

THE COMPASS

Second Quarter, 2002

A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Economic recovery well under way; corporate profits to follow

April 10, 2002

Although most economic indicators improved significantly during the first quarter, accounting questions and Middle East tensions weighed on the financial markets, resulting in a slightly negative performance for both stocks and bonds. The stock market has shown remarkable resilience in the face of continuing crises. As political and structural conditions stabilize, stock market prices should better reflect improving economic conditions.



Corporate profits are the most important factor affecting stock prices. At the beginning of every economic recovery concerns about valuations and earnings visibility abound. As with most things, valuations have to be put in context to be mean-

ingful. Instead of simply looking at trailing twelve-month price-to-earnings ratios, it is important to consider normalized earnings (i.e., earnings averaged over a multi-year period) in the context of economic cycles and rates of inflation. Historically, twelve-month trailing price-to-earnings valuations are high at the beginning of economic recoveries because the preceding weak economic environment has temporarily depressed earnings. Valuations also are higher in periods of low inflation because reported earnings do not have to be discounted as much by inflation in order to derive real earnings. Relative to previous economic cycle and inflation periods, normalized earnings valuations today are quite attractive. As economic growth eventually translates into better corporate earnings, the stock market rebound begun in the fourth quarter of last year should resume as this year progresses.

The past several years have been very unusual in the history of economic and



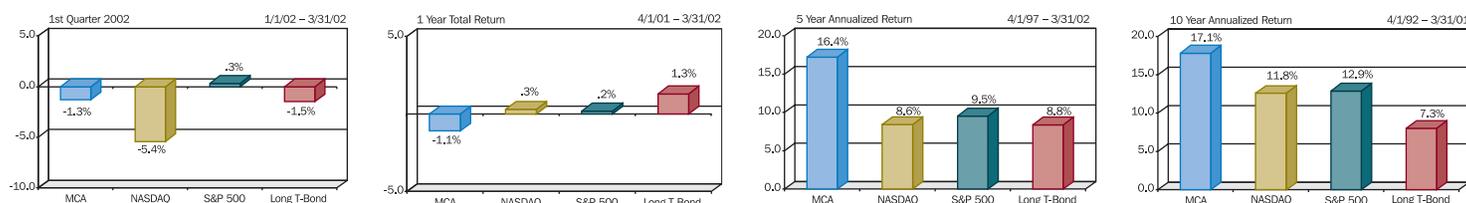
financial market performance. At some point, performance should return to the less volatile historical trend. Therefore, it most likely would be a mistake to extrapolate recent historical extremes into future expectations. It should be a long time before we experience another "millennium roller-coaster ride."

Positive macro-economic fundamentals suggest that fiscal and monetary stimuli already in place should continue to contribute to improving economic conditions. Given the fact that we are in the initial stages of an economic recovery, the odds are very good, based on historical precedent, that the next few years should see above average economic and financial market performance.

MCA Flexible Portfolios
12-month Tax Efficiency: 101.4%
(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

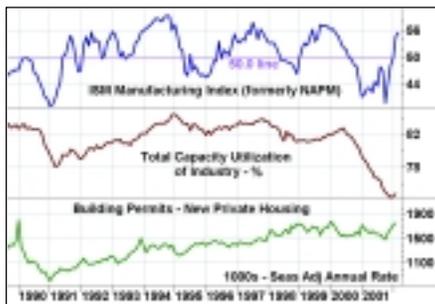


See Important Disclosure Notice on back page.

Economic growth in the 1st quarter of 2002 has been estimated to be as high as an annualized rate of 5%, following 1.7% growth in the previous quarter. The stock market sensed the recovery in the 4th quarter of 2001 and came back strongly but so far failed to follow through in 2002. The Table of Market and Economic Statistics below shows the lackluster performance of the important stock indexes over the last three months. The sharp drop in earnings that occurred during the economic slowdown pushed up P/Es to historically high levels. The stock market is now waiting for better earnings to come through before advancing higher. The change in short interest rates over 12 months is impressive, particularly with the Fed Funds target down 65%. This drop in rates has been vital to the economic recovery and has helped stocks when their returns are compared to T-bills or money market funds. Commodity prices have remained relatively stable, though gold prices have risen gradually over the past year and oil moved up sharply at the end of the quarter.

INDUSTRY

The manufacturing sector of our economy, hardest hit in last year's economic slowdown, is on the road to recovery. The Institute for Supply Management's Manufacturing Index (formerly the NAPM) rose for the fifth straight month to 55.6 in March, substantially above 50.0, which separates contraction from expansion. The top chart shows the rise off the low of last October to be the sharpest increase since the last recession. One component of the ISM Index tracks new orders, which rose to the highest level since 1986. Inventories were drawn down



during the slowdown and now, as sales have picked up, they must be replenished. Total capacity utilization of industry rose in January and February 2002 to 74.8%, the first monthly increases since June 2000. Capacity utilization of manufacturing shows exactly the same pattern, though at a lower level, reaching 73.2%. The middle chart shows how capacity utilization fell during the latest slowdown compared to 1990-91, illustrating the fact that last year's slowdown had a worse effect on manufacturing than the last recession.



The ISM Non-Manufacturing Index, sometimes called an index of services, fell slightly to 57.3 in March from 58.7, though still remaining at a high level. The positive news here is that services, which represent about a third larger portion of our economy than manufactured goods, are also in a strong recovery mode.

The housing industry has remained one of the brightest spots in our economy. Cyclical economic slowdowns typically have been led by rising inflation, which caused long interest rates to rise in response. This time, inflation did not increase significantly before the slowdown began, so mortgage rates did not rise. The continuation of low mortgage rates, combined with relatively strong consumer spending, has provided strong support for the housing industry.

SALES

The recent economic contraction resulted more from big cuts in business spending than from consumers pulling in their horns. As consumer spending makes up two-thirds of our economy, consumers kept the economy on a relatively even keel. Though retail sales grew more slowly, the 12-month change never actually fell below zero as it did during the 1990-91 recession. Auto and light truck sales also remained relatively strong, actually beating a previous monthly record by 10% last October, as strong incentives were offered by manufacturers. The good news in the last few months is that vehicle sales have

continued to be relatively strong rather than falling below the trend after the big sales month of October. New home sales have continued on a high plateau since 1998, a strong performance during an economic slowdown. As mentioned above, low mortgage rates take much of the credit for this good sales performance. As the economic recovery takes hold, businesses should begin to spend again, as they will need to replenish inventories and participate in the next high-tech product cycle.

LABOR

Just as at the end of the last recession, weekly initial unemployment claims have dropped sharply as employers started reducing the numbers of layoffs. Though a sizeable increase in claims occurred in the last week of March, which caused the latest monthly average to tick up, it resulted largely from the extension of time available for laid-off workers to collect unemploy-



ment checks. The average numbers of hours worked in manufacturing has increased as employers made more use of workers already hired before going out to hire more. The increase in hours worked in manufacturing takes on additional significance because the manufacturing sector of our economy was hit hardest in the economic slowdown. The Conference Board uses both of these figures in its Index of Leading Indicators that is used to predict the direction of the economy as a whole. Another measure of average hours per week is overtime: just as longer hours

are worked per week, overtime hours are going up, confirming the expansion taking place in manufacturing. Though the unemployment rate rose from 5.5% to 5.7% in March, it is a lagging indicator.

INFLATION

The Consumer Price Index rose only 1.1% in 12 months through February, the smallest such increase since January 1965. The “core” CPI, which excludes volatile food and energy sectors, is up 2.4% in a year. Before 1997, one has to look back to 1966 to find a core rate of inflation this low. The inflation rate typically continues to subside for six to 12 months after a recession has ended, so an extension of the downward trend in inflation for another three to six months would be normal in these circumstances.

A recent increase in the price of oil, however, may reverse this downward trend in the inflation rate. This price increase has mostly resulted from the conflict in Israel and Palestine, the worst situation there since the 1967 war. Arab countries initiated the oil price shock of 1973 partially as a pro-Palestinian weapon, and Saddam Hussein has recently advocated the use of oil as a weapon again. While that’s scary, the oil supply situation is quite a bit different now from 1973. The price of oil in 1973 had languished at less than \$3/barrel for years as demand



continued to grow, so part of the price adjustment of the 1970s may have been an adjustment to reality. Today, oil is already over \$27/barrel, so the 10-fold increase of the 1970s won’t recur. Also, OPEC is not as much of a unified Arab cartel as it was in the 1970s, as many major oil-producing countries today are either non-Arab or non-OPEC. Russia became the largest producer of oil in the world last month, surpassing Saudi Arabia for the first time. Even if Arab countries severely cut production and force prices up in order to create pressure on Israel, the end result would be less devastating than the debacle of 1973. Furthermore, most Arab oil producing countries badly need the income and leaders who drastically cut oil output will be trashing their countries’ economies and threatening their own survival as leaders. Also, global economic activity today hasn’t rebounded enough to increase demand sufficiently to sustain higher oil prices.

SUMMARY AND OUTLOOK

Evidence of an economic recovery is abundant and impossible to ignore, as almost all leading indicators have been pointing to improving conditions for several months. With P/E ratios at record levels, many investors want to see earnings increase before buying more stocks. As business spending picks up in the normal course of economic recovery, earnings will also recover. The oil price increase will produce a rise in the inflation rate and will probably cause interest rates to rise higher than otherwise might be expected. However, if oil stays at or below \$30/barrel, as is most likely, no significant damage to our economy will result. It is important to remember that oil and gold are rising in response to political, not economic conditions, so the “core” rate of inflation will hardly be affected. Higher oil prices and interest rates will act as taxes, reducing consumers’ disposable income, and causing our economy to grow a bit more slowly. The other side of this coin is that the Fed will maintain a stimulative monetary policy until the economy is clearly expanding at a sustainable rate. Thus, the most likely outcome of the current situation is that the recovery of the economy and corporate earnings will continue, perhaps a little more slowly than might have been the case without the conflict in the Middle East.

MARKET AND ECONOMIC STATISTICS

as of Market Close March 29, 2002,
with 3-month and 12-month changes

	4th Quarter '01	Final	3 mo	12 mo
GDP-Bil\$	9349		-1.7% apr	0.5%
GDP Deflator	109.8		-0.1% apr	1.9%
Empl Cost Index	156.7		0.9%	4.1%
NF Productivity	120.2		5.2% apr	2.0%

STOCK INDICES*		3 mo	12 mo	INTEREST RATES		3 mo	12 mo	PRICES, INFLATION		3 mo	12 mo
Dow Industrials	10404	3.8%	- 0.9%	91-day T-Bill DR	1.77%	3.5%	-57.8%	CPI, Feb	178.0	0.3%	1.1%
S&P 500	1147	-0.1%	- 6.3%	30-yr T-Bond Yld	5.80%	6.2%	6.4%	PPI, Feb	138.1	-0.2%	- 2.5%
NASDAQ Comp	1845	-5.4%	-14.6%	FNMA 30yr mortg	6.95%	-0.9%	- 0.6%	Gold, cash	301.4	8.1%	17.0%
NASDAQ 100	1453	-7.9%	-20.7%	Prime Rate	4.75%	0.0%	-40.6%	W Tx Int Cr Oil	26.33	32.7%	- 0.5%
NYSE Comp	600	1.8%	- 3.4%	Fed Funds Trgt	1.75%	0.0%	-65.0%	Copper, cash	0.77	17.3%	1.0%
Wilshire 5000	10776	0.5%	- 5.5%	Fed Disc Rate	1.25%	0.0%	-72.2%	CRB Futures Ind	204.9	7.5%	- 2.5%
Russell 2000	506	3.7%	- 1.3%	S/L Long T-Bnd Ind	9794	-1.5%	2.9%	CRB Raw Indust	231.8	6.6%	- 4.2%

*excluding dividends

MONEY

M2, Bil Curr\$, Feb	5499	1.5%	9.4%
Free Reserves	1249	-30%	-6%
Money Mkts-Bil\$	2320	-1.2%	11.6%
US \$\$\$ Index	118.7	1.6%	-0.6%

INDUSTRY

ISM Index, Mar	55.6	7.4	12.5
Indus Prod Ind, Feb	137.6	0.3%	-4.1%
Cap Utiliz, Feb	74.8%	0.1%	-4.1%
Bldg Permits, Feb	1752K	9.8%	5.4%

LABOR – Mar. '02

Unemployment Rate	5.7%	-0.1%	1.4%
New Non-Farm Jobs	+58K	-11K	+21K
Avg Hourly Wages	14.67	0.6%	3.5%
Avg Init Unempl Clms	399K	-45K	+54K

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

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

Performance Expectation

	March 2003		March 2007	
	Target	Total Return	Target	Total Return
S&P 500	1550	+35%	2500	+120%
NASDAQ	2675	+45%	4900	+170%
30-Yr. T-Bond	5.3%	+15%	4.9%	+ 45%

MARTIN CAPITAL

U.S. OPPORTUNITY FUND

	NAV	YTD	Annual-ized	Since Inception
U.S. Opportunity Fund-MCUSX*	\$6.14	-3.61%	-14.79%	-38.14%

*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 3/31/02

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1 Dell Computer	26.11	6 Enzon	44.29	11 Advent Software	59.16	16 Electronic Arts	60.80
2 Applied Materials	54.27	7 SPDR Trust	114.52	12 Microsoft	60.31	17 Williams-Sonoma	45.99
3 Whole Foods Market	45.69	8 Nasdaq 100	36.06	13 Oracle Systems	12.80	18 CitiGroup	49.52
4 Texas Instruments	33.10	9 Intel	30.41	14 Home Depot	48.61	19 LAM Research	29.32
5 Charles Schwab	13.09	10 Tiffany	35.55	15 Cisco Systems	16.93	20 Starbucks	23.13

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%
2002	-1.3%	+4.3%	+0.2%	-5.4%	+1.0%	-1.6%	+0.3%	+0.3%
Total ³	+585.8%	+423.7%	+348.1%	+393.7%	+331.4%	+166.9%	+63.0%	+32.6%
Avg. ⁴	+18.7%	+15.9%	+14.3%	+15.3%	+13.9%	+9.1%	+4.4%	+2.5%

¹Total 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. ²Without dividends. ³Total compounded return, including reinvestment of dividends and interest. ⁴1991-2002 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 58 individual portfolios and 45.0% of all funds under management by MCA on 3/31/02. 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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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.