THE COMPASS

April 2008

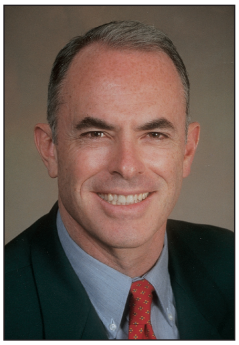
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Fed Action Finally Tempers Credit Crisis

April 21, 2008

After being hit hard in the first three weeks of January and then retesting the lows again in mid-March, stock prices have rebounded over the last month. The rebound is due in large part to actions by the Federal Reserve to provide additional liquidity to the credit markets. In particular, the Fed opening the discount window to investment banks on March 17 seems to have assuaged concerns about the possibility of additional investment bank failures in the wake of the collapse of Bear Stearns. Also, the Fed has aggressively dropped the federal funds rate to a point where the financial markets are beginning to anticipate an eventual recovery from the current economic malaise.



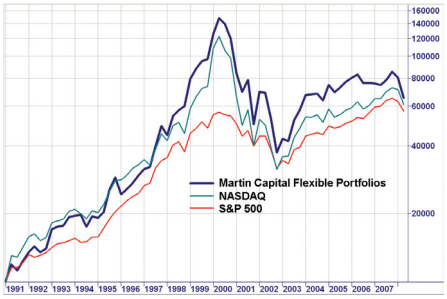
The unfolding of the credit crises has produced an unusually wide disparity of returns in the fixed income markets, with U.S. Treasury securities performing quite well, at least until very recently, while other fixed income instruments, such as mortgage-backed securities, have continued to be plagued by liquidity issues. As a result of the wide disparity of performance, U.S. Treasuries appear to be overvalued relative to other fixed income securities.

Treasuries also appear to be overvalued relative to stocks. In fact, the earnings yield for the S&P 500 relative to the 10-year Treasury Note is higher than it has been in many years, reflecting the extreme risk aversion induced by the credit crisis. Given the significant outperformance of Treasury securities versus stocks over the past year and over the past ten years, which is very unusual, we should see a "return to the mean" of stocks outperforming bonds over the next several years.

On March 10, which so far has proven to be the date of the closing low for the major stock market indexes, I sent a "market perspective" memo to clients, in which I said: "It is important to remember that stocks normally bottom just a month or two into a recession – and we are probably right around that point now." In another memo a few days later, I pointed out that "While the credit crisis was initially somewhat justified by the housing slump, it has spiraled to the point where panic has created unusually attractive prices in the financial markets." Although a retest of the March 10 low is still possible, I am even more confident today that we will see much higher stock prices over the next few years. We may even be at the beginning of a powerful bull market that could run for many years. Of course, market timing is always a game of probabilities, but I think stocks today are more attractively priced than they have been in a very long time.

MCA Flexible Portfolios
12-month Tax Efficiency: 99.2%
(After Tax Return divided by Before Tax Return)

Growth of $10,000
1/1/91–3/31/08



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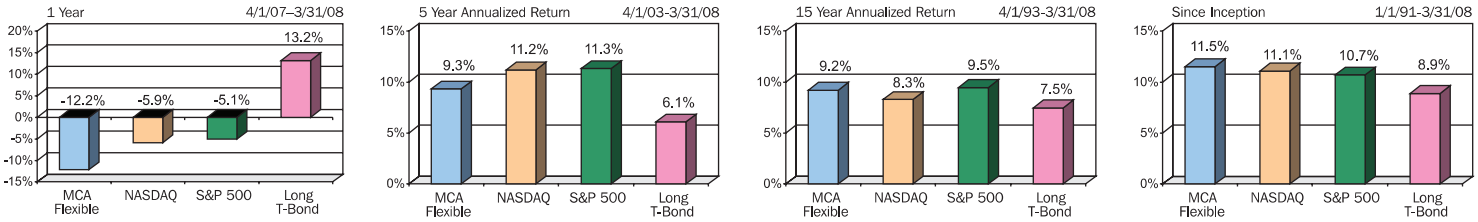
INVESTMENT RESULTS

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



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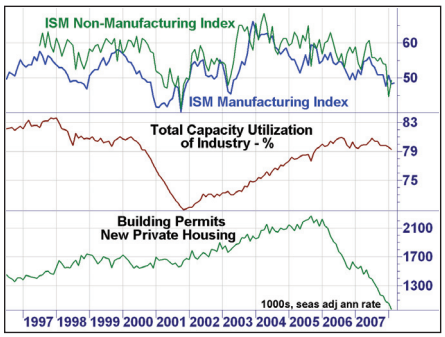
The final reading for growth in the 4th quarter of 2007 was +0.6%, annualized, and the first quarter of 2008 will almost certainly be weaker, probably zero to –0.5%. Equities have mostly slipped in the quarter just ended, with all major stock indexes down significantly. Interest rates have dropped across all maturities, most sharply on the short end of the spectrum, as the Fed has cut rates sharply. Inflation has been most severe in commodities, but core rates have had smaller increases. Both manufacturing and services have shown little growth in the quarter and sales have been lackluster, as well. The labor market has also shown weakness. While there's not much to cheer about, we can take comfort in the fact that we're only seeing relatively widespread minor weakness outside of the financial sector and housing industry.

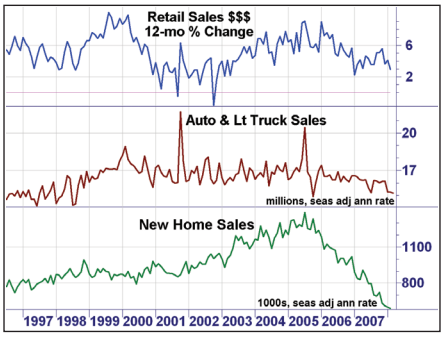
INDUSTRY



Neither the manufacturing nor the services sectors have shown any strength during the quarter just ended. The ISM Manufacturing Index averaged 49.2 for those 3 months, ending at 48.6 in March. Individual components of that index in March showed new orders, inventories and imports contracting, while prices were increasing faster. The Non-Manufacturing or Services Index averaged 47.8 for the 3 months, ending at 49.6 in March, up considerably from 44.6 in January. Components of that index showed the backlog of orders shrinking and employment contracting, while prices were high and increasing faster. When below 50.0, these indicators point to contraction, rather than expansion. Factory orders for January and February showed declines in total orders, durable goods and durables excluding transportation. Total capacity utilization of industry fell 0.6% in February to 80.9%, while capacity utilization of manufacturing was down 0.3% to 79.3%. In perspective, a drop of 0.6% in one month is large, but the current levels of capacity utilization are still relatively high and do not show weakness by themselves. What we're seeing in industry as a whole now is vastly milder than the big drop from mid-2000 to late 2001.

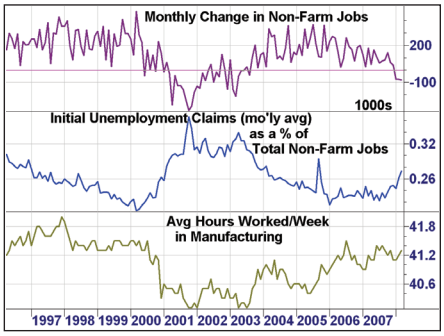
Building permits are a leading indicator of our economy and they continue to point in a negative direction. Permits in February 2008 were down 57% from the peak in September 2005. A lot of sellers today can't find buyers who can qualify for a loan. The decline in housing started with the bursting of a price bubble across the country and has been greatly exacerbated by the mortgage crisis that has swept over the world's financial sector. As a result, lending standards have become extremely tight. Just as loose loan standards helped create a bubble, overly tight ones are helping drive the industry downward. The housing industry cannot recover until lenders begin easing those standards so more people who want to buy can qualify for home loans.

SALES



Total retail sales have been essentially flat over the last two quarters. Excluding autos and light trucks, sales were up 2.1% in that period, confirming the weakness apparent in the chart of auto sales in the past year. Due to the increase in the price of oil, a bigger share of total sales has been spent on gasoline and other fuel, leaving less money available for other things. Prices for food have also gone up, leaving still less disposable income available to consumers. Sales of both new and existing homes have taken a beating, hit hard by the factors cited above: the bursting of the housing bubble and the mortgage crisis that has wreaked havoc on financial institutions around the world. These two things are closely related, as loose lending practices helped create the bubble, then the collapse of the bubble cut the value of lenders' collateral. Unfortunately, improvement in the housing market is not likely to occur within the next several quarters, as it will require the lending industry to get back on its feet and to have motivated buyers again.

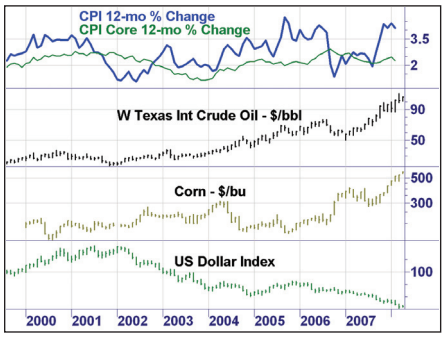
LABOR



The number of new non-farm jobs has been gradually tapering off since mid-2006, though it was only in January 2008 that the numbers fell to or near a net loss of 80,000 for 3 straight months. The average of weekly initial unemployment claims for March rose to 376,750, the highest since a spike in 2005, and a number seen to be indicative of a recession. The chart shows claims as a percentage of total jobs in order to take into account the growing number of jobs over time. The average number of hours worked in manufacturing, a leading indicator like initial unemployment claims, rose 0.1 in both February and March. This typically happens in a strengthening market, so it's counter to the general

trend of weakness. The unemployment rate rose from 4.9% to 5.1% in March, though that's generally more of a lagging indicator than a leader. Taken all together, the general pattern is one of a weaker labor market, though with some mixed signals. In any case, we're looking at a slightly weaker market now, rather than one that has fallen off a cliff. Compared to conditions in the last recession, we're experiencing a stiff breeze instead of a hurricane.

INFLATION



The overall rate of inflation, as measured by the Consumer Price Index, has been rising at a relatively rapid rate, though it remained unchanged in February. The 12-month increase has remained over 4% for the past 4 months, with February's figure being 4.1%. The core CPI, which excludes the volatile food and energy sectors, rose 2.3% in 12 months through February. A weak US dollar has pushed up prices for many items, particularly commodities. Food and energy prices are under far more pressure that most other sectors are experiencing, an unusual condition that has made the gap between the CPI and the core rate of inflation wider than usual. Prices for corn and other grains have shot up in response to a variety of factors such as poor harvests in Australia, use of corn for making gasohol to reduce oil consumption and increased feeding of grain to animals for meat production in Asia. Energy, particularly oil, has been in greater and greater demand, as the world economy has grown faster and faster. China went from being a net exporter of oil in the 1990s to one of the biggest importers today, to say nothing of the many other countries whose growth has expanded their needs. In addition, political problems in many major oil producing countries have created uncertainty about deliveries. Some have said that we will soon reach a tipping point, where world oil production is near a peak and will start to decline. Others theorize that the demand for oil has become so great that its price will never again decline even as far as $50/bbl, a high figure only a few years ago. It would take a worldwide slowdown to decrease the demand for oil enough to know where prices could go, so it may be best that we don't find out.

SUMMARY AND OUTLOOK

Everyone knows a credit crunch is bad for business. The mortgage crisis has created an unexpected credit crunch and we're seeing the economy slow in response. In "normal" business cycles, the Fed is known for taking away the proverbial punchbowl when the party gets going and our economy is overheating. This time, however, it's the mortgage crisis that snuck in and stole the punchbowl and the Fed now is busily trying to put it back before the party's completely over and we're mired in a recession.

The Fed made an extraordinary move by keeping Bear Stearns from failing in order to prevent a domino effect involving other institutions. Whether this was a bailout or not doesn't matter—what does matter is that the Fed showed the world how determined it is to keep the system from failing. Perhaps the most important question now is how many more institutions will be forced to go the route of Bear Stearns? Nobody knows the answer to that today. In any case, we do know that the Fed will go to nearly any lengths to fix the problem. This is extremely important and in profound contrast to the Fed's actions in the Great Depression, when it consistently did exactly the wrong thing and made the depression worse.

MARKET AND ECONOMIC STATISTICS

as of Market Close March 31, 2008
with 3-month and 12-month percentage changes

4th Qtr. '07	Final	3 mo	12 mo
GDP-Bil$	11676	0.6% apr	2.5%
GDP Deflator	120.5	2.4% apr	2.6%
Empl Cost Index	106.8	0.8%	3.3%
NF Productivity	139.7	1.9% apr	2.9%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	12263	–7.6%	–0.7%
S&P 500	1323	–9.9%	–6.9%
NASDAQ Comp	2285	–13.8%	–5.6%
NASDAQ 100	1782	–14.5%	0.5%
NYSE Comp	8797	–9.7%	–5.0%
Wilshire 5000	13332	–10.0%	–7.5%
Russell 2000	688	–10.2%	–14.1%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	3.43%	–0.60%	–1.22%
3-mo T-Bill Rate	1.31%	–1.92%	–3.72%
Trea Spd 10y-3mo	2.12%	1.32%	2.50%
Fed Funds Trgt	2.25%	–2.00%	–3.00%
Prime Rate	5.25%	–2.00%	–3.00%
FNMA 30yr mortg	5.67%	–0.44%	–0.45%
S/L Long T-Bnd Ind	15832	3.98%	13.20%

PRICES, INFLATION		3 mo	12 mo
CPI-U, Feb	212.6	0.8%	4.1%
CPI Core, Feb	213.9	0.6%	2.3%
PCE Core Defl, Feb	116.0	0.5%	2.0%
Gold, cash $/tr oz	917.0	10.0%	38.1%
W Tx Int Cr Oil $/bbl	101.59	5.8%	54.2%
Copper, $/lb	3.86	27.5%	22.9%
CRB Futures Ind	386.9	7.9%	22.1%

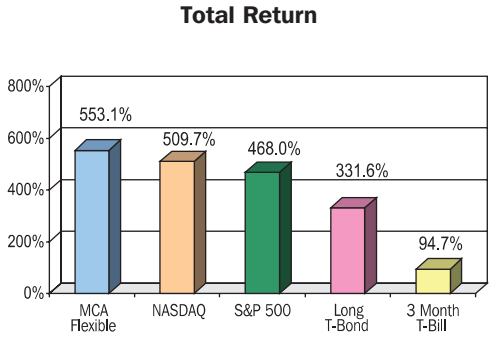
INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Mar	48.6	0.9	–2.3
ISM Services, Mar	49.6	–4.3	–2.8
Cap Utiliz, Feb	80.9%	–0.6%	–0.7%
Bldg Permits, Feb	978K	–15.8%	–36.5%

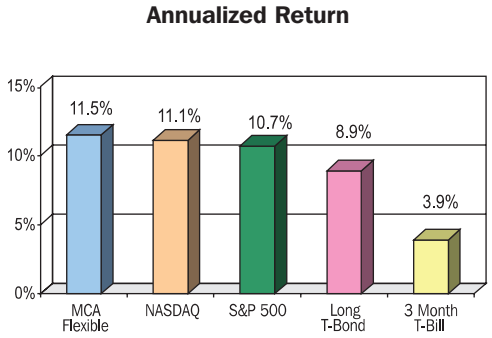
SALES		3 mo	12 mo
Total Retail-$B, Feb	380.2	–0.8%	3.0%
Ttl ex Autos-$B, Feb	305.6	–0.2%	4.6%
Autos-M Units, Mar	15.2	–6.0%	–6.6%
New Homes, Feb	590K	–6.5%	–29.8%

LABOR – Mar '08		3 mo	12 mo
Unemployment Rate	5.1%	0.1%	0.7%
New Non-Farm Jobs	–80K	–232K	536K
Avg Init Unempl Clms	377K	+33.5K	+60.5K
Avg Hourly Wages	17.86	0.9%	3.8%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to March 31, 2008





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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

as of December 31, 2007

1	Apple	143.50	6	Texas Instruments	28.27	11	Intuitive Surgical	324.35	16	OmniVision	16.82
2	Whole Foods Mkt	32.97	7	Intel	21.18	12	Starbucks	17.50	17	SanDisk	22.57
3	Charles Schwab	18.83	8	Applied Materials	19.51	13	Williams-Sonoma	24.24	18	LAM Research	38.22
4	Cisco Systems	24.09	9	MEMC	70.90	14	Dell	19.92	19	Bank of New York	41.73
5	Oracle	19.56	10	Tiffany	41.84	15	Caterpillar	78.29	20	Advent Software	42.62

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
1991	33.9%	56.9%	30.6%	24.5%	34.2%	18.5%	5.6%	3.1%
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	5.9%	9.8%	5.5%	8.9%	5.7%	10.1%	4.7%	4.3%
2008	-18.4%	-14.1%	-9.5%	-7.0%	-9.6%	4.0%	0.6%	0.8%
Total[2]	553.1%	509.7%	468.0%	606.4%	490.3%	331.6%	94.7%	58.2%
Avg.[3]	11.5%	11.1%	10.7%	12.0%	10.8%	8.9%	3.9%	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]1991-2008 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 28 individual portfolios and 35.6% of all funds under management by MCA on 3/31/08. 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.