THE COMPASS

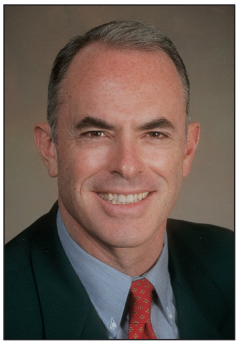
January 2007 A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stock Indexes Did Well in 2006, Though Martin Capital Returns Were Disappointing

January 22, 2007

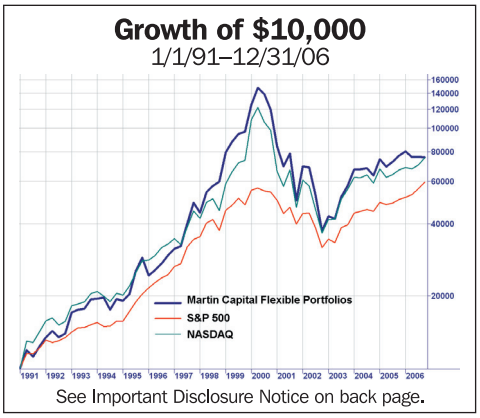
Stock market indexes achieved good returns for the fourth quarter and for the year. Unfortunately, many of our large positions suffered significant declines in 2006, such as Whole Foods (-39%), Dell (-16%), Texas Instruments (-10%), Williams-Sonoma (-27%), SanDisk (-32%), Intel (-19%), Tiffany (-10%), Advanced Micro Devices (-34%), Red Hat (-38%) and Centex (-26%). Although we did have many advancing positions, including Apple (+35%), Starbucks (+18%), Charles Schwab (+32%), Cisco Systems (+60%), LAM Research (+42%), Oracle (+40%), Bear Stearns (+41%), Advent Software (+22%) and Mellon Financial (+15%), the net result was a loss for the year and our first annual under-performance relative to the NASDAQ and S&P 500 since 2002.



MCA Flexible Portfolios
12-month Tax Efficiency: 97.1%
(After Tax Return divided by Before Tax Return)

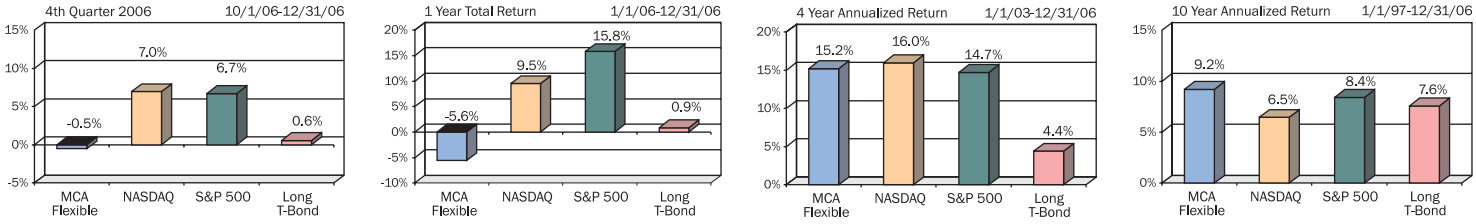
I think that we will see a rebound at some point in 2007 in the performance of many of the stocks that did not do well in the past year. Of some concern to me today, however, is whether the stocks that achieved high returns in 2006 will give back some of their gains in the near-term. During the next few months we may see some profit taking in stocks that have done well over the past year, and perhaps some reciprocal tax loss selling in poor performers also, but I think as the year progresses the odds are good that earnings and economic conditions will warrant higher stock prices, especially for many of the positions that were beaten down in 2006 and for high-tech companies that stand to benefit from the Microsoft Vista upgrade cycle.

There are numerous counterbalancing factors that will determine the performance of the financial markets in 2007. Some of the most obvious are energy prices, economic strength, global stability, inflation and monetary policy. Each of these factors influences the others to at least some degree. The challenge is to determine the most likely impact each will have on the financial markets at any given time. The probable impact can best be judged by assessing popular expectations. Today, the consensus seems to be that the price of oil is going higher, the economy will slow, global instability will persist or worsen, inflation will go up and the Fed will either ease or tighten monetary policy in the near future. Since the least amount of risk and greatest reward are usually on the opposite side of consensus expectations, investment portfolios in 2007 probably have the best chance of achieving superior returns by being positioned to take advantage of the prospects for unexpectedly lower energy prices, stronger economic growth, less global instability, moderating inflation and little to no change in interest rates as the year unfolds.



INVESTMENT RESULTS

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

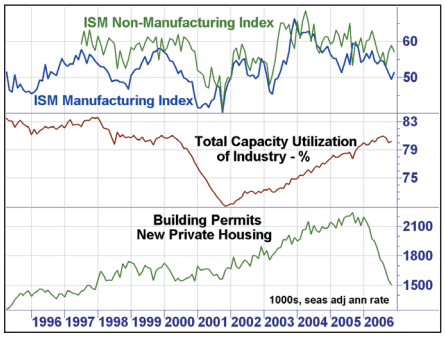


See Important Disclosure Notice on back page.

The US economy grew at an annualized rate of only 2.0% in the third quarter of 2006, the second-lowest quarterly rate since early 2003, and the 12-month rate of growth was only 3.0%, also the lowest since 2003. The fourth quarter should show growth of around 2.5%, just marginally stronger. Most stock indexes had a good year. Interest rates showed hardly any change over the last quarter and over the entire year. Inflation was in retreat during the last quarter, good news for interest rates and prospects for the Fed not to raise rates. Some weakness was seen in manufacturing as homebuilding continued to contract. Retail sales eased off somewhat over the last quarter. Though the labor market continues to be strong, we might see some softening there in the future.

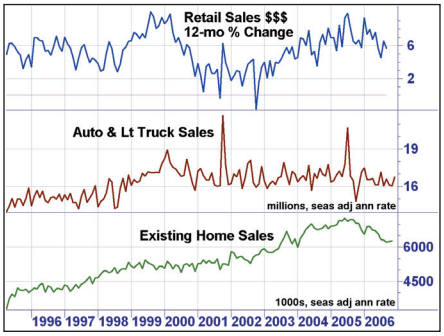
INDUSTRY

Service industries were strong in the fourth quarter, while manufacturing seems to have remained nearly flat. The ISM Services Index closed out 2006 at 57.1, the third month in a row over 57, while the ISM Manufacturing Index stood at 51.4, the highest reading in the quarter. Capacity utilization began to fall from its peak in September, both for the total of all industries and for manufacturing alone, standing at 81.8% and 80.2%, respectively, in November. The most striking development in the industrial sector has been the year-long drop in housing, illustrated here by building permits, which were down to 1.506 million annualized in November, the lowest since late 1997. The drop began last February and was well under way in March, as mortgage rates broke out to new highs. Though rates have subsided since then, the housing market has clearly taken no comfort from that, as the drop in fixed investment in residential property cut 1.2% off GDP growth in the third quarter. More negative effects of this drop may be seen in the labor market over the next year, which are described below.



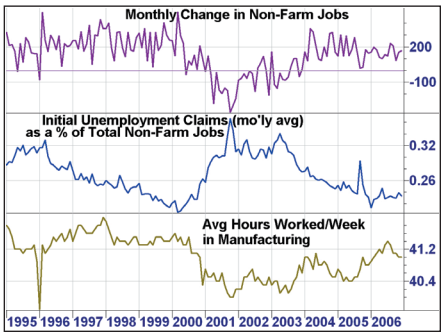
SALES

Total retail sales over the four months ending in November were up only 0.3%. Excluding autos, total sales were down 0.1% over those four months. As two-thirds of GDP is made up of consumer spending, this overall pattern does not point toward robust growth. The chart clearly shows the decline in year-over-year total sales as the slowdown has occurred. December auto and light truck sales were 16.76 million units at a seasonally adjusted annual rate, up slightly from a weak 16.04 million in November. We're not seeing a sharp decline in auto sales, but rather a slow weakening over the past year. Home sales slowed across the country, continuing the decline that began late last year. With the November figures, we might be seeing a bottoming out of that industry. New home sales were down 15.3% over 12 months, but were up 2.5% in the last reported three months. The change in existing home sales between the last full year and the last three months through November were not so pronounced, but were nevertheless significant: -10.7% and -0.3%. In order for builders to sell new homes in most areas in the past several months they had to make concessions in the form of free upgrades, so profit margins were compressed.



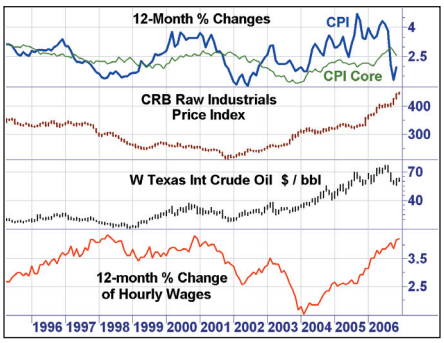
LABOR

The labor market rebounded in December, with an increase of 167,000 net new jobs, the most since last September. The average monthly figure for the quarter was a respectable 137,000. Weekly initial unemployment claims for December averaged 317,500, down 11,000 from November's figure. The total number of average hours worked per week was 33.9, equal to the highest in the past year. Average weekly hours in manufacturing, however, were 0.4 off the peak of 41.0 reached last July. This drop in manufacturing hours is a confirmation of the weakness in the ISM Manufacturing Index. The other indicators, however, point to a relatively healthy labor market and to a healthy economy, as well, since initial unemployment claims and hours worked in manufacturing are two of the Conference Board's leading indicators. Though these figures combined signal a relatively healthy labor market, the construction industry may have a surprise in store. The big decline in the construction industry, particularly in housing, has not been accompanied by a drop in employment in that industry as yet. According to the Bureau of Labor Statistics, the number of unemployed in construction in December 2005 was 813,000, and in December 2006 had dropped to 725,000. The unemployment rate in construction went from 8.2% down to 6.9% over that one-year period. Figures from other sources appear to confirm that significant layoffs have not occurred in the construction industry. This leaves one wondering about how the industry will handle lower production levels without a considerable number of layoffs.



INFLATION

The inflation outlook received a boost in the last quarter, as a break in the uptrend of the Consumer Price Index occurred with the index falling half a percent in both September and October. The year-over-year change, which had reached +4.3% in June, was down to +2.0% in November. The core CPI, which leaves out the volatile food and energy components, has been slower to fall. It was unchanged in November and up 2.4% in 12 months. Most industrial commodity prices have continued to rise, as shown in the chart of the CRB Raw Industrials price index. However, prices of two important commodities, oil and copper, have declined. Oil is the commodity whose price has the greatest effect on the economy and inflation, so its influence is obvious. Copper's price has less effect on inflation than oil's, but it's often seen as a bellwether in terms of the direction of manufacturing, so its value is that of an indicator. Labor costs appear to be the strongest potential source of inflation today, with a year-over-year increase in hourly wages at or above 3.8% for the past seven months, peaking in November and December at 4.2%. As labor costs are said to be responsible for two-thirds of inflation, this data seems to hold the potential for higher inflation. However, as the rest of the economy has slowed somewhat into the 2% to 2.5% range of



growth, labor's strength may be showing up as a lagging indicator, a sign of past strength rather than what is to come. Also, we may well see a softening in the labor market if construction workers begin to be laid off.

It has been surprising to many that crude oil prices up to nearly $75/barrel have not caused hyperinflation. In fact, the recent peak of near $75 was easier for our economy to take in stride than $40/barrel in 1980, which was equivalent to $98 today, adjusted for inflation. Nevertheless, $3/gallon for gasoline represented a pain threshold for many consumers. Another important factor helping us avoid hyperinflation and recession has been the evolution of the US economy from being a heavily energy-dependent manufacturing economy to a service economy that requires less energy.

SUMMARY AND OUTLOOK

The Fed's long, steady series of rate hikes has finally had the desired effect of slowing the economy. At a 2% annualized rate, our economy is growing below capacity, which, given time, should bring a lower inflation rate. Two areas of uncertainty with regard to our economy today are related to the housing and construction industries. One is the possibility of a large number of layoffs in the weak housing environment, which would have a softening effect. Another area causing concern is the mortgage market, specifically subprime lending and adjustable rate mortgages. Subprime lending involves home loans being made at higher interest rates to those with weak credit. Such loans now total about $625 billion. About 8% of all subprime loans were delinquent 60 days or more in October. Adjustable rate mortgages have made it possible for many to buy homes they couldn't otherwise afford. A homebuyer qualifies at a low introductory rate, expecting either to sell the home within a few years or to be earning more money when the interest rate and payments ratchet up. As home prices haven't performed well across the country recently, it is creating problems for those expecting to sell quickly. About $475 billion in such loans adjust to higher rates in 2007. No financial crisis exists at this point and it is unlikely that one will occur as a result of all this. Nevertheless, if problems develop here, they might cause a further slowing of our economy.

MARKET AND ECONOMIC STATISTICS

as of Market Close December 31, 2006, with 3-month and 12-month percentage changes

3rd Qtr. '06	Final	3 mo	12 mo
GDP-Bil$	11444	2.0% apr	3.0%
GDP Deflator	116.4	1.9% apr	2.9%
Empl Cost Index	102.7	1.1%	3.3%
NF Productivity	137.7	0.2% apr	1.4%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	12463	6.7%	16.3%
S&P 500	1418	6.2%	13.6%
NASDAQ Comp	2415	6.9%	9.5%
NASDAQ 100	1757	6.2%	6.8%
NYSE Comp	9139	7.9%	17.9%
Wilshire 5000	14258	6.8%	13.9%
Russell 2000	788	8.6%	17.0%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	4.70%	0.07%	0.30%
3-mo T-Bill Rate	4.99%	0.11%	0.92%
Trea Spd 10y-3mo	–0.29%	–0.04%	–0.60%
Fed Funds Trgt	5.25%	0.00%	1.00%
Prime Rate	8.25%	0.00%	1.00%
FNMA 30yr mortg	6.14%	–0.08%	0.05%
S/L Long T-Bnd Ind	13827	0.6%	0.9%

PRICES, INFLATION		3 mo	12 mo
CPI-U, Nov	201.7	–1.0%	2.0%
CPI Core, Nov	207.7	0.4%	2.6%
PCE Core Defl, Nov	112.9	0.5%	2.2%
Gold, cash $/tr oz	636.6	6.3%	23.1%
W Tx Int Cr Oil $/bbl	61.06	–3.0%	0.0%
Copper, $/lb	2.85	–17.5%	32%
CRB Futures Ind	307.3	0.5%	–7.4%

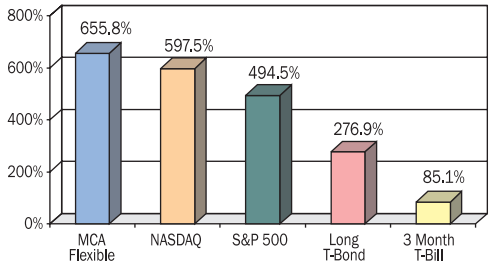
INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Dec	51.4	–1.5	–2.8
ISM Services, Dec	57.1	4.2	–3.9
Cap Utiliz, Nov	81.8%	–0.6%	1.1%
Bldg Permits, Nov	1506K	–12.8%	–31.3%

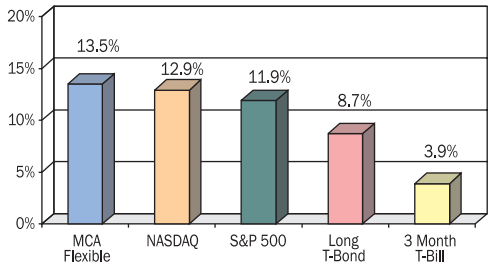
SALES		3 mo	12 mo
Total Retail-$B, Nov	368.9	0.4%	5.5%
Ttl ex Autos-$B, Nov	291.0	–0.3%	5.3%
Autos-M Units, Dec	16.8	1.1%	–2.2%
New Homes-K, Nov	1047	2.5%	–15.3%

LABOR – Dec '06		3 mo	12 mo
Unemployment Rate	4.5%	–0.1%	–0.4%
New Non-Farm Jobs	167K	407K	1838K
Avg Init Unempl Clms	317.5K	3.6K	7.1K
Avg Hourly Wages	17.04	1.1%	4.2%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 2006





THE COMPASS

A Quarterly Publication of
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FLEXIBLE PORTFOLIO TOP 20 POSITIONS

as of December 31, 2006

1	Whole Foods Mkt	46.93	6	LAM Research	50.62	11	Citigroup	55.70	16	Caterpillar	61.33
2	Starbucks	35.42	7	Texas Instruments	28.80	12	Bear Stearns	162.78	17	Dell	25.09
3	Charles Schwab	19.34	8	Oracle	17.14	13	Intel	20.25	18	Advanced Micro Dev	20.35
4	Cisco Systems	27.33	9	Williams-Sonoma	31.44	14	Advent Software	35.29	19	Applied Materials	18.45
5	Apple	84.84	10	SanDisk	43.03	15	Tiffany	39.24	20	Mellon Financial	42.15

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	-5.6%	19.1%	15.8%	9.5%	15.9%	0.9%	4.9%	2.0%
Total[2]	655.8%	597.5%	494.5%	546.1%	517.6%	276.9%	85.1%	50.6%
Avg.[3]	13.5%	12.9%	11.9%	12.4%	12.1%	8.7%	3.9%	2.6%

[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 27 individual portfolios and 26.2% of all funds under management by MCA on 12/31/06. 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.