THE COMPASS

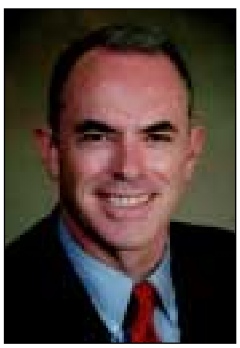
April, 2004 — **A Quarterly Newsletter of Martin Capital Advisors, LLP**

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Prospects for economy and stocks positive despite Iraq and terrorism wars

April 15, 2004

After rallying more than five percent at the beginning of the quarter and then declining almost ten percent off the highs, most stocks recovered enough by the end of the first quarter to close about where they ended last year. Initial enthusiasm for improving economic conditions was tempered by rising concerns about terrorism, the war in Iraq and some weaker than anticipated employment statistics. Bonds and interest rate sensitive securities benefited from these concerns, resulting in an almost six percent return for long treasury bonds.



As the second quarter unfolds stocks should respond positively to continuing strong economic news. Interest rates may rise in response to improving economic activity and increasing employment, but disinflationary factors, such as high productivity, should keep inflation in check and reduce the likelihood of a sustained surge in interest rates. Although the Federal Reserve Board may begin to raise short interest rates in the not too distant future, short rates should still be accommodative to economic expansion from the present Fed Funds rate of one percent up to about four percent. Contrary to the fears of many bond market analysts, the probability is low that the Fed will aggressively raise rates in the face of the possibility of another major terrorist attack and the geopolitical instability surrounding the ongoing conflict in Iraq. The upcoming presidential election is another reason the Fed may be more accommodative than usual, at least until the end of the year.

While Iraq and the war on terrorism may be problematic for a long time, at this point they probably will not do much damage to the economy and may, in fact, strengthen the economy, as has been the case during many other periods of war and conflict. It's important to remember that even in the weak economic environment at the time of the September 11th attacks it only took one month for stocks to recover to pre-attack levels, and that the economy continued to recover from the 2001 recession, returning to strong growth by the end of the year. Unfortunately, the uncertainty caused by the build-up to the war with Iraq in 2002 caused the economy to slow again and the stock market to retreat a second time. Given the amount of monetary stimulus already in place today, however, any terrorist attacks, difficulties in Iraq or other shocks to the system should have a smaller negative impact on the economy and the stock market. On the other hand, if greater progress is made in the war on terrorism and the Middle East starts to show signs of stabilization, then the above average economic growth and stock market performance achieved in 2003 may prove to be just the beginning of another long-term bull market.

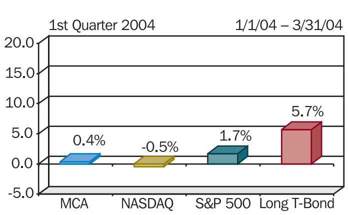
MCA Flexible Portfolios
12-month Tax Efficiency: 99.4%
(After Tax Return divided by Before Tax Return)

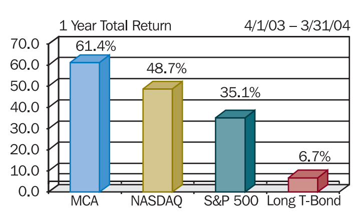
Growth of $10,000
1/1/91–3/31/04

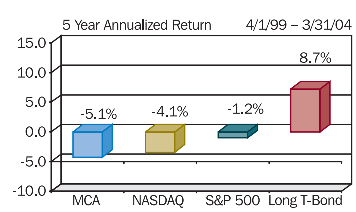
See Important Disclosure Notice on back page.

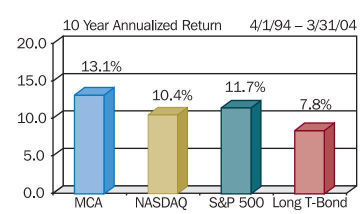
INVESTMENT RESULTS

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. ——

QUARTERLY ECONOMIC REVIEW by Alston Boyd, Economic Director

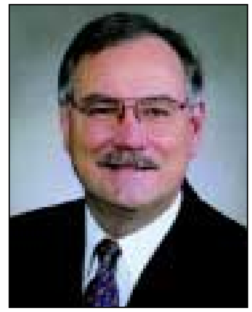
April 7, 2004

Growth in the first quarter of 2004 was probably about equal to the growth rate of the last quarter of 2003, an annualized rate of 4.1%. Productivity rose sharply last year, good news for corporate earnings. The major stock market indexes all increased dramatically in 2003, then took a little bit of a rest in the first quarter, staying roughly flat. Interest rates remained virtually flat in the first quarter, though long rates declined about 5% and are far below those of a year ago. Inflation overall has remained low, though gold and industrial commodities have risen sharply. The two sectors of our economy that have been the slowest to recover, industry and labor, are now showing clear evidence of a strong recovery.

INDUSTRY

Long a laggard in the economic recovery, manufacturing has come back strong. The Institute for Supply Management's Manufacturing Index has remained above 50 for the last nine months and above 60 for the past five. A value greater than 50 means expansion rather then contraction and 60 indicates extraordinary strength. Before the last five months, this index had not been above 60 since 1987. Capacity utilization of manufacturing has risen sharply to 75.2%, up 3.1% from its low last April. Total capacity utilization of industry has risen to 76.6%, up 2.6% from its low. Factory orders have risen 6.3% in 12 months and durable goods are up 7.7%. While manufacturing's share of our economy has contracted to about 15% of GDP over the past 25 years, services have grown to form about 70%. The ISM Services Index rose to 65.8 in March, the highest since this index was created in July 1997. In summary, all of these indicators point to a strong recovery and there are no important indicators showing weakness at present.

Homebuilding has performed strongly before, during and after the recession. Homes have been made into bargains by low mortgage rates, as relatively small monthly payments made housing affordable and even irresistible to many consumers. Homebuilders have taken advantage of the situation, building as many homes as possible to meet the strong demand.



SALES

As consumer spending makes up about two-thirds of our economy, sales are an important indicator of economic health. Retail sales were up 0.6% in February, and up 8.1% over a year earlier. Though February of last year was a slow month because of nervousness in anticipation of the invasion of Iraq, the strong upward trend on the top chart at right stands out regardless. Auto and light truck sales have remained strong but volatile since 9/11, boosted by an environment of low interest rates, which has allowed manufacturers to offer zero-interest loans as incentives to buyers. Auto sales have been relatively strong or weak from one month to the next, depending on the incentives being offered. Home sales have remained exceptionally strong over the past year. As stated above, low mortgage rates have been the driving force. In addition to consumer spending, business spending has also picked up. This had been the weakest area of sales nationwide, and there is still room for improvement. Nearly every measure of the inventory to sales ratio of business or manufacturing stands at a 30-year low because sales have picked up sharply while products have not been replaced. This implies that more production will be needed in order to meet the expanding rate of sales. In addition, a need for more production carries with it the need for more employees to do the work.

LABOR

Several important indicators point to a recovery in the labor market, which has been the slowest part of our economy to recover from the recession. Weekly initial unemployment claims, a measure of the number of people losing their jobs and also a leading indicator of the economy as a whole, have fallen from a monthly average of 447,000 last April to 342,000 last month. The break point above which job growth occurs and below which jobs are lost in our economy is at about 400,000 claims. The top chart shows initial unemployment claims as a percent of total non-farm jobs in order to portray them as a portion of the overall labor market, which has grown over time. As a portion or percentage, unemployment claims are a smaller part of the labor market now than at any time in the past 25 years except for the period 1997 through 2000. The average number of hours worked per week in

manufacturing, another leading indicator, has increased sharply from a low of 40.1 last July to 41.0 in February, though March hours declined 0.1. Most important to workers, the number of non-farm jobs was reported to have increased 308,000 in March, the largest increase since March 2000. In comparison, the worst month of the recent recession was October 2001, when 352,000 jobs were lost. Confirming the strong upward trend, the 12-month running total of the change in jobs reached negative 2,050,000 in February 2002, and finally turned positive for the first time in nearly three years in February 2004. Another positive note should be added: the Bureau of Labor Statistics is probably underestimating employment from new business formation and corporate outsourcing of jobs within the US, so employment figures are likely better than they appear in official reports.

INFLATION

Rates of inflation in our economy appear to have reached extremes, with the core rate of inflation (which excludes food and energy) near a 30-year low, while raw industrial commodities and gold have risen dramatically. The core rate of inflation reached a 40-year low of 1.0% last December, and has since risen slightly to 1.2%. The Consumer Price Index as a whole is up 1.6% in 12 months, the lowest rate in 18 months. The 12-month change in hourly wages is only 1.6%, a low figure last seen in 1986, as downward pressure from overseas competition has kept recent wage increases small. At the other extreme, prices of crude oil, raw industrial materials and gold are close to multi-year highs. Many expected the price of oil to fall after the invasion of Iraq. However, political problems in Nigeria and Venezuela have cut the supply, while demand in China has increased

tremendously. Also, OPEC has recently agreed to cut output by 1 million barrels/day in April, so the combination of lower supply and higher demand has pushed up oil prices to near $40/barrel. Rapid growth in manufacturing in China and consequent increased demand has also pushed up prices for industrial raw materials, reflected in the CRB Raw Industrials Index, which is at a six-year high. Another factor pushing up raw materials prices in the US is the decline in the value of the dollar, which has declined steadily over the past two years. It takes more of the cheaper dollars to buy anything on the world market.

SUMMARY AND OUTLOOK

The economic recovery appears robust and has now spread across all important segments of our economy, including the labor market, which was the last remaining big problem area. The Fed has left short interest rates low for an extended period in order to avoid the threat of deflation and give the economy a push up and out of the recession. Now that the recovery appears to be widespread and most likely self-sustaining, we may expect to see the Fed adjust rates upward at some time in the next three to six months. Before the Fed makes that move, the labor market must be stable with several months of 200,000-plus net job gains. The core rate of inflation is making small upticks and if that trend continues, the Fed might act sooner to raise rates rather than later. As the economy accelerates and interest rates rise, we may see housing strength fall off somewhat because monthly mortgage payments will be bigger and price some people out of the market on that basis. Growth in the rest of the economy, however, will more than make up for any drop in housing. A factor that will tend to hold back the growth rate to some extent is the high level of consumer debt, an unusual condition following a recession. When credit card debt, installment loans and mortgage debt are added up, the average consumer is carrying a heavy load. More jobs and higher wages will be needed to counteract this restraint and these should come as the recovery progresses.

MARKET AND ECONOMIC STATISTICS

as of Market Close March 31, 2004, with 3-month and 12-month changes

LABOR – Mar ’04		3 mo	12 mo
Unemployment Rate	5.7%	0.0%	+0.1%
New Non-Farm Jobs	+308K	+513K	+192K
Avg Hourly Wages	15.54	0.6%	1.6%
Avg Init Unempl Clms	342K	–14K	–82K

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10358	–0.9%	29.6%
S&P 500	1126	1.3%	32.8%
NASDAQ Comp	1994	–0.5%	48.7%
NASDAQ 100	1438	–2.0%	41.2%
NYSE Comp	6599	2.1%	39.5%
Wilshire 5000	11039	2.2%	37.1%
Russell 2000	590	6.0%	61.9%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	0.94%	1.1%	–14.9%
30-yr T-Bond Yld	4.78%	–5.7%	–1.0%
FNMA 30yr mortg	5.52%	–0.5%	1.4%
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	5.7%	6.7%

PRICES, INFLATION		3 mo	12 mo
CPI, Feb	186.3	0.9%	1.6%
PPI, Feb	145.8	0.9%	2.1%
Gold, cash	426.4	2.6%	25.6%
W Tx Int Cr Oil	0.00	9.2%	15.2%
Copper cent/lb	135.55	30.3%	92.3%
CRB Futures Ind	283.8	11.2%	22.0%
CRB Raw Indust	319.2	3.5%	24.6%

MONEY		3 mo	12 mo
M2, Bil Curr$, Aug	6128	0.8%	4.2%
Free Reserves	1.60	–16.0%	–1.0%
Money Mkts-Bil$	2024	–3.2%	–10.5%
US $$$ Index	87.5	–0.8%	–11.5%

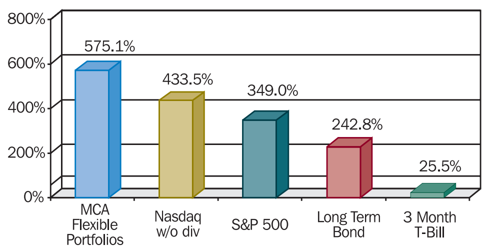
INDUSTRY		3 mo	12 mo
ISM Index, Mar	62.5	–4.3	16.3
Indus Prod Ind, Feb	114.6	0.3%	1.7%
Cap Utiliz, Feb	76.6%	0.0%	0.5%
Bldg Permits, Feb	1903K	2.8%	1.1%

4th Qtr. ’04	Final	3 mo	12 mo
GDP-Bil$	10600	4.1% apr	4.3%
GDP Deflator	106.2	1.5% apr	1.6%
Empl Cost Index	168.7	0.7%	3.9%
NF Productivity	131.6	2.6% apr	5.4%

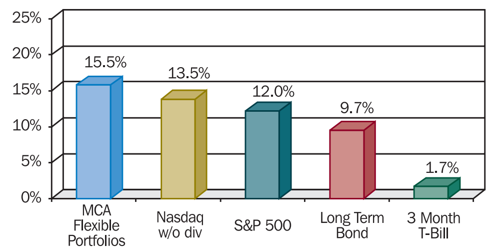
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to March 31, 2004

Total Return



Annualized Return



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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 Inc	33.62	6	Nasdaq 100	35.84	11	Intel	27.20	16	Centex	54.06
2	Whole Foods Market	74.95	7	Tiffany	38.17	12	Charles Schwab	11.61	17	Microsoft	24.93
3	Applied Materials	21.33	8	Texas Instruments	29.22	13	S&P Dep. Receipts	113.10	18	Bear Stearns	87.68
4	Starbucks	37.87	9	Williams Sonoma	34.20	14	Oracle Systems	12.00	19	Home Depot	37.36
5	Electronic Arts	53.74	10	Cisco Systems	23.57	15	CitiGroup	51.70	20	LAM Research	25.12

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%
2004	+0.4%	–0.4%	+1.7%	–0.5%	+2.6%	+5.7%	+0.4%	+0.9%
Total[3]	+575.1%	+445.2%	+349.0%	+433.5%	+356.8%	+242.8%	+66.0%	+38.9%
Avg.[4]	+15.5%	+13.7%	+12.0%	+13.5%	+12.2%	+9.7%	+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]1991-2004 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 42 individual portfolios and 46.3% of all funds under management by MCA on 3/31/04. 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.