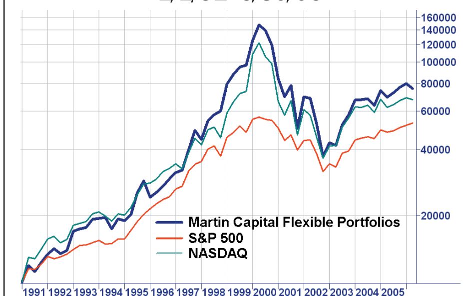
THE COMPASS

July 2006

A Quarterly Newsletter of Martin Capital Advisors, LLP

Global Instability Weighs on Markets; Global Economy Remains Resilient

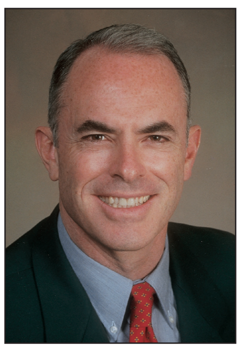
Growth of $10,000
1/1/91–6/30/06



See Important Disclosure Notice on back page.

July 17, 2006

Financial markets declined in the second quarter. Global instability and monetary tightening were the primary catalysts. However, the decline was not as surprising as the fact that it wasn't worse than what could have happened in the face of higher energy prices, higher commodity prices, global terrorism, climbing interest rates, weakening economic conditions, softening corporate profits, monetary tightening, and global instability.



So far, the third quarter has been dominated by the same factors that have negatively impacted the second quarter. At this point, one has to wonder how much more negative sentiment can be generated before stocks and bonds have fully discounted all risks and begin to build a base for future advances. My guess would be that we have already seen most of the worst in the recent declines, but that there still may be some downside risk pending a break in further Fed Funds rate increases.

Bond prices have begun to recover as signs of economic moderation have become apparent. Although stock prices have been driven lower by the latest Middle East flare-up, greater global instability may give the Fed another reason to at least take a break from increasing monetary restraint. Since the financial markets have started to price in negative economic expectations, any suggestion that the Fed may be less restrictive should be positive for both stocks and bonds in the near-term.

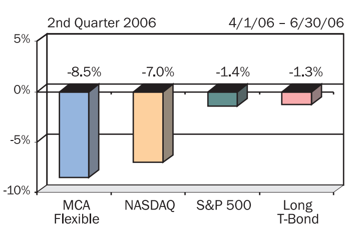
In the long-run, however, economic prosperity will depend upon reasonable monetary restraint and global stability, which will continue to be influenced by changes, for the better or worse, in monetary, fiscal and diplomatic policies. Unfortunately, these policies lately have become somewhat counter-productive to economic growth; fortunately, the resiliency of the global economy thus far has counterbalanced much of the negative impact.

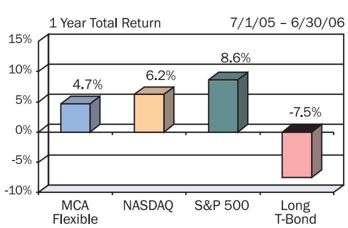
At this point, the financial markets have mostly factored in the possibility of an economic slowdown, yet there is still a good chance that monetary tightening will be restrained in time to prevent a significant economic decline. Therefore, the odds are good that the drop in stock prices over the last few months may be nearly over and that a substantial rebound could ensue if the Fed signals an end to tighter monetary policy in the near future.

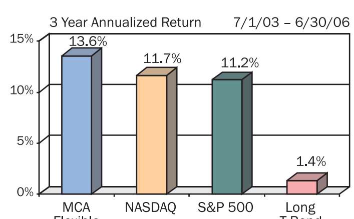
MCA Flexible Portfolios
12-month Tax Efficiency: 98.2%
(After Tax Return divided by Before Tax Return)

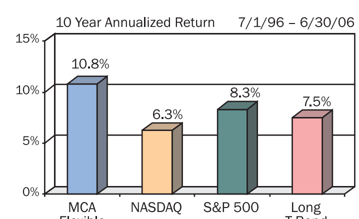
INVESTMENT RESULTS

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









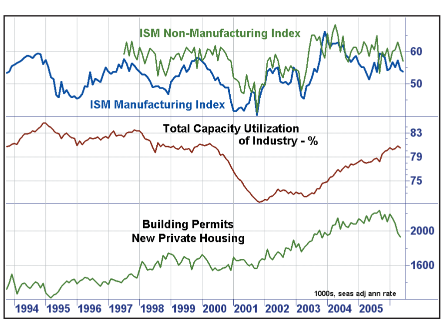
—— See Important Disclosure Notice on back page. ——

We've experienced uneven growth over the last several quarters, with GDP up 4.1%, 1.7% and 5.6% in the last three quarter reports. The second quarter just completed should show GDP up about 4.0%. Interest rates have gone up across the board over both the past three and 12 months, with short rates up more, giving us a virtually flat yield curve. The labor market is tight and wages have been accelerating. Overall inflation is also up, with commodity prices leading the way. Industry is generally a little weaker, with housing the weakest part.

INDUSTRY

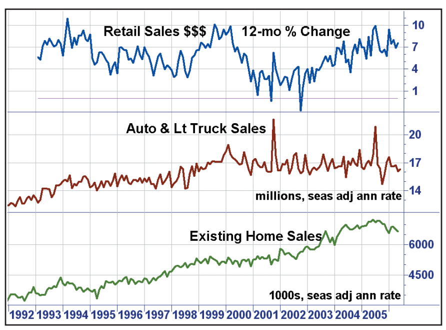
The manufacturing sector of our economy shows a slight tendency toward weakening, as the ISM Manufacturing Index fell to 53.8 in June, the lowest since August of last year, and a figure not far above the 50.0 level separating expansion from contraction. Of the ten components making up that index, six were weaker, three stronger and one unchanged. New orders were up, however, a positive indication for the future. The ISM Non-Manufacturing Index fell from 60.1 to 57.0, though still a strong showing. Of nine components in that index, seven were weaker. Total capacity utilization of industry was 81.7% in June, only 0.2% below the May figure, which was the highest since July 2000. Likewise, capacity utilization of manufacturing was 80.5, just below the 6-year high seen in May.

The housing industry appears to have experienced a setback of moderate proportions, as building permits for single-family homes in May were down 8.5% from a year before. Housing starts were stronger, up 5.0% in May, but were still down 3.8% in 12 months. Higher mortgage rates have clearly had a dampening effect on our housing market nationwide, though some areas continue to remain strong, outpacing others that were perhaps overpriced. In general, as higher rates drive up monthly payments, fewer people can afford to buy and must rent instead.



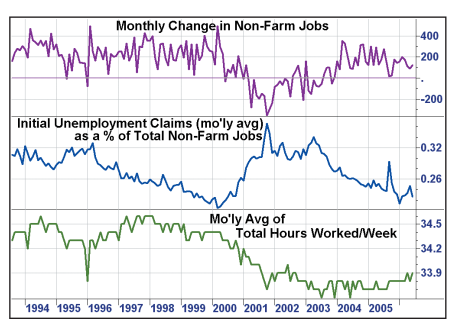
SALES

Total retail sales are an important figure because consumer spending makes up about two-thirds of our economy. So far this year, total sales have held up well, though a larger portion of that total is now spent on gasoline and other energy products than was true a year ago, pulling consumers' disposable income away from other items. In May, total sales were up 0.1%, but excluding autos, they were up 0.5%. On a year-over-year basis, they were up 7.6% and 9.1%, respectively. Auto and light truck sales, which make up about a quarter of total sales, are an area of weakness, having fallen off considerably since gasoline prices passed $3/gallon. The weakness in sales has been most pronounced in SUVs and other low-mileage vehicles. May showed 16.1 million auto and light truck units sold on an annualized, seasonally adjusted basis, while June was only slightly stronger at 16.3 million units. These figures were down 3.5% and 8.7%, respectively, from a year before. Existing homes sales may have topped out and started down, as the chart shows. At 6.77 million, May's figure was 8.3% below the high of June 2005. New home sales, on the other hand, have increased in each of the past three months, with May up 18.9% to 1.234 million over a February low. It appears the higher mortgage rates are having less of an effect on new home than on existing home sales.



LABOR

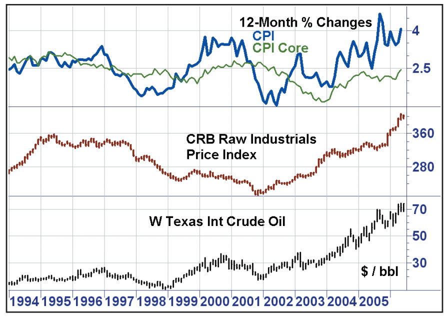
Although all indicators don't entirely conform, the labor market appears tight. The 121,000 gain in the number of non-farm jobs in June was surprisingly small for a strong economy such as we have now. Nearly all gains were in services, with hardly any in manufacturing or construction. Weekly initial unemployment claims for June averaged out to be 306,000, a low number indicating full employment and somewhat at odds with the low number of new jobs. A spike in unemployment claims occurred in May because of a government shutdown in Puerto Rico, but that is past and we're now seeing new numbers without that unique distortion. The middle chart shows initial claims as a percent of total jobs in order to compensate for employment growth over the past dozen years. In this regard, we're near the lows of that period, which also points to a tight labor market. The monthly average of weekly hours worked in industry was 33.9 in June, equal to the highest in four years. The average number of hours worked per



week in manufacturing was 41.3, the highest since July 2000. This last figure is a leading indicator in the Conference Board's Index of Leading Indicators, along with initial unemployment claims. Hourly wages rose 0.5% in June, and were up 3.9% over 12 months, which is the highest 12-month increase in five years. The Employment Cost Index, which represents total labor costs, including benefits as well as wages, has been falling even as wages have been accelerating. The latest numbers we have on the Employment Cost Index are from the first quarter, so the figures from the second quarter will be very important in showing whether or not an acceleration of total labor costs has occurred.

INFLATION

The Consumer Price Index rose 4.1% in 12 months through May, while the core rate, excluding food and energy, rose only 2.4%. Obviously, energy prices are having a big effect and lately appear to be "leaking over" somewhat into the rest of the economy. The core PCE deflator, another inflation indicator closely watched by the Fed, was up 2.1% in 12 months, 0.1% above the Fed's comfort zone. An expanding world economy has driven up prices of raw materials of all kinds, particularly those used in industry. Reflecting this increased demand, the CRB Raw Industrials Index of commodity prices rose sharply in 2005 and 2006. Copper prices were up 123% in the last 12 months, though a slight drop occurred recently. Gold has risen 45.1% in the last 12 months, partly because of inflation and also due to other factors like demand for gold jewelry in Asia and because of political uncertainty in the Mid-East. Oil, however, has been the greatest source of inflation. We're wired into a booming world economy and that's what is primarily responsible for the high energy prices. Added to that is a risk factor for activities around the Persian Gulf, giving us record high oil prices. About two thirds of inflation comes from labor costs, so the acceleration of wages needs to be closely monitored. The real story will be told when the Employment Cost Index figures come out for the second quarter, showing the direction of total labor costs.



SUMMARY AND OUTLOOK

All eyes seem to be on the Fed now. Will it pause after 17 rate hikes or will it continue raising rates, overshoot the mark and weaken the economy too much? It's a difficult job to get it just right, because the results of rate increases on the economy aren't apparent until about a year later. The delayed results are the reason why the Fed has unwittingly caused recessions in the past. If it only looks at overall current conditions and acts on information at hand without a careful eye toward any evidence of slowing in individual indicators, the Fed is playing a dangerous game. We're seeing some weakness in the ISM Indexes, the homebuilding industry and auto sales, which together might mark the beginning of an overall slowdown. Also, the number of new jobs has been less than expected. Surely the members of the Federal Open Market Committee are aware that our economy is also facing a big headwind from high energy prices, particularly gasoline, that act like a huge tax on consumers, potentially slowing the economy as much as rising interest rates.

MARKET AND ECONOMIC STATISTICS

as of Market Close June 30, 2006, with 3-month and 12-month changes

1st Qtr. '06	Final	3 mo	12 mo
GDP-Bil$	11404	5.6% apr	3.7%
GDP Deflator	114.4	3.1% apr	3.1%
Empl Cost Index	100.7	0.6%	2.9%
NF Productivity	138.1	3.7% apr	2.5%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	11150	0.4%	8.5%
S&P 500	1270	–1.9%	6.6%
NASDAQ Comp	2172	–7.2%	5.6%
NASDAQ 100	1575	–7.5%	5.5%
NYSE Comp	8169	–0.8%	13.2%
Wilshire 5000	12849	–2.3%	8.2%
Russell 2000	725	–5.3%	13.3%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	4.99%	8.2%	58.4%
30-yr T-Bond Yld	5.19%	6.1%	23.9%
FNMA 30yr mortg	6.71%	5.7%	23.8%
Prime Rate	8.25%	6.5%	32.0%
Fed Funds Trgt	5.25%	10.5%	61.5%
Fed Disc Rate	4.75%	11.8%	72.7%
S/L Long T-Bnd Ind	12880	–1.3%	–7.5%

PRICES, INFLATION		3 mo	12 mo
CPI, May	201.9	1.4%	4.1%
PPI, May	160.8	1.6%	4.3%
PCE Core Defl, May	111.5	0.8%	2.1%
Gold, cash $/tr oz	616.0	5.7%	41.5%
W Tx Int Cr Oil $/bbl	73.98	11.0%	30.9%
Copper, $/lb	3.46	39.2%	123%
CRB Futures Ind	346.4	4.0%	15.5%

MONEY		3 mo	12 mo
M2, Bil Curr$, May	6797	0.5%	4.7%
Free Reserves	1.380	51.5%	–5.8%
Money Mkts-Bil$	2117	3.0%	11.7%
US $$$ Index	85.2	–5.1%	–4.4%

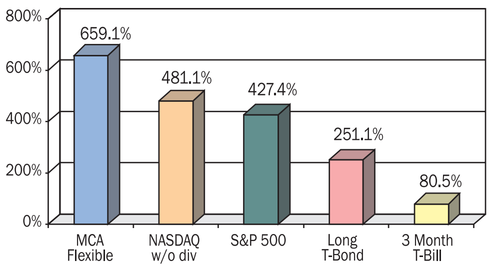
INDUSTRY		3 mo	12 mo
ISM Manuf, Jun	53.8	–1.4	0.0
ISM Non-Manuf, Jun	57.0	–3.5	–5.2
Cap Utiliz, May	81.7%	0.6%	1.9%
Bldg Permits, May	1932K	–10.0%	–8.5%

LABOR – Dec '05		3 mo	12 mo
Unemployment Rate	4.6%	–0.1%	–0.4%
New Non-Farm Jobs	+121K	+500K	+1642K
Avg Hourly Wages	16.70	1.2%	3.9%
Avg Init Unempl Clms	306K	–29K	–179K

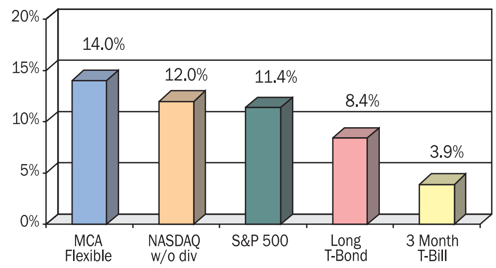
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 2006

Total Return



Annualized Return



THE COMPASS

A Quarterly Publication of
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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	Whole Foods Mkt	64.64	6	LAM Research	46.72	11	Oracle Systems	14.49	16	Advanced Micro Dev	24.42
2	Starbucks	37.76	7	Sandisk	50.98	12	CitiGroup	48.25	17	Intel	19.00
3	Dell Inc.	24.46	8	Williams Sonoma	34.05	13	Advent Software	36.07	18	Tiffany	33.02
4	Charles Schwab	15.98	9	Cisco Systems	19.53	14	Caterpillar	74.48	19	Apple Computer	57.27
5	Texas Instruments	30.29	10	Bear Stearns	140.08	15	Red Hat	23.40	20	Intermagnetics	26.98

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%	7.3%	7.7%	15.5%	9.0%	8.0%	3.5%	2.9%
1993	14.5%	17.0%	10.0%	14.8%	11.3%	17.3%	2.9%	2.8%
1994	-2.1%	5.0%	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%	28.7%	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%	-15.0%	-22.1%	-31.5%	-20.9%	17.2%	1.7%	2.4%
2003	56.8%	28.3%	28.7%	50.0%	31.6%	2.1%	1.0%	1.9%
2004	10.7%	5.3%	10.9%	8.6%	12.6%	8.0%	1.4%	3.6%
2005	7.6%	1.7%	4.9%	1.4%	6.3%	6.7%	3.0%	3.5%
2006	-5.2%	5.2%	2.7%	-1.5%	3.5%	-6.1%	2.3%	2.9%
Total[3]	659.1%	516.6%	427.4%	481.1%	451.7%	251.1%	80.5%	51.4%
Avg.[4]	14.0%	12.5%	11.4%	12.0%	11.7%	8.4%	3.9%	2.7%

[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]1991-2006 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 32 individual portfolios and 32.9% of all funds under management by MCA on 6/30/06. 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.