THE COMPASS

First Quarter, 2004

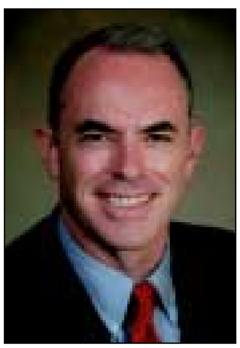
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Accommodative Fed policy reversing negative economic impact of war and terrorism

January 16, 2004

Fourth quarter stock market returns were quite positive as accommodative monetary policy continued to stimulate the economy. Despite few signs of inflation, bond returns were depressed by the improving economy and some uneasiness about whether the current economic stimulus will be maintained for too long – possibly stoking the fires of inflation.



The Federal Reserve Board has made it clear that enhancing economic growth is a higher priority than fighting inflation for the foreseeable future. This position is based largely on the recent deflation scare (the Fed is perpetually fighting the last war) and disinflationary conditions, such as high productivity and global business competition. The reason that Fed policy has been the most accommodative in fifty years and most likely will maintain a bias toward stimulating growth versus fighting inflation is also based on concerns about war and terrorism and their potential for causing economic instability. The net result of the Fed being more accommodative than it would be without the ongoing issues of war and terrorism is a much greater potential for above average economic growth and better stock market performance.

Although the Fed's new posture of erring on the side of growth has very positive implications for stocks, the opposite applies to interest rate sensitive investments, such as bonds, which may achieve mediocre returns, at best, as strong economic growth increases fears of inflation. Given the disinflationary conditions mentioned before, however, it is very unlikely that a significant pick-up in inflation will occur anytime soon.

The combination of sustained monetary stimulus and subdued inflation is a powerful force for economic expansion and accelerating corporate profits, which should produce higher stock market returns. Just as it was a mistake to be bullish several years ago in the face of a restrictive monetary policy, it probably will be a mistake to be bearish in the face of today's stimulative monetary policy. While 2000 to 2002 were unusually difficult years for the stock market, the next several years are poised to be unusually profitable.

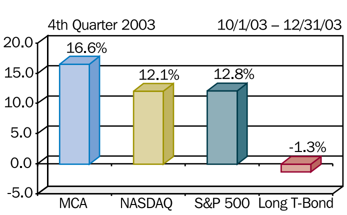
MCA Flexible Portfolios
12-month Tax Efficiency: 99.9%
(After Tax Return divided by Before Tax Return)

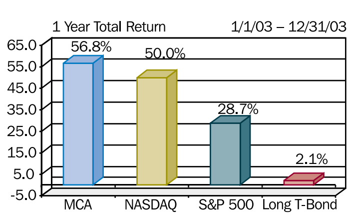
Growth of $10,000
1/1/91–12/31/03

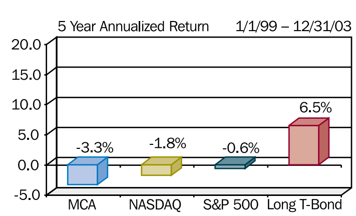
See Important Disclosure Notice on back page.

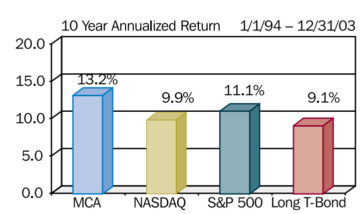
INVESTMENT RESULTS

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







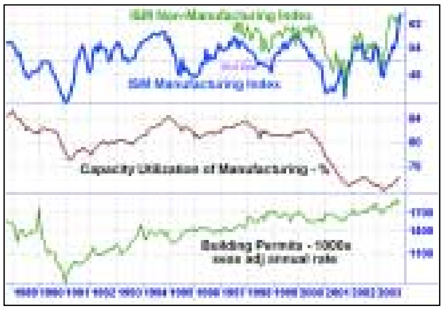


See Important Disclosure Notice on back page.

The torrid 8.2% annualized growth rate of GDP in the third quarter of 2003 probably slowed somewhat in the fourth quarter – to a nearly normal 4% or 5% pace. Major stock indexes all produced double-digit increases in the last quarter, while all major indexes increased at least 25% over the entire year, led by the NASDAQ, which rose 50%. Stimulative monetary and fiscal policies have been the main driving forces of the economy and the equity markets. Inflation seemed to show a split personality, with the Consumer Price Index up only 1.8% in 12 months through November, while gold and industrial commodities showed big increases.

INDUSTRY

Manufacturing, the weakest part of the economy in the last recession, is finally showing signs of a strong recovery. The ISM Manufacturing Index for December reached 66.8, the highest since 1983. Out of 20 industries surveyed, 17 showed growth. The supplier delivery index, a component of both the Manufacturing Index and the Conference Boards Index of Leading Indicators, rose to the highest level since February 1995. Customer inventories were found to be unusually low and the jobs component of the index increased dramatically. Most of the jobs lost since the recession began were in manufacturing, so an improvement there comes where it is most needed. The ISM Non-Manufacturing or Services Index has remained over 60 for six of the last seven months. As services make up over 75% of GDP, indications are that the largest part of our economy has been in recovery for over half a year. Capacity utilization of manufacturing was only 74.3% in November, up from the low of 72.1% last April, low levels that show how severe the decline in US Manufacturing has been. On the positive side, low capacity utilization in the recovery means that companies will be able to expand into existing facilities at lower cost than if they had to build new ones, thereby improving profit margins.



Home construction has remained the strongest part of our economy for the past two years. Building permits and housing starts remain near record levels, supported by low mortgage rates, with low monthly payments making homes into bargains that have been irresistible for many.

SALES

Consumer spending remained relatively strong throughout the recent economic decline in contrast to business spending which saw drastic cuts. Retail sales, though volatile from month to month, have registered an annual increase of 6.8% for several months, a solid performance compared to the previous decade. Auto and light truck sales have been strong but volatile for the past two years. Car manufacturers introduced zero-interest loans after 9/11, which provided the first leap upward. Other incentives offered since then have given further sharp boosts, keeping sales close to the range of 16 to 18 million units on an annualized basis. Home sales have been the star performers over the past two years, supported by low mortgage rates. Business spending appears to be picking up significantly for the first time in several years. The inventory to sales ratio of manufacturing fell to 1.29 in November, by far the lowest level in a decade, implying that more products must be produced in order to meet expanding demand.

LABOR

The labor market has been the second weak spot in our economy. Most of the 2.1 million jobs lost since 2000 have been in manufacturing, as businesses cut spending and companies moved plants overseas in order to gain an advantage from lower wages there.

The economy struggled to produce jobs in 2003, with six straight months of negative job growth that ended in July. Since then we have seen positive job numbers each month and a total gain of 278,000, though December was a disappointment with only 1,000 new jobs. Initial unemployment claims, a measure of jobs lost each week, have fallen sharply to an average of 356,000 in December, substantially below 400,000, a level that implies no job growth. The middle chart shows initial unemployment claims as a percent of total jobs in an effort to adjust for the effect of our continually growing labor market. With this perspective, current initial claim figures are now lower than the entire period 1989 to 1996. Another bit of good news is that the average

number of hours worked per week in manufacturing was 40.7, well above the low of 40.1 last July. Both initial claims and hours worked in manufacturing are components of the Conference Board's Index of Leading Indicators. Average overtime hours per week are also up from 4.0 last June to 4.6 in December. Companies, including those in the manufacturing sector, are hiring once again. Even allowing for slightly weaker numbers in December, this is the best news from the labor market in over three years, as virtually all important indicators of the labor market are now pointing to a strong recovery.

INFLATION

The overall rate of inflation in our economy as indicated by the Consumer Price Index change over 12 months is 1.8%. The core rate of inflation, which excludes volatile food and energy sectors, shows an inflation rate of 1.15%, the lowest since 1963. Charts of both CPI inflation and the core rate show a declining pattern, while gold is up 56% in a little less than three years. Part of this rise is due to the decline in the value of the US dollar, but the change is also due to geopolitical uncertainty and to the appeal of gold in India and China, which are both prosperous today. A manufacturing boom in China is largely responsible for sharp rises in copper, nickel, aluminum and scrap steel prices, with demand for raw materials there enough to push the CRB Raw Industrials Commodity Price Index up 44% in a little over two years. Oil prices finished out the year over $32/barrel, supported by increasing demand from China, as well as reduced supplies caused by political problems in Venezuela and labor problems in Nigeria. Commodity prices, however, make up only a small part of the cost of manufactured products, while labor makes up the lion's share. In fact, labor is generally regarded as being responsible for two-thirds of inflation. The bottom chart shows the annual rate of change of hourly wages in the US, which were up 2.0% through December, a rate that has declined from a peak of 4.3% a little over three years ago. Thus, we are seeing little danger of inflation from that direction. On the other hand, fears of deflation have been reduced by the rapid growth of our economy.

SUMMARY AND OUTLOOK

The Fed's loose monetary policy incorporating extraordinarily low interest rates plus the fiscal policy of tax cuts have been the main driving forces of the economy. With that kind of stimulus, it's hard to see the 8.2% growth of the third quarter being an anomaly when it's obvious that strong growth has continued into the fourth quarter and no slowdown is apparent for the future. Uncertainty about the war in Iraq was a restraint during the first half of the year, but when the economy and markets were released from the grip of uncertainty, they surged forward. Looking ahead, the chances for any significant outbreak of inflation are slim in spite of rising commodity prices and a falling US dollar. More influential are the deflationary forces of rapidly increasing productivity, low capacity utilization and slower increases in labor costs. At this early stage of the recovery, the stimulus of low interest rates is still needed to keep it rolling. The Fed has come close to promising that it won't take away the punchbowl as soon as the party gets going, so we can probably expect more leniency from the Fed than in most recoveries in the past. Another reason for the Fed being more accommodative is a fairly close brush with deflation in the recent past, a risk that hasn't entirely gone away today. Still another factor is the Fed's hedging against another terrorist attack by taking a more stimulative stance than it would under more traditional and secure circumstances. A critical part of this recovery has been the sharp increase in corporate earnings, which has given legs to the recovery and allowed the hiring of more workers, which we are seeing now. High debt levels of both businesses and consumers are likely to act as a damper on the expansion, otherwise all these factors point to a continuing recovery and a strong economy.

MARKET AND ECONOMIC STATISTICS

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

LABOR – Dec '03		3 mo	12 mo
Unemployment Rate	5.7%	–0.4%	–0.3%
New Non-Farm Jobs	+1K	+77K	–309K
Avg Hourly Wages	15.50	0.4%	2.0%
Avg Init Unempl Clms	355.8K	–49K	–55K

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10454	12.7%	25.3%
S&P 500	1112	11.6%	26.4%
NASDAQ Comp	2003	12.1%	50.0%
NASDAQ 100	1468	12.6%	49.1%
NYSE Comp	6464	14.5%	29.3%
Wilshire 5000	10800	11.9%	29.4%
Russell 2000	557	14.2%	45.4%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	0.93%	–1.1%	–23.1%
30-yr T-Bond Yld	5.07%	3.9%	6.1%
FNMA 30yr mortg	5.55%	1.6%	0.5%
Prime Rate	4.00%	0.0%	–5.9%
Fed Funds Trgt	1.00%	0.0%	–20.0%
Fed Disc Rate	0.50%	0.0%	–33.3%
S/L Long T-Bnd Ind	11900	–1.3%	2.1%

PRICES, INFLATION		3 mo	12 mo
CPI, Nov	184.6	0.1%	1.8%
PPI, Nov	144.5	0.8%	3.4%
Gold, cash	415.7	7.9%	19.4%
W Tx Int Cr Oil	32.78	12.1%	5.0%
Copper cent/lb	104.00	27.9%	49.2%
CRB Futures Ind	255.3	4.8%	8.9%
CRB Raw Indust	308.3	9.9%	24.0%

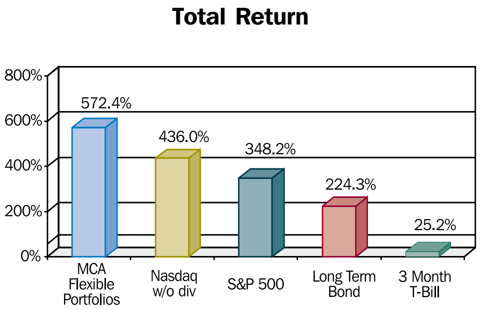
MONEY		3 mo	12 mo
M2, Bil Curr$, Aug	6071	–1.2%	5.1%
Free Reserves	1.89	43.0%	–2.0%
Money Mkts-Bil$	2091	–2.9%	–11.3%
US $$$ Index	86.8	–6.5%	–14.8%

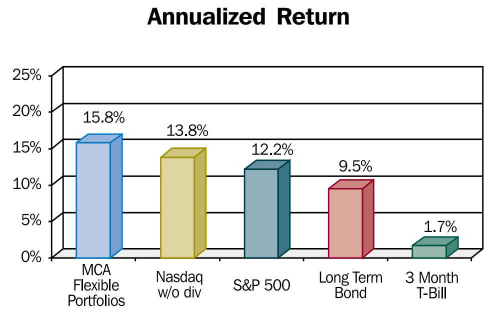
INDUSTRY		3 mo	12 mo
ISM Index, Dec	66.8	13.1	11.6
Indus Prod Ind, Nov	112.9	0.3%	1.7%
Cap Utiliz, Nov	75.7%	0.0%	0.5%
Bldg Permits, Nov	1874K	2.8%	1.1%

3rd Qtr. '03	Final	3 mo	12 mo
GDP-Bil$	10493	8.2% apr	3.6%
GDP Deflator	105.9	1.6% apr	1.7%
Empl Cost Index	167.5	1.0%	4.0%
NF Productivity	131.8	9.4% apr	4.1%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 2003





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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios. Independent CPA performance review available on request.

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Computer	33.98	6	Nasdaq 100	36.46	11	Electronic Arts	47.68	16	Microsoft	27.37
2	Whole Foods Market	67.13	7	Texas Instruments	29.38	12	Charles Schwab	11.84	17	Centex	107.65
3	Applied Materials	22.44	8	Williams Sonoma	34.77	13	SPDR Trust	111.28	18	CitiGroup	48.54
4	Tiffany	45.20	9	Starbucks	33.16	14	Oracle Systems	13.23	19	Home Depot	35.49
5	Intel	32.05	10	Cisco Systems	24.23	15	LAM Research	32.30	20	Bear Stearns	79.95

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	+56.8%	+28.3%	+28.7%	+50.0%	+31.6%	+2.1%	+0.6%	+1.8%
Total[3]	+572.4%	+447.6%	+348.2%	+436.0%	+345.2%	+224.3%	+65.3%	+37.7%
Avg.[4]	+15.8%	+14.0%	+12.2%	+13.8%	+12.2%	+9.5%	+3.9%	+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]1991-2003 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 44 individual portfolios and 46.1% of all funds under management by MCA on 12/31/03. 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.