THE COMPASS

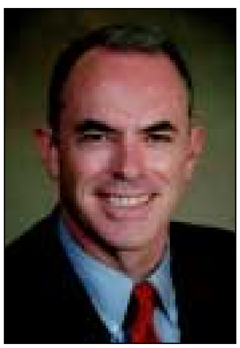
First Quarter, 2003 **A Quarterly Newsletter of Martin Capital Advisors, LLP**

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks rebound despite continuing geo-political uncertainties

January 15, 2003

Most stock indexes rebounded in the fourth quarter, although some of the gains were lost in December as tensions escalated between the U.S. and North Korea. Bond returns were flat as signs of improving economic conditions and the prospect of further economic stimulus outweighed most geo-political concerns and deflation fears began to ease. Oil and gold prices continued to benefit from the threat of war in the Middle East and turmoil in Venezuela.



The past several years have been one of the most unusual and extreme periods in the history of U.S. financial markets. The question looking forward is how much longer will these wild perturbations prevail. Taking history as a guide, stocks should rally significantly over the next few years and bonds should languish as the economy improves – even in the face of continuing geo-political uncertainties. Some would argue that the September 11th attacks were unique in American history and consequently parallels cannot be drawn to other severe bear market cycles. There are, in fact, other attacks and fears of attack on American soil that were at least as traumatic as September 11th. More Americans died in the Civil War than have died in all other wars combined, yet prices on the New York Stock Exchange rose significantly throughout the war. Four months after the attack on Pearl Harbor, "December 7, 1941 – a date which will live in infamy", stocks began a huge four-year rally, even though the threats of Japanese and German terrorism and invasion were high during the first years of the war. Unfortunately, after initially taking the war on terrorism to the enemy, the Bush administration spent most of 2002 broadcasting the potential for future attacks without clearly presenting and taking responsibility for the steps necessary to win the war on terrorism.

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

Growth of $10,000
4/1/91–12/31/02

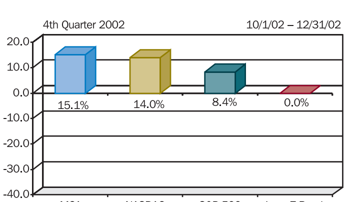
See Important Disclosure Notice on back page.

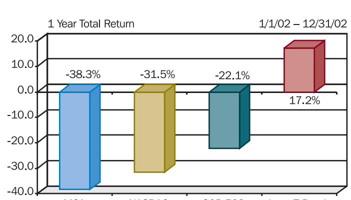
However, as we enter 2003, the financial markets have already discounted a tremendous amount of fear and uncertainty. Accordingly, the downside risk for stocks should be relatively small and the upside potential great as the war on terrorism proceeds and geo-political problems begin to stabilize.

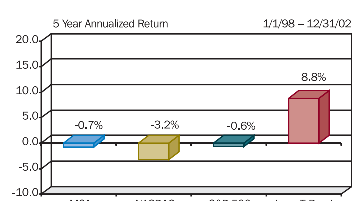
Great opportunities come from the ashes of turmoil and uncertainty. Over the past few years growth stocks have endured one of the worst periods of turmoil and uncertainty in the history of American financial markets. As long as the American economy does not spiral into an unprecedented decline worse than the Great Depression – a very unlikely scenario – most stocks, especially growth stocks, should achieve well above average returns from currently depressed levels over the course of the next several years.

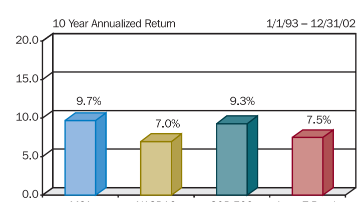
INVESTMENT RESULTS

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









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MARTIN CAPITAL
ADVISORS

The last quarter of 2002 was marked by general improvement in the stock market, lower interest rates and a slower economy. The table below shows that all major stock indexes rose and that the NASDAQ 100 outpaced the market as a whole in the last quarter in spite of dropping the most in 12 months. Short interest rates were down sharply due to the Fed easing. Long rates ended up almost unchanged, with the 30-year bond yield up slightly and mortgage rates down slightly. Economic growth probably declined to an annualized 1.0% to 1.5% rate from the 4.0% experienced in the third quarter. The softer economy was most apparent in the manufacturing sector and the labor market, while the housing industry remained strong. Spending by consumers remained the principal support of our economy. A slight uptick in inflation has occurred, produced primarily by higher prices for oil, gold and some other commodities.

INDUSTRY

The manufacturing sector continued to show weakness for most of the last quarter until the ISM Index (top chart) vaulted up more than five points to a strong 54.7 in December. That Index had remained close to 50.0, which divides growth from contraction, for the previous five months. New orders were primarily responsible for the higher reading in December. This is good news because it means that at least some of the idle capacity will be used. The middle chart shows total capacity utilization of industry, which languished at 75.6% in November, only slightly above the 18-year low of 74.4%, reached in December 2001. After a bit of a recovery early in 2002, it has slipped back down since last July, an indication of weakness. Capacity utilization in manufacturing alone, which has remained lower than the total figure for a dozen years, was only 73.8% in November.

The housing industry has been one of the brightest spots in our economy, supported by low mortgage rates. Though home prices in many parts of the country have continued to rise, monthly mortgage payments have been kept smaller by low interest rates. Unfortunately, this potential benefit has not been able to help commercial construction because the demand by businesses for office space and other commercial uses has contracted with the slower economy. Total construction spending through November, including housing, was only up 0.8% in 12 months. The demand for commercial space will only improve with a stronger economy, when overall business spending has picked up.

SALES

Retail sales have been sluggish, with seasonally adjusted figures in November only about 0.8% above June and 1.0% below August. The numbers from December are not in yet, but the holiday season has been described as the worst in decades in terms of the small increase from the previous year. As strong consumer spending has carried the economy while business spending has been cut to the bone, this is not good news. Some have said that sales weren't as bad as early reports described, so the story may improve when more data is available. Auto and truck sales have been volatile but level for about the past two years, recently tapering off slightly. After a huge jump in October 2001, when zero-interest financing became available, car and truck sales were volatile, moving above and below an annualized average of about 16.5 million units, which happens to be the exact figure for December. October and November sales had slid to the lower end of the range, as some manufacturers' incentives were pulled back. As sales weakened somewhat without the incentives, they will probably be at least partially restored. Buyers have shown that they are intent on getting the best deals possible for all purchases, so it remains to be seen when manufacturers will be able to eliminate most of the costly incentives and start making bigger profits. Home sales continue to be the strongest area of consumer spending, with November's annualized figure of 1.069 million units setting an all-time record. Existing home sales have been equally strong. These sales are directly related to low mortgage rates and consumers' desires to take advantage of low monthly payments. As long as rates stay this low, barring major geopolitical crises, home sales will remain strong.

LABOR

The labor market showed increasing strength through 2001 until the last quarter, then it weakened, showing the same pattern as the overall economy. The number of non-farm jobs, fell 101,000 in December and 200,000 in the last quarter. The loss for the entire year was only 181,000 jobs, compared to 1.2 million in 2001. The December average of weekly initial unemployment claims rose to 419,000 from 377,000 in November, confirming the weak trend. Total average hours worked per week fell 0.1 to 34.1, but hours worked in manufacturing, the weakest sector over the entire previous year, rose 0.3 to 40.9. Overtime hours also rose 0.2 to 4.2, another sign of strength hidden in the cloud of weak labor market news. Initial unemployment claims and average

hours worked per week in manufacturing are leading indicators that are currently pointing in opposite directions. The unemployment rate rose 0.3% to 6.0% in November and stayed there in December, though this indicator tends to lag the economy as a whole. Expansion and hiring by businesses are badly needed to improve labor market conditions.

INFLATION

The overall rate of inflation in our economy has turned up slightly, both in the last quarter and over 12 months. The Consumer Price Index shows a 2.3% increase and the Producer Price Index of wholesale prices a 0.9% increase in 12 months. Crude oil and gold have been primary contributors to the slight increase in the inflation rate. Oil prices rose over most of the past year, as war in the Persian Gulf region has become increasingly likely. Venezuela's political problems have recently caused a near shutdown of oil exports. As about 14% of U.S. oil imports come from Venezuela, this situation has led to a shortfall in U.S. oil supplies and prices have gone up several dollars a barrel in response. Gold prices have trended up over most of the past year in response to widespread global political uncertainties. Another factor pushing up the price of gold has been the corresponding decline in the strength of the U.S. dollar. As the dollar

weakens, more of our currency is needed to buy each ounce or pound of any commodity on the world market. The bottom chart shows the 12-month change in hourly wages, an important measurement because two-thirds of inflation usually comes from wage costs. As the rate of wage increases is declining, this clearly doesn't show any threat from rising inflation.

SUMMARY AND OUTLOOK

After a strong showing in the third quarter of 2002, the economy sagged. Though all the figures aren't in yet, we'll be lucky to see an annualized growth rate of 1.5% in the fourth quarter, less than half that of the previous three months. Some are worried that the economy will continue to sink into another recession and even into a downward deflationary spiral. What will keep this from happening? Several things. First, we had a recession that had bloated inventories as a primary cause. With the inventory-to-sales ratio now at lows not seen for several decades, oversized inventories are no longer a problem. Second, the Fed is now more concerned about the potential of deflation rather than inflation, an important change. Instead of fighting inflation, it has turned to deal with the problems of a slow economy and no pricing power. This means that the Fed is pumping money into the economy and will continue to maintain a loose monetary policy until after clear signs of a sustained recovery have appeared. Third, tax cuts already in place have given consumers' disposable income a boost and more tax cuts are apparently on the way. If the potential of a war with Iraq has gone away by April or May, whether because the war has been won or because Saddam has been removed, the door will be open to a strong recovery in both the economy and stock market. Uncertainty has been a principal factor holding back business spending and the economy as a whole. The resolution of most of the problems with Iraq will put us on a stronger footing psychologically, even if other problems like Al Qaeda and North Korea still remain. With the strong fiscal and monetary stimulus already in place and less global uncertainty, we might find ourselves with an economy stronger than we anticipated or even wanted by the end of next year.

MARKET AND ECONOMIC STATISTICS

as of Market Close December 31, 2002, with 3-month and 12-month changes

3rd Quarter '02	Final	3 mo	12 mo
GDP-Bil$	9486	4.0% apr	3.3%
GDP Deflator	110.8	1.0% apr	0.8%
Empl Cost Index	161.1	0.8%	3.7%
NF Productivity	123.8	5.1% apr	5.6%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	8342	9.9%	–16.8%
S&P 500	880	7.9%	–23.4%
NASDAQ Comp	1336	13.9%	–31.5%
NASDAQ 100	984	18.2%	–37.6%
NYSE Comp	473	6.2%	–19.8%
Wilshire 5000	8343	7.3%	–22.2%
Russell 2000	383	5.7%	–21.6%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	1.21%	–24.8%	–29.2%
30-yr T-Bond Yld	4.78%	2.1%	–12.5%
FNMA 30yr mortg	5.52%	–3.3%	–21.3%
Prime Rate	4.25%	–10.5%	–10.5%
Fed Funds Trgt	1.25%	–28.6%	–28.6%
Fed Disc Rate	0.75%	–40.0%	–40.0%
S/L Long T-Bnd Ind	11657	0.0%	17.2%

PRICES, INFLATION		3 mo	12 mo
CPI, Nov	181.5	0.6%	2.3%
PPI, Nov	139.5	0.7%	0.9%
Gold, cash	348.1	7.5%	24.9%
W Tx Int Cr Oil	31.23	2.6%	57.4%
Copper, cash	0.70	5.6%	6.7%
CRB Futures Ind	234.5	3.5%	23.0%
CRB Raw Indust	248.6	3.3%	14.4%

MONEY			
M2, Bil Curr$, Nov	5801	2.1%	7.1%
Free Reserves	1451	15.0%	– 8.0%
Money Mkts-Bil$	2358	6.2%	0.5%
US $$$ Index	101.8	–4.7%	–12.8%

INDUSTRY			
ISM Index, Dec	54.7	5.2	6.5
Indus Prod Ind, Nov	110.8	–0.5%	1.8%
Cap Utiliz, Nov	75.6%	–0.5%	0.9%
Bldg Permits, Nov	1725K	3.5%	4.0%

LABOR – Dec. '02			
Unemployment Rate	6.0%	0.4%	0.2%
New Non-Farm Jobs	–101K	–200K	–181K
Avg Hourly Wages	14.98	0.9%	2.9%
Avg Init Unempl Clms	419K	–6K	+9K

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

		Δ
Stocks	140%	−10%
Bonds	0%	0%
Cash	−40%	+10%

Performance Expectation

	December 2003 Target	December 2003 Total Return	December 2007 Target	December 2007 Total Return
S&P 500	1160	+35%	1950	+125%
NASDAQ	1950	+45%	3300	+145%
30-Yr. T-Bond	5.25%	− 5%	4.5%	+ 30%

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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.

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Computer	26.74	6	SPDR Trust	88.23	11	Cisco Systems	13.10	16	Bear Stearns	59.40
2	Whole Foods Market	52.73	7	Microsoft	51.70	12	Electronic Arts	49.77	17	Medtronic	45.60
3	Charles Schwab	10.85	8	Oracle Systems	10.80	13	Texas Instruments	15.01	18	Enzon	16.72
4	Williams Sonoma	27.15	9	Nasdaq 100	24.37	14	Intel	15.57	19	Citigroup	35.19
5	Applied Materials	13.03	10	Tiffany	23.91	15	Starbucks	20.38	20	Home Depot	23.96

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	−38.3%	−15.1%	−22.1%	−31.5%	−20.9%	+17.2%	+1.1%	+2.3%
Total[3]	+328.8%	+326.9%	+248.3%	+257.3%	+238.2%	+217.7%	+64.3%	+35.3%
Avg.[4]	+12.9%	+12.9%	+11.0%	+11.2%	+10.7%	+9.3%	+4.2%	+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]1991-2002 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 58.8% of all funds under management by MCA on 12/31/02. 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 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.