190.6	0.1%	–16.3%
CRB Raw Indust	217.3	– 3.2%	–15.3%

MONEY			
M2, Bil Curr$, Nov	5413	2.9%	10.5%
Free Reserves	15652	–89%	60%
Money Mkts-Bil$	2347	5.3%	26.1%
US $$$ Index	116.8	–1.2%	6.9%

INDUSTRY			
ISM Index, Dec	48.2	1.2	3.9
Indus Prod Ind, Nov	137.1	–2.0%	–5.9%
Cap Utiliz, Nov	74.7%	–1.7%	–6.0%
Bldg Permits, Nov	1564K	–0.4%	–3.1%

LABOR – Dec. '01			
Unemployment Rate	5.8%	0.9%	1.8%
New Non-Farm Jobs	–124K	–1108K	+1080K
Avg Hourly Wages	14.61	1.1%	4.1%
Avg Init Unempl Clms	410K	–45K	+54K

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

Stocks	135%	Δ	−10%
Bonds	0%	Δ	0%
Cash	−35%	Δ	+10%

Performance Expectation

	December 2002		*December 2006*	
	Target	Total Return	Target	Total Return
S&P 500	1550	+35%	2500	+120%
NASDAQ	2800	+45%	5300	+170%
30-Yr. T-Bond	5.5%	+ 5%	5.0%	+ 40%

MARTIN CAPITAL

U.S. OPPORTUNITY FUND

	NAV	YTD	Annual-ized	Since Inception
U.S. Opportunity Fund-MCUSX*	$6.37	–33.51%	–14.88%	–35.85%

*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 12/31/01

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Computer	27.18	6	SPDR Trust	114.30	11	Oracle Systems	13.81	16	Electronic Arts	59.95
2	Enzon	56.28	7	Whole Foods Market	43.56	12	Tiffany	31.47	17	Citigroup	50.48
3	Charles Schwab	15.47	8	Intel	31.45	13	Advent Software	49.95	18	Williams-Sonoma	42.90
4	Applied Materials	40.10	9	Microsoft	66.25	14	Home Depot	51.01	19	Medtronic	51.21
5	Nasdaq 100	38.91	10	Texas Instruments	28.00	15	Cisco Systems	18.11	20	Starbucks	19.05

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	–17.4%	–5.4%	–11.9%	–21.2%	–11.0%	+4.6%	+3.8%	+1.9%
Total[3]	+595.0%	+401.7%	+341.3%	+422.0%	+327.3%	+171.5%	+63.1%	+32.0%
Avg.[4]	+19.3%	+15.8%	+14.4%	+16.2%	+14.1%	+9.5%	+4.5%	+2.6%

[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 60 individual portfolios and 44.7% of all funds under management by MCA on 12/31/01. 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 periods of apparent high market risk, while increasing investment commitment during periods of apparent lower risk.

THE COMPASS

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