THE COMPASS

October 2006 A Quarterly Newsletter of Martin Capital Advisors, LLP

Financial Markets Rebound on Fed Pause, Lower Energy Prices

October 17, 2006

After getting off to a weak start in July, stock prices rebounded in August and September. The primary catalysts were a significant drop in energy prices and the Federal Reserve's decision to hold off on further rate increases. Bond prices rallied throughout the third quarter as the fixed-income markets began to anticipate lower inflation around the corner, justified primarily by falling oil prices and nascent signs of moderating economic expansion.

As we enter the fourth quarter, stocks have continued to rally, but bonds have given back some of their recent gains. The financial markets seem to be adjusting to the notion that the economy may not fall off into recession. My guess is that is probably true. Despite a severe slump in residential housing activity and the negative implications of an inverted yield curve, consumer spending will probably remain resilient due to the recent improvement in wage growth, which should counterbalance the negative impact of weaker areas of the economy. Lower energy prices are also helping to maintain economic growth and offset the drag of restrictive monetary policy.

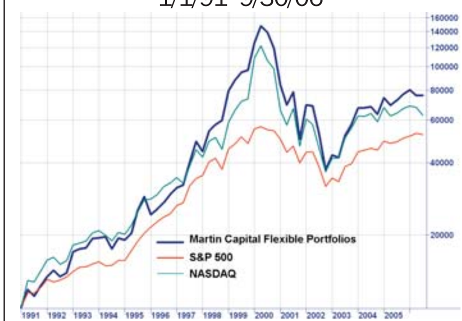
Of course, if the Fed were to get back on the path of relentlessly raising rates, and/or energy prices were to spike because of an interruption in supplies, then stock prices probably would suffer and bond prices probably would benefit. These concerns are part of the reason why bonds remain relatively more expensive than stocks and, therefore, have more risk and less return potential relative to stocks. In the absence of any major disruptions to the global economy, stocks should outperform bonds over the next several years.

The saving grace for both stocks and bonds, even in the face of global instability, is the global tendency towards disinflation. The main global disinflationary force is the increasing access to lower cost labor. While labor costs are picking up some in the U.S., they are being offset by access to lower labor costs elsewhere. Whether one agrees or disagrees philosophically with the outsourcing of U.S. jobs, the result is highly disinflationary. Another disinflationary aspect of the global economy is the price competition produced by free trade. Again, one can debate the pros and cons of free trade, but clearly one of the pros is the disinflationary impact of companies around the world competing for business, with price being one of the determinants of success or failure.

These global disinflationary tendencies should engender lower inflation with only a modest decline in economic growth, which is good for both stocks and bonds. The next several months will tell whether this is true or not.

MCA Flexible Portfolios
12-month Tax Efficiency: 97.9%
(After Tax Return divided by Before Tax Return)

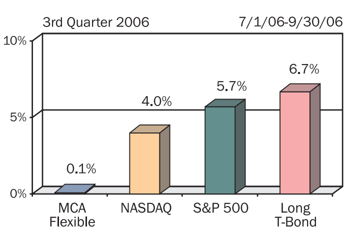
Growth of $10,000
1/1/91–9/30/06

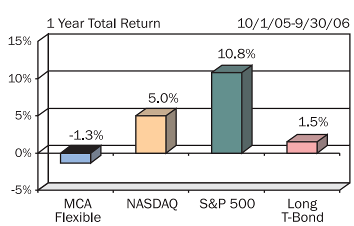


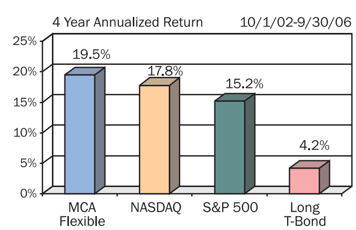
See Important Disclosure Notice on back page.

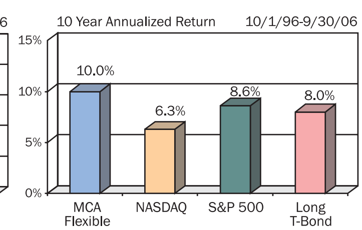
INVESTMENT RESULTS

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









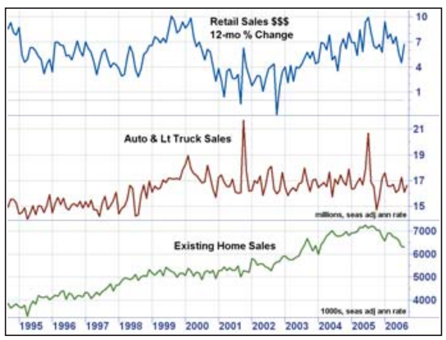
—— See Important Disclosure Notice on back page. ——

The US economy grew at an annualized rate of 2.6% in the second quarter of 2006, and the third quarter will probably show slightly slower growth. Over 12 months the economy grew at a 3.5% rate, a respectable pace. The stock market showed some strength in the third quarter, and some stock indexes were up into double digits over 12 months, with large caps doing best. Interest rates rose over nine months and then declined during the third quarter. We saw an upsurge in rates of inflation during the quarter and the past 12 months, largely due to much higher oil prices in the past year, though they have fallen sharply in the last two months. Industry has eased off slightly in the past quarter and 12 months, as the Fed's tightening has taken hold. Housing in particular has slowed. The job market still remains relatively tight and hourly wages have continued to rise, though some softness has become apparent.

INDUSTRY

Both manufacturing and services industries appear to have slowed during September, the third quarter and over the past 12 months. The ISM Manufacturing and Non-Manufacturing (Services) Indexes both fell to 52.9 in September, continuing a volatile downtrend, though 52.9 is still considerably above the 50.0 line that separates growth from contraction, so healthy conditions still prevail. Nevertheless, a slowdown is apparent from the sizzling activity of two years ago. At 82.4%, total capacity utilization remains near a cyclical peak, the highest in six years, and shows no evidence of softening. Factory orders are so volatile that one month's change hardly gives any sense of what's going on. However, the three-month changes through August for total and durable goods orders were +0.6% and +0.3%, respectively, running considerably below the annual rates of change of +4.6% and +4.2%. Overall, a healthy slowing appears to be under way – healthy because it is not extreme and it gives evidence for the Fed to consider not raising rates.

Single-family housing is undergoing a substantial contraction that began early this year, as shown by building permits in the chart, down 21.9% in 12 months. This was probably triggered by mortgage rates rising above 6% late last fall and it has accelerated since then. Roughly 40% of new homes constructed last year were second homes and many of those were speculative investments. Part of this decline represents an end to or at least a pause in that speculation. As always, not all areas of the country are experiencing the same conditions; the decline is particularly severe on the East and West Coasts.



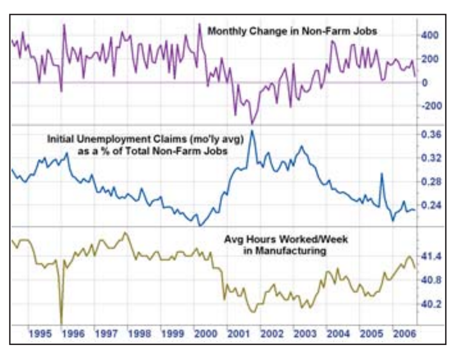
SALES

Total retail sales have remained relatively strong over the past year, though not as strong as in 2005. Total sales dollars were up 1.1% over the three months ending in August, while they were up 6.7% over 12 months, indicating some deceleration. Numbers of auto and light truck sales hardly changed in 12 months through September, though high gasoline prices drove many buyers away from large, poor mileage vehicles like SUVs into smaller, more fuel-efficient cars. The dollar amount spent on vehicles rose only 3.5% in 12 months.

One effect of high gasoline prices was a shift of consumers' dollars into fuel and away from other types of purchases. Now that oil and gasoline prices have fallen somewhat, we may see a shift back to more normal purchasing patterns. Home sales have plummeted, with August existing home sales off 12.6% and new home sales off 17.4% from a year earlier. As stated before, we are probably seeing a disgorging of speculative home purchases, particularly second homes that have been bought over the past several years in some parts of the country.

LABOR

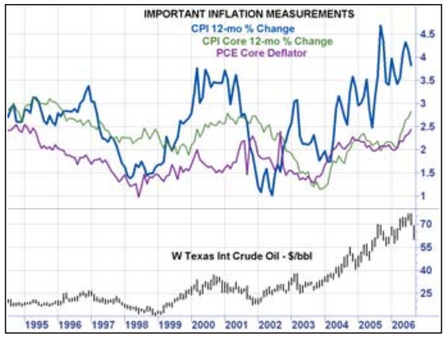
The employment picture shows slight weakness. The unemployment rate is down to 4.6%, but that is a lagging indicator. The number of net new jobs in September was down to 55,000, though August's figure was revised up 60,000 to a gain of 188,000. Looking at the chart of non-farm jobs, one has to conclude that the past 12 months have not been anywhere near as strong as the previous two years. The average gain of 131,900 is relatively weak by historical standards; the average for the prior three 12-month periods was 175,000. Initial unemployment claims, a leading indicator, show no weakness, especially when divided by the number of jobs in our economy in order to remove the effects of a growing job market. Those monthly averages have hardly changed at all over the past four months. Average hours worked per week are showing some weakness, with those



in manufacturing, another leading indicator, down 0.3 from July. Overall average hours worked per week were down 0.1 in two months and overtime hours were down 0.3 from June. Overtime hours tend to lead hiring and firing of workers because they take up the slack in times of rapid growth. It makes more sense for an employer to have existing employees work longer hours on a short term basis, even if they have to be paid more, than to hire new ones they might have to let go if the surge in business activity proves to be only temporary.

INFLATION

The Consumer Price Index was up 0.2% in August and up 3.8% in 12 months, with the big increase largely due to high energy prices. Crude oil reached a peak in July that was about seven times the low price seen only eight years earlier. It has since fallen from its peak of about $77/bbl down to under $60, which should give some relief, provided it lasts. The CPI Core rate and the PCE Core Deflator both exclude the volatile food and energy components from inflation measurements and therefore reflect considerably lower rates of inflation. The CPI Core increased 2.8% in 12 months and the PCE Core Deflator was up 2.5%. Unfortunately, the Fed's comfort limit for those indicators is 2.0%, so they are both into what the Fed considers to be



dangerous territory. While fighting inflation is a primary duty of the Fed, we're seeing signs of a slower economy, which should eventually bring down the overall inflation rate.

In conjunction with the decline in oil prices, unleaded gasoline reached the lowest price point since last March, while natural gas is now the lowest in four years. Other commodity prices, such as aluminum and copper, have declined slightly from their April and May peaks. Gold has also come down over the last four months. While this pattern of declining prices doesn't hold true for all commodities, it certainly represents a change from a year earlier.

SUMMARY AND OUTLOOK

A number of different types of data show that we've probably passed the peak of economic activity for this cycle and our economy is gradually slowing. The housing sector is the most prominent example, with building permits down sharply and even median prices down over 12 months, the first time that has happened in over 10 years. From 2000 to 2005, median home prices in some areas of the US rose over 100%, so there should be no great surprise that we're seeing a slight decline. Evidence also comes from industry, where both manufacturing and services show a tendency toward slowing. Total retail sales were lower in the most recent three months than for the previous 12 months. The Fed will probably hold off raising rates again in spite of a relatively high rate of inflation, as long as they see a slower economy. Inflation tends to lag economic activity, so the economy may have to slow considerably before we see much evidence of a change. If the Fed were to raise rates again in the next few months, it might cause the economy to roll over from a healthy slowdown into a recession. Back in 2000, in spite of evidence of an already slowing economy, the Fed raised the Fed funds target half a point to 6.5%, too much too late, and produced a recession. Presuming that the Fed takes no further action over the next several months, we're likely to see a slower economy, but not a recession. One wild card is that while cheaper oil brings relief to consumers and businesses, it could give the economy too much of a boost, causing the Fed to resume raising rates.

MARKET AND ECONOMIC STATISTICS

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

2nd Qtr. '06	Final	3 mo	12 mo
GDP-Bil$	11388	2.6% apr	3.5%
GDP Deflator	115.9	3.3% apr	3.3%
Empl Cost Index	101.6	0.9%	3.0%
NF Productivity	137.7	1.6% apr	2.5%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	11679	4.7%	10.5%
S&P 500	1336	5.2%	8.7%
NASDAQ Comp	2258	4.0%	5.0%
NASDAQ 100	1654	5.0%	3.3%
NYSE Comp	8470	3.7%	11.0%
Wilshire 5000	13346	3.9%	8.6%
Russell 2000	726	0.1%	8.7%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	4.63%	–0.51%	0.30%
3-mo T-Bill Rate	4.88%	–0.11%	1.32%
Trea Spd 10y-3mo	–0.25%	–0.37%	–1.02%
Fed Funds Trgt	5.25%	0.00%	1.50%
Prime Rate	8.25%	0.00%	1.50%
FNMA 30yr mortg	6.22%	–0.49%	0.37%
S/L Long T-Bnd Ind	13749	6.7%	1.5%

PRICES, INFLATION		3 mo	12 mo
CPI-U, Aug	203.7	0.9%	3.8%
CPI Core, Aug	206.9	0.7%	2.8%
PCE Core Defl, Aug	112.4	0.6%	2.5%
Gold, cash $/tr oz	598.9	–2.8%	27.6%
W Tx Int Cr Oil $/bbl	62.92	–14.9%	–5.0%
Copper, $/lb	3.46	–0.1%	92%
CRB Futures Ind	305.6	–11.8%	–8.2%

MONEY		3 mo	12 mo
M2, Bil Curr$, Aug	6874	1.1%	4.7%
Free Reserves	1.096	–20.6%	–43.5%
Money Mkts-Bil$	2218	4.8%	14.1%
US $$$ Index	86.0	0.9%	–3.9%

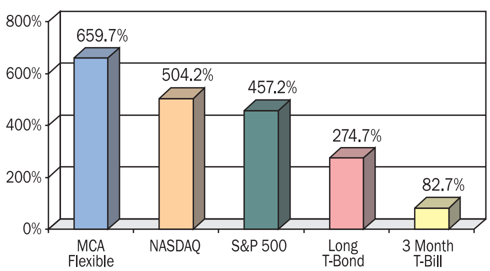
INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Sep	52.9	–0.9	–6.5
ISM Services, Sep	52.9	–4.1	–0.4
Cap Utiliz, Aug	82.4%	0.7%	2.1%
Bldg Permits, Aug	1722K	–11.5%	–21.9%

LABOR – Sep '06		3 mo	12 mo
Unemployment Rate	4.6%	0.0%	–0.5%
New Non-Farm Jobs	+51K	+362K	+1583K
Avg Init Unempl Clms	313.4K	+4.6K	–25.5K
Avg Hourly Wages	16.84	0.9%	4.0%

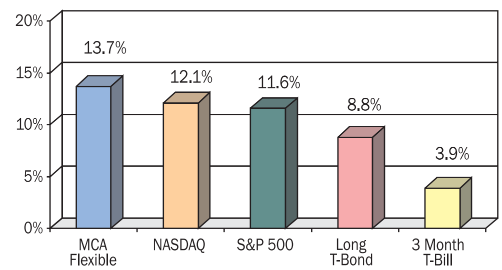
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2006

Total Return



Annualized Return



THE COMPASS

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FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Whole Foods Mkt	59.43	6	LAM Research	45.33	11	Bear Stearns	140.10	16	Caterpillar	65.80
2	Starbucks	34.05	7	Cisco Systems	22.98	12	Advent Software	36.21	17	Red Hat	21.08
3	Charles Schwab	17.91	8	Sandisk	53.54	13	CitiGroup	49.67	18	Tiffany	33.20
4	Texas Instruments	33.25	9	Oracle Systems	17.74	14	Intel	20.57	19	Dell	22.84
5	Apple Computer	76.98	10	Williams Sonoma	32.39	15	Advanced Micro Dev	24.85	20	DaVita	57.87

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	Dow Jones Industrial Avg.	S&P 500	NASDAQ	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	-5.1%	10.9%	8.5%	-1.5%	8.0%	0.3%	3.6%	3.6%
Total[2]	659.7%	549.5%	457.2%	504.2%	475.5%	274.7%	82.7%	52.4%
Avg.[3]	13.7%	12.6%	11.6%	12.1%	11.8%	8.8%	3.9%	2.7%

[1]Total Annual Performance, net of commissions, fees, and expenses, of all Martin Capital Advisors flexible investment portfolios.
[2]Total compounded return, including reinvestment of dividends and interest. [3]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; however, Nasdaq returns are without dividends. 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 29 individual portfolios and 28.9% of all funds under management by MCA on 9/30/06. 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.