THE COMPASS

October 2008

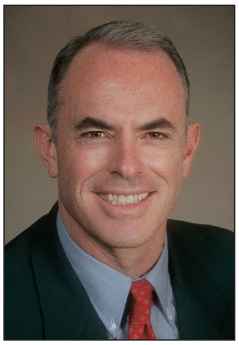
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Irrational Pessimism Signals Greatest Buying Opportunity of a Generation

October 24, 2008

Stocks have had a rough ride over the last year, and especially over the last few weeks. Although there are many reasons given for the current bear market, the major issue seems to me to be a mechanical problem driven by unregulated credit default swaps (i.e., institutional credit insurance). Just as portfolio insurance (i.e., institutional stock insurance) in 1987 was the catalyst for a mechanical market meltdown, credit default swaps have been the catalyst causing solvent financial institutions, such as Bear Stearns and Lehman Brothers, to catastrophically lose liquidity and then be driven out of business. As in 1987, this mechanically created instability has created a vicious cycle of stock market liquidations.



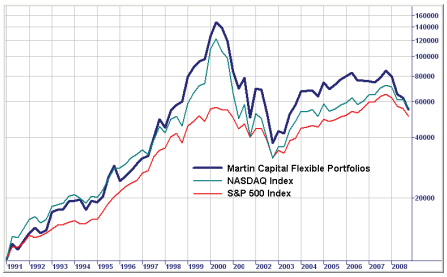
Fortunately, the vicious cycle of selling should be nearing exhaustion sometime in the next few weeks as regulators and market participants alike take action to rein in the credit default swap market. As in 1987, once the mechanical force destabilizing the financial markets is brought under control we probably will find that the economic depression now being priced into stocks is just a subconscious mirage projected by fear. Although it will take time to recover from the fear and uncertainty generated by the current stock market turmoil, I believe that the irrational pessimism that has spread throughout the financial markets has produced a once in a generation opportunity to buy stocks at extremely depressed prices.

Market timing involves assessing probabilities that never reach the level of certainty. I have suggested all year that stocks were attractively priced and should move higher, but so far I have been wrong. Trying to predict the direction of the stock market is often a humbling endeavor. That said, part of my job as a money manager is to wake up every day and make my best guess about what the financial markets will do over the next six to twelve months and invest accordingly. Based on the extreme and in many cases record levels of the various market indicators that I follow, the probability of significantly higher stock prices sometime in the next few years is the highest I have ever seen. This does not mean that there is no risk in the near-term, but rather that those who can stay invested and even add to their investments over the next few months have a high probability of being very pleased with their returns a year or two from now.

To paraphrase Warren Buffet: investors should be greedy when others are fearful. Well, one thing everyone can agree on these days is that there is a lot of fear out there.

MCA Flexible Portfolios
12-month Tax Efficiency: 100.5%
(After Tax Return divided by Before Tax Return)

Growth of $10,000
1/1/91–9/30/08



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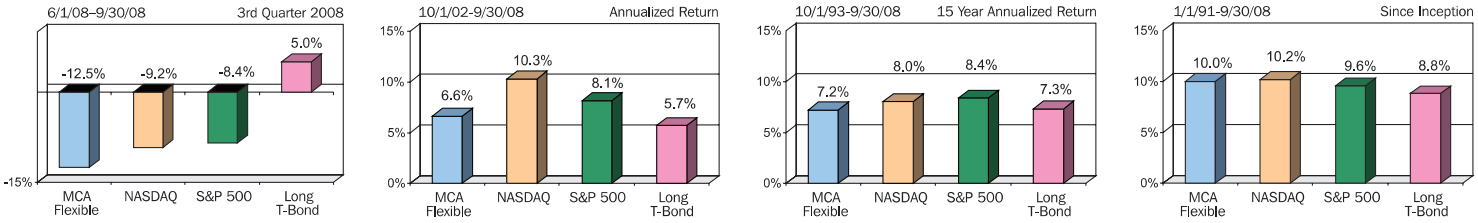
INVESTMENT RESULTS

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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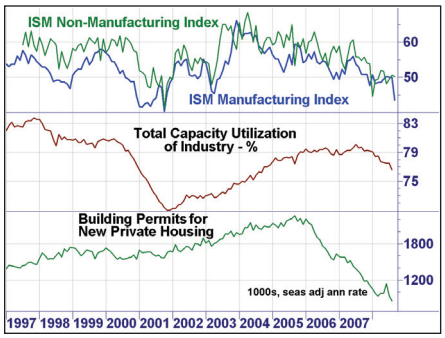
The economy grew at an annualized rate of 2.8% in the second quarter, an improvement over 0.9% growth in the first, helped by decreased imports and increased exports, increased state and local government spending and consumer spending. Growth in the third quarter was probably slightly negative, as the credit crunch threw sand in the gears of the economy. The third quarter closed with a bang, as the US House of Representatives failed to pass a rescue bill and turmoil in financial markets increased. Uncertainty, which the markets hate, was rampant. Major stock indexes show the damage by their decreases over the last 3 and 12 months. Interest rates have either remained unchanged or have dropped over the last 3 and 12 months in anticipation of a slowing economy, in spite of rising inflation. Commodity prices, however, have fallen sharply in the 3rd quarter. Overall growth rates of both industry and sales have slowed somewhat over the past year and the employment situation has worsened recently, exacerbated by hurricanes that hit the US.

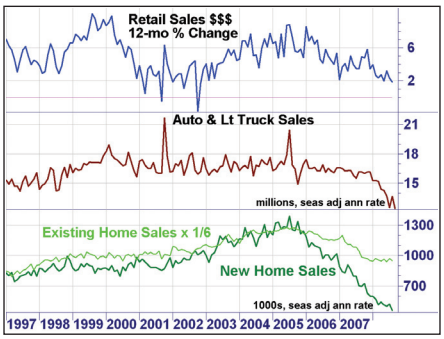
INDUSTRY



The ISM Manufacturing Index fell to 43.5 in September, the lowest since 2001. The weakest components of that index were orders and the backlog of orders, not a bright sign for the manufacturing sector in the immediate future. The ISM Manufacturing or Services Index, which represents a much larger portion of the economy than the Manufacturing Index, remained steady at 50.2, just above the 50.0 level separating growth from contraction. The weakest component of this index was employment and the strongest was inventory sentiment. Total capacity utilization of industry was down 1.0% in August to 78.7%, while capacity utilization of manufacturing fell to 76.6%. The impacts of the hurricanes will no doubt push them lower in September. Though capacity utilization is declining, it is nowhere near as low as it was in 2001 and 2002.

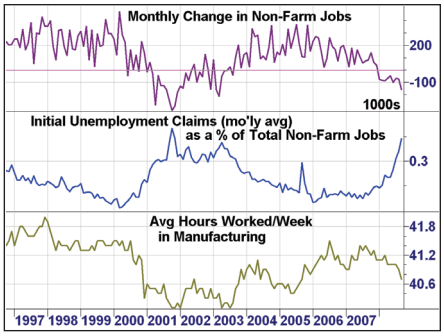
Building permits and housing starts in August were down to 854,000 and 895,000, respectively, on an annualized, seasonally adjusted basis, the lowest since January 1991, when the first Gulf War began. The collapse of the housing boom and the sub-prime mortgage crisis have been followed by a severe credit crunch that has kept potential buyers from getting home loans and has brought home construction down to about a third of the pace of 2005. Credit is the lifeblood of real estate and the homebuilding industry is grinding to a halt without it.

SALES



Growth of total retail sales has been slowing since early 2006, when year-over-year sales were up 8.6%. The year-over-year figure for August 2008 was up 1.8%, below the rate of inflation and indicating negative growth in real terms. Sales of autos and light trucks, which make up roughly a quarter of total sales, have been by far the weakest sector. Retail sales excluding autos & trucks were much healthier, up 5.5%. The middle chart of auto and light truck sales clearly shows that weakness, as they were down to 12.44M on a seasonally adjusted annualized basis in September, the lowest since 1992. Nationwide sales of both new and existing homes began to fall in late 2005, as air started coming out of the housing bubble. The drop continued through late 2007. Numbers of existing home sales flattened out in 2008 and didn't fall further, while new home sales have continued down through August, when they reached the lowest number since 1991. On the basis of the total percentage drop, existing home sales through August 2008 were down 32% from the 2005 high, whereas new home sales were down 67%, more than double.

LABOR

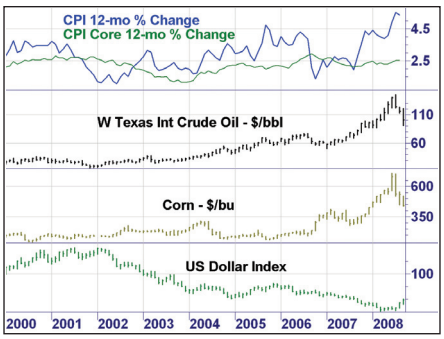


The labor market has been weak all through 2008, as net losses of non-farm jobs occurred during every month of this year. Job losses reached 159,000 in September, the most for any month since March 2003. This weakness has been made considerably worse by Hurricane Ike that hit the Texas-Louisiana Gulf coast, as damage from that hurricane has had a big effect on employment near that part of the Gulf and has inflated the number of job losses nationwide. Along with the number of jobs lost, weekly initial unemployment claims, a leading indicator of the economy, have increased sharply. As a percentage of total non-farm jobs, initial claims were the highest since 2001. The average of all hours worked per week in August fell 1.0 to 33.6, while average hours worked in manufacturing, a leading indicator, fell 0.8 to 40.7. These are all pretty weak figures, but it's difficult to separate the weakness of the economy as a whole from the weakness caused by the hurricanes in order to get a true picture of the performance of the economy. Many people in the Houston-Galveston area didn't lose their jobs, but were unable to work because electric

power had been knocked out at home and at work. Even after power was restored, the effort and cost of cleanup and repairs have been a severe drag on local productivity.

INFLATION

The inflation rate measured by the Consumer Price Index reached 5.5% in July, the highest since 1991, then dropped to 5.4% in August. The high price of crude oil was primarily responsible for this peak, though food grains were also a factor. The core rate of inflation, which excludes the volatile food and energy components, was up 2.5% in 12 months in both July and August. The Producer Price Index of wholesale prices, which is greatly affected by commodities, was up 9.7% in 12 months through August. The CPI rate of inflation eased after the prices of many commodities, including oil and corn, broke down in July. Oil's price came down because it was unsustainably high in the face of what came to be seen as almost a certainty that the world economy was going to slow considerably and that oil consumption would decrease as a part of that slowdown. The chart shows the price of corn, which is representative of other widely used grains like wheat and rice. Those three grains are largely interchangeable in food for people. Corn prices went up as much or more than other grains because it is also being used to produce alcohol for



fueling autos as a substitute for high-priced gasoline. The rise in prices of the group was primarily due to a series of poor harvests in several places in the world and also partially due to corn's use in making alcohol. Fortunately, recent harvests were good and the increased supply of grain helped push down prices. Another factor in the past several months that has helped bring down commodities prices has been the increase in the strength of the dollar. The Dollar Index, which measures the strength of the US dollar against a basket of other currencies, started the year at the lowest level in at least 40 years. This weakness in the dollar has also been a driver of higher commodity prices.

SUMMARY AND OUTLOOK

At the end of September and the beginning of October, the US faced a political problem, the outcome of which would have a big influence on the outcomes of the current financial and economic crises, crises that have involved the whole world, not just the US. Congress took a week to make up its mind about whether to pass what was a financial rescue bill, not a "bailout", as many had called it. By the end of that turbulent week, a bill was passed that will hopefully ease the credit crunch and help lenders and our economy as a whole begin functioning normally. Congress, particularly the House, failed to inspire any confidence whatever in our government. As one media pundit put it, "Where are the adults?" In the end, it appeared that the biggest concern in the House was about getting re-elected, not about doing what was best for the country in an emergency situation. That ugly performance may be one reason why equity markets went down instead of up after the rescue bill was voted in. Our government has now allocated a lot of money to help fix the credit crunch and we'll all be holding our breaths to see how it goes.

We're probably in the beginning of a recession now, with jobs being lost, unemployment increasing, consumers starting to close their wallets and many banks lending very little. In the year ahead, we hope to see confidence improve, banking problems being resolved and our economy returning to a stable footing. The presidential and congressional elections are about a month in the future. With new leadership may come more confidence, which is badly needed.

MARKET AND ECONOMIC STATISTICS

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

2nd Qtr. '08	Final	3 mo	12 mo
GDP-Bil$	11727	2.8% apr	2.1%
GDP Deflator	121.9	1.3% apr	2.0%
Empl Cost Index	108.3	0.7%	3.0%
NF Productivity	141.0	4.3% apr	3.2%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10851	–4.4%	–21.9%
S&P 500	1165	–9.0%	–23.7%
NASDAQ Comp	2092	–8.8%	–22.6%
NASDAQ 100	1595	–13.2%	–23.7%
NYSE Comp	7533	–13.6%	–25.0%
Wilshire 5000	11875	–9.2%	–22.7%
Russell 2000	680	–1.5%	–15.6%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	3.84%	–0.12%	–0.74%
3-mo T-Bill Rate	0.89%	–0.39%	–2.91%
Trea Spd 10y-3mo	2.95%	0.71%	2.17%
Fed Funds Trgt	2.00%	–0.00%	–2.75%
Prime Rate	5.00%	0.00%	–2.75%
FNMA 30yr mortg	5.91%	–0.32%	–0.34%
S/L Long T-Bnd Ind	16261	5.04%	13.19%

PRICES, INFLATION		3 mo	12 mo
CPI-U, Aug	218.9	1.7%	5.4%
CPI Core, Aug	216.7	0.8%	2.5%
PCE Core Defl, Aug	117.7	0.8%	2.6%
Gold, cash $/tr oz	870.9	–5.9%	17.2%
W Tx Int Cr Oil $/bbl	100.64	–28.1%	23.2%
Copper, $/lb	2.89	–25.5%	–20.5%
CRB Futures Ind	345.5	–25.3%	3.5%

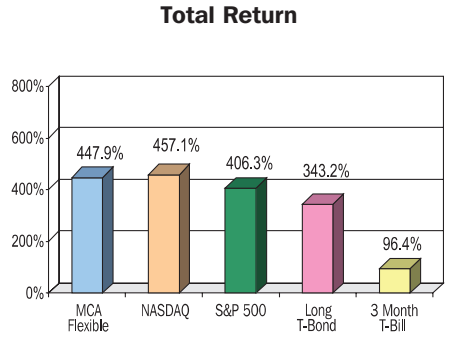
INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Sep	43.5	–6.7	–8.5
ISM Services, Sep	50.2	2.0	–4.6
Cap Utiliz, Aug	78.7%	–1.0%	–2.5%
Bldg Permits, Aug	854K	–0.3%	–35.7%

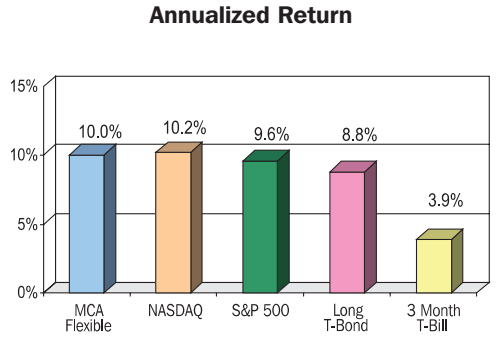
SALES		3 mo	12 mo
Total Retail-$B, Aug	381.2	–0.7%	1.8%
Ttl ex Autos-$B, Aug	313.7	0.3%	5.5%
Autos-M Units, Sep	12.4	–9.9%	–13.5%
New Homes, Aug	460K	–10.7%	–34.5%

LABOR – Sep '08		3 mo	12 mo
Unemployment Rate	6.1%	0.6%	1.4%
New Non-Farm Jobs	–159K	–299K	–519K
Avg Init Unempl Clms	474K	375K	346K
Avg Hourly Wages	18.17	0.9%	3.6%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2008





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FLEXIBLE PORTFOLIO TOP 20 POSITIONS

as of September 30, 2008

1	Apple	113.66	6	Whole Foods Market	20.03	11	Applied Materials	15.13	16	Caterpillar	59.60
2	Charles Schwab	26.00	7	Texas Instruments	21.50	12	Bank of New York	32.58	17	MEMC	28.26
3	Oracle	20.31	8	Starbucks	14.87	13	Tiffany	35.52	18	Dell, Inc.	16.48
4	Cisco Systems	22.56	9	Davita	57.01	14	Blackrock, Inc.	194.50	19	Williams-Sonoma	16.18
5	Intuitive Surgical	240.98	10	Intel	18.73	15	OmniVision Tech.	11.41	20	Nasdaq Biotech Holdrs	81.36

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	-31.5%	-21.5%	-19.3%	-18.2%	-19.1%	6.8%	1.44%	2.5%
Total[2]	446.3%	457.4%	406.7%	504.8%	427.7%	344.2%	97.2%	61.3%
Avg.[3]	10.0%	10.2%	9.6%	10.7%	9.8%	8.8%	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 26 individual portfolios and 32.3% of all funds under management by MCA on 9/30/08. 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.