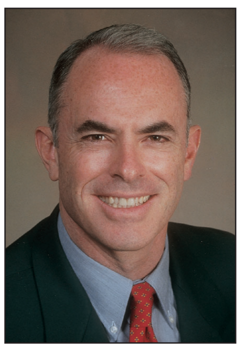
THE COMPASS

July 2005 — **A Quarterly Newsletter of Martin Capital Advisors, LLP**

Stocks and Bonds Rebound on Solid Growth, Moderate Inflation

July 15, 2005

The stock and bond markets rallied in the second quarter in response to solid earnings growth and moderating inflation statistics. Although the month of April was hard on stocks, lower long-term interest rates and persistent signs of continuing economic strength allowed stock prices to rebound and push higher by the end of June. Bond yields fell during the quarter, even as the Fed Funds rate rose from 2.75% to 3.25%. This flattening of the yield curve was driven primarily by the widening dichotomy of perceptions of the risk of inflation between the Federal Reserve Board and the bond market.

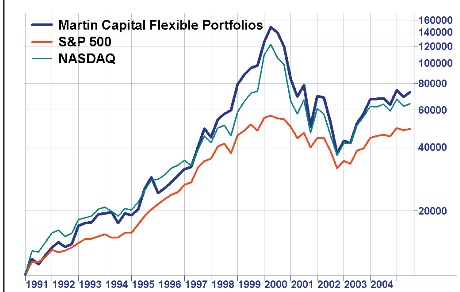


So far the stock market has been able to follow the bond market in shrugging off the tightening moves by the Fed. This is due in large part to the fact that current monetary policy remains very accommodative. The question for the third quarter and for the rest of the year is whether the Fed will show any signs of refraining from further Fed Funds increases as rates approach the neutral Fed Funds rate of about 4%. My guess is that the bond market has it right and inflation is not a problem. If inflation statistics stay on a moderate course, then the Fed may begin to signal a willingness at least to take a hiatus from tightening beyond a neutral rate by the end of the third quarter. In this scenario stocks would probably surge higher while bond prices would paradoxically decline on the reduced probability that the Fed would raise rates to the point of risking a recession. Conversely, if the Fed raises rates through the end of the year and shows no signs of abating, then stocks will probably rise modestly in the near-term, but may come under pressure next year. Bonds would probably continue to do well in this scenario. I think that the odds favor the first scenario because of global disinflationary forces, such as low labor costs and global competition. While oil and terrorism are still wild cards; the financial markets seem to have already significantly discounted the likelihood of higher oil prices and the London bombings demonstrate that the world economies are coming around to the notion that terrorism is a fact of life and the best way to fight it is to not be terrorized.

At this point, stocks in the US and around the world are trading at valuations well below those of other asset classes. Bonds and real estate in particular are quite expensive relative to stocks. When the valuation differentials between stocks and other assets will stop expanding is anyone's guess; however, taking history as a guide, they will eventually reverse to the mean of their long-term relative value. Translation: the reward to risk ratio for stocks relative to bonds and real estate heavily favors stocks by a wide margin.

MCA Flexible Portfolios
12-month Tax Efficiency: 91.3%
(After Tax Return divided by Before Tax Return)

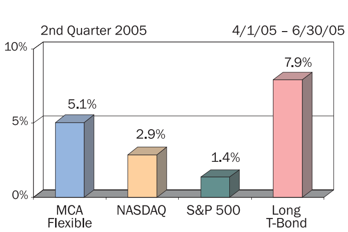
Growth of $10,000
1/1/91–6/30/05

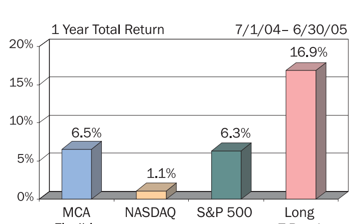


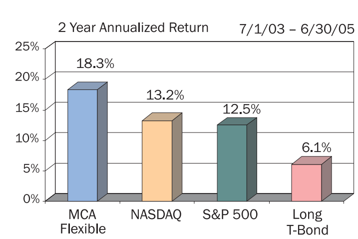
See Important Disclosure Notice on back page.

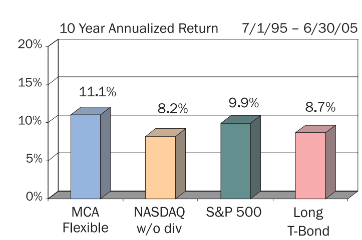
INVESTMENT RESULTS

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.

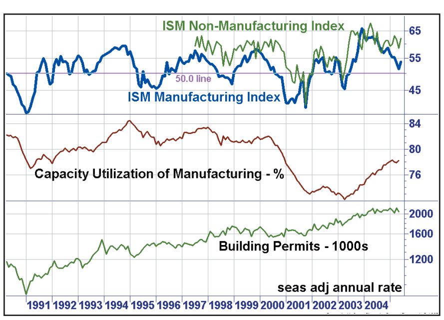
QUARTERLY ECONOMIC REVIEW by Alston Boyd, Economic Director

July 8, 2005

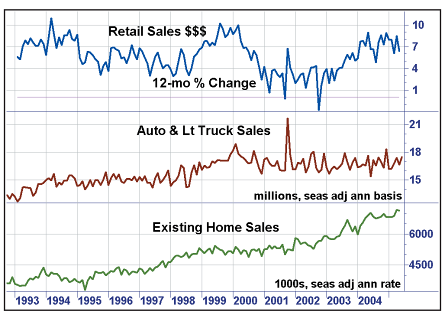
The fourth quarter of 2004 and the first of 2005 both showed annualized GDP growth of 3.8% in spite of rising energy costs and continuing rate hikes by the Fed. The quarter just ended probably saw growth almost equally strong. The broad stock market gained slightly in the quarter, though the Dow Industrials slipped a little. Short interest rates rose as long rates fell, combining to produce a flatter yield curve. Oil prices ended the quarter near all time highs, though the overall inflation rate fell slightly during the quarter. Other commodity prices and inflation indexes shown in the table below were nearly flat over the three-month period. Manufacturing flattened out in the quarter, while home construction and sales continued apace. The labor market continued its pattern of low unemployment but relatively slow addition of new jobs.

INDUSTRY

The manufacturing sector experienced moderate growth over the quarter, with the Institute of Supply Management's Manufacturing Index at 53.8 for June. This index has slid from a high of 66.2 in December 2003, which represented feverish growth, down to current levels a little above 50.0, which separates growth from contraction. Factory orders for May were up 2.9%, though they were down 0.1% when transportation items were excluded. The difference is explained by non-defense aircraft & parts, which jumped a whopping 165% that month, as Boeing reported 200 new plane orders. After rising strongly for two years, both total and manufacturing capacity utilization flattened out, a confirmation of the lower Manufacturing Index. This year's sharp rise in oil prices is mostly responsible for the slowdown in manufacturing growth. On the positive side, a lot of money is being spent on new factories or on renovation of existing facilities. Service industries, which represent a much larger portion of our economy than manufacturing, have experienced strong growth for two years. The June ISM Services Index stood at 62.2, indicating rapid expansion. As service industries tend to use less energy, high oil prices have less of an impact and thus services have managed to maintain a rapid growth rate.



Building permits for new private homes and housing starts have remained close to record highs for more than a year, as relatively low mortgage payments have allowed many individuals to buy homes that otherwise could not have afforded them. Likewise, commercial construction, both public and private, has remained strong over the last quarter and 12-month periods. Though commercial construction is helped by low interest rates, it is actually driven more by demand in an expanding economy.

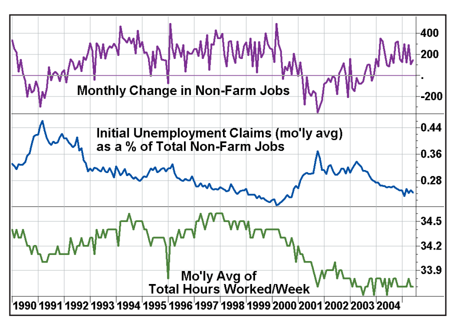


SALES

Total retail sales have remained strong, up 6.4% in 12 months through May, though May's 0.5% decline was the first monthly drop in nearly a year. A decline in a single month is not significant by itself, so we're seeing a continuing strong trend in total sales. Auto and light truck sales rose to 17.5 million units on an annual basis, the highest in six months, though still within the range of the past three years. GM effectively cut prices in June, offering to the general public the discounts normally given to their own employees. It was a simple sales concept, the public responded strongly to the inducement and lots of GM cars and trucks were sold. It's doubtful, however, that GM made lots of money by selling the vehicles at those prices. And there's also the question of what they'll need to do to attract buyers in the future after offering this great deal. Home sales have continued to be so strong that questions have been asked about whether the industry is experiencing a bubble in prices. April and May showed the highest numbers of existing home sales in history, while May saw the second-highest number of new home sales in history. Low mortgage rates are largely responsible for the strength in this sector, though rapid price appreciation has attracted some investors who were burned in the stock market decline of 2000-2002 and want to try something else.

LABOR

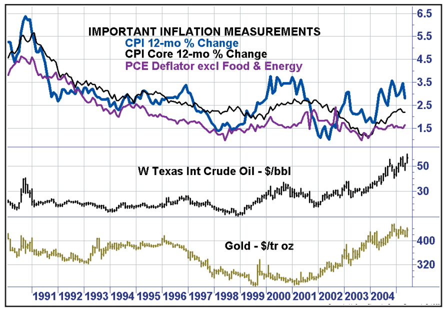
Employment and labor market conditions are in a healthy state of balance today, though hiring has not been as vigorous during this recovery and expansion as in historically similar times. A good part of the difference is no doubt attributable to the increased productivity and efficiency of modern technology. June showed a net increase of 146,000 non-farm jobs, with 150,000 gained in services and 24,000 lost in manufacturing. Weekly initial unemployment claims, measuring jobs lost, remained at a low level, averaging 323,500 in June. The chart below shows claims as a percent of total jobs in order to mitigate the effect of a growing job market over time. Total hours worked per week remained low at 33.7, and hours worked per week in manufacturing alone also remained relatively low at 40.4. Two leading



indicators appear to be pointing in opposite directions. Initial claims, which involve the entire economy, are low and point toward strength, while manufacturing hours, which relate to about 14% of the economy, are low and point toward weakness in that sector.

INFLATION

The 12-month change in the Consumer Price Index was up 2.8% in May, but down from 3.5% the month before. When food and energy are removed, leaving the CPI core, the inflation rate dropped to 2.2% in May. A more obscure measure of inflation is the core Personal Consumption Expenditure Deflator. This has undergone increased scrutiny recently because it is reportedly Chairman Allan Greenspan's favorite inflation indicator. The 12-month change stands at 1.6%, below the 2.0% threshold of the inflationary danger zone. Rising oil prices have had a big impact on our rate of inflation. The principal driver of oil prices today is a strong world economy, which is responsible for steadily increasing consumption. All major producers are pumping flat out, so any significant increase in supply is unlikely in the short term. The supply can only be increased over the long term by exploration for oil plus exploitation of non-traditional sources like tar sands and oil shales. Prices are also boosted now by uncertainties in



major oil producing countries, ranging from potential terrorism in the Persian Gulf to labor problems in Nigeria and ugly politics in Venezuela. Part of the increase in prices of many commodities over the past several years was due to the falling US dollar, which turned up near the beginning of this year. Gold prices show the effect of the stronger dollar by the slight decline since late last year. Unfortunately, oil shows no such decline.

SUMMARY AND OUTLOOK

Our economy has grown strongly over the past three quarters in spite of adverse conditions produced by rising oil prices and rising short interest rates. This is quite an achievement, though it seems to receive little praise or even recognition. Contrast this with Europe, which is essentially stagnant. The US dollar has risen 12% off its lows of late last year, at least in part because of our higher short interest rates. An important factor supporting our continued growth is continued low long interest rates, somewhat unexpected because we would more typically see long rates rising in an economic expansion. However, foreign investors and governments, particularly those in Asia, have bought and held a large quantity of our treasury debt instruments, resulting in higher securities prices and lower rates. They certainly would not do this if our treasury's securities were not the most secure investments available in the world today. To put the size of those holdings in perspective, the $16 billion offered for Unocal is perhaps 10% of China's trade surplus with the US over the last 12 months. Oil prices today are at record levels and the Fed continues to raise rates, so the same question applies to both factors: how much higher will they go? Even our robust, vibrant economy can stand just so much of this. As for oil prices, it's likely that the economic slowdown in Europe and a slower rate of growth anticipated in China will slow the rate of increase in oil consumption, thereby easing some of the pressure on prices. After nine rate hikes totaling 2.25%, the Fed's decision on rates should hinge on the prospects for inflation. Given that Chairman Greenspan's favorite inflation measurement produces a real Fed Funds target of +1.7%, we should see only a few more quarter-point increases. This would leave adequate room for healthy economic growth.

MARKET AND ECONOMIC STATISTICS

as of Market Close June 30, 2005, with 3-month and 12-month changes

LABOR – June '05		3 mo	12 mo
Unemployment Rate	5.0%	–0.2%	–0.6%
New Non-Farm Jobs	+146K	+477K	+2296K
Avg Hourly Wages	16.06	0.7%	2.6%
Avg Init Unempl Clms	324K	–9.0K	–12.5K

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10275	–2.2%	–1.5%
S&P 500	1191	0.9%	4.4%
NASDAQ Comp	2057	2.9%	0.4%
NASDAQ 100	1494	0.7%	–1.5%
NYSE Comp	7218	0.7%	9.3%
Wilshire 5000	11877	2.0%	6.6%
Russell 2000	640	4.0%	8.1%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	3.15%	13.3%	144.2%
30-yr T-Bond Yld	4.19%	–12.0%	–20.9%
FNMA 30yr mortg	5.42%	–6.6%	–5.6%
Prime Rate	6.25%	8.7%	47.1%
Fed Funds Trgt	3.25%	18.2%	160.0%
Fed Disc Rate	2.75%	22.2%	266.7%
S/L Long T-Bnd Ind	13921	7.9%	16.9%

PRICES, INFLATION		3 mo	12 mo
CPI, May	194.1	1.1%	2.8%
PPI, May	153.5	0.7%	3.3%
Gold, cash	435.3	1.6%	10.4%
W Tx Int Cr Oil	56.50	2.0%	52.5%
Copper $/lb	1.55	2.8%	28.9%
CRB Futures Ind	300.0	–4.3%	12.8%
CRB Raw Indust	329.3	–1.7%	7.6%

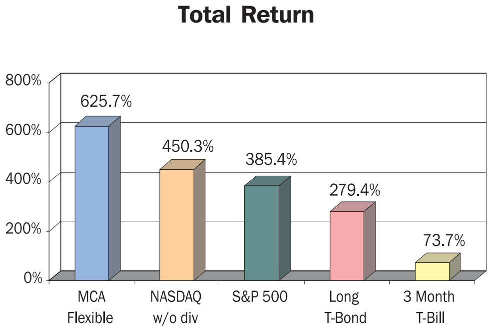
MONEY		3 mo	12 mo
M2, Bil Curr$, May	6465	0.2%	3.2%
Free Reserves	1.465	22.5%	–14.2%
Money Mkts-Bil$	1887	0.0%	–3.4%
US $$$ Index	89.1	6.0%	0.4%

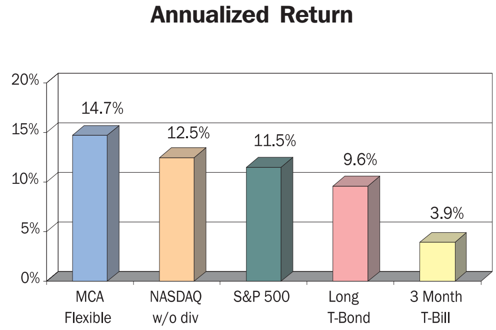
INDUSTRY		3 mo	12 mo
ISM Index, Jun	53.8	–1.4	–7.3
Indus Prod Ind, May	118.6	0.3%	2.7%
Cap Utiliz, May	79.4%	0.0%	1.2%
Bldg Permits, May	2050K	–2.1%	–3.7%

1st Qtr. '05	Final	3 mo	12 mo
GDP-Bil$	11096	3.8% apr	3.7%
GDP Deflator	109.9	2.9% apr	2.4%
Empl Cost Index	176.7	0.7%	3.4%
NF Productivity	136.1	2.9% apr	2.6%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 2005





THE COMPASS

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FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Inc	39.46	6	Texas Instruments	28.07	11	Centex	70.67	16	Home Depot	38.90
2	Whole Foods Market	118.21	7	Applied Materials	16.18	12	Charles Schwab	11.28	17	LAM Research	28.95
3	Starbucks	51.66	8	Tiffany	32.76	13	Nasdaq 100	36.78	18	S&P Dep Recpts	119.18
4	Williams Sonoma	39.57	9	Intel	26.02	14	Oracle Systems	13.20	19	Bear Stearns	103.94
5	Electronic Arts	56.61	10	Cisco Systems	19.08	15	CitiGroup	46.23	20	Medtronic	51.79

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%	37.4%	40.0%	36.5%	30.7%	5.6%	2.5%
1996	29.4%	29.1%	23.1%	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%	28.6%	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%
2005	-2.5%	-3.7%	-0.8%	-5.5%	0.0%	8.4%	1.4%	2.2%
Total[3]	625.7%	455.6%	385.2%	450.3%	401.4%	279.4%	73.7%	45.3%
Avg.[4]	14.7%	12.6%	11.5%	12.5%	11.8%	9.6%	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]1991-2005 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 37 individual portfolios and 40.3% of all funds under management by MCA on 6/30/05. 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.