THE COMPASS

January 2009

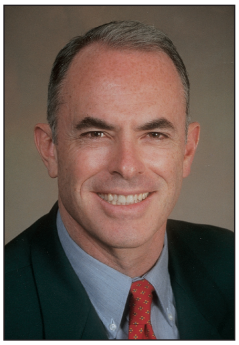
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Extreme Pessimism Continues to Signal Greatest Buying Opportunity of a Generation

January 29, 2009

In the last newsletter, written on October 24, I explained why the selling had been so severe at the beginning of the month and I laid out the case for what I believe to be the "greatest buying opportunity of a generation." At that time I said that "the vicious cycle of selling should be nearing exhaustion sometime in the next few weeks." It actually took just over three and a half weeks. Since then stocks have rallied and are back to about where they were on October 24. I believe that the odds are very good that we saw the stock market bottom in mid-November and that a base is being built from which much higher prices will be realized over the next several years. Any further weakness from here, especially if caused by an external event, should be seen as an even greater buying opportunity for anyone with an investment horizon of at least two years.



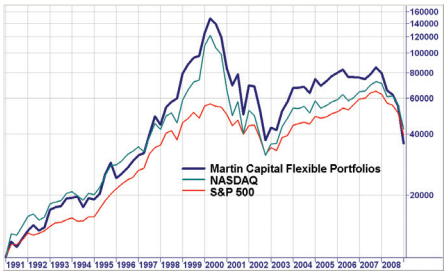
My bullish case for stocks is primarily based on the likelihood of extreme pessimism dissolving as credit default swaps become regulated and illiquid assets on bank balance sheets are quarantined. Of course, those making the bearish case will point to signs of further economic weakness, such as higher unemployment, as reasons for why the bear market still has a long way to go, but they forget that stocks normally bottom in the middle of recessions and unemployment tends to rise for months or even years after stocks have entered a new bull market. Anyone waiting for an economic green light will miss much of the stock market rally.

I have to admit that I did not anticipate the almost record breaking decline in stocks that has occurred over the past year. For the first time since 1991, our Flexible Portfolios are underperforming most long-term index returns. Unfortunately, bear markets can be difficult to predict, especially when they are exacerbated by mechanical factors, such as unregulated derivative securities. The nascent beginnings of bull markets, on the other hand, are much easier to identify when fear becomes palpable and uncertainty abounds. Now that the signals indicate that we are about to enter another bull market, I expect that the Flexible Portfolios will begin to outperform again over the next few years.

At major market bottoms the bears always argue that the economy will get worse, but as I mentioned above, the economy usually continues to deteriorate in the first stage of a bull market. The great bull markets always rise from the ashes of the most destructive bear markets – and the last nine years in some ways have been worse than the Great Depression bear market. For instance, the performance of the S&P 500 today, nine years after the 2000 high, is worse than it was in 1938, nine years after the 1929 high; in other words, based on performance, stock prices today have already discounted worse economic conditions than the Great Depression. This means that if the economy does in fact drop into another Great Depression (we're at 7.2% unemployment now, so we'd have to go up to about 25% unemployment) stock prices should hold roughly where they are currently; however, if we're not headed into another Great Depression, then stocks could post a massive rally over the next few years. In the context of the history of the S&P 500, the risk for stocks from here is low, and the upside potential is great. (By the way, from 1938 to the end of World War II, the S&P 500 went up almost 200%.) In any event, for more than two hundred years it has always been a mistake to stay pessimistic about the prospects for the U.S. economy. Maybe it's different this time, but I don't think so.

MCA Flexible Portfolios
12-month Tax Efficiency: 101.5%
(After Tax Return divided by Before Tax Return)

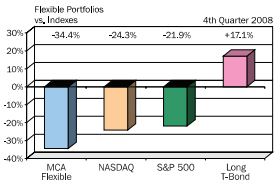
Growth of $10,000
1/1/91–12/31/08

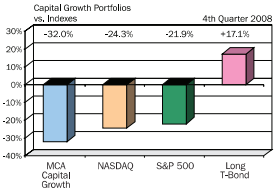


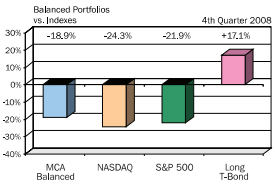
See Important Disclosure Notice on back page.

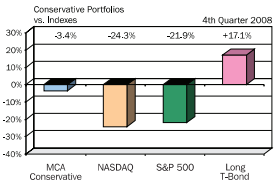
INVESTMENT RESULTS

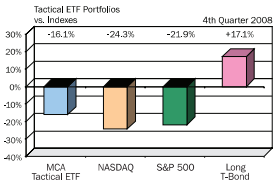
Martin Capital Advisors Flexible Portfolios vs. NASDAQ Composite, the S&P 500 Index and the Lehman Brothers Long Treasury Bond Index







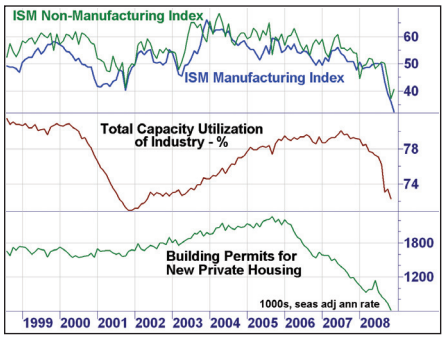




See Important Disclosure Notice on back page.

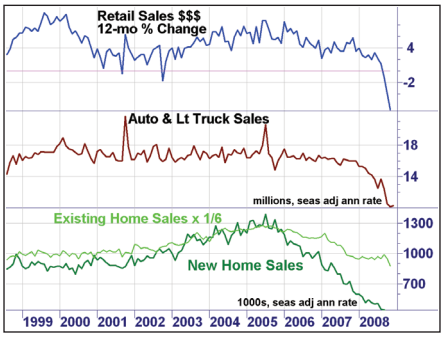
Final GDP figures for the 3rd quarter of 2008 showed an annualized contraction of 0.5%, with growth of just 0.7% in 4 quarters. The 4th quarter just completed likely saw annualized contraction between 2.5% and 4.0%, with the total change for 2008 right around zero. GDP in the 1st quarter of 2009 is projected to shrink at an annualized rate of about 2.5%. The equity market has suffered tremendously in this situation, with the largest declines over 12 months in major stock indexes since 1931. Interest rates have plummeted as the Fed cut rates and prospects for growth in most of 2009 simply have been blown away. The brightest spot to be seen is the market for Treasury-backed securities, as investors fled to that safe haven. Industry has been devastated as demand for most products has fallen sharply. Sales of homes and autos have hit lows not seen for over 20 years. Employment figures reflect huge job losses and a rapidly rising unemployment rate. Many of the statistics represent extremes not seen for decades.

INDUSTRY



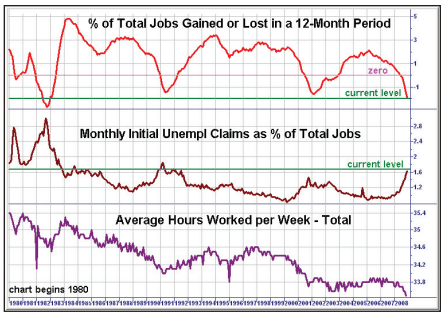
The manufacturing sector has been hit particularly hard by the recession. The ISM Manufacturing Index fell to 32.4 in December, a 28-year low, with 10 components showing contraction and only one showing expansion. The price component fell to 18.0 on a scale of 100. More importantly, since services make up a much larger part of our economy, the ISM Services Index rose 3.3 to 40.6´, but with nine of ten components showing contraction. Total capacity utilization of all industries fell to 75.4% in November, down 5.7% in 12 months in the sharpest, though not the deepest, drop since 1981. Orders for durable goods were down 13.7% in 12 months, while durables excluding transportation were down only 6.2%, reflecting in part weakness in the auto industry. As the recession continues to worsen, consumers have been less inclined to buy expensive items, which partially explains why sales of autos and homes have slowed dramatically. Other reasons for the huge drop in home construction are the lack of home mortgages and the big inventory of existing homes for sale. Housing starts are now less than a third of the peak in 2006.

SALES



Total retail sales started a drastic decline in June, and are now down 6.7% through November on a year-over-year basis, the largest such negative change in at least 40 years. While a large part of this drop in sales dollars was due to the fall in gasoline prices, the main cause was consumers preferring to hold onto their cash rather than spend it in the uncertain times we face now. Holiday sales were weak, putting pressure on prices of virtually all items from clothes to electronics. Auto and light truck sales have been very weak, mostly due to consumers not wanting to spend, but also due to a lack of available financing. While numbers of sales have declined, the mix of vehicles being sold has also changed toward fewer large, expensive models and more less expensive, high-mileage cars. The large, expensive models tend to have higher profit margins and vice-versa for smaller, cheaper models, so vehicles sold and profit margin per vehicle have both come down. Home sales have suffered the most in the downturn. Our current economic problems began as the housing bubble popped and huge numbers of home loans that had been packaged and sold turned out to be nearly worthless. Not surprisingly, home sales suffered even more when loans became hard to get and home prices dropped. It appeared that existing home sales numbers had stabilized between October 2007 and October 2008 at a rate of about 5 million per year, roughly the same as 1998 through 2000, but November showed a drop of 10% from that level. New home sales have fared much worse than existing home sales, down 71% from the peak in 2005, while existing home sales are down "only" 38%. With big inventories of existing homes on the market and loans hard to get, many homebuilders have completely shut down. Though usually with only about 1/6th the number of sales, new homes have a bigger impact on the economy because of the materials used and jobs dedicated to building them.

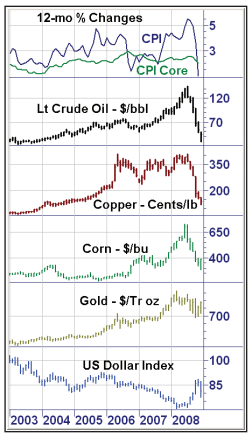
LABOR



The loss of 2.59 million non-farm jobs in 2008 represents the largest portion of total jobs lost since 1983, 1.9%, and more than half of those were lost in the 4th quarter. This puts the gravity of the current situation in perspective. Weekly initial unemployment claims averaged 551,500 in December, which as a percentage of total non-farm jobs was the worst since 1991. Average hours worked per week have been in decline for many years, but December marked a historic new low of 33.3, down a half an hour in 12 months. Average hours worked in manufacturing fell to 39.9, down 1.2 hours in 12 months, an even larger drop. The national unemployment rate jumped

0.5% to 7.2% in December, up 2.2% in a year. Virtually all labor statistics point to a weaker economy with none pointing in a positive direction yet.

INFLATION



The 12-month change in the Consumer Price Index, the most widely accepted measure of inflation, fell from 5.5% in June to 1.0% in December, the steepest 6-month drop for that indicator since 1950. The chart shows the drop in prices of oil, copper and grain, which helped cause the change in the overall inflation rate. The sudden decline in inflation resulted from the economic slowdown, in turn caused by the financial meltdown that began with the sub-prime loan crisis. As major banks and other financial institutions became shaky and were taken over or failed, lenders virtually quit lending, either to each other, to businesses or to individuals. With lending essentially shut down, the world economy went into a tailspin that has not ended yet. The exception to the rule of falling commodity price declines is gold, which is being bought for purposes of financial security, just as US Treasury securities are being bought for the same reason.

SUMMARY AND OUTLOOK

We're faced today with a deep recession, already as bad as any we've seen for several decades, involving contraction in industry, sales, labor and price inflation. In other words, virtually all parts of the US economy and the world economy, as well, are affected. Conditions will likely get worse before they get better, particularly with regard to jobs.

However, the present financial and economic picture is complex and is changing rapidly. Banks, which were afraid to lend to each other a few months ago, are now lending relatively easily, thanks to injections of cash by the Fed. The Fed has cut rates to almost zero, which makes loans advantageous to borrowers, and is in the process of reliquifying the economy as fast as it can. With Congressional approval, the Treasury is making available more than $700 billion to fix banks and other major financial institutions and pushing to make funds available for buying homes through Fannie Mae and Freddie Mac. Mortgage rates on new homes are now down to historic lows below 5%. In addition, Congress is likely to pass tax cuts for individuals and businesses. The total amount of liquidity injected into our economy in various ways will probably top $2 trillion. These actions by the government are without precedent in size and variety and the economic pump is being primed like never before in history. On top of all that, the decrease in the price of gasoline has acted like a tax cut, leaving more money in consumers' pockets. It typically takes between 12 and 18 months for Fed's actions to have a noticeable effect on the economy and, consequently, the current weak economic conditions will most likely begin to improve by late 2009.

The massive flow of funds to banks (at least those helped by the government) and low interest rates will help most banks' balance sheets and restore lending to credit-parched businesses and individuals. First among recoveries will likely be the banking and housing industries and perhaps auto sales. The housing industry was the first to turn down and is so depressed now that the demand created by low mortgage rates could create a big turnaround. There's a huge inventory of existing homes and foreclosures continue at a rapid rate, but lenders are more in a position to sell assets cheaply and low mortgage rates will bring in buyers to take advantage of the bargains. A lot of our nation's wealth is in real estate, so this is a key factor.

What happens after the recovery? If the unprecedented amount of fiscal and monetary stimulation brings about an economic recovery quickly, it could also bring extraordinarily rapid growth, and with it a potential new round of inflation. The Fed tends to react late to such things and we must keep a sharp eye out for this in 2010 and beyond.

MARKET AND ECONOMIC STATISTICS

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

3rd Qtr. '08	Final	3 mo	12 mo
GDP-Bil Chained$	524	–0.5% apr	0.7%
GDP Deflator	123.1	3.9% apr	2.5%
Empl Cost Index	109.1	0.7%	3.0%
NF Productivity	142.3	1.3% apr	3.2%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	8776	–19.1%	–33.8%
S&P 500	903	–22.5%	–38.5%
NASDAQ Comp	1577	–24.3%	–40.5%
NASDAQ 100	1212	–23.5%	–41.9%
NYSE Comp	5757	–23.6%	–40.9%
Wilshire 5000	9087	–23.5%	–38.7%
Russell 2000	499	–26.5%	–34.8%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	2.24%	–1.60%	–1.79%
3-mo T-Bill Rate	0.08%	–0.81%	–3.15%
Trea Spd 10y-3mo	2.16%	0.79%	1.36%
Fed Funds Trgt	0.13%	–1.88%	–4.13%
Prime Rate	3.25%	1.75%	–4.00%
FNMA 30yr mortg	4.53%	–1.38%	–1.58%
S/L Long T-Bnd Ind	19043	17.11%	25.06%

PRICES, INFLATION		3 mo	12 mo
CPI-U, Nov	213.1	–2.7%	1.0%
CPI Core, Nov	216.8	0.1%	2.0%
PCE Core Defl, Nov	117.6	0.1%	1.9%
Gold, cash $/tr oz	881.7	1.2%	5.8%
W Tx Int Cr Oil $/bbl	44.60	–55.7%	–53.5%
Copper, $/lb	1.40	–51.7%	–54.0%
CRB Futures Ind	229.5	–33.6%	–36.0%

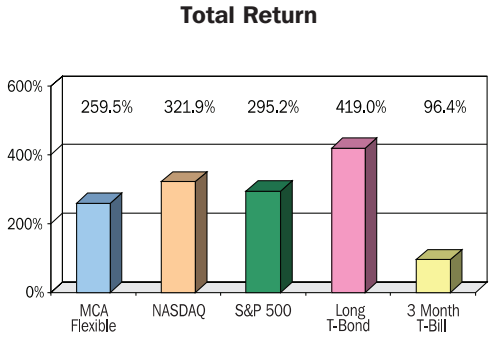
INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Dec	32.4	–11.1	–15.3
ISM Services, Dec	40.6	–9.6	–13.3
Cap Utiliz, Nov	75.4%	–2.9%	–5.7%
Bldg Permits, Nov	616K	–28.1%	–48.1%

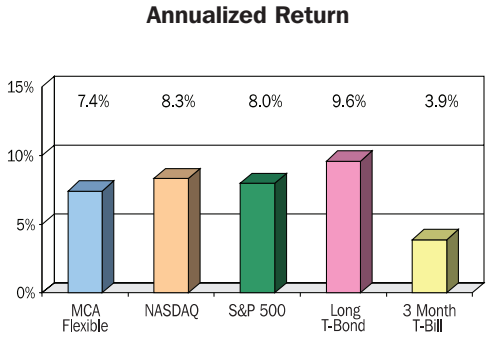
SALES		3 mo	12 mo
Total Retail-$B, Nov	352.6	–7.0%	–7.5%
Ttl ex Autos-$B, Nov	293.2	–5.9%	–3.8%
Autos-M Units, Dec	10.3	–17.5%	–35.6%
New Homes, Nov	407K	–9.2%	–35.3%

LABOR – Dec '08		3 mo	12 mo
Unemployment Rate	7.2%	1.1%	2.2%
New Non-Farm Jobs	–524K	–1531K	–2589K
Avg Init Unempl Clms	552K	375K	346K
Avg Hourly Wages	18.36	1.0%	3.7%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 2008





THE COMPASS

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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, 2008

1	Apple	85.35	6	DaVita	49.57	11	Whole Foods Market	9.44	16	Tiffany	23.63
2	Charles Schwab	16.17	7	Texas Instruments	15.52	12	Starbucks	9.46	17	BlackRock	134.15
3	Oracle	17.73	8	Intel Corp.	14.66	13	Nasdaq Biotech Index	71.05	18	Dell	10.24
4	Cisco Systems	16.30	9	Bank of New York	28.33	14	Caterpillar	44.67	19	MEMC	14.28
5	Intuitive Surgical	126.99	10	Quest Diagnostics	51.91	15	Applied Materials	10.13	20	Peet's Coffee & Tea	23.25

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	33.8%	56.9%	30.6%	24.5%	34.2%	18.5%	5.6%	3.1%
1992	26.5%	15.5%	7.7%	7.3%	9.0%	8.0%	3.5%	2.9%
1993	14.3%	14.8%	10.0%	17.0%	11.3%	17.3%	2.9%	2.8%
1994	-2.0%	-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	29.2%	22.7%	23.1%	28.7%	21.2%	-0.8%	5.2%	3.3%
1997	41.6%	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	58.3%	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	-55.1%	-40.5%	-37.0%	-33.8%	-37.3%	25.1%	1.8%	-0.1%
Total[2]	259.5%	321.9%	295.2%	389.4%	308.7%	419.0%	97.9%	57.2%
Avg.[3]	7.4%	8.3%	8.0%	9.2%	8.1%	9.6%	3.9%	2.5%

[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 27 individual portfolios and 30% of all funds under management by MCA on 12/31/08. 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.