THE COMPASS

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

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Risk of war amplifies "irrational pessimism"; long-term prospects remain bullish

October 17, 2002

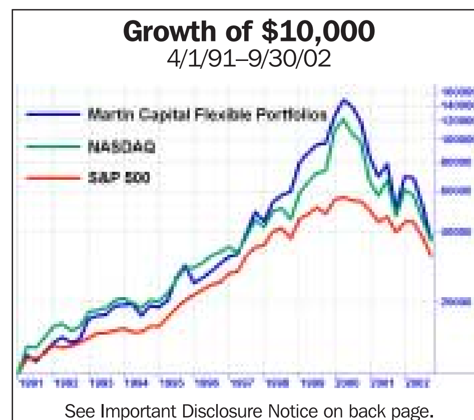
Stocks fell more in the third quarter than in any quarter since the crash of 1987 – despite signs of improving prospects for above average economic growth. As of the end of September, many stock market indexes had suffered the worst declines since the 1929 - 1932 bear market. Although corporate governance, terrorist threats and international tensions continued to have a negative psychological impact on stocks during the third quarter, the primary cause of the severe sell-off appears to have been an acceleration in the march toward a possible war with Iraq. The increased uncertainty surrounding the economic impact of a war with Iraq reinforced speculation about the potential for a "double-dip" recession and called into question positive corporate earnings projections. In this environment of high anxiety, bonds, especially treasury bonds, continued to significantly outperform stocks, with interest rates dropping to levels not seen in forty years. Gold and oil prices also benefited from the fear of war with Iraq.

MCA Flexible Portfolios
12-month Tax Efficiency: 102.3%
(After Tax Return divided by Before Tax Return)

As we enter the fourth quarter of 2002, one month shy of the longest bear market on record, one has to wonder how much worse sentiment can get and how much lower stock prices may retreat. Given the unusual number of negative factors already discounted by the historic fall of the stock market and reflected in pervasively negative investor sentiment, it would seem that the risk of substantially lower stock prices should be minimal and the potential for higher prices great once conditions begin to normalize. Investor sentiment should start to improve as the government shifts from saber-rattling and exaggerated fears of terrorism to confidence building that we will work with the global community to control rogue nations and that the war on terrorism can and will be won.

Interestingly, the greatest five-year performance of the S&P 500 occurred from 1932 to 1936 in the middle of the great depression, right after the 1929 - 1932 bear market mentioned above. In spite of the continuing depression, this bull market rally began with Franklin Roosevelt's confident admonition that "we have nothing to fear but fear itself." From 1937 to 1942, the escalation of World War Two weighed on the stock market, but after Jimmy Doolittle's April 18, 1942 bombing raid on Tokyo, which actually did little damage, American morale skyrocketed and the stock market rallied for the rest of the war. Of course, everyone knew in the spring of 1942 that the war would be long and bloody, but the fact that the war was being taken to the enemy gave Americans confidence that eventually the war would be won. I believe that we are on the verge again today of renewed confidence that we can overcome the challenges before us. As confidence grows, monetary and fiscal stimuli already in place and positive macro-economic fundamentals, such as productivity enhancing demographics and global business opportunities, should contribute to the resumption of above average economic growth and improving stock market performance.

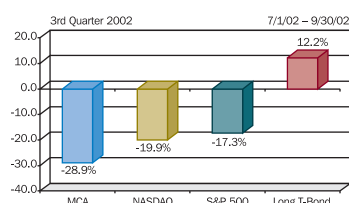
Growth of $10,000
4/1/91–9/30/02

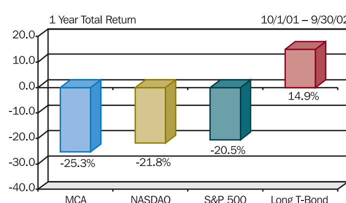


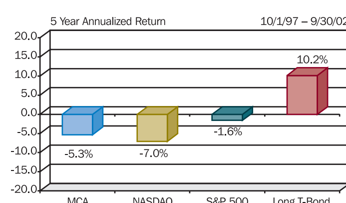
See Important Disclosure Notice on back page.

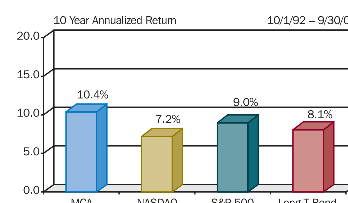
INVESTMENT RESULTS

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







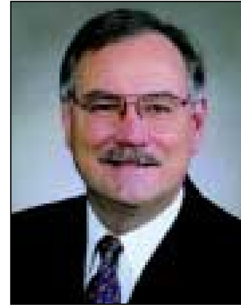


—— See Important Disclosure Notice on back page. ——

Beset by global uncertainties, corporate malfeasance and signs of a weakening economy, the stock market had a bad quarter, with all major indexes down at least 15%. Both long and short rates are down to historically low levels. Short interest rates have moved only slightly in the past quarter, but are far below those of a year ago. Long rates are down a lesser amount, nearly the same percentage from three months and 12 months ago. Inflation in both consumer and wholesale prices has been slight, with the exception of oil prices, which are up because of risk rather than increasing consumption. Manufacturing has not been growing as fast as it did earlier in the year, generating fears of a double-dip recession. The labor market has remained relatively strong compared to other recessions in the past, though recovery in terms of new jobs created has been sub-par. Consumer spending has supported our economy, while manufacturing and labor have been the biggest source of worry in terms of economic weakness.

MANUFACTURING

The manufacturing sector was the weakest part of our economy during the recession of 2001, and it has weakened again in the last three months. The ISM Manufacturing Index has fallen from 56.2 in June to 49.5 in September, below the 50.0 line separating expansion from contraction. Part of the trouble comes from a lot of excess capacity due to a big buildup that took place prior to Y2K. Capacity utilization of manufacturing reached a recession low of 72.9, the lowest since 1983, then gradually rose to 74.4% in August. Total capacity utilization of industry is slightly higher now at 76.0%. This excess capacity means that as economic expansion occurs, there will be capacity available rather than having to build new equipment or create new facilities. Though this will not be true in every case because new types of demands will require new capacity, it will nevertheless be a drag on capital spending. The good news is that the excess capacity will help hold down inflation. Inventories, on the other hand, are very low. The total business inventory to sales ratio is 1.35, the lowest since 1973. Sales are outpacing the available inventory, so new inventory must be ordered. New orders have come back strongly on a year-over-year basis, which will eventually mean more being produced by manufacturers.



The bright spot in industry is still the housing sector. Though commercial construction has fallen off because of lower demand in a weak economy, new homes have continued to sell. Low mortgage rates have been the driving force, as low monthly payments have made homes into bargains for consumers.

SALES

Consumer spending has remained relatively strong through the recession up to the present, providing badly needed support to the economy. Retail sales were up 0.8% in the month of August and up 5.2% in 12 months, a relatively strong showing. Auto and light truck sales, however, fell from an annualized 18.7 million units in August, the third highest in history, to 16.3 million in September. This drop to near the average of the past four years occurred in spite of zero-interest financing, which has been a strong incentive for buyers. New home sales hit an annualized 996,000 in August, a record high. Existing home sales were down slightly to an annualized 5.28 million in August, once again about the average of the past four years. Consumer spending makes up about two-thirds of our economy, so we have been fortunate that we have had this support. Nevertheless, business spending has lagged and this must pick up for an extended economic recovery to proceed.

LABOR

Though the labor market became stronger immediately after the recession, its recovery seems to have paused. The unemployment rate has fallen from a high of 6.0% in April to 5.6% in September. This is good news, but the unemployment rate is not usually seen as a reliable indicator of the direction of the economy. Non-farm jobs fell by 43,000 in September, the first decline since last April. The blow is softened somewhat by the fact that the August number was revised upward by 68,000 to plus 107,000. Seasonal factors are probably at work here and we can expect another revision for September. Initial unemployment claims backed up to a weekly average of 423,000 in August, an unfavorable sign in a more reliable leading indicator. The average number of hours worked per week fell sharply to 34.0 in July before recovering its

June level of 34.3 by September. Hours worked in manufacturing alone, another leading indicator, were flat in September at 40.9, while average weekly overtime hours fell 0.1 to 4.1 hours. Taken all together, the data conflict with regard to conditions being better or worse. Higher initial unemployment claims and the drop in non-farm jobs tip the balance slightly toward the side of weakness, though improvements in hours worked and the

unemployment rate keep it from being considered a serious deterioration. Compared to other periods following recessions, job growth has been weak.

INFLATION

The overall rate of inflation in our economy has remained low, with the 12-month change in the Consumer Price Index up only 1.7% through August. The Producer Price Index of wholesale prices is actually down 1.5% in 12 months, an indication of weak demand in a soft world economy. The only exception to this picture of benign inflation is crude oil, which has surged because of a risk premium due to the potential of war with Iraq. The potential for an interruption of oil deliveries from the Persian Gulf has driven up prices. As oil is by far the most used commodity in the U.S. and the rest of the world, higher oil prices have a large impact on individuals and businesses. The effect is roughly akin to a tax increase, where less disposable cash is available after paying for gasoline, electricity and other petroleum related products, thereby slowing the economy. Gold has increased in price by a lesser percentage than oil. This price rise has been due to more broadly based geopolitical fears. The Israeli-Palestinian problems, the India-Pakistan potential for nuclear war and now the problems

with Iraq have led some investors around the world to seek safety in gold. What inflation we have is not coming from a worldwide economy straining to meet surging demand, such as occurs late in an economic cycle. The 12-month change in hourly wages shows a decline because of a soft economy, not a vigorous one. Inflation is no threat to our economy except for the potential for problems in the Persian Gulf and resulting higher oil prices.

SUMMARY AND OUTLOOK

Our economy most likely experienced growth at about a 4% annualized rate in the third quarter. It appears that strong consumer spending was largely responsible and that some sales were pulled forward from the quarter ahead, meaning that the next quarter may be somewhat weaker. Excess capacity is a drag on the economy, as less needs to be built or created as the economy expands. Indications of slower growth have appeared in manufacturing and in the labor market that tend to confirm that projection. Regardless of the signs of weakness, inventories are low and must be rebuilt and improved factory orders support this idea. The stimulus of the Fed's rapid rate cuts last year is still boosting our economy, while mortgage refinancings are counteracting the drag of higher oil prices. The key to the expansion of the economy is business spending, which has hardly increased during 2002. In an environment of stiff competition, earnings have increased more slowly than expected. Thus we find our economy in a state of balance, held there by conflicting forces and in this state of balance, the possibility of a war with Iraq looms large. A war that proceeded slowly and with unexpected setbacks would almost certainly lead to higher oil prices for an extended period, resulting in more inflation and higher interest rates. With this in mind, businesses are reluctant to increase spending now. On the other hand, a quick, successful war would reduce oil prices by cutting out the risk premium and act like a tax cut in terms of giving consumers more disposable income. This uncertainty will continue until the Iraq issues are resolved.

MARKET AND ECONOMIC STATISTICS

as of Market Close September 30, 2002, with 3-month and 12-month changes

2nd Quarter '02	Final	3 mo	12 mo
GDP-Bil$	9392	1.3% apr	2.2%
GDP Deflator	110.5	1.2% apr	1.1%
Empl Cost Index	159.8	1.0%	3.9%
NF Productivity	122.3	1.5% apr	4.8%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	7592	–17.9%	–14.2%
S&P 500	815	–17.6%	–21.7%
NASDAQ Comp	1172	–19.9%	–21.8%
NASDAQ 100	833	–20.8%	–28.7%
NYSE Comp	445	–16.4%	–18.1%
Wilshire 5000	7774	–17.2%	–18.7%
Russell 2000	362	–21.7%	–10.5%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	1.61%	– 4.7%	–32.1%
30-yr T-Bond Yld	4.68%	–15.1%	–13.8%
FNMA 30yr mortg	5.71%	–11.9%	–11.1%
Prime Rate	4.75%	0.0%	–20.8%
Fed Funds Trgt	1.75%	0.0%	–41.7%
Fed Disc Rate	1.25%	0.0%	–50.0%
S/L Long T-Bnd Ind	11654	12.1%	14.9%

PRICES, INFLATION		3 mo	12 mo
CPI, Aug	180.5	0.6%	1.7%
PPI, Aug	138.5	0.0%	–1.5%
Gold, cash	323.9	1.7%	10.8%
W Tx Int Cr Oil	30.45	13.3%	30.0%
Copper, cash	0.66	–14.0%	2.2%
CRB Futures Ind	226.5	8.2%	18.9%
CRB Raw Indust	240.7	– 2.7%	7.2%

MONEY			
M2, Bil Curr$, Aug	5686	2.5%	8.0%
Free Reserves	817	–26%	–95%
Money Mkts-Bil$	2221	– 1.2%	–0.4%
US $$$ Index	106.8	0.6%	–9.6%

INDUSTRY			
ISM Index, Sep	49.5	–6.7	2.5
Indus Prod Ind, Aug	140.5	0.8%	0.4%
Cap Utiliz, Aug	76.0%	0.4%	–0.4%
Bldg Permits, Aug	1669K	–0.4%	3.9%

LABOR – Sept. '02			
Unemployment Rate	5.6%	–0.3%	0.7%
New Non-Farm Jobs	–43K	+118K	–965K
Avg Hourly Wages	14.87	0.8%	3.0%
Avg Init Unempl Clms	423K	+30K	–30K

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

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

Performance Expectation

	September 2003		*September 2007*	
	Target	Total Return	Target	Total Return
S&P 500	1150	+45%	1750	+115%
NASDAQ	1850	+60%	2800	+140%
30-Yr. T-Bond	5.25%	– 7%	4.5%	+ 30%

MARTIN CAPITAL

U.S. OPPORTUNITY FUND

	NAV	YTD	Annual-ized	Since Inception
U.S. Opportunity Fund-MCUSX*	$2.76	–56.67%	–30.62%	–72.20%

*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 9/30/02

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Computer	23.51	6	Williams-Sonoma	23.63	11	Starbucks	20.64	16	Intel	13.89
2	Whole Foods Market	42.84	7	Applied Materials	11.55	12	Cisco Systems	10.48	17	Bear Stearns	56.40
3	Electronic Arts	65.96	8	Microsoft	43.74	13	Nasdaq 100	20.72	18	Medtronic	42.12
4	Charles Schwab	8.70	9	Tiffany	21.43	14	Oracle Systems	7.86	19	Home Depot	26.10
5	SPDR Trust	81.79	10	Texas Instruments	14.77	15	Enzon	19.24	20	Citigroup	29.65

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	–46.4%	–23.2%	–28.2%	–39.9%	–26.6%	+17.1%	+0.9%	+1.3%
Total[3]	+272.6%	+286.0%	+221.2%	+213.6%	+197.7%	+217.6%	+64.0%	+33.9%
Avg.[4]	+11.6%	+12.2%	+10.4%	+10.2%	+9.7%	+10.3%	+4.3%	+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 53 individual portfolios and 50.8% of all funds under management by MCA on 9/30/02. 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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A Quarterly Publication of
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