THE COMPASS

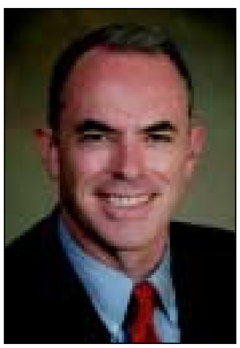
Second Quarter, 2003 **A Quarterly Newsletter of Martin Capital Advisors, LLP**

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

It's not a matter of if, but when higher growth resumes

April 19, 2003

Investment results were mixed over the first quarter as the weight of tensions with North Korea, Iraqi weapons inspections debates and the buildup to the U.S./U.K. invasion of Iraq counterbalanced positive underlying economic conditions. After an initial rally at the beginning of the quarter on the hope that the disarmament of Iraq would be pursued through the U.N., the stock market fell back as the likelihood of war without multilateral consensus became increasingly evident. Just before the "shock and awe" campaign started in mid-March stocks rebounded on the lifting of the uncertainty of whether and when the war would happen, then fell back as casualties occurred contrary to the notion that with precision bombing no one would be hurt.



Now that the war is essentially over and the oil fields have been secured the financial markets can begin to focus on economic conditions again. Although the uncertainty of the war and high oil prices depressed economic activity and corporate earnings in the first quarter, the odds are high that the stock market will quickly begin to look beyond the present economic weakness to expectations of better economic and earnings performance later in the year. Most likely, we are on the verge of a substantial rally that could carry most stocks, especially economically sensitive growth stocks, to much higher levels by the end of the year. Bonds will probably not fare as well as faster economic growth replaces fears of deflation with nascent concerns about inflation. All bets are off, however, if the Bush administration manages to stir up further geo-political unrest. But the president must know that he has only a year and a half to get the economy back on track to improve his chances for re-election and that reducing international tensions is necessary for sustained acceleration of economic growth.

Given the extremely poor performance of most stocks for several years amidst an unrelenting barrage of problems and uncertainties, it would be easy to believe that the economy and the stock market may never rise again to anything more than a mediocre performance, at best. Fortunately, it's not a matter of if, but when Americans will shrug off overblown fears of terrorism and geo-political unrest. Then positive macro-economic, monetary and fiscal conditions already in place should produce strong economic growth and above average stock market returns.

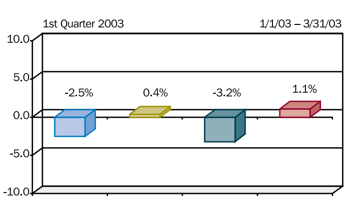
MCA Flexible Portfolios
12-month Tax Efficiency: 102.1%
(After Tax Return divided by Before Tax Return)

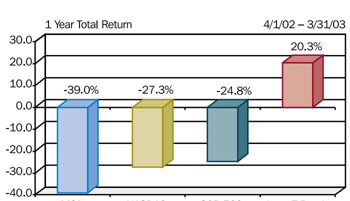
Growth of $10,000
4/1/91–3/31/03

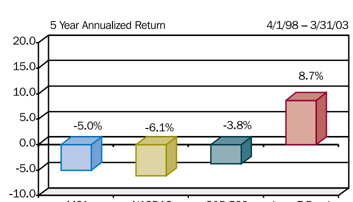
See Important Disclosure Notice on back page.

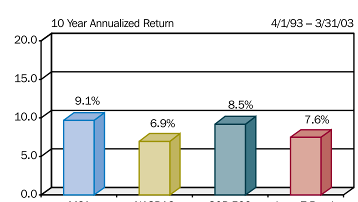
INVESTMENT RESULTS

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









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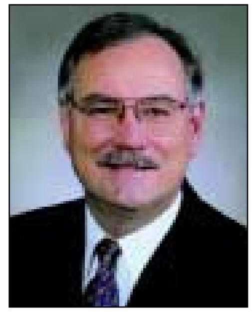
The 1st quarter of 2003 may be seen as a period leading up to a war, with all of the uncertainties and worries that such a time implies. Though the war with Iraq finally began, the most important uncertainty still remained at the end of the quarter: the outcome. Most stock indexes fell slightly during the quarter, not only because of the uncertainties, but also because of the direction of the economy. Economic growth fell to an annualized 1.4% rate in the last quarter of 2002, and the prospects for the quarter just ended are probably close to that. Interest rates remained stable over the period, though inflation has increased since the middle of last year, pushed up by higher oil prices. Prices of gold, copper and oil, however, have all recently declined. Manufacturing and industry, except for housing, have suffered. The job market has also weakened, both because of a weaker economy and because of the country moving to a war footing.

INDUSTRY

Manufacturing hit a big pothole in March. In two months, the ISM Index of Manufacturing fell from 53.9 to 46.2, as sharp a decline as any in the past dozen years, as shown in the top chart at right. No good news was apparent anywhere in the report, as nearly every one of the nine components registered a decline except for prices. The ISM Non-Manufacturing Index showed virtually the same pattern. Capacity utilization of industry as a whole and of manufacturing in particular remained near 20-year lows in February, at 75.6% and 73.4%. The Industrial Production Index, which appears to react more slowly, rose 0.1% in February, and 1.7% over 12 months.

Single-family homes have been the strongest segment of our economy, supported by low mortgage rates. Though volatile from month to month, housing starts have been increasing since mid-2000. February 2003 showed one of the largest monthly declines in housing starts for the past couple of years, though bad weather as well as war worries might have helped to pull this down.



SALES

Businesses have cut spending to the bone, leaving consumers with the job of keeping our economy going. The 12-month change in retail sales shows a pattern of declining from the greater than 8% growth rates of late 1999 and early 2000 to a lower plateau of roughly 3% to 4% growth per year. As consumers have been the main support for our economy over the past couple of years, we have been fortunate that the decline was not as severe as it was during the 1990-91 recession. Total retail sales in February were down 1.6%, pulling the year-over-year figure down to 2.6%. Auto sales have been extraordinarily volatile since October 2001, when zero-interest loans and other strong incentives were first offered. Though still strong by historical standards, the monthly average has declined slightly over the six months. A distinct decline occurred in January of this year, as zero-interest financing was pulled back so auto companies could earn some money. New home sales remained strong until the past two months. January's figure fell 12.6%, and February's another 8.1%, resulting in the lowest number of home sales since August 2000. In contrast, sales of existing homes remained far more stable, with February's roughly the same as two months before. The difference between sales of new and existing homes is somewhat of a mystery, though the market for existing homes is far larger: about six times as many existing homes as new homes are sold each month.

LABOR

The labor market has been hard-hit by the uncertainties about and preparations for war with Iraq. Though the unemployment rate has not risen sharply, remaining at 5.8% for the past two months, the 4-week average of weekly initial unemployment claims has surged upward to 426,000, the highest such figure since May of last year. Moreover, 409,000 jobs have been lost in the past four months. Though things looked better in January, when we gained 203,000 jobs, February and March put an end to the improvement. Interestingly, the average number of hours worked per week and the number

of overtime hours per week have remained relatively stable and have not pointed to a worsening of conditions. Initial unemployment claims and the average number of hours worked per week in manufacturing are two of the Conference Board's nine Leading Indicators. Thus, we see one indicator pointing to weaker conditions and the other to more stable conditions. In any case, the principal cause of weakness has been the reluctance of businesses to hire workers in today's uncertain times. The Challenger Report of corporate layoffs showed a counter-trend, with 138,117 jobs cut in February, but only 85,396 in March. The apparent improvement in March may have been the result of companies being reluctant to do anything at all, even let people go.

INFLATION

Overall inflation has increased over the past eight months, driven up primarily by the rising price of oil. The top chart at right shows the 12-month change in the Consumer price Index, the most widely followed measure of inflation, with the 12-month change in the core rate, which omits food and energy prices. The CPI inflation rate has risen from 1.1% last July to 3.0% in February, a sharp increase by historical standards. In contrast, the CPI Core rate has fallen from a high of 2.4% in May of last year to 1.8% last month, *the lowest since 1966*. Energy has been responsible for the difference between the two inflation measurements. Note how the change in the CPI in the top chart tends to follow the price of oil in the middle chart, while the CPI Core rate has little in common with the price of oil. The price of oil dropped sharply as the war began, following the pattern established in the previous Gulf War, so we will soon see inflation decline with it. High oil prices have a negative impact on our economy as a whole because consumers have to pay more for energy-related products like gasoline and have less available to spend on other goods and services. Thus, cheaper oil bodes well for the future. Gold's price also rose, but it has little impact on the average consumer or on the CPI. This traditional measure of inflation is up because of uncertainty and because of the decline in the value of the US dollar.

SUMMARY AND OUTLOOK

We're faced with a complex economic picture today because of the war with Iraq and the uncertainties associated with it. There is no doubt whatever that a large part of the resources of equipment and personnel dedicated to the war have come at the expense of the rest of our economy and left it weaker. It is also almost certain that most of this will not be made up later and therefore the economy will probably not come leaping back. The rebuilding of Iraq will require even more of our resources, but at least there is an opportunity for companies, both US and foreign, to make money in that process and contribute to growth. As this is written, it appears that the war is entering its final phase, with coalition forces surrounding Baghdad. One can only guess at how long it will take to draw to a close and ring down the curtain on Saddam Hussein. Though born in Tikrit like Saladin, who fought gloriously and won against Richard the Lionheart, he faces an ugly end and will not be well remembered by his people.

The war has weakened the world economy, as well as that of the US. In this environment, we are likely to see a plunge in the price of crude oil over the next three months or so. Oil has been kept high not only because of the war in the Persian Gulf, but also because of political problems in Venezuela and by labor problems in Nigeria, two other major producers. The problems causing the slowdown in oil production in both of those countries will probably be resolved in a few months and oil will start to flow from Iraq again. In the face of a weak world economy, prices will probably drop at least to the low $20s. This will be a great help in reinvigorating the US economy without causing inflation. In fact, considering how low the core rate of inflation is today, we may start hearing about deflation again. The return of many of our troops, the removal of uncertainty about the war and lower oil prices will provide an excellent tonic for our economy.

MARKET AND ECONOMIC STATISTICS

as of Market Close March 31, 2003, with 3-month and 12-month changes

4th Quarter '02	Final	3 mo	12 mo
GDP-Bil$	9518	1.4% apr	2.9%
GDP Deflator	111.3	1.8% apr	1.3%
Empl Cost Index	162.3	0.7%	3.4%
NF Productivity	123.9	0.8% apr	4.1%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	7992	–4.2%	–23.2%
S&P 500	848	–3.6%	–26.1%
NASDAQ Comp	1341	0.4%	–27.3%
NASDAQ 100	1019	3.5%	–29.9%
NYSE Comp	4730	–5.4%	–25.5%
Wilshire 5000	8052	–3.5%	–25.3%
Russell 2000	365	–4.8%	–28.0%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	1.12%	–7.4%	–36.7%
30-yr T-Bond Yld	4.83%	1.0%	–16.7%
FNMA 30yr mortg	5.44%	–1.4%	–21.7%
Prime Rate	4.25%	0.0%	–10.5%
Fed Funds Trgt	1.25%	0.0%	–28.6%
Fed Disc Rate	0.75%	0.0%	–40.0%
S/L Long T-Bnd Ind	11787	1.1%	20.3%

PRICES, INFLATION		3 mo	12 mo
CPI, Feb	183.3	1.0%	3.0%
PPI, Feb	143.0	2.4%	3.5%
Gold, cash	337.4	–3.1%	11.9%
W Tx Int Cr Oil	31.03	–0.6%	17.9%
Copper, cash	0.71	2.2%	–6.3%
CRB Futures Ind	232.2	–1.0%	13.3%
CRB Raw Indust	258.0	3.8%	11.3%

MONEY			
M2, Bil Curr$, Feb	5880	1.7%	6.9%
Free Reserves	1663	15.0%	24.0%
Money Mkts-Bil$	2271	–3.7%	–2.1%
US $$$ Index	98.9	–2.9%	–16.7%

INDUSTRY			
ISM Index, Mar	46.2	–9.0	–8.5
Indus Prod Ind, Feb	111.1	0.3%	1.7%
Cap Utiliz, Feb	75.6%	0.0%	0.5%
Bldg Permits, Feb	1786K	2.8%	1.1%

LABOR – Mar. '03			
Unemployment Rate	5.8%	–0.2%	0.1%
New Non-Farm Jobs	–108K	–262K	–292K
Avg Hourly Wages	15.10	0.8%	3.1%
Avg Init Unempl Clms	326K	+7K	+2K

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

Stocks	135%	Δ	–5%
Bonds	0%	Δ	0%
Cash	–35%	Δ	+5%

Performance Expectation

	March 2004		March 2008	
	Target	Total Return	Target	Total Return
S&P 500	1100	+30%	1700	+110%
NASDAQ	1800	+35%	3000	+130%
30-Yr. T-Bond	5.25%	– 5%	5.0%	+ 25%

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A Quarterly Publication of
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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	27.31	6	Microsoft	24.21	11	Cisco Systems	12.98	16	Bear Stearns	65.60
2	Whole Foods Market	55.64	7	Oracle Systems	10.85	12	Charles Schwab	7.22	17	Medtronic	45.12
3	Applied Materials	12.58	8	Tiffany	25.00	13	Nasdaq 100	25.25	18	Citigroup	34.45
4	Electronic Arts	58.64	9	SPDR Trust	84.74	14	Texas Instruments	16.37	19	Home Depot	24.36
5	Starbucks	25.76	10	Williams-Sonoma	21.80	15	Intel	16.28	20	Centex	54.36

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%
2003	–2.5%	–3.6%	–3.2%	+0.4%	–3.1%	+1.1%	+0.2%	+1.0%
Total[3]	+318.2%	+311.3%	+237.3%	+258.8%	+227.8%	+221.3%	+64.6%	+36.6%
Avg.[4]	+12.4%	+12.2%	+10.4%	+11.0%	+10.2%	+10.0%	+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]1991-2003 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 54 individual portfolios and 57.9% of all funds under management by MCA on 3/31/03. 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.