THE COMPASS

July 2008

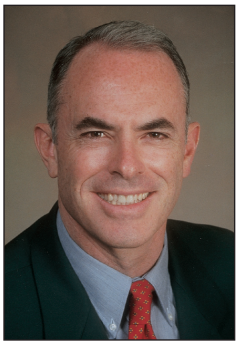
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Economic Uncertainty Produces Unusually Attractive Stock Valuations

July 23, 2008

Stocks rallied for the first two months of the second quarter, but lost ground in June as economic uncertainty returned with a vengeance, resulting in somewhat negative returns for most indexes. Financial stocks were hit especially hard as mortgage write downs continued to plague the banking industry. Bonds also had slightly negative returns as higher commodity prices raised inflation concerns, pushing rates higher.



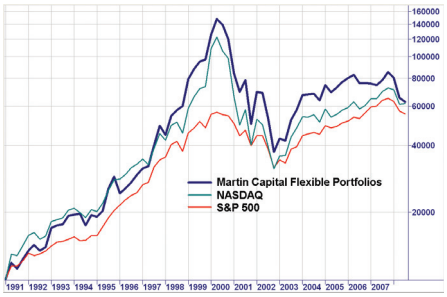
Third quarter returns for stocks and bonds so far are mixed. I believe, however, that the U.S. stock market is in the process of retesting the January and March lows, and that this retest will soon complete a base from which prices will move much higher. Despite a litany of economic issues, financial markets since mid-March are holding up better than the headlines would lead you to believe.

MCA Flexible Portfolios
12-month Tax Efficiency: 99.4%
(After Tax Return divided by Before Tax Return)

A tremendous amount of bad news appears already to have been priced into stocks, as reflected by unusually attractive stock valuations. Also, unusually negative sentiment readings indicate that most investors have already severely lowered their expectations to the point where any positive economic news could spark a major rally. In the meantime, further bad news should have a smaller effect on stock prices as time goes by. The resulting reward to risk ratio makes stocks extremely attractive for investors who can weather any further near-term volatility in order to participate in what could be significantly higher returns in the next six to twelve months.

The main question for the rest of the year is at what point will the issues weighing on stocks and the economy begin to show signs of improvement. My guess is that we are getting close to that point now, which should allow stock prices to complete a base from which prices may begin to advance before the end of the year. In fact, stock valuations are so compelling at current prices that I suspect we are on the verge of a major bull market that could last for many years. Whether the worst is already behind us remains to be seen, but I am very confident that we will see much higher stock prices over the next few years.

Growth of $10,000
1/1/91–6/30/08



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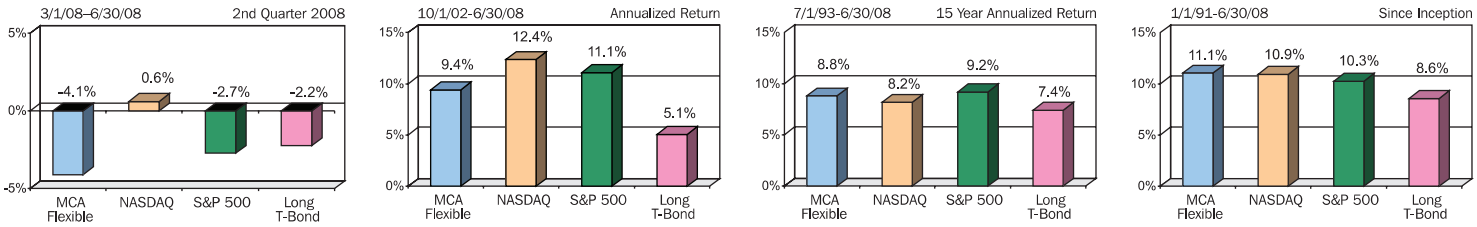
INVESTMENT RESULTS

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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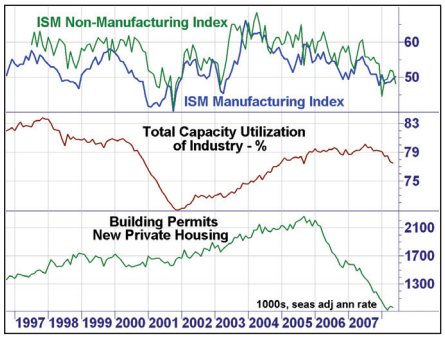
Economic growth in the US during the first quarter of 2008 was 1.0% on an annualized basis, up from 0.6% in the previous quarter. The quarter just finished may show a little stronger growth, perhaps as much as 2%, due to increased exports and an improved balance of trade picture. Equities were generally weak in the second quarter, with the NASDAQ and Russell 2000 eking out slight gains, while the Dow Industrials and S&P 500 declined. Short interest rates fell and long rates rose as the yield curve steepened. Inflation speeded up, as oil prices continued marching skyward. Industrial activity slowed, especially in construction and autos. Retail sales growth was helped by the government stimulus package, with an increased portion of sales devoted to energy and food. The labor market continued to weaken. All in all, it was not a wonderful quarter except for the oil industry.

INDUSTRY

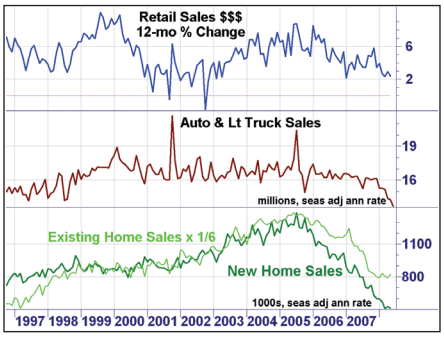


The ISM Manufacturing Index rose to 50.2 in June, the highest in 5 months. The strongest of 11 components in the index was prices and the weakest was labor. New export orders were a strong component, no doubt because of increased demand caused by the weak dollar making our products more competitive. The ISM Non-Manufacturing or Services Index fell to 48.2, the lowest in 5 months. As with the Manufacturing Index, the strongest component was prices and the weakest was labor. The new orders component contracted after 3 months of growth. Total capacity utilization of industry and of manufacturing have both dropped 0.9% in the last 3 months through May, now down to 79.4% and 77.5%, respectively. The decline has become steeper in the last 2 quarters. A sea change has occurred in the auto industry, as buyers have flocked to smaller, more efficient cars, which are unfortunately less profitable for manufacturers.

Building permits and housing starts have reached lows not seen since early 1991, two recessions ago. The combination of a bursting housing bubble and an associated crisis in the home mortgage industry has brought a virtual collapse in the housing industry. Many buyers can't buy without mortgage loans, which are difficult to get now.

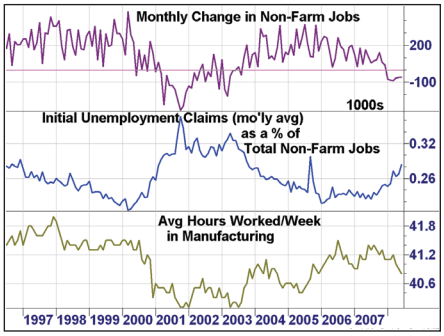
SALES

Total retail sales dollars were up 1.0% in May, the last month measured, a sharp increase mainly due to the government's



stimulus package delivering cash to most people in the country. Over 12 months, the increase in total sales was 2.4%. Excluding autos, retail sales were up 1.4% in June alone and up 4.6% in 12 months. An unusually large portion of sales dollars was paid over the past several months for gasoline and food, whose prices have risen significantly. Since 1950, gasoline has taken up 2% to 6% of real disposable income and it's near the top of that range now. Retail sales in other categories probably suffered—auto sales certainly did. Auto and light truck sales fell to 13.69M on a seasonally adjusted, annualized basis, the lowest sales rate since 1993. Adding to the impact on manufacturers of a lower number of sales was the fact that far fewer high-profit SUVs were sold and more relatively low-profit, fuel efficient cars were sought by consumers. In many cases not enough of the smaller cars were available for consumers to buy, which subtracted from total auto sales numbers. The longer high prices for gasoline persist, the less chance there is for the large SUVs to recover market share. On a happier note, the light at the end of the tunnel may be in sight for the housing market, at least in terms of the numbers of sales. Existing home sales have been flat for about the past 9 months and new home sales for the past 3 months. While these numbers are historically low, we're probably seeing a bottom in the number of both new and existing home sales. There are large existing inventories to be worked off, but it looks at this point like the bottom has been set.

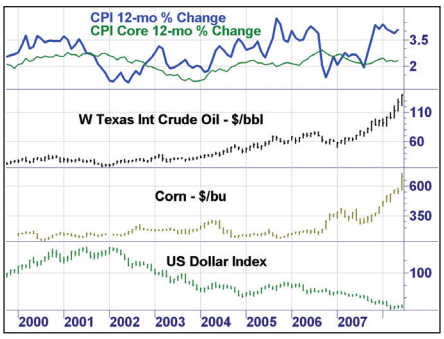
LABOR



We've now seen 6 straight months of job losses, totaling 438,000 – spelling out a weak labor market and a weak economy. The past 12 months have seen a net gain of only 15,000 non-farm jobs. Weekly initial unemployment claims, a direct indication of the number of people losing their jobs, are rising more quickly week after week, with the June average reaching 390,500. The chart shows initial claims as a percentage of total non-farm jobs to take into account the increased number of workers in the job market over time. Except for a spike in September 2005, we have to look back to 2003 for this many unemployment claims. The average number of hours worked per week in manufacturing, a leading indicator of our economy, like unemployment claims, also shows weakness, falling 0.4 hours in the second quarter. Overtime hours were also down 0.4 in the second quarter. Total hours worked per week have been more stable, remaining close to the 33.7 recorded in May and June.

INFLATION

Wages are usually considered to be the leading cause of inflation, but they are not the culprit in our current situation. That dubious honor goes to the skyrocketing price of crude oil. A combination of factors has been involved in the 130% oil price increase in the past 18 months. Looking first on the supply side, no huge new fields have come on line, while production declines and political instability have dogged many areas. Mexico has experienced a major decline in production as oil fields age, the Iran-Iraq situation is familiar to nearly everybody, while Hugo Chavez of Venezuela has managed to reduce production in his country by obnoxious incompetence. Nigeria has rebels that demand a share of the oil money flowing through their part of country or else they'll blow up production equipment. Political problems have introduced a big risk factor, which has brought a risk premium to oil prices. On the demand side, manufacturing economies like those of India and China are using more and more oil as they expand. The collision of flat, endangered supply with growing demand has blown oil prices through the roof. Added to this is the trading and hoarding of speculators, though the magnitude of their impact on oil prices is not at all clear. One of the root causes of higher oil prices in the US has been the drop in the value of the US dollar, though that was not the case in the last quarter. However, there's a positive



side to the dollar's decline, which has been an increase in exports and our international balance of trade deficit because our products have become more competitive.

Food prices have also risen sharply, the result of several factors. Poor harvests in many places are the primary cause, with Australia's wheat crop a shadow of its former size and our mid-west corn crop diminished by recent, widespread flooding. In addition, increased demand for corn to make ethanol has driven up corn prices considerably. Some grain exporting countries are proposing export duties on grain, sure to cause consternation in poor countries that must import it.

SUMMARY AND OUTLOOK

The Fed has made it clear that no more rate cuts are coming and instead hints about needing to raise rates to combat inflation. Losses in banks and other financial institutions around the world coming from the sub-prime mortgage crisis keep expanding, leaving banks with less and less to loan. As a result, it's difficult to find financing in many areas. The losses in equity in home values and stock markets around the world are now well up into multiple trillions of dollars. The price of crude oil has shot up past $140/bbl, painful to the extent that US consumption of gasoline is probably down about 1% from a year ago, though part of the drop could be due to a slower economy. The real test of oil consumption will come in China and other industrial countries, where governments have fixed prices in exchange for political stability. These price controls will have to come off at some point, which will bring an increase in inflation and a cut in consumption. Add up decreased economic activity and rising prices and the result is probably stagflation, at least in the short term. Remember, however, that markets have discounted a lot of these negatives already.

Considering that consumer spending makes up over two-thirds of US GDP and that consumers have lost trillions in equity plus much of their ability to borrow on their homes, the US government stimulus package of $100 billion or so begins to look small. The slowing of the world economy, which has already started, cannot help but pull down the price of oil eventually. We should hope that the resulting lower oil prices will return us to a sense of greater stability.

MARKET AND ECONOMIC STATISTICS

as of Market Close June 30, 2008
with 3-month and 12-month percentage changes

1st Qtr. '08	Final	3 mo	12 mo
GDP-Bil$	11704	1.0% apr	2.5%
GDP Deflator	121.3	2.7% apr	2.2%
Empl Cost Index	107.6	0.7%	3.3%
NF Productivity	140.5	2.6% apr	3.2%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	11350	–7.4%	–15.4%
S&P 500	1280	–3.2%	–14.9%
NASDAQ Comp	2293	0.6%	–11.9%
NASDAQ 100	1837	3.1%	–5.0%
NYSE Comp	8716	–0.9%	–11.7%
Wilshire 5000	13074	–1.9%	–14.1%
Russell 2000	690	0.2%	–17.3%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	3.96%	0.53%	–1.08%
3-mo T-Bill Rate	1.28%	–0.03%	–3.54%
Trea Spd 10y-3mo	2.24%	0.12%	2.02%
Fed Funds Trgt	2.00%	–0.25%	–3.25%
Prime Rate	5.00%	–0.25%	–3.25%
FNMA 30yr mortg	6.23%	0.56%	–0.38%
S/L Long T-Bnd Ind	15481	–2.23%	12.89%

PRICES, INFLATION		3 mo	12 mo
CPI-U, May	215.1	1.2%	4.1%
CPI Core, May	214.8	0.5%	2.3%
PCE Core Defl, May	116.5	0.4%	2.1%
Gold, cash $/tr oz	925.6	0.9%	42.5%
W Tx Int Cr Oil $/bbl	140.00	37.8%	98.0%
Copper, $/lb	3.88	0.3%	12.2%
CRB Futures Ind	462.7	19.6%	46.6%

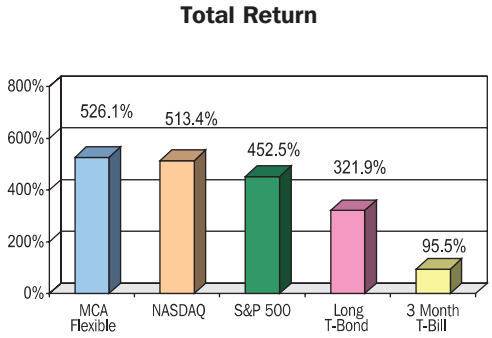
INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Jun	50.2	1.6	–5.8
ISM Services, Jun	48.2	–1.4	–12.5
Cap Utiliz, May	79.4%	–0.9%	–1.5%
Bldg Permits, May	969K	–1.2%	–36.3%

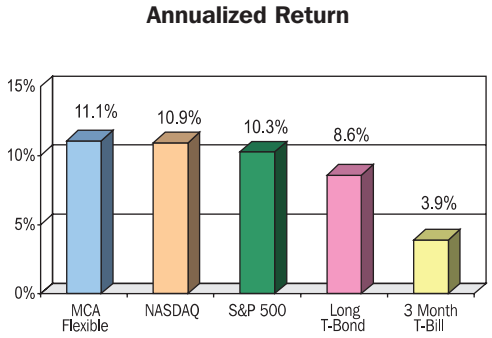
SALES		3 mo	12 mo
Total Retail-$B, May	385.4	1.9%	2.4%
Ttl ex Autos-$B, May	312.7	3.0%	4.6%
Autos-M Units, Jun	13.7	–9.9%	–13.5%
New Homes, May	512K	–10.5%	–40.5%

LABOR – Jun '08		3 mo	12 mo
Unemployment Rate	5.5%	0.4%	1.0%
New Non-Farm Jobs	–62K	–191K	+15K
Avg Init Unempl Clms	391K	375K	346K
Avg Hourly Wages	18.01	0.8%	3.5%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 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 June 30, 2008

1	Apple	167.44	6	Whole Foods Market	23.69	11	Caterpillar	73.82	16	LAM Research	36.15
2	Charles Schwab	20.54	7	Intel	21.48	12	Intuitive Surgical	269.40	17	OmniVision Tech	12.09
3	Cisco Systems	23.26	8	Applied Materials	19.09	13	Williams-Sonoma	19.84	18	NASDAQ Biotech Index	76.84
4	Oracle	21	9	Tiffany	40.75	14	Starbucks	15.74	19	Bank of New York	37.83
5	Texas Instruments	28.16	10	MEMC	61.54	15	Dell, Inc.	21.88	20	SanDisk	18.70

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	-21.8%	-13.6%	-11.9%	-13.4%	-11.0%	1.7%	1.0%	3.1%
Total[2]	526.1%	513.4%	452.5%	557.6%	481.6%	321.9%	95.5%	61.9%
Avg.[3]	11.1%	10.9%	10.3%	11.4%	10.6%	8.6%	3.9%	2.8%

[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 26 individual portfolios and 32.8% of all funds under management by MCA on 6/30/08. 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.