THE COMPASS

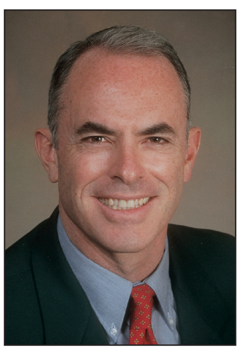
July 2004 — **A Quarterly Newsletter of Martin Capital Advisors, LLP**

Sideways market assimilates fears and builds base for next bull move

July 16, 2004

Most stock market indexes in the second quarter followed a similar pattern to the first quarter – making modest gains at the beginning of the quarter, then pulling back, and then rallying at the end of the quarter to finish about where they started. These modest rollercoaster movements reflect the ongoing struggle between positive economic growth fundamentals (created to a large degree by the most accommodative Federal Reserve monetary policy in fifty years) and negative fiscal and political conditions (induced primarily by the prosecution of the war with Iraq and the extreme polarization of the American electorate). On the fixed-income side, bonds performed poorly in the second quarter, reversing first quarter gains, as long-term interest rates rose on fears of strong economic growth and rising deficits fueling inflation.

As we enter the third quarter, stocks have broken the pattern of the previous two quarters with a modest decline. Recent data have suggested somewhat of a slowdown in economic growth and there have been some mixed signals regarding the sustainability of strong corporate earnings. Historically, the economy and corporate earnings slow to a sustainable pace after an initial surge at the beginning of a recovery. This occurs as pent-up demand is exhausted and the economy and corporate earnings adjust to a sustainable rate of growth. Unfortunately, market psychology can be thrown off by the uncertainty of whether the adjustment is a transition to sustainable growth or portends a reversion to a weak economy. Given the high degree of monetary stimulus and the Federal Reserve's willingness to err on the side of growth as the Fed Funds rate is gradually raised to a neutral level, the current stock market correction probably presents an attractive buying opportunity, rather than the beginning of a new bear market.

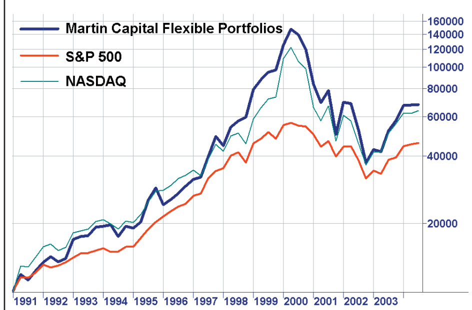


MCA Flexible Portfolios
12-month Tax Efficiency: 99.6%
(After Tax Return divided by Before Tax Return)

Although the sideways motion of the stock market over the last two quarters has been frustrating, it's important to keep in mind that a lot of negative information has already been assimilated into current prices. Some indicators of market psychology point to the stock market overall, and the NASDAQ in particular, as being extremely oversold and poised for a major rally. One has to wonder how much longer bearish psychology may continue to convolute earnings reports of stocks like Intel – extrapolating superficially negative bits of data into significant disappointments within otherwise stellar earnings reports. The unpredictable nature of mass psychology is what makes short-term market timing such a difficult game. Fortunately, for the long-term investor, reality always trumps fantasy in the fullness of time.

By almost every measure the economy and corporate earnings are on track for sustainable growth into the foreseeable future. While it's always hard to say how far negative psychology can move the market, at some point investors and speculators alike have to pay attention and respond to the positive earnings prospects of a broadly expanding economy.

Growth of $10,000
1/1/91–6/30/04



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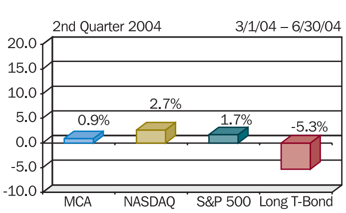
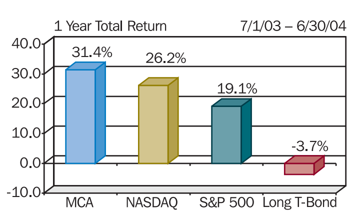
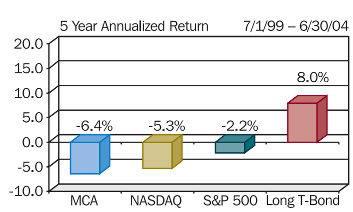
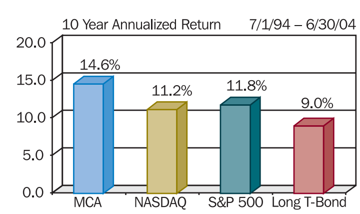
INVESTMENT RESULTS

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







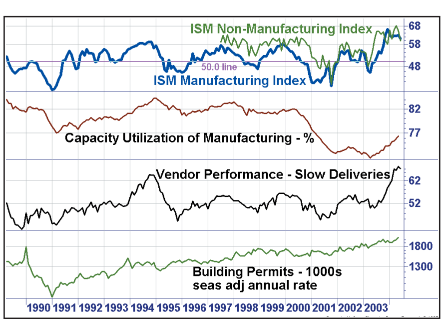


—— See Important Disclosure Notice on back page. ——

The final reading of economic growth in the first quarter of 2004 was an annualized 3.9%. The second quarter will probably show an even faster rate, perhaps 4.5%. We have now experienced five consecutive quarters of growth exceeding 3%. Our economy is hitting on all cylinders, with the last two laggards, manufacturing and labor, now pulling strongly with the rest. Nearly 1.4 million jobs have been added in the last 12 months as we've shifted gears from recovery into expansion. Major stock market indexes showed little change over the last two quarters but big changes over the past 12 months. The slowdown in gains over the last six months has largely been due to concern about higher interest rates, which finally arrived at the short end of the yield curve with the Fed meeting in late June. Long rates had already moved higher during most of the second quarter. Fears of deflation have been washed away as inflation has begun to increase, led by higher prices for raw materials, particularly oil.

INDUSTRY

The Institute for Supply Management's Manufacturing Index has remained above 60 for eight straight months through June, the first such consecutive readings in 20 years. The level of 50 marks the boundary between expansion and contraction, while 60 represents extraordinarily strong growth. Capacity utilization of manufacturing is up 3.7% to 77.3% since the low of June 2003, as economic expansion is bringing more idle facilities back on line. The ISM Non-Manufacturing Index, which measures mostly services, fell to 59.9 in June, but remained above 60 for 11 of the previous 12 months. As services make up a much larger part of our economy today than manufacturing, this is a strong indication of overall conditions. Vendor performance in terms of slow deliveries by manufacturers is a component of the ISM Manufacturing Index and it's also one of the Conference Board's leading indicators. As demand for products increases, suppliers' deliveries take longer, either because suppliers are sold out or because there aren't enough people and equipment involved in delivery. Slow deliveries for the past two months are at the highest level since 1979, showing very tight conditions.



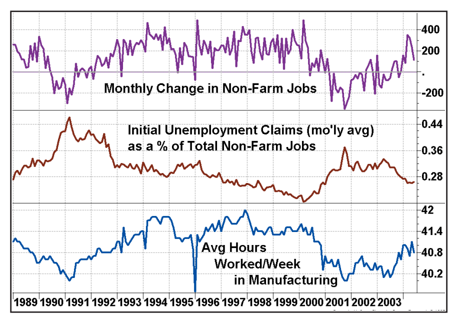
Issuance of building permits for single-family homes reached a rate of 2.077 million/year in May, the highest in history. The housing industry maintained its strength throughout the last recession, providing support to an otherwise weak economy. As long rates rise, housing may lose some of its luster, but the rest of the economy is back on track and can now afford less strength in this sector.

SALES

Retail sales rose 8.8% in the 12 months ending in May, a growth rate comparable to the strongest of the past decade. As consumer spending makes up roughly two-thirds of our economy, this is a good indication of its current strength overall. Auto and light truck sales have been bolstered over most of the past three years by manufacturers' incentives like zero-interest loans. Last month's 15.4 million annual rate of sales was the lowest in 20 months, down at least partly because some of those incentives were withdrawn. New and existing home sales have remained strong, supported by low mortgage rates, which have made housing affordable for many who otherwise could not buy. Existing home sales in May were the highest in history and new home sales absolutely blew the lid off the record. Potential buyers may be getting off the fence now because they fear that the low interest mortgage rate train is leaving the station and that opportunities for low monthly payments will soon be gone. The weakest area of sales during the recession was in business, and now those have been surging ahead. New durable goods orders are up 12.6% in 12 months, while the business inventory to sales ratio of 1.30 is the lowest in nearly 40 years.

LABOR

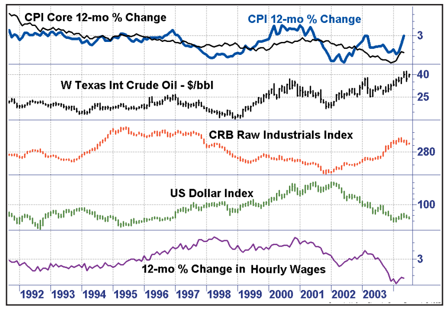
The last sector to recover from the recession, labor has shown clear signs of increasing strength. A strong but uneven uptrend in the number of net new jobs starting in late 2001 is apparent in the top chart below. The 12-month running totals are more informative: from a net loss of 2.05 million jobs as of February 2002, we're up to a net gain of 1.4 million, despite a lower monthly figure in June. Roughly 400,000 initial unemployment claims are regarded as the dividing line between weakness and strength in the job market. These have fallen from 486,000 following 9/11 to below 350,000 in each of the past four months. The middle chart below shows initial claims as a percent of total jobs



to offset the increase in the size of the labor market over time. Using this methodology, initial claims today are a smaller percentage of non-farm jobs than in all but four of the past 15 years. Together with initial unemployment claims, the Conference Board uses the average number of hours worked in manufacturing as a component of its Index of Leading Indicators. The figures for hours worked were down slightly in June from the previous month, but May's figure was the highest in nearly four years. The current range represents a recovery about halfway back to the highs of the last decade. The unemployment rate, which tends to be more of a lagging than a leading indicator, was 5.6% in June and has stood at either 5.6% or 5.7% for the past seven months.

INFLATION

The most widely used measure of inflation in our economy, the 12-month change in the Consumer Price Index, was 3.0% in May, well above the 1.1% rate recorded in June 2002, which marked a 29-year low. The core rate of inflation, which excludes volatile food and energy components, was 1.8% in May, up from 1.0% in December 2003, a 41-year low. Several factors are responsible for this increase in the rate of inflation. First, the price of oil rose from less than $20/barrel in early 2002 to over $40 in May and June of this year. This doubling of the price of oil was caused by a combination of conditions and circumstances, which include a stronger world economy, Middle East political/war conditions, various global political and labor problems and the decline in the value of the US dollar. The prices of many other raw industrial materials have increased sharply over the same period, pushed up by increased demand from China's manufacturing boom. Within a few years, China has changed from being a



net exporter to being one of the largest importers of oil in the world. The growth rate of China's economy has recently slowed, as the former pace was unsustainable. Wages in the US have not experienced any significant increases so far, though labor costs have risen primarily due to higher costs for medical benefits. Labor is considered to be responsible for two-thirds of inflation, so this part of the inflation picture looks good for now. As the expansion continues with more jobs being created, we may expect to see the labor market tighten up and wages begin to rise more rapidly.

SUMMARY AND OUTLOOK

The economic expansion under way in the US is actually global in scope. China led the way with its manufacturing boom and much of the rest of the world has joined in the recovery and expansion. Fears of deflation have been replaced by the awareness that price increases that began with raw materials, especially for oil, have spread into the economy as a whole and that the core rate of inflation is rising. The early part of the expansion has used a lot of excess capacity and labor that has been relatively cheap. As the expansion continues, business expenses may increase because of shrinking excess capacity requiring the construction of new facilities and a tightening labor pool demanding higher wages. The Fed has just raised rates in the first step of what is expected to be a series and we may expect gradual increases totaling approximately 2% over the next 12 to 18 months. The Fed's policy is and has been accommodative, with the real Fed Funds rate now below minus 2%. The rise would gradually shift monetary policy back to neutral, in keeping with the economic expansion under way. We must also expect the unexpected, as things happen to alter this outlook. Occurrences that could change the outlook include faster or slower than expected economic growth, reduced oil deliveries from the Persian Gulf that would lead to higher prices and a successful major terrorist attack in this country. We may expect the Fed to lean slightly toward being accommodative in order to keep the economy strong so it would be able to shrug off a serious attack. Nevertheless, the outlook for continued, steady economic growth is excellent.

MARKET AND ECONOMIC STATISTICS

as of Market Close June 30, 2004, with 3-month and 12-month changes

LABOR – Jun '04		3 mo	12 mo
Unemployment Rate	5.6%	–0.1%	–0.8%
New Non-Farm Jobs	+112K	+671K	+1398K
Avg Hourly Wages	15.65	0.6%	1.8%
Avg Init Unempl Clms	347K	+7K	–72K

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10435	0.8%	16.1%
S&P 500	1141	1.3%	17.1%
NASDAQ Comp	2048	2.7%	26.2%
NASDAQ 100	1517	5.4%	26.2%
NYSE Comp	6603	0.1%	19.9%
Wilshire 5000	11139	0.9%	19.2%
Russell 2000	592	0.2%	31.9%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	1.29%	37.2%	50.0%
30-yr T-Bond Yld	5.30%	10.9%	16.5%
FNMA 30yr mortg	5.74%	4.0%	14.1%
Prime Rate	4.25%	6.3%	6.3%
Fed Funds Trgt	1.25%	25.0%	25.0%
Fed Disc Rate	0.75%	50.0%	50.0%
S/L Long T-Bnd Ind	11912	–5.3%	–3.7%

PRICES, INFLATION		3 mo	12 mo
CPI, May	188.8	1.3%	3.0%
PPI, May	148.8	2.1%	4.9%
Gold, cash	394.2	–7.6%	13.8%
W Tx Int Cr Oil	37.05	3.5%	22.8%
Copper $/lb	1.21	–11.1%	61.1%
CRB Futures Ind	265.9	–6.3%	13.8%
CRB Raw Indust	306.1	–4.1%	18.0%

MONEY		3 mo	12 mo
M2, Bil Curr$, May	6269	2.6%	4.8%
Free Reserves	1.746	9.3%	2.6%
Money Mkts-Bil$	1962	–3.1%	–11.5%
US $$$ Index	88.8	1.4%	–6.3%

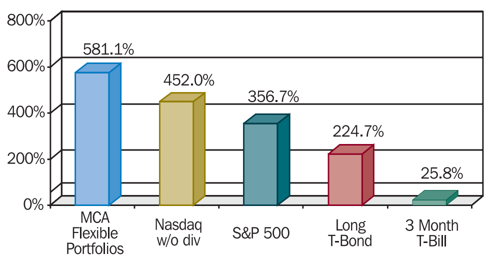
INDUSTRY		3 mo	12 mo
ISM Index, Jun	61.1	–1.4	11.3
Indus Prod Ind, May	116.9	0.3%	1.7%
Cap Utiliz, May	77.8%	0.0%	0.5%
Bldg Permits, May	2077K	2.8%	1.1%

1st Qtr. '04	Final	3 mo	12 mo
GDP-Bil$	10702	3.9% apr	4.8%
GDP Deflator	106.9	2.9% apr	1.7%
Empl Cost Index	170.8	1.1%	3.9%
NF Productivity	132.7	3.5% apr	5.4%

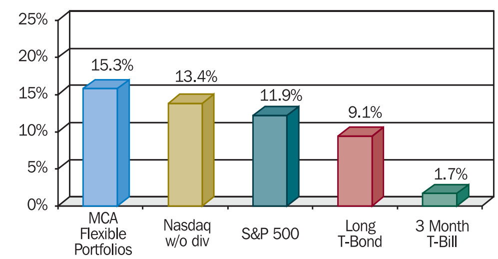
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 2004

Total Return



Annualized Return



THE COMPASS

A Quarterly Publication of
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FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Inc	35.82	6	Nasdaq 100	37.74	11	Texas Instruments	24.18	16	LAM Research	26.80
2	Whole Foods Market	95.45	7	Tiffany	36.85	12	S&P Deposit. Rcpts.	114.53	17	CitiGroup	46.50
3	Starbucks	43.49	8	Cisco Systems	23.70	13	Microsoft	28.56	18	Bear Stearns	84.31
4	Applied Materials	19.62	9	Williams Sonoma	32.96	14	Oracle Systems	11.93	19	Home Depot	35.20
5	Electronic Arts	54.55	10	Intel	27.60	15	Charles Schwab	9.61	20	Centex	45.75

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	+1.3%	+0.8%	+3.5%	+2.2%	+4.0%	+0.1%	+0.4%	+0.9%
Total[3]	+581.1%	+452.0%	+356.7%	+447.8%	+362.9%	+224.7%	+66.6%	+40.7%
Avg.[4]	+15.3%	+13.5%	+11.9%	+13.4%	+12.0%	+9.1%	+3.9%	+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]1991-2004 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 40 individual portfolios and 46.0% of all funds under management by MCA on 6/30/04. 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.