

# THE COMPASS

October 2011

A Quarterly Newsletter of Martin Capital Advisors, LLP

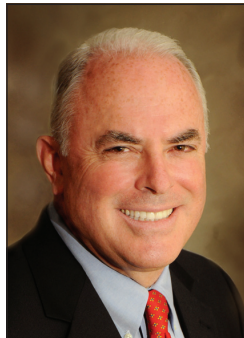
## INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

### Third Quarter Correction in Line with Expectations; Fourth Quarter Rebound Likely

October 17, 2011

The long awaited bull market correction materialized in the third quarter with most stock indexes down over ten percent for the quarter and down over five percent year-to-date. Bond yields fell in anticipation of a weaker economy as ongoing European financial concerns and a U.S. debt rating downgrade rattled markets and appeared to increase the likelihood of a double-dip recession.

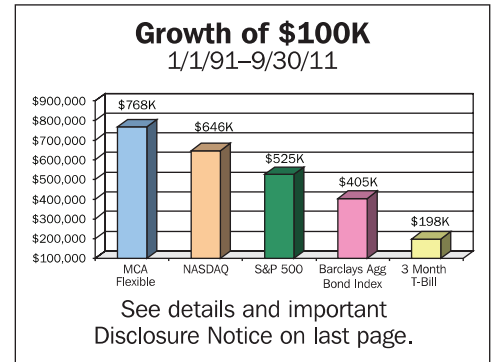
Stocks have begun to rebound and bond prices have begun to fall two weeks into the fourth quarter in anticipation of some resolution to the European financial crisis and the likelihood that corporate earnings may continue to surprise to the upside. Also, a more positive tone toward the economy is developing in light of improving economic statistics. For instance, recent economic reports have been better than expected for trucking and rail car activity, industrial production, retail



sales and construction spending.

The sum of economic data released over the last few months adds up to third quarter GDP coming in higher than two percent when it's published at the end of this month. Although GDP at around two percent is not enough to make much of a dent in unemployment, it is much better than the negative numbers some economists were recently positing. It is important to remember that corporate earnings were quite good in the first half of the year, with GDP averaging only about one percent, so two percent or better GDP in the second half should help to boost earnings reports above current consensus forecasts.

Ultimately, corporate earnings drive stock market performance, and better than expected third quarter earnings and fourth quarter guidance could be the catalyst for a strong rally into the end of the year. In any event, the stock market has already priced in poor third and fourth quarter earnings, so the downside risk should be fairly small, creating a very favorable risk/reward ratio to be long



stocks at current prices. Bonds, conversely, are well into bubble territory and have a very poor risk/reward ratio. At this point bonds are not a viable investment and they should only be used for diversification and portfolio risk management as a hedge against stock market volatility.

The historically low valuation of the stock market today, especially relative to interest rates and inflation, record high cash levels that are earning nothing, a very accommodative Fed, solid corporate balance sheets, and last, but not least, extremely negative sentiment toward the prospects for the future suggest that the odds favor a continuation of the bull market. Based on these conditions I believe that we have seen the worst of the current correction and that stock prices have the potential to be significantly higher over the next three to six months.

## COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to September 30, 2011

	Martin Capital Advisors <sup>1</sup>	NASDAQ	S&P 500	Dow Jones Industrial Avg.	Dow Jones Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total <sup>2</sup>	667.6%	546.2%	425.2%	572.9%	434.8%	304.6%	98.1%	69.6%
Avg. <sup>3</sup>	10.3%	9.4%	8.4%	9.6%	8.5%	7.0%	3.4%	2.6%

<sup>1</sup>Total annual performance, net of commissions, fees, and expenses of all Martin Capital Advisors' *Flexible Portfolios*.

<sup>2</sup>Total compounded return, including reinvestment of dividends and interest. <sup>3</sup>1991-2011 annualized return.

— See Important Disclosure Notice on last page. —

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The final numbers for GDP showed that the U.S. economy grew at an annualized rate of 1.3% for the second quarter, which is certainly an anemic pace, but is better than the 1.0% that was previously estimated. The slowdown in growth has caused many to fear that a double-dip recession is imminent. While another recession is a possibility, it is not as likely as some are making it out to be. A look at the economic indicators from August and September show that the economy is improving in comparison to the second quarter. **(Figure 1)**



The economy added 103,000 jobs in September, beating the market's expectations by 59,000 jobs; however, this was not strong enough to push down the unemployment rate from 9.1%, where it has been for the past three months. The private sector added 137,000 jobs and the government cut 34,000. Also, in September's report, the July jobs number was revised up to 127,000 from 85,000. The reason the unemployment rate has remained at 9.1% is because the number of workers entering or reentering the work force is outpacing the number of jobs being added. **(Figures 2, 3, & 4)**

The ISM Manufacturing index expanded to 51.6 in September, better than expectations and continuing to rebound after lower numbers recorded in April, May and June. The New Orders component, however, which is a forward-looking indicator, has been at 49.6 for the past two months – slightly below the 50-mark that indicates contraction. The Non-Manufacturing index fell from 53.3 in August to 53.0 in September. Despite the fall, the number was better than the market expected. The past few readings have been much lower than what was recorded earlier in the recovery; in the past year, Non-Manufacturing has averaged 55.3, hitting a high of 59.7 in February. Both readings from the Manufacturing and Non-Manufacturing index are still above 50, indicating that the economy is in expansion. **(Figure 5)**

Consumer confidence was 45.4 in September, which is essentially unchanged from the number recorded in August. Confidence dropped 14.7 points in August, which was the biggest one-month drop since October 2008, a time when the financial crisis climaxed with the collapse of Lehman. Confidence in the economy is the lowest it has been since March 2009 during the depths of the recession. This metric has many worrying that if consumer pessimism begins to match consumer spending

patterns, then the economy could begin to contract again. **(Figure 6)**

After posting strong growth earlier this year, retail sales continued to slow, just as they did in the second quarter. From April 2009 through March 2011, the average monthly growth in retail sales was 0.6%; however, since April, average monthly growth has been 0.1%. On the other hand, auto sales continue to post strong sales, increasing about 10% in September to over 13 million. **(Figure 7)**

Housing has improved from earlier this year. Existing home sales rose 7.7 percent in August to an annualized rate of 5.03 million, which is 18.6 percent higher than a year ago. Sales of new one family houses sold were mostly flat for the quarter, but are 6.1 percent higher than August 2010. "Operation Twist", initiated by the Federal Reserve to sell \$400 billion in short-term Treasuries and buy long-term government bonds has so far had the intended effect of keeping mortgage rates low. Average 30-year mortgage interest rates recently fell below 4% for the first time in history. Lower mortgages should boost home sales, but one of the big problems plaguing the housing market is that banks are still hesitant to lend. **(Figure 8)**

After six months of steepening inflation, prices began to decline in June. CPI was up 0.3% in August and core CPI was up 0.2%. Pressure on producer prices has also lessened: PPI was unchanged in August and only increased 0.2% in July, and core PPI was only up .06%. **(Figure 9)**

The Fed launched "Operation Twist" on September 21 in an effort to keep long-term Treasury rates low. Yields on 10-year Treasuries were recently at historical lows and are now hovering just above 2 percent, about a full percentage point lower than what they were earlier this year. 30-year Treasury yields fell below 3 percent recently and are now slightly back above 3 percent, which is about a percent and a half lower than yields recorded earlier this year. The decline in yields can partially be attributed to the Fed's actions, but most of the decline is due to lowered market expectations for economic growth. **(Figure 10)**

The high volatility seen this quarter certainly created fear in the market, but as the problems that caused the high volatility begin to fade consumer attitudes will probably rebound and the economy will continue to grow.

Figure 1

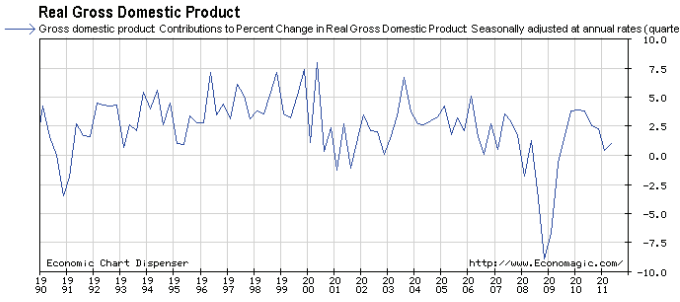


Figure 2



Figure 3

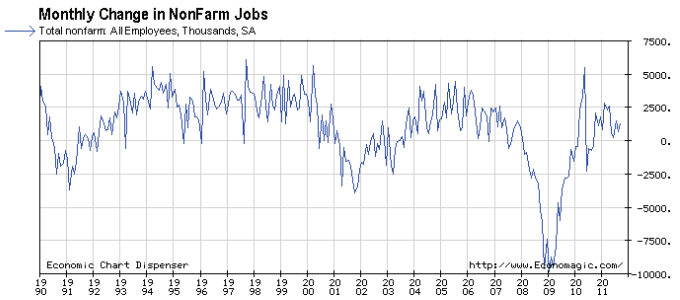


Figure 4

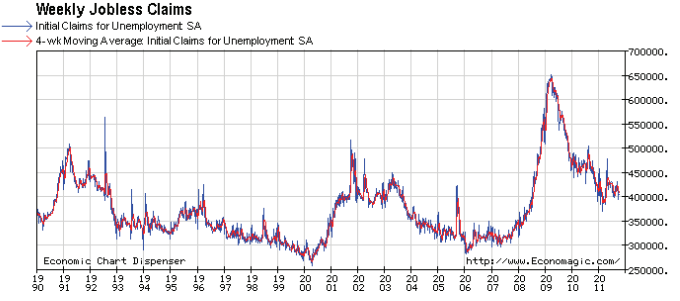


Figure 5

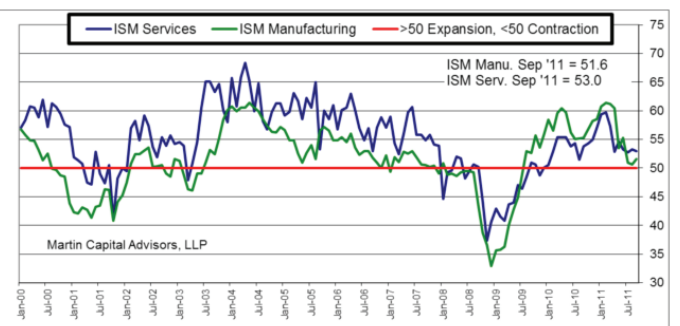


Figure 6

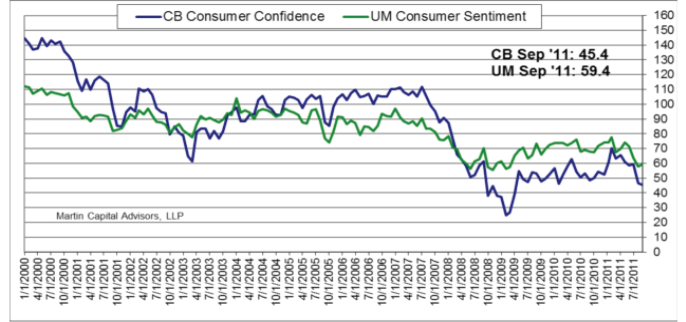


Figure 7

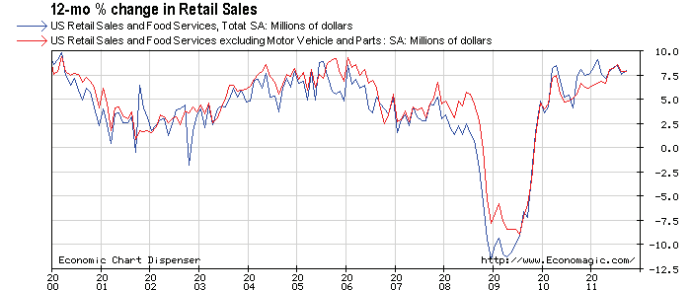


Figure 8

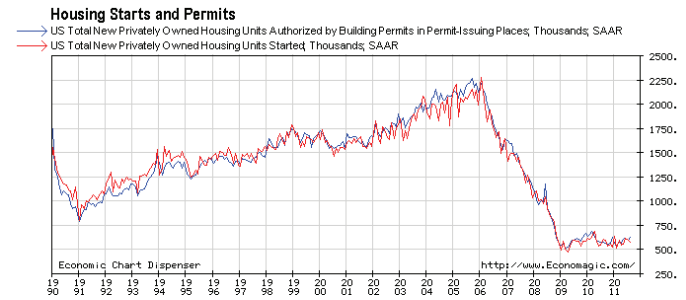


Figure 9

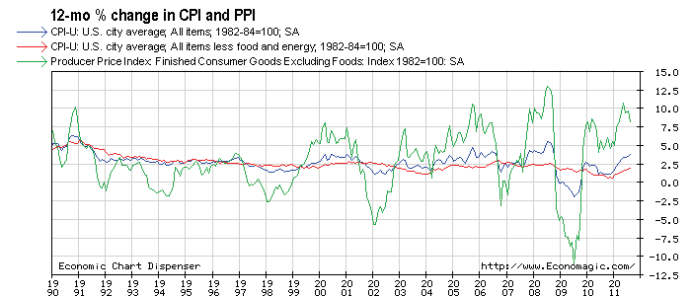
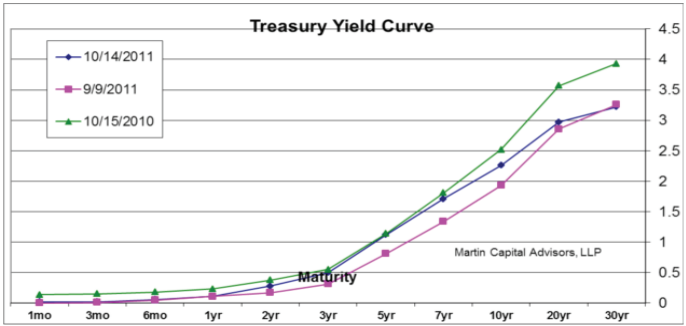


Figure 10



# RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2011



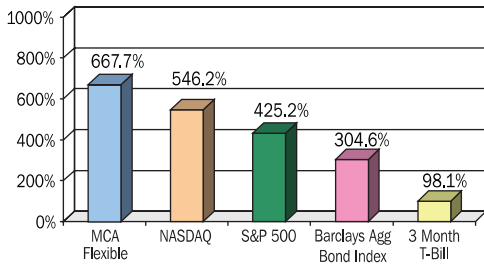
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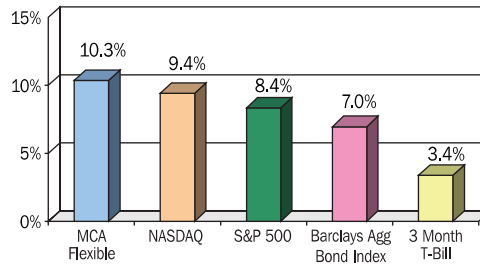
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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios. Independent performance reporting provided by Robert Harrell, Inc.

## Total Return



## Annualized Return



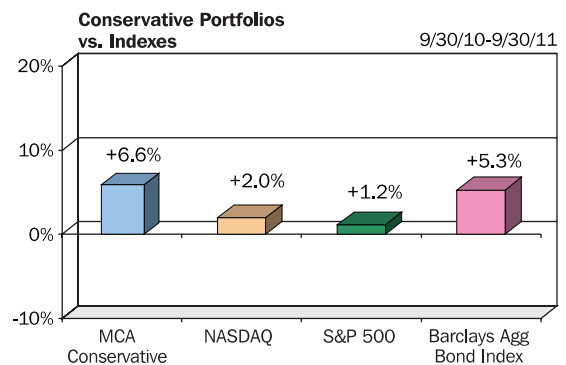
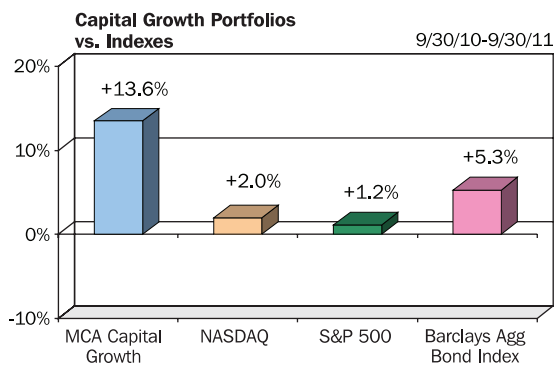
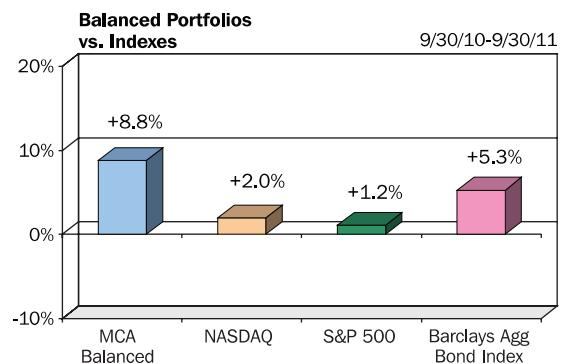
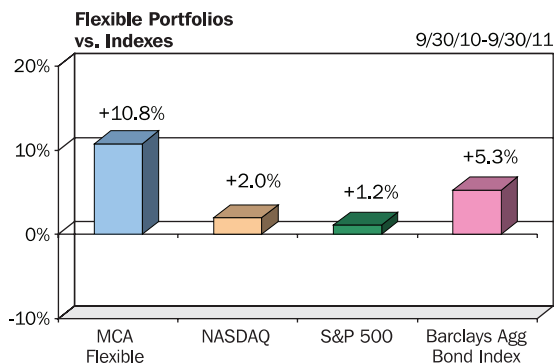
# FLEXIBLE PORTFOLIO TOP 20 POSITIONS

as of September 30, 2011

1 Apple	381.32	6 NASDAQ 100 ETF	52.49	11 Texas Instruments	26.65	16 Intel	21.33
2 Whole Foods Market	65.31	7 Tiffany	60.82	12 Davita	62.67	17 OmniVision Technologies	14.04
3 Intuitive Surgical	364.28	8 Williams Sonoma	30.79	13 Peet's Coffee & Tea	55.64	18 Coach	51.83
4 Starbucks	37.29	9 Charles Schwab	11.27	14 Cisco Systems	15.50	19 iShares Russell 3000 ETF	66.73
5 Oracle	28.74	10 SanDisk	40.35	15 Caterpillar	73.84	20 Mastercard, Inc.	317.16

# INVESTMENT RESULTS

Martin Capital Advisors' Investment Portfolios vs. NASDAQ Composite, S&P 500 and Barclays Aggregate Bond Indexes



**IMPORTANT DISCLOSURE NOTICE:** Past performance does not guarantee future results. Figures include the reinvestment of all dividends received and reflect cash and cash equivalents and are net of all fees and expenses; 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 20 individual portfolios and 29% of all funds under management by MCA on 9/30/11. 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.