THE COMPASS

Third Quarter, 2002

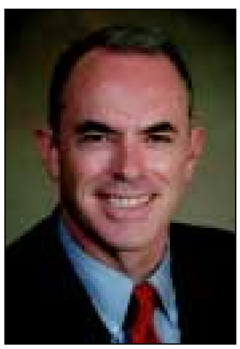
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Corporate scandals and terrorism weigh on stocks, but economy points to better times ahead

July 12, 2002

The performance of the stock market over the second quarter was extremely disappointing. Corporate governance issues, terrorist threats and international concerns weighed heavily on investor psychology. Treasury bonds fared well as inflation remained low and investors sought safety from the higher risks perceived in stocks.



It is very unusual for the stock market to decline at the beginning of an economic expansion. Many commentators blame the spate of corporate accounting troubles for the stock market's poor performance in spite of improving economic fundamentals. However, corporate governance issues have always been a problem after weak economic periods. The corporate scandals plaguing the stock market this time are no worse than what has occurred at the beginning of other economic recoveries. For example, the banking crisis that lasted for several years after the 1990-1991 recession was much more of a threat to our economic system, yet the stock market advanced through the early nineties in the face of bank failures and scandals such as the "Keating Five" controversy. The reason for the stock market's current disconnection from the positive economic reality probably has more to do with international tensions and the threat of additional terrorist attacks. Stock market prices today reflect the fear that another attack on the scale of September 11th is imminent. Contrary to the government's hand wringing, the potential for another major terrorist attack in the U.S. in the foreseeable future is a lot less than it was before September 11th. The problem for the past few months has been that the government seems to have decided that the way to prevent another attack is to keep Americans terrorized. There are signs lately though that the government is finally beginning to realize the importance of maintaining confidence that we can win the war on terrorism. As confidence returns, the stock market should begin to respond to improving economic conditions.

Although the economy appears to have slowed somewhat from the first quarter's brisk pace, most economic data continue to point toward a sustained recovery, with the economy strengthening in the second half of the year. This bodes well for stocks as the year progresses, but eventually may prove to be a problem for bonds as the resurgence in economic activity creates concerns about future inflation.

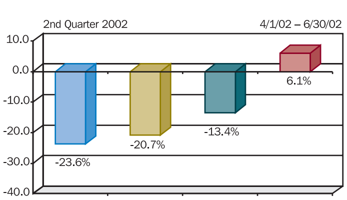
MCA Flexible Portfolios
12-month Tax Efficiency: 101.6%
(After Tax Return divided by Before Tax Return)

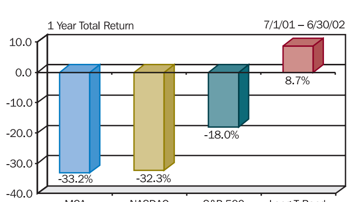
Growth of $10,000
4/1/91–6/30/02

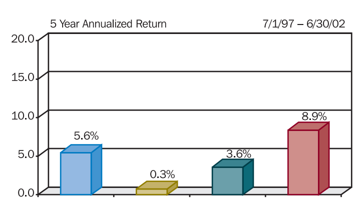
See Important Disclosure Notice on back page.

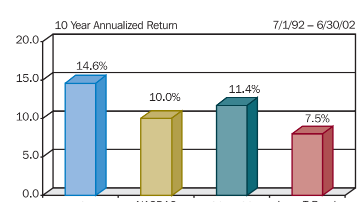
INVESTMENT RESULTS

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







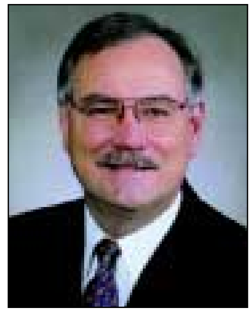


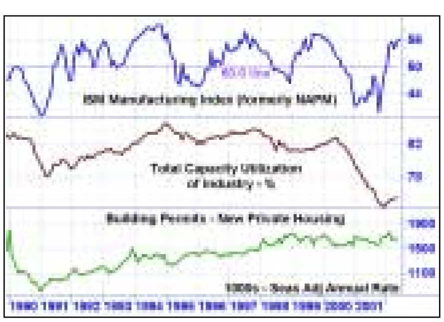
See Important Disclosure Notice on back page.

GDP growth in the second quarter of 2002 appears to have slowed to between a 2.5% and 3.5% annualized rate, somewhat slower than the 6.1% rate of the first quarter. As shown in the table below, all major stock indexes were damaged in the second quarter, primarily by continued alarms about terrorism, as well as other international issues and a widening scandal over fraudulent accounting and false reporting of billions of dollars of corporate earnings. Market interest rates, both long and short, declined slightly over the quarter. Inflation is benign, though oil and gold prices are up because of some special conditions. Job growth is slow but improving, and the number of hours worked is increasing. All of these data bode well for a continuing economic recovery.

MANUFACTURING

The manufacturing sector has been the weak spot of the economy during the current slowdown. It appears to be headed toward a recovery, though not a particularly rapid one. The ISM Manufacturing Index rose to 56.2 in June, the highest level since February 2000. This is the fifth straight month that this indicator and the ISM Non-Manufacturing Index have both come in above 50, indicating expansion. The Manufacturing Index has 10 components, which include such things as production, new orders and inventories. Production is increasing, showing that the expansion is under way. New orders are increasing and inventories are far too low, both of which point to continued improvement in the future. Capacity utilization showed its fifth straight monthly increase in May to 75.5%, but that level is nevertheless one of the lowest since 1983. There is both good and bad news here. The good news is that the currently unused capacity will be available for expansion and thereby help keep inflation low. The bad news is that there won't be as much need for new facilities, which means less demand for manufactured products. Inventory replacement made up a lot of the increase in the first quarter's big increase in GDP, and many regarded this as being only a temporary factor. Far from being over, more inventory replacement is clearly necessary. One of the Conference Board's leading indicators of the economy is the ratio of inventories to sales, which fell in April, the last month reported, to a 28-year low of 1.31. Putting this number in perspective, an average ratio for the past 15 years would be about 1.4, while highs were around 1.53. Aside from recent figures, the lowest since 1978 was 1.36. Therefore the current level of 1.31 cries out for inventory rebuilding that could go on for several more quarters.





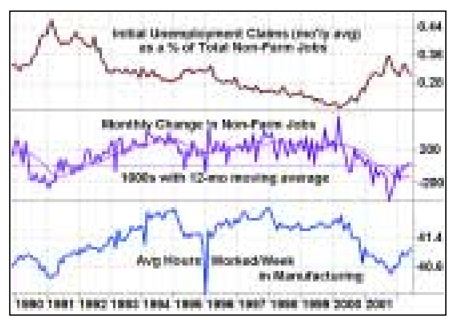
Construction has remained relatively strong during the economic slowdown, particularly home building. Low mortgage rates have been the principal source of support for the home building industry, making monthly mortgage payments affordable for consumers and overcoming the negative effects of a softer economy. On the other hand, commercial construction fell last month, particularly of office buildings, in response to shrinking demand from business.

SALES

Though total retail sales slipped 0.9% during the month of May, they were up 2.4% on a year over year basis. This annual rate of growth is about average for the past year and not far below the rate of the mid-1990s. In comparison, the surge in retail sales during 1991–92 represented a rebound after a severe slowdown in consumer spending during the 1990 recession. Consumer spending didn't contract as much during the latest recession, so there hasn't been a big rebound afterward. Auto and light truck sales came in at an annual rate of 16.5 million units in June, about average for the past year except for the extremes of last September and October. Sales of new homes in May vaulted to a record 1.028 million units on an annualized basis, while sales of existing homes rose to 5.75 million, the third-highest number in history. Low mortgage rates have been very supportive to the housing industry, as they mean low, affordable monthly payments for consumers. Consumer spending has remained relatively strong in contrast to much weaker business spending. As the economic recovery progresses, corporate earnings will increase and business spending will also pick up again.

LABOR

Indicators of conditions in the labor market point to steady improvement and slow job growth. The unemployment rate for June was 5.9%, up 0.1%. While



the unemployment rate is a lagging indicator, other labor market data tends to lead the economy. For instance, two of the Conference Board's Leading Indicators are weekly initial unemployment claims and the average number of hours worked per week in manufacturing. The monthly average of weekly unemployment claims in June was 395,000, and the figure for the last week of June was 382,000, the lowest since mid-March. The chart at right shows the monthly average of claims as a percentage of the total number of non-farm jobs in order to better put it in perspective with the past. The current level is comparable to the period 1993-95, which was a period of healthy economic growth. The peak occurred last October and was followed by an uneven decline. The secondary peak last April occurred as the result of a change in government policy, not from an increase in layoffs. Hours worked in manufacturing has picked up substantially to 41.1 from the low of 40.4 last October. Corresponding increases have been recorded in average overtime hours per week and average total numbers of hours worked per week. Employers tend to have existing employees work longer hours as business improves before they hire new people. Thus, more hours worked tend to point to a recovery before the unemployment rate.

INFLATION

The overall rate of inflation in our economy declined through 2001 and has been flat so far this year, as shown by the 12-month change of the Consumer Price Index in the top chart at right. The current rate of inflation according to this indicator is 1.2%, which is the lowest since 1964 except for 1.1% reported in January and February of this year. The core rate of inflation, excluding food and energy prices, is up 2.4%. Wholesale prices, as indicated by the Producer Price Index, have fallen 2.7%

in 12 months. Other than last February, this is the lowest since 1950. Two widely watched commodities, oil and gold, have run counter to this trend. The price of oil has risen because of uncertainty over the Middle East in connection with Israel/Palestine and the terrorist connection in Saudi Arabia. Gold prices have also risen because of the same uncertainties and additionally because of the decline in the US dollar. As two-thirds of inflation is related to labor costs, the 12-month change in hourly wages, shown in the bottom chart at right, is important. The rate of increase in wages has come down substantially since the end of 2000, as the job market has softened. The overall decline in the inflation rate, aside from the unusual conditions involving oil and gold, is typical for the early stages of a recovering economy. The demand for many items and materials as well as labor declined during the slowdown and has not entirely returned to a normal level. Even though the economy has started to recover, demand has only just begun to recover. Some industrial commodity prices are up slightly, and the number of net new non-farm jobs is up, though the unemployment rate is still rising.

SUMMARY AND OUTLOOK

Last year's economic slowdown was distinguished by slower growth in consumer spending, and drastic cuts in business spending. Looking at the weakest part of the economy, manufacturing, particularly high-tech, saw sales drop precipitously after early 2000. That created extreme pessimism among many businesses that is still widespread, with a lack of confidence in the future and a consequent reluctance to spend more than the absolute minimum or to hire new employees. Though sales have begun to recover, inventory replacement has so far been minimal. Therefore, the rebuilding of inventories will continue to add to economic growth for the next several quarters. We are currently at the second highest rate of mortgage refinancing in history, which will leave more cash in consumers' pockets. Only about half of the stimulative effects of the Fed's rate cuts have been felt so far. Evidence is convincing that the economic recovery now under way will continue, albeit at a slower pace than the first quarter.

MARKET AND ECONOMIC STATISTICS

as of Market Close June 28, 2002, with 3-month and 12-month changes

1st Quarter '02	Final	3 mo	12 mo
GDP-Bil$	9489	6.1% apr	1.7%
GDP Deflator	110.1	1.3% apr	1.4%
Empl Cost Index	158.2	0.8%	3.9%
NF Productivity	122.8	8.6% apr	4.3%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	9243	–11.6%	4.5%
S&P 500	990	–13.7%	– 4.9%
NASDAQ Comp	1463	–19.6%	– 2.4%
NASDAQ 100	1051	–25.5%	–10.0%
NYSE Comp	533	–11.4%	– 2.0%
Wilshire 5000	9384	–13.9%	– 1.9%
Russell 2000	463	–9.0%	14.3%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	1.69%	–4.5%	–51.0%
30-yr T-Bond Yld	5.51%	–5.0%	– 4.3%
FNMA 30yr mortg	6.48%	–6.8%	–10.4%
Prime Rate	4.75%	0.0%	–29.6%
Fed Funds Trgt	1.75%	0.0%	–53.3%
Fed Disc Rate	1.25%	0.0%	–61.5%
S/L Long T-Bnd Ind	10391	6.0%	2.5%

PRICES, INFLATION		3 mo	12 mo
CPI, May	179.5	0.8%	1.2%
PPI, May	138.6	0.4%	–2.7%
Gold, cash	318.5	5.7%	17.7%
W Tx Int Cr Oil	26.88	2.1%	2.4%
Copper, cash	0.77	0.9%	8.4%
CRB Futures Ind	209.3	2.1%	1.8%
CRB Raw Indust	247.3	6.7%	0.5%

MONEY			
M2, Bil Curr$, May	5544	0.7%	7.9%
Free Reserves	1084	–18%	–4%
Money Mkts-Bil$	2249	–3.1%	6.8%
US $$$ Index	106.2	–10.8%	–10.2%

INDUSTRY			
ISM Index, Jun	56.2	0.6	11.5
Indus Prod Ind, May	139.2	0.9%	–1.6%
Cap Utiliz, May	75.5%	0.5%	–2.0%
Bldg Permits, May	1674K	–5.2%	0.7%

LABOR – June '02			
Unemployment Rate	5.9%	0.2%	1.4%
New Non-Farm Jobs	+36K	+39K	–1477K
Avg Hourly Wages	14.76	0.6%	3.4%
Avg Init Unempl Clms	395K	–12K	+12K

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

Stocks	150%	Δ	+15%
Bonds	0%	Δ	0%
Cash	–50%	Δ	–15%

Performance Expectation

	June 2003		June 2007	
	Target	Total Return	Target	Total Return
S&P 500	1320	+35%	2100	+110%
NASDAQ	2250	+55%	3700	+155%
30-Yr. T-Bond	5.75%	0%	5.0%	+ 40%

MARTIN CAPITAL

U.S. OPPORTUNITY FUND

	NAV	YTD	Annual-ized	Since Inception
U.S. Opportunity Fund-MCUSX*	$4.22	–33.75%	–23.15%	–57.50%

*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 6/30/02

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Computer	26.14	6	Charles Schwab	11.20	11	Electronic Arts	66.05	16	Intel	18.27
2	Whole Foods Market	48.22	7	Williams Sonoma	30.66	12	Starbucks	24.85	17	Home Depot	36.73
3	Applied Materials	19.02	8	Texas Instruments	23.70	13	Cisco Systems	13.95	18	Bear Stearns	61.20
4	Tiffany	35.20	9	Nasdaq 100	26.10	14	Oracle Systems	9.47	19	CitiGroup	38.75
5	SPDR Trust	98.96	10	Microsoft	54.70	15	Enzon	24.61	20	Medtronic	42.85

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	–24.6%	–6.9%	–13.2%	–25.0%	–11.8%	–1.6%	+0.7%	+0.6%
Total[3]	+424.1%	+367.6%	+288.3%	+291.4%	+277.0%	+166.9%	+63.6%	+33.0%
Avg.[4]	+15.5%	+14.4%	+12.5%	+12.6%	+12.2%	+9.1%	+4.4%	+2.5%

[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]1991-2002 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 55 individual portfolios and 49.0% of all funds under management by MCA on 6/30/02. 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.

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