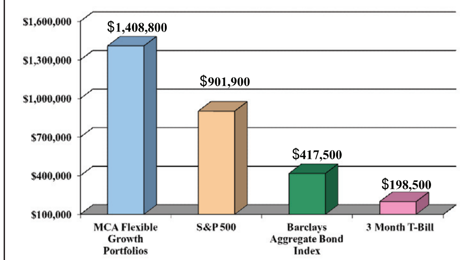
THE COMPASS

January 2014

A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Growth of $100K
1/1/91–12/31/13

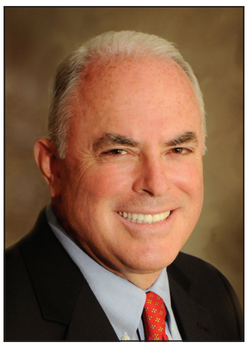


See details and important Disclosure Notice on last page.

Market Gains in 2013 Confirm Long-Term Bull Market, but Add to Short-Term Risk

January 25, 2014

Stocks finished 2013 with a powerful advance of 10.5% in the fourth quarter, resulting in a 32.4% total annual return for the S&P 500 – the best annual performance since 1997. MCA Flexible Growth Portfolios averaged a 9.9% return for the quarter and 26.6% for the year, underperforming the S&P 500, yet longer-term returns continued to be relatively better than the S&P 500 (see last page for additional performance information). Bonds, however, as represented by the Barclays Aggregate Bond Index, finished with losses for both the quarter (-0.1%) and the year (-1.7%). The performance of gold, as represented by the GLD exchange traded fund, was nearly the opposite of stocks, -9.4% for the quarter and -28.3% for the year.



As we enter 2014, stocks have gotten off to a rocky start, while bonds and gold have rebounded a little from their disappointing 2013 returns. My best guess is that this reversal of performance from last year may persist for a while as stocks digest their bull market advances of the past year and bonds and gold recover some of their losses in a short-term, counter-trend rally. Although the short-term risk for stocks is higher today than it has been in quite a while, investors should remain fully invested and not reduce exposure to stocks in anticipation of further short-term weakness, since the long-term prospects for stocks are still very bullish. On the other hand, short-term strength in bond and gold prices should be used to pare back exposure and add to equity positions and/or to short duration fixed income investments.

For several years now, most investors, including professional money managers, have worried far too much about the prospects for short-term stock market corrections, holding onto large amounts of cash in anticipation of lower prices somewhere down the road. So far, this has proven to have been a mistake. Essentially, by focusing on the potential for short-term corrections at the expense of the long-term prospects for stocks, they have been missing the forest for the trees! Although the stock market today is well overdue for a correction, the problem with trying to time it is that you have to be right twice – selling at higher prices and then buying back in at lower prices. This is a fool's errand in a secular bull market, such as the one that exists today, which is being driven by extremely accommodative central bank policies, high cash levels, and attractive equity valuations, especially relative to interest rates and fixed income alternatives. That said, for investors who still question the long-term prospects for stocks, it's important to remember that the annualized average total return for the S&P 500 since 1926 is almost 10%, so a bet against the stock market by holding large amounts of cash, which is currently earning almost nothing, is likely to be a losing proposition.

COMPARISON OF INVESTMENT RESULTS

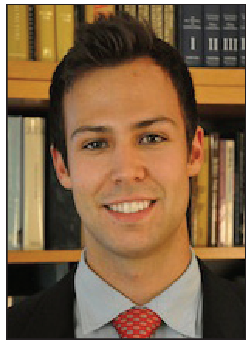
January 1, 1991 to December 31, 2013

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1308.8%	801.9%	876.9%	317.5%	98.5%	74.2%
Avg.[3]	12.2%	10.0%	10.4%	6.4%	3.0%	2.5%

[1]Total performance, net of commissions, fees, and expenses of all Martin Capital Advisors' *Flexible Growth Portfolios*.
[2]Total compounded return, including reinvestment of dividends and interest. [3]1991-2013 annualized return.

—— See Important Disclosure Notice on last page. ——

As we begin 2014, the economy faces the fewest obstacles in the post-Great Recession era. A year ago, the fiscal cliff and government austerity loomed. In years past, the sovereign debt crisis in Europe, weak global demand, and stubborn U.S. debt-ceiling negotiations weighed on the economy and the markets. For this year, austerity won't be as severe, Europe and Asia appear to be recovering, and the U.S. macro economy is on stronger footing. The economy appears to finally be on the cusp of entering a virtuous economic cycle of low inflation with sustained healthy GDP growth. In the third quarter of 2013, the economy grew at an annualized rate of 4.1 percent, which is only the second time since 2009 that the reading has been above 4 percent. **(Figure 1)**



The Fed's policy on how to handle the transition from an economy requiring monetary stimulus to one that is self-sustaining is at the center of discussion on trading floors and in newsrooms. At the heart of the Fed's policy is the decision to taper, which we've heard covered ad nauseam for over a year. The taper refers to a cutback in the Fed's asset purchasing program known as Quantitative Easing (QE). Conjectures about when and to what scale the Fed will taper have had a significant impact on the equity and debt markets. Last June, Ben Bernanke mused about beginning to taper in a press conference, and his words sent the stock market into a sharp correction and caused long-term bond rates to spike precipitously. With every economic report the markets and the media are attempting to interpret any macroeconomic news in the context of what it means for the Fed's decision to taper.

In the December job report released last week, the market expected an increase of nearly 200,000 jobs, which the economy had recorded on average the prior three months, but the number came in at a dismal 74,000. Despite this seemingly disappointing report, the S&P 500 actually closed higher the day of the release. One reason there wasn't a selloff was because headline unemployment fell from 7.0 percent to 6.7 percent, but another reason was because market participants believed the disappointing number might indicate that the Fed could push back its time table and scale of tapering QE. **(Figure 2)**

The emphasis on QE has caused some to believe that the Fed has created this rally and that as soon as they stop injecting liquidity into the market, the U.S. economy will topple like a proverbial house of cards. While this is an extreme view, overall far too much importance is being placed on tapering and QE. There is strong evidence that suggests the policy has made only a small impact on its primary objective.

QE has three main goals: one is purely psychological – to show the market that the Fed is willing to stimulate the economy and remain accommodative; another, to hold down long-term interest rates; and finally, the main goal, to provide liquidity to the market by boosting lending in the hope of stimulating economic growth and improving the labor market.

There's no doubt that QE has accomplished the first two goals. However, QE hasn't been very effective at accomplishing its main purpose of boosting lending. Instead of using the money from the Fed to loan to businesses and individuals, banks are primarily keeping the money in excess reserves at the Fed and earning 25 basis points in interest.

This money is never being injected into the economy and there are several reasons why this is happening. First, banks are willing to keep their money in reserves because a risk-free 25 basis points rate is a relatively good return in the extremely low interest rate environment of the last several years. The main reason though is a fault in the structure of QE itself. As mentioned, one of the purposes of QE is to keep down long-term rates. However, since rates are so low, banks are reluctant to lend because they anticipate in the coming years, when there is no longer QE and the economy is stronger, that rates will be much higher. Additionally, when this time comes, the banks will have the capital that is sitting in excess reserves to loan out at the higher rates.

One only needs to look at the inflation rate to see that QE hasn't been effective. In the last year inflation is up 1.2 percent and has been particularly weak the past couple readings. One could argue that low interest rates, helped by QE, have facilitated the housing recovery by boosting demand. Building permits and housing starts remain strong and are up 9 percent and 29.6 percent, respectively, in the last year. However, one could also argue that the low rates may be hindering the housing recovery by making banks reluctant to lend and qualifying for a loan difficult. **(Figure 3)**

The bottom line is the market has placed too much of an emphasis on QE. Instead of worrying about the taper, it's important to keep a long-term perspective on the economy. As the Fed continues to taper, the housing market rebounds, and the world economy strengthens, long-term interest rates will continue to rise. This will likely cause the yield curve to continue to steepen, which historically is good for the economy and for stocks. **(Figure 4)**

ECONOMIC CHARTS

as of December 31, 2013

Figure 1

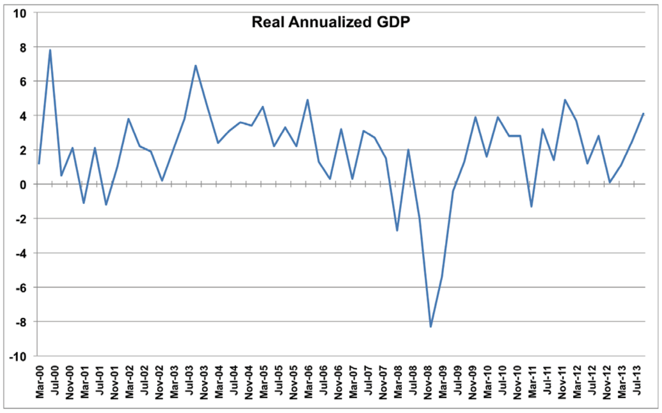


Figure 2

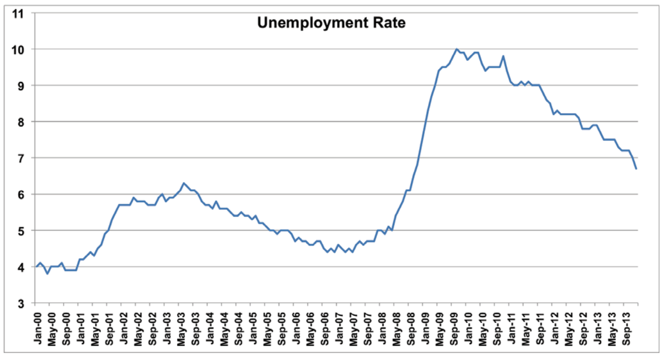


Figure 3

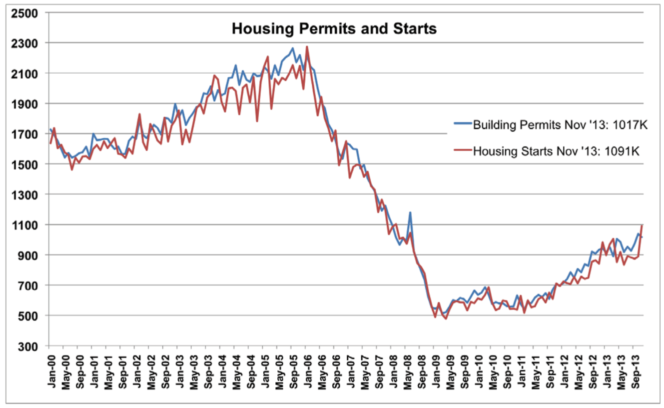
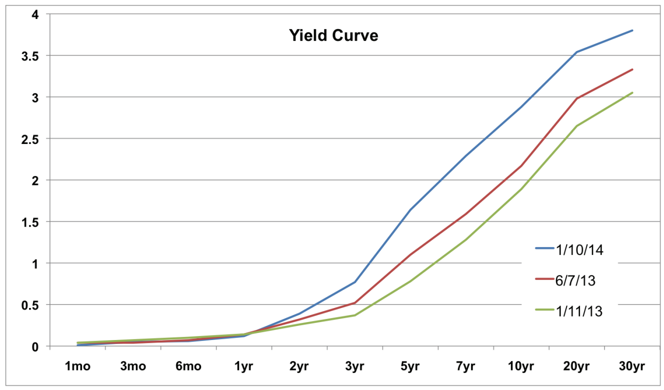


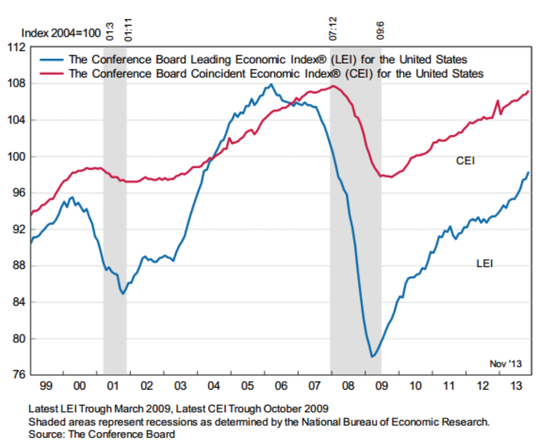
Figure 4



LEADING ECONOMIC INDICATORS

as of December 19, 2013

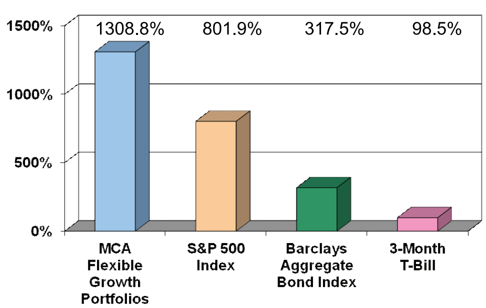
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	98.3	0.8%	3.2%
S&P 500	1784	3.7%	8.8%
Average weekly hours, manufacturing	42.0	0.1	0.2
Initial Jobless Claims	322.8K	-26.8K	-29.7K
Manufacturers' new orders, capital goods ex. aircraft	40.8B	1.0%	-2.6%
Manufacturers' new orders, consumer goods and materials	133.6B	0.1%	1.9%
ISM New Orders	63.6	2.9	14.8
Building Permits	1007K	-3.1%	2.2%
Spread between 10-yr Treasury Note and Federal Funds Rate	2.64	0.11	0.82
Avg. Consumer Expectations for Business Conditions	-0.81	0.28	-0.76
Leading Credit Index (negative readings are positive for the LEI)	-1.76	-0.09	-0.93



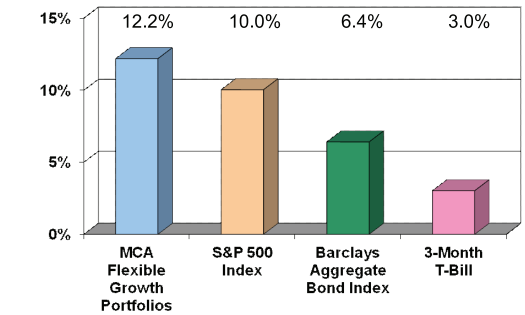
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 2013

Total Return



Annualized Return



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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios.

MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS

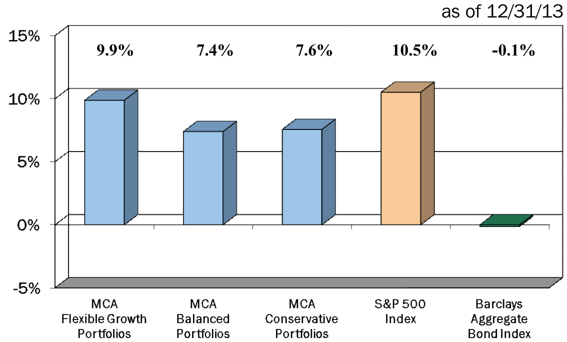
as of December 31, 2013

1	Apple	561.02	6	Charles Schwab	26.00	11	SanDisk	70.54	16	Costco Wholesale	119.02
2	Whole Foods Market	57.83	7	Intuitive Surgical	384.08	12	Texas Instruments	43.91	17	BlackRock	316.47
3	Starbucks	78.39	8	Tiffany	92.78	13	Cisco Systems	22.43	18	Google	1120.71
4	Oracle	38.26	9	Mastercard	835.46	14	Visa	222.68	19	Caterpillar	90.81
5	Williams-Sonoma	58.28	10	DaVita	63.37	15	Intel	25.96	20	OmniVision	17.20

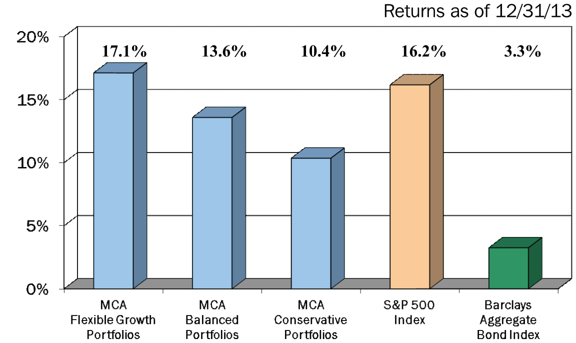
INVESTMENT RESULTS

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

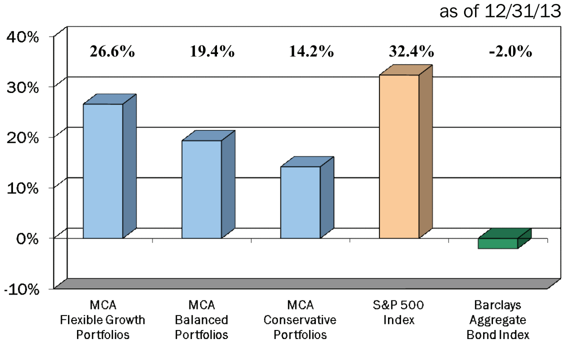
Three-Month Returns
as of 12/31/13



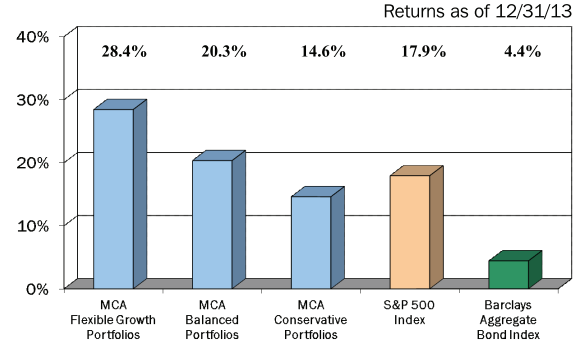
Three-Year Annualized
Returns as of 12/31/13



One-Year Returns
as of 12/31/13



Five-Year Annualized
Returns as of 12/31/13



IMPORTANT DISCLOSURE NOTICE

Past performance does not guarantee future results. Figures include the reinvestment of all dividends received and reflect cash and cash equivalents. Martin Capital Advisors, LLP (MCA) composite returns are net of all fees and expenses. From time to time composite performance may reflect the use of margin investing and options, as well as material investments in bonds and cash, and volatility may differ from that of the benchmark. As of 12/31/2013, the MCA Flexible Growth/Balanced/Conservative Portfolios' returns represent, respectively, 31/6/1 individual portfolios and 65%/30%/3% of all funds under management by MCA. Clients explicitly elect these management styles on their Personal Data Form. The MCA Flexible Growth Portfolios are managed for capital appreciation, and the MCA Balanced and Conservative Portfolios are managed for capital appreciation and income. Independent performance reporting is provided by CGM Investment Management.

MCA claims compliance with the Global Investment Performance Standards (GIPS) and has prepared and presented this report in compliance with the GIPS standards. The listed composites contain all fee-paying accounts with an investment strategy as indicated by the composite title. Non-fee paying or nondiscretionary portfolios are excluded from the composites, but are included in the definition of total firm assets. Performance results are expressed in U.S. dollars. Performance returns are considered PRELIMINARY numbers until examined according to GIPS for the reporting period. To receive a complete list and description of Martin Capital composites and a presentation that adheres to the GIPS standards, contact Paul Martin at (210) 694-2100, ext. 1, or paul@martincapital.com.