THE COMPASS

October 2007

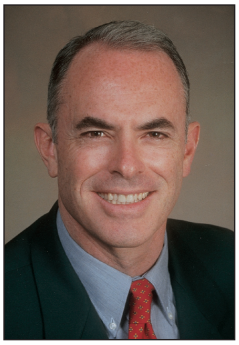
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Sea Change at the Fed Bodes Well For Stocks and the Economy

October 15, 2007

Third quarter returns were quite good for both stocks and bonds. The positive performance of the stock market was especially impressive given the ongoing deflation of the housing market bubble and the expanding mortgage crisis. Strong global growth seems to be counter-balancing recessionary factors in the US, allowing stocks to anticipate at least moderate economic growth for the foreseeable future. Bonds have also done well over the last several months as economic activity has moderated and core inflation has come down into the Fed's "comfort zone."



The most important event of the third quarter, and arguably of the past few years, was the half point cut in the Federal Funds rate on September 18.

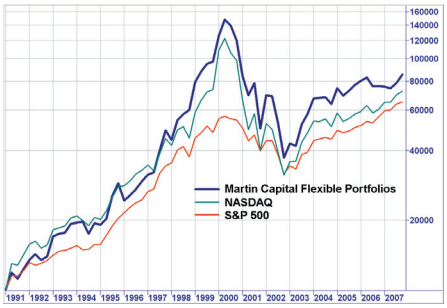
MCA Flexible Portfolios
12-month Tax Efficiency: 98.9%
(After Tax Return divided by Before Tax Return)

This cut signaled that the Fed will take decisive action to support the economy in the face of destabilizing market forces.

Many financial pundits have said that the Fed's easing of monetary conditions in response to systemic instability creates a "moral hazard" because those who have taken risks are rescued from financial ruin. On the contrary, I think that the Fed has a responsibility to act as the lender of last resort in the interest of maintaining price stability, which, in addition to full employment, is one of the Fed's legislated mandates. The inflation hawks, however, seem to think that price stability only applies to fighting inflation and not to providing liquidity to markets in turmoil.

Whether one agrees or not that the Fed should act to provide liquidity in times of financial stress, the fact is that the Bernanke Fed now has done that and has set a precedent for erring on the side of defending the economy from the destabilizing effects of systemic market disruptions. This fact represents a tremendous sea change in monetary policy, not just for the near-term reversal of the Fed moving from a tightening to an easing bias, but more importantly for the long-term signal – at least as long as Ben Bernanke is the Fed chairman – that the Fed will ride to the rescue of the economy when it is threatened by market malfunctions. The establishment of a more stable foundation for capital investment through the Federal Reserve's demonstrated willingness to intervene decisively in a crisis should prove to be an extremely positive development for the future performance of the stock market and the economy.

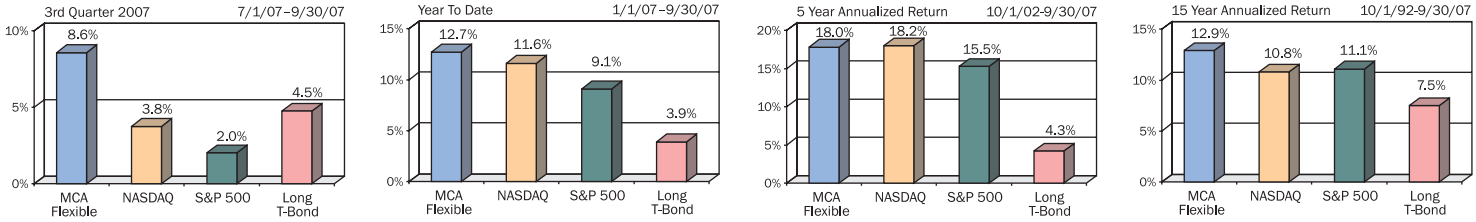
Growth of $10,000
1/1/91–9/30/07



See Important Disclosure Notice on back page.

INVESTMENT RESULTS

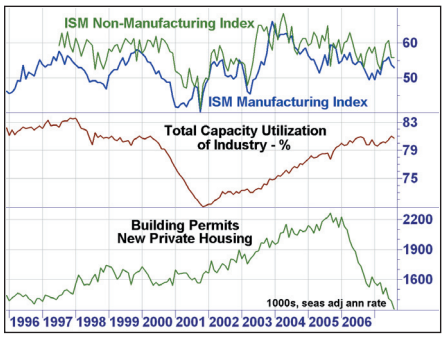
Martin Capital Advisors Flexible Portfolios vs. NASDAQ Composite, the S&P 500 Index and the Lehman Brothers Long Treasury Bond Index



See Important Disclosure Notice on back page.

Final GDP numbers for the second quarter of 2007 pegged growth at an annualized 3.8%, the strongest in 5 quarters, with 1.9% growth over 12 months. The third quarter just completed was probably a little weaker than the second, with perhaps around 2.5% to 3% growth. Stock indexes showed moderate increases in the third quarter, with the exception of the Russell 2000, which fell slightly. All major stock indexes showed double-digit gains over 12 months. Both long and short interest rates were flat to down over the last quarter and over 12 months, with the biggest change being -1.08% over a year for the 91-day T-bill yield. Industry showed slow growth, with the exception of homebuilding, which continued its steep decline. Total retail sales showed a small increase, with auto sales being somewhat stronger. Home sales continued sharply downward. The employment figures show a stable labor market, but with relatively weak gains in the number of new jobs over the quarter. Inflation has moderated overall, though oil and gold prices were up sharply over 3 and 12 months. The scare and uncertainty over sub-prime mortgage problems appears to have had little effect on the overall economy, apparently being limited to the housing sector and the institutions holding those particular securities.

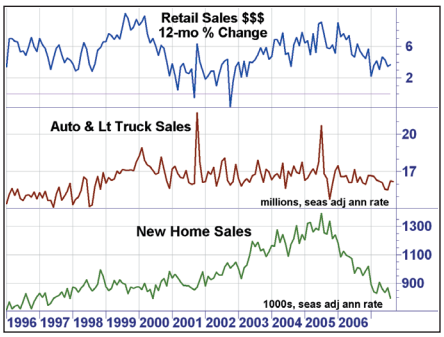
INDUSTRY



The manufacturing sector maintained a stable, low rate of growth in the third quarter, with the ISM Manufacturing Index ranging between 52.0 and 53.8 during the 3 month period. The strongest component of the index in September was prices, though less so than in August. The ISM Services Index showed a little more strength with equal stability, ranging from 54.8 to 55.8 in the period. Prices and employment were the components of that index showing the biggest increases. Total capacity utilization at 82.2% was unchanged in September, equal to the highest since last August. Capacity utilization in manufacturing was down 0.3% in August, though the 81.0% registered in July was the highest in a year. In the first 2 months of the quarter, total factory orders were unchanged, while durable goods orders were up 1.1%. The ISM components related to new orders in September showed a slower rate of growth. Excluding housing, the picture is one of relatively slow, stable, positive growth in industry.

The home-building industry has been taking a big hit as a widespread bubble in home prices deflates. As always, particular areas vary widely from the average, with construction and sales continuing to be strong in some fortunate locales. Nevertheless, nationwide building permits and housing starts have continued to drop, reaching 1.307M and 1.331M, respectively, in August. These were down 24.5% and 19.1% in 12 months. The August numbers were probably pushed down somewhat as the scare factor of news about sub-prime mortgage problems hit lenders.

SALES



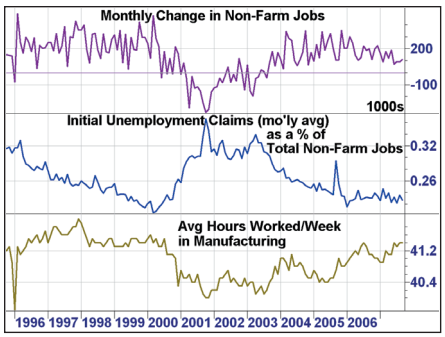
Total retail sales figures show a year-over-year downtrend through 2005 and 2006, then a slight rebound in early 2007, arriving at +3.7% in August. Increased spending by consumers in the third quarter gave July and August a bigger total increase, +0.8%, than that of the previous three months, a differential due primarily to higher auto sales. Both July and August showed higher auto sales than any month in the previous quarter.

As consumer spending makes up about two-thirds of our economy, these numbers are an important part of the economic picture. The real headline, however, is the home sales numbers. New home sales for August were an annualized 795,000, the lowest since June 2000, down 21.2% in 12 months and down 42.8% from the peak of 1,385,000 in July 2005. These depressing figures reflect the glut of existing homes on the market in many parts of the country, which in turn is the result of the housing bubble's collapse. Part of the problem has been caused by the easy credit and the kinds of mortgages that were used to finance homes, including the sub-prime mortgage fiasco. As home prices rose ever higher in many areas, the only way many could afford to buy a home was with an adjustable-rate mortgage, which reduced the interest rate initially for several years, after which it was to rise to the market rate at that time. This resulted in initially low mortgage payments, which were affordable at first. Now we've come to the time that rates go up to the market and mortgage payments are drastically higher. Many can't afford the higher payments and are forced to sell. Increasing numbers of these loans are reaching the point of rate increases, so more and more people are in this situation. With so many existing homes forced onto the market as well as double the number of foreclosures compared to last year, it should be no surprise that new home sales are suffering.

Sub-prime mortgages are a different aspect of that easy credit phenomenon. These loans were made to people with bad credit, and then the loans were bundled into large packages and sold to investors as investment grade securities. The scandal and uncertainty resulted from investors' surprise at the low quality and therefore low value of these securities.

LABOR

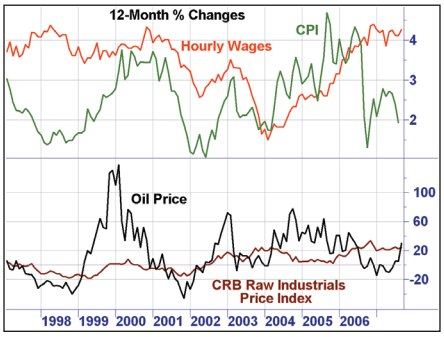
September's employment figures showed 110,000 new jobs, the highest in 5 months, as well as sharply raising the numbers for 2 previous months and thereby improving the perception of the job market's strength. Unfortunately, the background does not look so strong,



as the third quarter had the smallest number of new jobs since the third quarter of 2003, when the job market was pulling out of the recession. Weekly initial unemployment claims appear relatively low and stable, with a September average of 313,500. They are shown on the chart as a percentage of total jobs in order to compensate for growth of the labor market over time. The average of weekly claims in the last quarter was 314,923, compared to 317,641 in the first 3 quarters of 2007,and 312,962 for all of 2006, so we're seeing a very stable labor market from that perspective. Average hours worked in manufacturing, a leading indicator like initial unemployment claims, has remained high, a sign of strength in the labor market.

INFLATION

The chart shows percent changes over 12 months of 4 things important to our economy: the Consumer Price Index, hourly wages, oil prices and an index of commodity prices. Two scales are necessary because of the wide variation in rates of change. The 12-month change in the CPI, our most widely quoted rate of inflation, has dropped from over 4% just over a year ago to 1.9% in August. One factor that has contributed to the drop is the lower price of housing, a byproduct of the decline in home sales, and more stable oil prices. Hourly wages have continued to increase at a rate over 4%, a matter of concern, as two-thirds of inflation is said to come from labor costs. However, we may be seeing a divergence in wages and the CPI similar to what occurred in 1997-1998, when wage increases continued to rise and CPI-measured inflation dropped. Hopefully, these wage increases will not come back later to bite us. The price of oil has a huge impact on our economy and it is remarkable that we have so little overall inflation with the oil price increases we experienced in 2004-2006. If this were the early 1970s, we'd be looking at a recession for sure. Fortunately,



energy prices have far less impact on our service-oriented economy today. The CRB Raw Industrial Index includes a basket of prices of raw materials used in industry. The relatively steady increase of more than 20% over the past 16 months reflects more than anything else the industrial expansion taking place in China.

SUMMARY AND OUTLOOK

It appears that the crisis over subprime mortgages has abated and that the securities markets and banking industry are on a firm footing again. While there is no doubt that considerable misery is yet to result from this problem, much of the uncertainty is gone. The half-point cut by the Fed at its last meeting contributed to the now-widespread sense of security. Further Fed rate changes are unlikely until the picture becomes clearer with more data in evidence. The economy as a whole appears to have slowed a little in the third quarter and probably will continue to slow in the fourth. Part of this is due to what can only be called a crash in housing. While this is certainly not the case everywhere, those who have used their homes like ATMs by drawing on equity won't be able or inclined to do so and those who felt richer because of skyrocketing home prices won't be spending like millionaires for a while. The good news is that there don't appear to be any other big problems on the horizon at the moment.

MARKET AND ECONOMIC STATISTICS

as of Market Close September 30, 2007
with 3-month and 12-month percentage changes

2nd Qtr. '07	Final	3 mo	12 mo
GDP-Bil$	11520	3.8% apr	1.9%
GDP Deflator	119.5	2.7% apr	2.7%
Empl Cost Index	105.1	0.9%	3.4%
NF Productivity	136.7	2.6% apr	0.9%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	13896	3.6%	19.0%
S&P 500	1527	1.6%	14.3%
NASDAQ Comp	2702	3.8%	19.6%
NASDAQ 100	2091	8.1%	26.4%
NYSE Comp	10039	1.7%	18.5%
Wilshire 5000	15362	1.0%	15.1%
Russell 2000	805	–3.4%	11.0%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	4.58%	–0.46%	–0.05%
3-mo T-Bill Rate	3.80%	–1.02%	–1.08%
Trea Spd 10y-3mo	0.78%	0.56%	1.03%
Fed Funds Trgt	4.75%	–0.50%	–0.50%
Prime Rate	7.75%	–0.50%	–0.50%
FNMA 30yr mortg	6.25%	–0.36%	0.03%
S/L Long T-Bnd Ind	14366	4.76%	4.49%

PRICES, INFLATION		3 mo	12 mo
CPI-U, Aug	207.7	0.2%	1.9%
CPI Core, Aug	211.3	0.6%	2.1%
PCE Core Defl, Aug	114.5	0.4%	1.8%
Gold, cash $/tr oz	743.0	14.4%	24.1%
W Tx Int Cr Oil $/bbl	81.67	15.5%	29.8%
Copper, $/lb	3.63	5.1%	5.0%
CRB Futures Ind	333.7	5.7%	9.2%

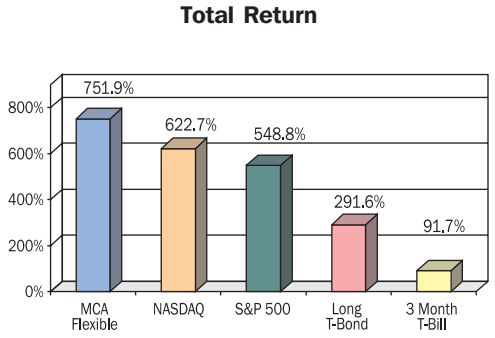
INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Sep	52.0	–4.0	–0.9
ISM Services, Sep	54.8	–5.9	1.9
Cap Utiliz, Aug	82.2%	0.7%	–0.2%
Bldg Permits, Aug	1501K	–14.0%	–24.5%

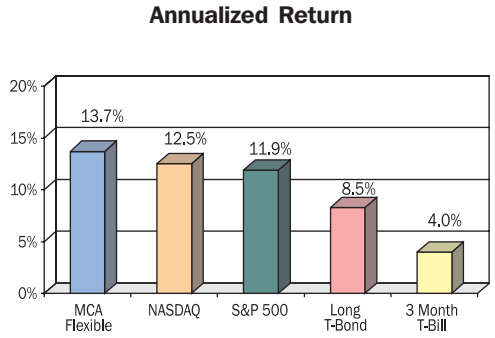
SALES		3 mo	12 mo
Total Retail-$B, Aug	377.6	0.0%	3.7%
Ttl ex Autos-$B, Aug	300.5	0.1%	3.9%
Autos-M Units, Sep	16.2	4.0%	–2.3%
New Homes, Aug	795K	–7.7%	–21.2%

LABOR – Sep '07		3 mo	12 mo
Unemployment Rate	4.7%	0.2%	0.1%
New Non-Farm Jobs	+110K	+292K	1629K
Avg Init Unempl Clms	313.5K	–6.8K	–2.5K
Avg Hourly Wages	17.57	1.0%	4.3%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2007





THE COMPASS

A Quarterly Publication of
MARTIN CAPITAL ADVISORS, LLP

1600 Virginia Avenue, Suite A
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 on request.

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

as of June 30, 2007

1	Apple	153.47	6	Oracle	21.65	11	Starbucks	26.20	16	Citigroup	46.67
2	Whole Foods	48.96	7	Intel	25.86	12	OmniVision	22.73	17	Boeing	104.99
3	Cisco Systems	33.13	8	SanDisk	55.10	13	Bear Stearns	122.81	18	LAM Research	53.26
4	Charles Schwab	21.60	9	Williams-Sonoma	32.62	14	Dell	27.60	19	MEMC	58.86
5	Texas Instruments	36.59	10	Tiffany	52.35	15	Applied Materials	20.70	20	Intuitive Surgical	230.00

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	NASDAQ	S&P 500	Dow Jones Industrial Avg.	Dow Jones Wilshire 5000	Long-Term T-Bond	3 Month T-Bill	Consumer Price Index
1992	26.8%	15.5%	7.7%	7.3%	9.0%	8.0%	3.5%	2.9%
1993	14.5%	14.8%	10.0%	17.0%	11.3%	17.3%	2.9%	2.8%
1994	-2.1%	-3.2%	1.3%	5.0%	-0.1%	-6.9%	3.9%	2.7%
1995	27.5%	40.0%	37.4%	36.9%	36.5%	30.7%	5.6%	2.5%
1996	29.4%	22.7%	23.1%	28.7%	21.2%	-0.8%	5.2%	3.3%
1997	41.4%	21.6%	33.4%	24.9%	31.3%	15.1%	5.3%	1.7%
1998	78.8%	39.6%	28.6%	18.1%	23.4%	13.5%	4.9%	1.6%
1999	58.2%	85.6%	21.0%	27.2%	23.6%	-8.7%	4.7%	2.7%
2000	-33.0%	-39.3%	-9.1%	-4.9%	-10.9%	20.1%	5.9%	3.4%
2001	-17.4%	-21.1%	-11.9%	-5.4%	-11.0%	4.6%	3.8%	1.6%
2002	-38.3%	-31.5%	-22.1%	-15.0%	-20.9%	17.2%	1.7%	2.4%
2003	56.8%	50.0%	28.7%	28.3%	31.6%	2.1%	1.0%	1.9%
2004	10.7%	8.6%	10.9%	5.3%	12.6%	8.0%	1.4%	3.6%
2005	7.6%	1.4%	4.9%	1.7%	6.3%	6.7%	3.0%	3.5%
2006	-5.6%	9.5%	15.8%	19.1%	15.9%	0.9%	4.9%	2.0%
2007 YTD	12.7%	11.9%	9.1%	13.3%	9.1%	3.9%	3.7%	3.0%
Total[2]	751.9%	622.7%	548.8%	690.4%	573.8%	291.6%	91.7%	55.4%
Avg.[3]	13.7%	12.5%	11.9%	13.1%	12.1%	8.5%	4.0%	2.7%

[1]Total Annual Performance, net of commissions, fees, and expenses of all Martin Capital Advisors' *Flexible Portfolios*.
[2]Total compounded return, including reinvestment of dividends and interest. [3]1991-2007 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 39.2% of all funds under management by MCA on 9/30/07. 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.