THE COMPASS

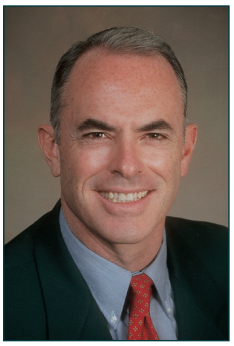
January 2005

A Quarterly Newsletter from Martin Capital Advisors, LLP

After Robust Fourth Quarter, Profit Taking Dampens Early 2005 Stock Market Returns, But Prospects Remain Positive

January 17, 2005

Stocks performed extremely well in the fourth quarter, resulting in a positive performance for the year. Most of the buying was probably related to the lifting of election uncertainty, strong corporate profits and relatively tame inflation. Despite rising short-term interest rates, long-term rates declined slightly for the quarter and the year, giving bonds a respectable return. The fixed income market does not seem to be selling into the consensus notion that higher inflation is just around the corner.



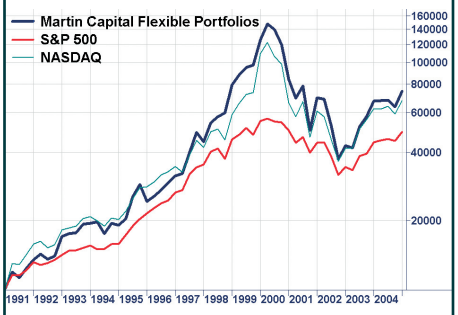
As we entered the new year, stocks declined sharply in the first few days, apparently on profit taking against substantial fourth quarter gains. Since then stocks have meandered sideways awaiting further earnings reports to set the tone for the market. Earnings have been mixed so far, but with a somewhat positive bias. Although dollar and oil price fluctuations have the potential to move the financial markets, stocks will most likely move up and down over the next month largely in response to earnings reports. My guess is that when the earnings season is over, most stocks will have benefited from better than expected announcements and the market should recover into positive territory sometime before the end of the quarter. The fixed income market, on the other hand, may give back some initial gains in the face of continuing economic strength.

For 2005, all eyes will be on the Fed as short-term rates are increased from the presently very accommodative Fed Funds rate of 2.25% toward the neutral rate of 4%. Since the 4% level is not likely to be reached before the end of the year, monetary policy will remain stimulative for the time being. This should contribute to above average economic expansion, strong corporate profits and higher stock prices. For bonds, the question as the year progresses will be whether the Fed appears to be ahead or behind the curve in raising short-term interest rates to keep inflation under control. Given the disinflationary forces at work in the global economy, I think there is a chance that the fixed income market may perceive the Fed to be ahead of the curve in shifting monetary policy to a neutral position, in which case long-term interest rates may stay near current levels. It's more likely, however, that long-term interest rates will rise and bond prices will fall due to the perception, but perhaps not the reality, that the Fed may not be raising rates fast enough to stave off the possibility of the economy overheating.

Accommodative monetary policy and benign macroeconomic fundamentals should continue to stimulate economic expansion for at least the next year, even in the face of growing fiscal problems, such as the ballooning budget deficit. Of course, unforeseeable catastrophes and greater geopolitical uncertainty could disrupt the financial markets at any time, but many threats are already discounted in current conditions and prices and would probably have only a short-term negative impact. The bottom line is that the odds favor 2005 being a good year for stocks and a flat to negative year for bonds.

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

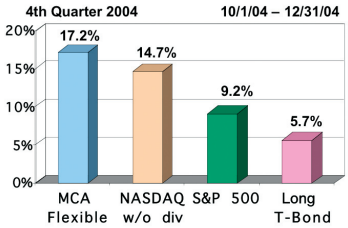
Growth Of $10,000
1/1/91 – 12/31/04

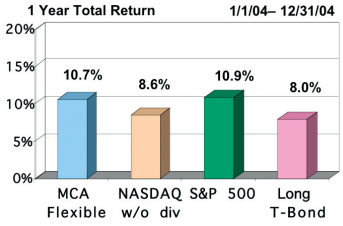


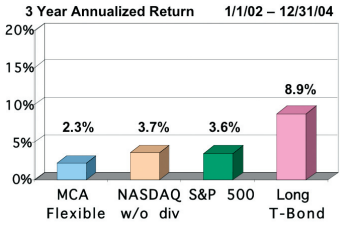
See Important Disclosure Notice on back page.

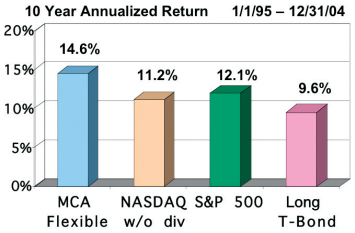
INVESTMENT RESULTS

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





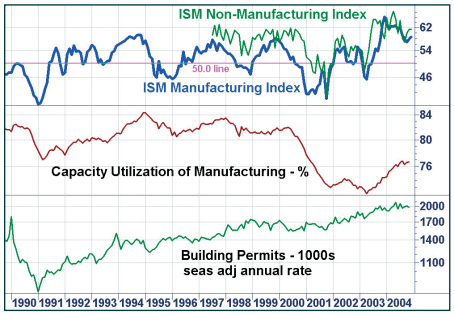




—See Important Disclosure Notice on back page.—

GDP growth for both the third quarter of 2004 and for the 12-month period ending September 30th was a strong 4.0% annualized rate. Growth in the fourth quarter was probably close to the same as that in the third. The stock market had a good fourth quarter, as uncertainties about the presidential election were removed in early November. Long interest rates moved up and down during the year, but have returned to nearly where they were at the beginning of 2004. Short rates, on the other hand, have moved up dramatically since last July, as the Fed has moved toward a more restrictive monetary policy. Inflation has increased considerably over both the last three and twelve months, pushed up by a steadily weakening dollar and by increased demand for raw materials in a strong global economy. Both the manufacturing and service sectors of our economy have remained strong. Only the labor market has been weaker than in a typical economic recovery.

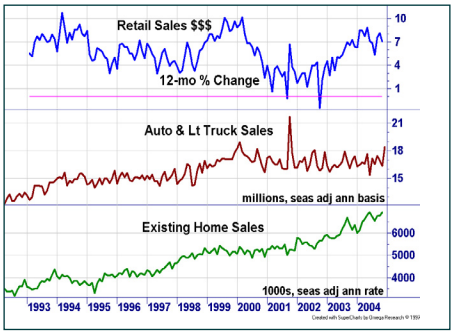
INDUSTRY



Manufacturing has continued to expand, with the ISM Manufacturing Index at 58.6 in December, the 18th straight month of readings over 50, which separates expansion from contraction. One of the strongest components of this index was new orders, which stood at 67.4, a good sign for the future, as it points to a strong increase in demand for products. Capacity utilization of manufacturing rose to 76.7% in November, far above the cycle low of 72.1% seen in April 2003. The ISM Non-Manufacturing Index held steady at 61.3 in November and December. As this represents the services sector of the economy, which is several times larger than the manufacturing sector, it points to unusually strong growth in our economy as a whole.

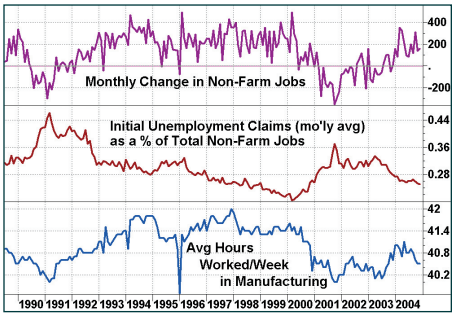
The homebuilding industry has grown relatively steadily since 1991, without a significant pullback during the last recession. Much of this strength has been the result of low mortgage rates. For many consumers, mortgage payments have been cheaper than rent. We may expect this strength to continue unless a significant rise in long rates occurs.

SALES



Retail sales grew at a rate of 2.5% over the last three months ending in November, and 7.0% over 12 months. The latter growth rate represents a strong performance, exceeding that of almost the entire past 10 years. Sales of autos and light trucks in December reached an annualized rate of 18.4 million units, the highest since incentives were first offered by manufacturers after 9/11. Sales over the last three years have fallen mostly within the range of an annualized 16 to 18 million units. Without incentives like zero interest financing, which have been costly to manufacturers but a boon to buyers, this level of sales could not have been maintained. Homebuyers have also been faced with a favorable situation in the form of unusually low mortgage rates, which have made it possible for many to buy their first homes and for others to upgrade. New home sales fell 12.0% in November to an annualized rate of 1.125 million, while existing home sales rose 2.7% to a record annualized 6.940 million. The November drop in new home sales was probably only a blip, perhaps the result of a particularly rainy month.

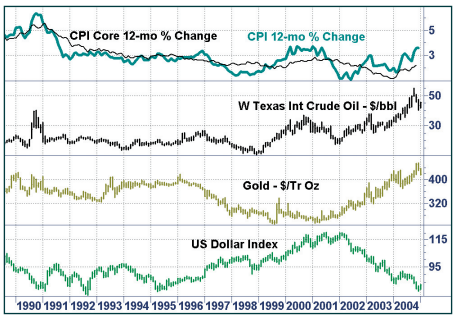
LABOR



Monthly increases in the numbers of jobs have typically run around 300,000 during economic recoveries and expansions after recessions. Though the chart shows an obvious uptrend in the number of jobs since the low of late 2001, the average monthly gain over the past 12 months is only 186,000 jobs, well short of historic standards. The monthly average of initial unemployment claims, a leading indicator, has fallen to nearly the lowest level since October 2000, meaning that fewer and fewer workers are losing their jobs. This good news helps counterbalance the lackluster number of new jobs. Another leading indicator, the average number of hours worked per week in manufacturing, has fallen from a high of 41.1 last May to 40.5 in December, hardly an indication of expansion. On the other hand, the average of total hours worked in our economy stands at 33.8, equal to the highest in over two years. Much has been said recently about the migration of jobs to factories overseas with lower labor costs. Productivity in the US, however, has been increasing rapidly, particularly in manufacturing, and it is likely that our weakness in job growth and hours worked in manufacturing is more a result of that growth in productivity than the loss of jobs to other countries.

INFLATION

The 12-month change in the Consumer Price Index, our most widely quoted rate



of inflation, reached 3.6% in November, the highest rate since May 2001. The 12-month change in the CPI core rate, excluding volatile food and energy sectors, reached 2.2% in November, the highest since October 2002, and a sharp increase over the 1.0% rate seen a year ago. Several powerful factors are at work. First, the world economy is growing rapidly and one of the results is increased demand for raw materials like oil and copper. Second, the value of the US dollar has declined roughly 25% over the past three years, causing us to have to pay more dollars for anything bought on the world market. The price of gold is a direct reflection of this dollar weakness. If there were one single culprit to point out as the major cause of inflation today, it would be the price of oil. Oil has been more volatile than gold because it has been subject to a lot of political uncertainties in major producing countries around the world. The drop in oil prices over the last quarter has been caused by some supply uncertainties becoming less intense, as no decrease in demand has occurred. If supply uncertainties fade, we may see oil prices decline further in the short-term.

Except for oil, commodity prices usually have only a small impact on our overall inflation rate, as most of the cost of finished products is due to labor. In fact, two-thirds of inflation is said to come from labor costs. Productivity has increased dramatically over the past three years at close to the same rate as that of labor costs. While this increase in productivity has caused a problem by decreasing the number of new jobs created in our economy, it has also helped by holding down the overall rate of inflation.

SUMMARY AND OUTLOOK

A number of factors is causing anxiety for investors today. We have large budget and trade deficits; the US dollar has fallen roughly 25% in value and continues to decline, a condition caused in large part by the twin deficits cited above; inflation is on the rise; the Fed has raised rates five times and will likely continue to raise them. Dealing with these factors one at a time and putting them in perspective may ease some of the anxiety. The big budget deficit helped our economy recover from the recession, but it's now time to reduce it and we may expect the government to do so over the next couple of years. The large trade deficit is primarily the result of the US economy growing faster than most of its competition, which is good news, not bad. Many of the dollars that end up overseas are being recycled by buying US government debt, which helps hold down our interest rates. The declining dollar makes our products more competitive on the world market, thereby easing our trade deficit. In spite of five rate increases in 2004, the Fed's monetary policy is still loose and accommodative, and this is perhaps the most important ingredient in this complex mix of interacting factors. The nominal Fed funds target today is 2.25%. Subtracting the inflation rate of 3.6% (from the CPI) leaves a real Fed Funds target of –1.35%, which is 3% or so below the typical real Fed funds target during a time of strong economic growth. This loose fiscal policy stimulates US economic growth, though at the same time it is likely to keep inflation from declining and is also partly responsible for the weak US dollar. While there is a lot to be concerned about, there seems to be more uncertainty today than is warranted by the facts. With loose Fed monetary policy and a robust economy, financial markets can withstand interest rates that are gradually moving higher.

MARKET AND ECONOMIC STATISTICS

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

3rd Qtr '04, Final		3 mo		12 mo
GDP-Bil$	10891	4.0%	apr	4.0%
GDP Deflator	108.5	1.4%	apr	2.2%
Empl Cost Index	173.9	0.9%		3.9%
NF Productivity	134.7	1.8%	apr	3.1%

Stock Indexes*		3 mo	12 mo
Dow Industrials	10783	7.0%	3.1%
S&P 500	1212	8.7%	9.0%
NASDAQ Comp	2175	14.7%	8.6%
NASDAQ 100	1621	14.8%	10.4%
NYSE Comp	7250	10.3%	12.2%
Wilshire 5000	11971	9.9%	10.8%
Russell 2000	652	13.7%	17.0%

* excluding dividends

Interest Rates		3 mo	12 mo
91-day T-Bill DR	2.22%	30.6%	138.7%
30-yr T-Bond Yld	4.83%	-1.2%	-4.7%
FNMA 30yr mortg	5.50%	-1.8%	-1.0%
Prime Rate	5.25%	10.5%	31.3%
Fed Funds Trgt	2.25%	28.6%	125.0%
Fed Disc Rate	1.75%	40.0%	250.0%
S/L Long T-Bnd Ind	12848	1.2%	8.0%

Prices, Inflation		3 mo	12 mo
CPI, Nov	191.2	1.0%	3.6%
PPI, Nov	151.8	2.3%	5.1%
Gold, cash $/tr oz	438.4	4.8%	5.5%
W Tx Int Cr Oil $/bbl	43.46	-12.5%	32.6%
Copper, $/lb	1.49	6.2%	43.0%
CRB Futures Ind	283.9	-0.4%	11.2%
CRB Raw Indust	321.5	1.0%	4.3%

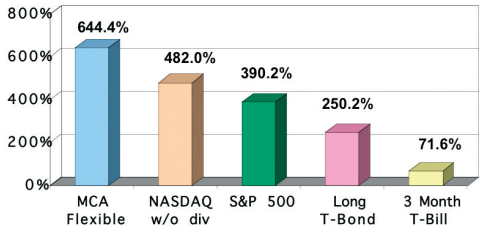
Money		3 mo	12 mo
M2, Bil Curr$, Nov	6380	1.3%	5.2%
Free Reserves - $Bil	1.797	65.8%	81.1%
Money Mkts - $Bil	1951	1.5%	-6.7%
US Dollar Index	80.9	-7.5%	-6.8%

Industry		3 mo	12 mo
ISM Index, Dec	58.6	0.1	-8.2
Indust Prod Ind, Nov	117.6	0.3%	1.7%
Capacity Utiliz, Nov	77.6%	0.0%	0.5%
Bldg Permits, Nov	1988K	2.8%	1.1%

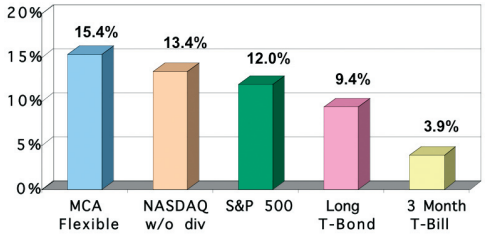
Labor - Dec'04		3 mo	12 mo
Unemployment Rate	5.4%	0.0%	-0.3%
New Non-Farm Jobs	+157K	+606K	+2231K
Avg Hourly Wages	15.86	0.5%	2.7%
Avg Init Unempl Clms	332K	-17.1K	-30.5K

RELATIVE LONG TERM PERFORMANCE January 1, 1991 to December 31, 2004

TOTAL RETURN



ANNUALIZED RETURN



THE COMPASS

A Quarterly Publication of

MARTIN CAPITAL ADVISORS, LLP

1600A Virginia Avenue
Austin, Texas 78704
512-477-7036 • Fax 512-477-7096

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

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Inc	42.14	6	Williams Sonoma	35.04	11	Intel	23.39	16	CitiGroup	48.18
2	Whole Foods Market	95.35	7	Nasdaq 100	39.92	12	Cisco Systems	19.32	17	Bear Stearns	102.31
3	Starbucks	62.36	8	Texas Instruments	24.62	13	Oracle Systems	13.72	18	LAM Research	28.91
4	Electronic Arts	61.68	9	Tiffany	31.97	14	Home Depot	42.74	19	Centex	59.58
5	Applied Materials	17.10	10	Charles Schwab	11.96	15	S&P Dep Recpts	120.87	20	Advanced Micro Dev	22.02

COMPARISON OF INVESTMENT RESULTS

PERFORMANCE OF RELEVANT INDEXES

	Martin Capital Advisors[1]	Dow Jones Industrial Avg.	S&P 500	NASDAQ[2]	Dow Jones Wilshire 5000	Long-Term T-Bond	3 Month T-Bill	Consumer Price Index
1991	33.9	24.5	30.6	56.9	34.2	18.5	5.6	3.1
1992	26.8	8.0	7.7	15.5	9.0	8.0	3.5	2.9
1993	14.5	18.1	10.0	14.8	11.3	17.3	2.9	2.8
1994	-2.1	5.9	1.3	-3.2	-0.1	-6.9	3.9	2.7
1995	27.5	36.9	37.6	40.0	36.5	30.7	5.6	2.5
1996	29.4	29.1	23.0	22.7	21.2	-0.8	5.2	3.3
1997	41.4	24.9	33.4	21.6	31.3	15.1	5.3	1.7
1998	78.8	18.1	28.7	39.6	23.4	13.5	4.9	1.6
1999	58.2	27.2	21.0	85.6	23.6	-8.7	4.7	2.7
2000	-33.0	-4.9	-9.1	-39.3	-10.9	20.1	5.9	3.4
2001	-17.4	-5.4	-11.9	-21.1	-11.0	4.6	3.8	1.6
2002	-38.3	-15.1	-22.1	-31.5	-20.9	17.2	1.7	2.4
2003	56.8	28.3	28.7	50.0	31.63	2.1	1.0	1.9
2004	10.7	5.3	10.9	8.6	12.6	8.0	1.4	3.6
Total[3]	644.4	476.7	390.2	482.0	401.3	250.2	71.6	42.8
Avg.[4]	15.4	13.3	12.0	13.4	12.2	9.4	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. 41991-2004 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 46.6% of all funds under management by MCA on 12/31/04. 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.