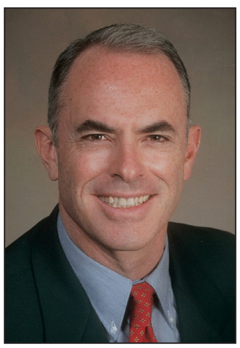
THE COMPASS

October 2004 A Quarterly Newsletter of Martin Capital Advisors, LLP

War, oil and politics pressure stocks, but post-election period should be positive

October 20, 2004

After declining in the first half of the third quarter and rising in the second half, stocks finished the quarter with a modest decline – about where they were at the time the last edition of this newsletter was written in mid-July. Although the usual suspects of war and politics contributed to the weak performance, a thirty-five percent increase in the price of oil probably had the most negative impact on market psychology. In the face of these concerns, however, stocks have held up fairly well, buoyed by extremely attractive valuations relative to inflation and interest rates. Bond prices rebounded in the third quarter from their second quarter decline as higher oil prices raised greater financial market fear of a weaker economy, implying lower core inflation, than the specter of potentially higher commodity driven prices.



Some stock indexes, such as the NASDAQ, are slightly positive since the beginning of the fourth quarter, despite another ten percent oil price increase and continuing political and military uncertainties. The presidential election is upon us, however, and my guess is that, no matter who is elected, the lifting of election uncertainty may improve stock market psychology enough to contribute to higher returns through the end of the year and possibly into the first part of next year – though it may be appropriate before then to consider making some securities allocation adjustments in light of election results.

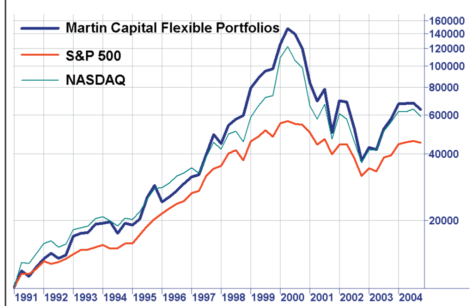
Although the issues of war and oil most likely will remain uncertain for some time after the presidential election, relatively low equity valuations already reflect these uncertainties to a large degree. Relatively high bond valuations also reflect these uncertainties, resulting in a large disparity between the relative prices of stocks and bonds. To put it another way, stocks currently have substantially lower risk and higher return potential relative to bonds.

While I can't say precisely when and how this disparity will be resolved, the highest probability is a combination of higher stock prices and lower bond prices when the pressures of war, oil and politics begin to subside.

For anyone subscribing strictly to the notion that stocks cannot do well in a rising interest rate environment, I would point out that in the latter half of the expansion phase of a normal economic cycle stock prices historically have risen even as bond prices have declined. I should also mention that as the present economic expansion unfolds, disinflationary forces should mitigate the propensity for higher interest rates, thus enhancing the potential for stronger economic performance and higher stock market returns over the next few years.

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

Growth of $10,000
1/1/91–9/30/04



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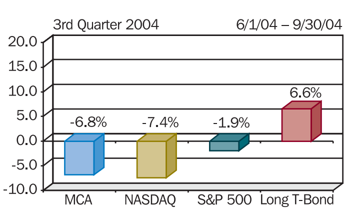
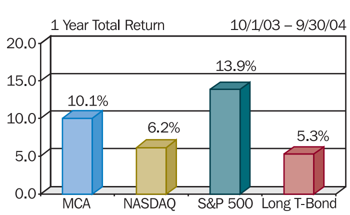
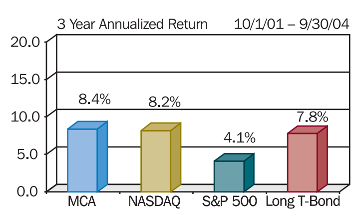
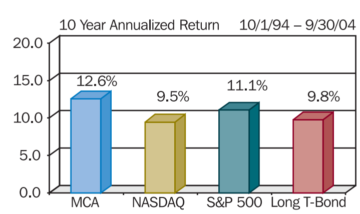
INVESTMENT RESULTS

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







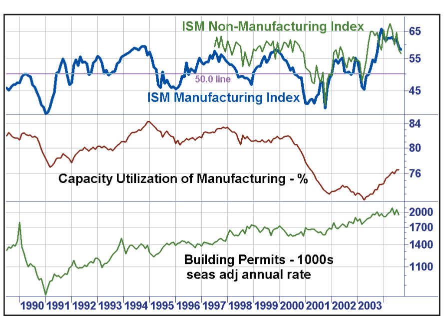


See Important Disclosure Notice on back page.

The final reading for economic growth in the second quarter of 2004 was a 3.3% annualized rate, healthy but the slowest in five quarters. Third quarter growth probably exceeded that figure by a small margin. Year-over-year growth through the second quarter was 4.8%, pushed up by a sizzling 7.5% growth in the third quarter of last year. Stock market indexes showed a small decline over the last quarter, though year-over-year figures are still strong because of gains that occurred in the last quarter of 2003. Interest rates show a diversion over the past three months, with short rates increasing sharply and long rates declining, resulting in a flatter yield curve. The PPI and CPI show that overall inflation has abated slightly over the past three months compared to the previous year, while prices of oil and copper have continued to increase by leaps and bounds. Industrial growth is on solid ground and the labor market has strengthened over the past year, though not to an extent comparable with previous economic recoveries.

INDUSTRY

The ISM Manufacturing Index stood at 58.5 in September, a level that is merely high compared to the near stratospheric levels that prevailed from November 2003 through July 2004. This index remained over 60 for 12 of 14 months until August 2004. The last period with comparably high statistics ended in 1974. Though volatile from month to month, total factory orders through August were 12.5% above a year ago. Slow supplier deliveries, an indication of busy manufacturers, were at record levels a few months ago, but now are easing somewhat. The ISM Non-Manufacturing Index (also called the Services Index) has also slipped a little, though it was still a healthy 56.7 in September. As services make up a much larger percentage of our economy than manufacturing, the latter ISM index is a more significant number. Capacity utilization of manufacturing has increased more rapidly since the low in early 2003 than after the 1990-91 recession, though it started from a much lower level. From 72.1% in April 2003, it has risen to 76.8%, which is only about halfway back to the levels common in the years 1994 through 1999. In summary, growth in manufacturing is strong but easing off a little from the rapid rate seen earlier in the year.



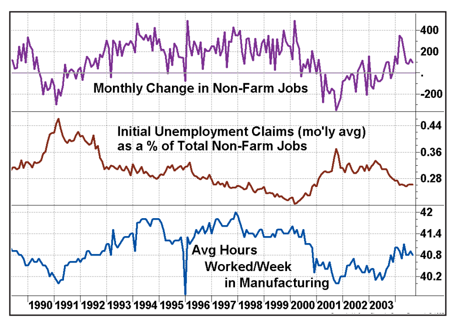
Building permits stood at an annualized rate of 1,952,000 in August, off slightly from the record set three months before. Housing starts are at comparably high levels, with both statistics responding positively to the low mortgage rates currently available. Total construction spending is up 10.1% in 12 months through August, an indication that commercial construction is also taking advantage of favorable rates. If rates were to move higher, which they did for a short time earlier this year, we might expect somewhat of a slowdown in this sector of the economy.

SALES

Retail sales have been in an up one month, down the next pattern over the past five months, though they show a healthy 5.1% increase over 12 months through August. A decline of 0.3% in August was most likely due to the first part of Florida's marathon hurricane experience. Auto and light truck sales jumped to 17.5 million on an annualized basis in September, the second highest monthly rate in 2004. Vehicle sales have been volatile over the past three years, largely subject to changing incentives offered by manufacturers. For instance, GM is now offering zero-interest financing for up to six years on some models, boosting sales. At some point the Fed's rate increases are likely to cut into this bonanza for buyers, but so far higher rates have had no effect. Existing home sales are off about 6% from the high of two months ago at an annualized 6,540,000 units. New home sales stand at an annualized 1,184,000 units, off 7% from the high last March. These slight declines are unlikely to presage a broad decline in home sales unless a sharp increase in mortgage rates occurs, which is unlikely given current conditions.

LABOR

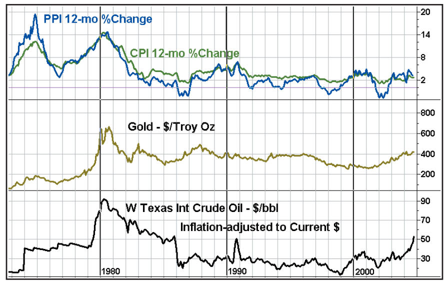
Conditions in the labor market seem stable and healthy, though job growth has lagged compared to previous economic recoveries. Gains of 300,000+ per month are normal for recoveries, but we've only seen roughly a third this many over the past four months. Monthly averages of initial unemployment claims, an indication of how many workers are losing their jobs and also a leading indicator, have fallen below 350,000, a relatively healthy level well below 400,000, which roughly separates increases from decreases in the total number of jobs. The chart at right shows initial claims as a percent of total jobs in order to adjust for the growth of the job market over time. Current levels are below those of 1992–95, during the last economic recovery. The average number of hours worked in manufacturing,



another leading indicator, rose sharply from 40.1 in late 2003, then flattened out between about 40.8 and 41.0. The current level is about halfway back to the average levels of 1995-99.

INFLATION

Though oil prices have grabbed the attention of the world, the most widely watched inflation indicator is the 12-month change in the Consumer Price Index. This started to decline in July and August, in spite of a sharp run-up in the price of oil. The August three-month change in the CPI was the lowest since last December, strongly indicating that the price of oil was not then pushing up the overall rate of inflation in our economy. It has been estimated that a specific increase in oil prices today has approximately one-fourth the impact on our economy that it had in the early 1970s, the time of the first oil-price shock. Not only have we become more energy-efficient, but our economy has changed from being mainly based on manufacturing to being largely a service economy, using less energy per dollar of GDP. The charts at right include the PPI and CPI 12-month changes, which show less response to oil price increases recently than in the past. The middle chart shows the price of gold, which has risen in response to a weaker dollar and to the potential for higher inflation. The bottom chart shows the price of oil adjusted for inflation. The price of oil has risen recently because of increased demand in a rapidly growing world economy and because of supply uncertainties that exist today. Regarding demand, China, now the world's second largest importer, has increased imports 40% this year alone. On the uncertain supply side, Russia is dismantling



Yukos, one of its two big oil companies; Nigeria has labor and political problems; Venezuela has political problems and the Persian Gulf situation needs little comment. Saudi Arabia has said that it can increase production 1.5 million bbl/day to meet demand, but so far hasn't had to do so. Current inflation-adjusted oil prices are already the highest in 19 years and we may well see them go higher in the short term. In the medium term, some problems in producing countries may be resolved: Russia badly needs the money, so the Yukos situation will stabilize. Nigeria will eventually come to terms with its labor and political problems, Venezuela's political problems have already calmed down somewhat and given more time, Saudi Arabia will be able to increase production. In the longer term, as world demand continues to increase, new sources of oil will come on line in response to higher prices. However, that new oil will be more expensive to find and to produce.

SUMMARY AND OUTLOOK

The rise in the price of oil to record levels produces two kinds of results: rational changes in how money must be spent and a psychological impact leading to uncertainty. The rational effect will be that consumers are forced to pay more for nearly all kinds of energy from gasoline and heating oil to electricity, leaving less for discretionary spending. Any product requiring energy in its production will cost the manufacturer more. One result is that each $10 rise in the price of oil is said to cut US GDP by ½%. By comparison a manufacturing-based economy like that of Thailand may face as much as a 4% cut in GDP from $50 oil. The psychological impact is making many people feel unsettled, uncertain and less comfortable about spending. This is also not a good thing for financial markets, which hate uncertainty. Given time, perhaps six months, at least some of the uncertainties cited above may well be resolved. Higher oil prices will slow economies around the world, which will lead to decreased demand for oil and consequently lower oil prices. The United States is fortunate in that it will be less affected than many countries. We may experience a somewhat slower economy over the next six months to a year, but a recession is unlikely.

MARKET AND ECONOMIC STATISTICS

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

LABOR – Sept '04		3 mo	12 mo
Unemployment Rate	5.4%	–0.2%	–0.7%
New Non-Farm Jobs	+96K	+309K	+1587K
Avg Hourly Wages	15.78	0.8%	2.2%
Avg Init Unempl Clms	345K	+7K	–72K

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10080	–3.4%	8.7%
S&P 500	1115	–2.3%	11.9%
NASDAQ Comp	1897	–7.4%	6.2%
NASDAQ 100	1413	–6.9%	8.4%
NYSE Comp	6570	–0.5%	16.4%
Wilshire 5000	10895	–2.2%	12.9%
Russell 2000	573	–3.1%	17.5%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	1.70%	31.8%	80.9%
30-yr T-Bond Yld	4.89%	–7.7%	0.2%
FNMA 30yr mortg	5.60%	–2.4%	2.6%
Prime Rate	4.75%	11.8%	18.8%
Fed Funds Trgt	1.75%	40.0%	75.0%
Fed Disc Rate	1.25%	66.7%	150.0%
S/L Long T-Bnd Ind	12695	6.6%	5.3%

PRICES, INFLATION		3 mo	12 mo
CPI, Aug	189.4	0.3%	2.7%
PPI, Aug	148.4	–0.3%	3.5%
Gold, cash	418.5	6.2%	8.6%
W Tx Int Cr Oil	49.65	34.0%	69.9%
Copper $/lb	1.40	16.2%	72.2%
CRB Futures Ind	285.0	7.2%	17.0%
CRB Raw Indust	318.3	4.0%	13.4%

MONEY		3 mo	12 mo
M2, Bil Curr$, Aug	6299	0.1%	3.2%
Free Reserves	1.084	–34.4%	–18.4%
Money Mkts-Bil$	1922	–2.0%	–10.8%
US $$$ Index	87.4	–1.5%	–5.8%

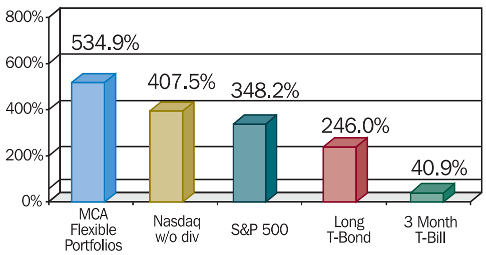
INDUSTRY		3 mo	12 mo
ISM Index, Sep	58.5	–2.6	4.8
Indus Prod Ind, Aug	116.6	0.3%	1.7%
Cap Utiliz, Aug	77.3%	0.0%	0.5%
Bldg Permits, Aug	1952K	2.8%	1.1%

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%

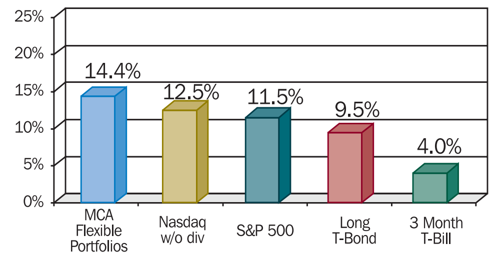
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2004

Total Return



Annualized Return



THE COMPASS

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MARTIN CAPITAL ADVISORS, LLP

1600A Virginia Avenue
Austin, Texas 78704

512-477-7036 • Fax 512-477-7096

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FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Inc	35.60	6	Electronic Arts	45.99	11	Microsoft	27.65	16	Oracle Systems	11.28
2	Whole Foods Market	85.79	7	Nasdaq 100	35.14	12	Intel	20.06	17	Bear Stearns	96.17
3	Starbucks	45.46	8	Tiffany	30.74	13	Home Depot	39.20	18	CitiGroup	44.12
4	Williams-Sonoma	37.55	9	Texas Instruments	21.28	14	S&P Deposit. Rcpts.	111.76	19	Centex	50.46
5	Applied Materials	16.49	10	Cisco Systems	18.10	15	Charles Schwab	9.19	20	Sandisk	29.12

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	–5.6%	–2.1%	+1.5%	–5.3%	+0.9%	+6.7%	+1.5%	+2.8%
Total[3]	+534.9%	+436.0%	+348.2%	+407.5%	+349.1%	+246.0%	+67.7%	+41.6%
Avg.[4]	+14.4%	+13.0%	+11.5%	+12.5%	+11.5%	+9.5%	+3.8%	+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 39 individual portfolios and 46.8% of all funds under management by MCA on 9/30/04. 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.