THE COMPASS

October 2014

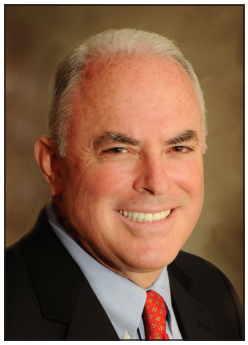
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

U.S. Economic Expansion Back on Track as GDP Rebounds

October 28, 2014

U.S. economic growth strongly rebounded in the second quarter and will probably show continuing strength when third quarter numbers are released. Although stock market returns have been mixed following last year's huge gains, the bias has been to the upside as economic expansion remains on track. Bonds have also achieved positive returns so far this year as low inflation and concerns about global economic weakness have contributed to an ongoing investor preference for "the return of my money, over the return on my money", to paraphrase Mark Twain. This preference has not supported the price of gold, however, as a stronger dollar and the resumption of the "reversion to the mean" bear market that has been discussed in previous newsletters weighed on the precious metal in the third quarter.

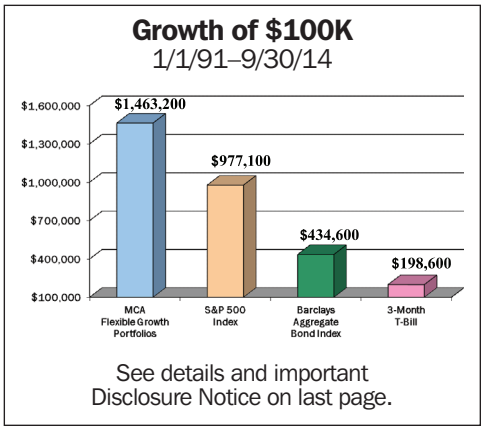


As we enter the fourth quarter, stock market volatility has increased significantly, with most major indexes dropping almost 10% from the September 18 high to the October 15 intraday low – the largest "correction" since the U.S. debt downgrade sparked a bear market in 2011. My best guess is that none of the reasons given for the selloff are material to the U.S. economy in the long run and that the secular bull market will eventually resume, as it did in 2011. At this point, the stock market has already made back most of the recent losses. It will be interesting to see if there is a retest of the mid-October lows sometime in the next few months, but I think that the odds are good that the stock market will be at least somewhat higher by the end of the year and significantly higher over the next few years.

The drop in interest rates and consequent bond rally that occurred as stocks sold off in the last month is starting to reverse and has probably run its course. I expect that as the U.S. economy continues to expand and employment improves over the next few years, inflation will begin to pick up – driving interest rates up and bond prices down. Investors who require some fixed income exposure to dampen the volatility of their portfolios should skew duration towards short maturities to mitigate the impending rise in rates.

Energy prices have declined significantly in the last few months due to large increases in production and lackluster global demand. This trend is likely to continue into next year, which would not be good for energy companies, but it would be good for the global economy and the stock market in general.

Bottom line: investors should overweight stocks and underweight bonds, gold and energy.



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to September 30, 2014

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1363.2%	877.1%	942.6%	334.6%	98.6%	77.8%
Avg.[3]	12.0%	10.1%	10.4%	6.4%	2.9%	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]1991-2014 annualized return.

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

Real Annualized Gross Domestic Product grew at a rate of 4.6 percent in the second quarter. This was stronger than expected, and growth has now surpassed 3.5 percent for three of the past four quarters. The strong growth further confirms that the contraction in the first quarter was weather related. For the third quarter, the economy continued to show steady growth, and GDP is expected to be around 3 percent. (**Figure 1**)

In September's employment report, the unemployment rate dropped from 6.1 percent to 5.9 percent. Part of the reason for the decline was a continuing drop in the labor participation rate, but the majority was due to the 248,000 jobs that were added and the upward revision of August and July's labor numbers. For the year, the labor market has added an average of 213,000 jobs per month and is showing no signs of slowing. This past week initial jobless claims recorded their lowest reading since April 15, 2000. (**Figure 2**)

U.S. manufacturing continues to do well. The ISM manufacturing index posted a reading of 56.6 in September, down from 59.0 in August, which had been the highest reading since March 2011. Manufacturing's strength is occurring despite weak global economies and a strong dollar, which is making exports less competitive and imports relatively cheap. The ISM services sector also continues to expand. In September the index recorded a reading of 58.6, down slightly from 59.6. A reading above 50 indicates expansion, so the index is still well into expansionary territory. Services are being supported by strong business activity, which in August posted the highest reading since 2004.

Consumer confidence is steadily improving. The preliminary report for the sentiment index in October beat expectations and came in at 86.4. This was the highest level in seven years and is being buoyed by lower gasoline prices and labor market gains.

Although consumer's attitudes are improving, there has been weakness in retail sales. In September retail sales fell 0.3 percent; however, they are still up 4.3 percent from a year ago, which is more than twice the rate of inflation. Vehicle sales continue to do well, recording an annualized rate of 16.4 million vehicles in September, which was the seventh time this year that sales recorded an annualized rate higher than 16 million.

The housing market has resumed after slowing considerably earlier this year. It's not growing at the strong rate that it was growing in 2013, but nevertheless is performing well. Housing starts grew 6.3 percent in in September to a 1.02 million annualized rate, while building permits grew 1.5 percent. Existing home sales, however, have been choppy. They fell 1.8 percent in August to an annual rate of 5.05 million, which is down 5.3 percent from a year ago. The median existing home price is up 4.8 percent from a year ago, while interest rates on mortgages are down. The average interest rate on a 30-year mortgage fell below 4 percent this past week for the first time in more than a year.

Inflation continues to be very mild. Both the consumer-price index (CPI) and producer price index (PPI) are below the Fed's inflation targets. Furthermore, the inflation indexes face downward pressure as global economies continue to struggle. In August, the CPI fell 0.2 and is up 1.7 percent over last year. The PPI fell 0.1 percent in September, falling for the first time in more than a year, and is up 1.6 percent over last year. The weak inflationary environment has many economists' believing that the Fed will not raise interest rates until late in 2015. (**Figure 3**)

Yields have continued to fall as they have throughout 2014. At the end of 2013 the 10-year Treasury was over 3 percent, by the end of March it fell to 2.73, it dropped to 2.53 at the end of June, and is now around 2.30 percent. Yields have been falling recently over global growth concerns. This decline in long-term rates is causing the yield curve to flatten, especially as the 2-year rate has actually risen this year. (**Figure 4**)

Continuing signs of economic weakness in Europe and Asia and the strengthening dollar will likely have some impact on earnings this quarter, but, overall, our economy continues to perform quite well and the labor market has been steadily improving. There are a record number of job vacancies and companies are having a tough time filling positions. Lower initial jobless claims combined with strong growth in the labor market should eventually put upward pressure on wages. In this low inflationary environment with falling energy and food prices, wage growth combined with improving consumer confidence should boost consumer spending and contribute to stronger GDP growth.

ECONOMIC CHARTS

as of September 30, 2014

Figure 1

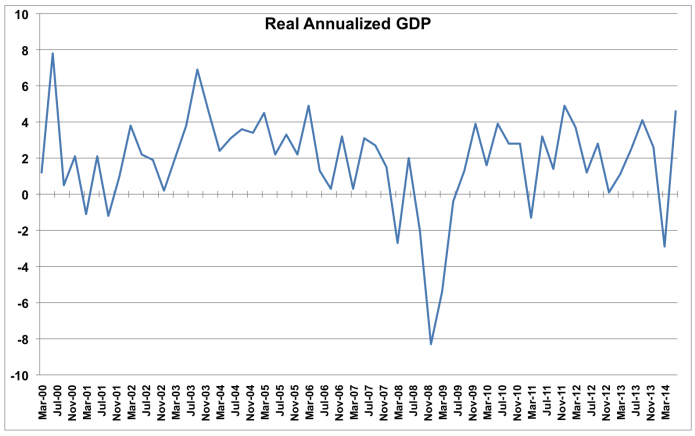


Figure 3

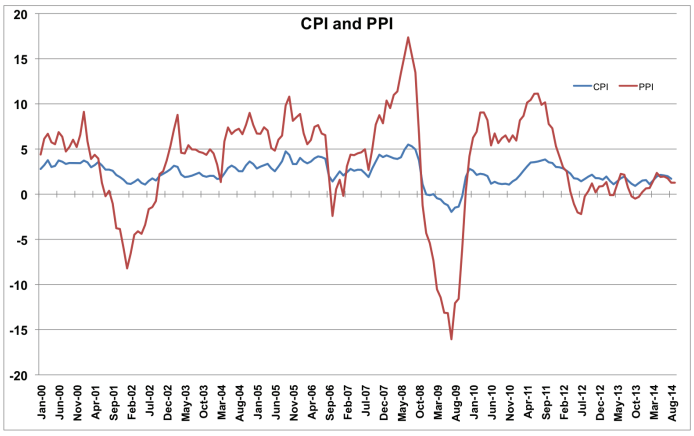


Figure 2

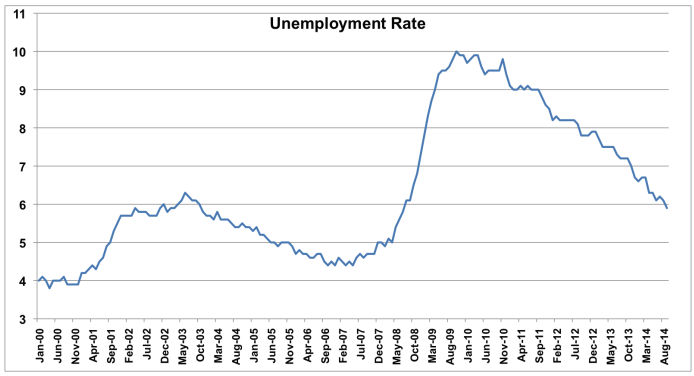
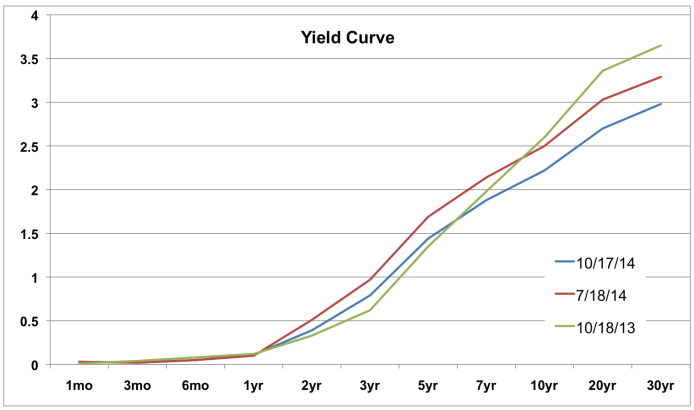


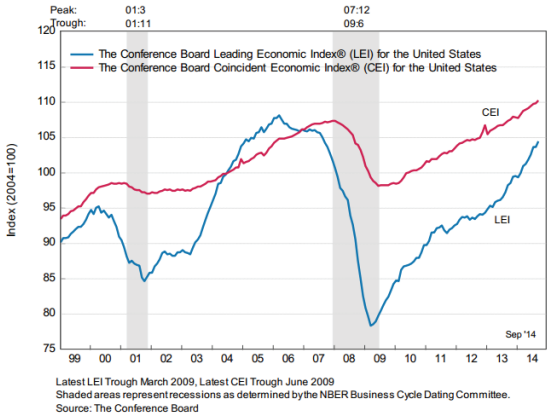
Figure 4



LEADING ECONOMIC INDICATORS

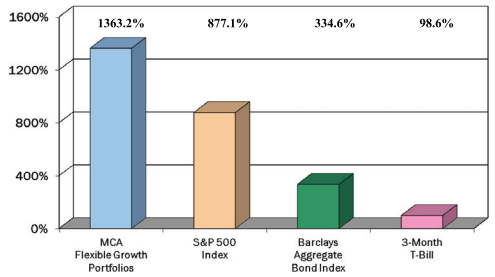
as of October 23, 2014

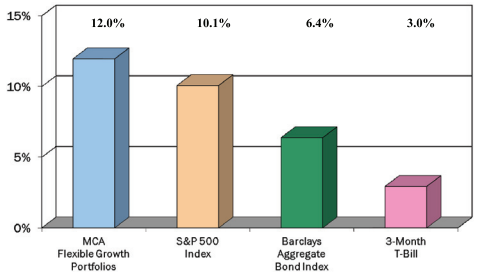
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	104.4	+0.7%	+3.5%
S&P 500	1993	+1.6%	+7.0%
Average weekly hours, manufacturing	42.1	+0.1	+0.1
Initial Jobless Claims	295K	-8.3K	-25.9K
Manufacturers' new orders, capital goods ex. aircraft	44.0B	+0.2%	+2.9%
Manufacturers' new orders, consumer goods and materials	134.1B	+0.3%	+1.3%
ISM New Orders	60.0	-6.7	+4.9
Building Permits	1018K	+1.5%	+1.8%
Spread between 10-yr Treasury Note and Federal Funds Rate	2.44	+0.11	-0.20
Avg. Consumer Expectations for Business Conditions	-0.05	-0.07	+0.10
Leading Credit Index (negative readings are positive for the LEI)	-1.37	-0.10	-0.40



RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2014





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MARTIN CAPITAL ADVISORS, LLP

100 Congress Avenue, Suite 2000
Austin, Texas 78701
3463 Magic Drive, Suite 100
San Antonio, Texas 78229
512-477-7036 • 210-694-2100

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

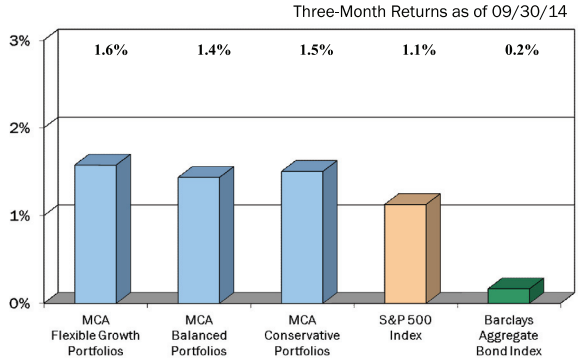
MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS

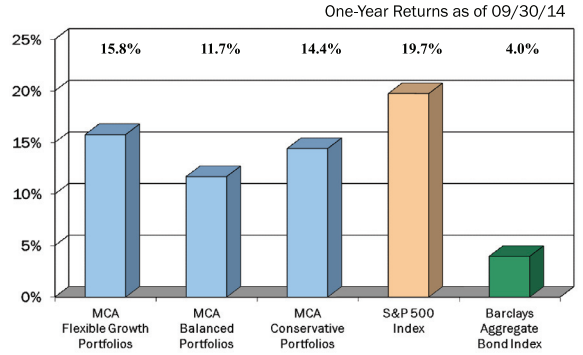
as of September 30, 2014

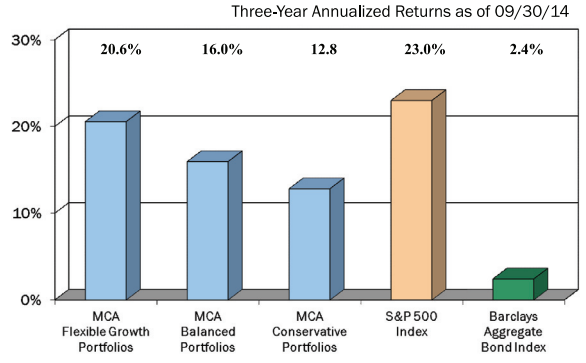
1	Apple	100.75	6	Intuitive Surgical	461.82	11	OmniVision	26.46	16	Qualcomm	74.77
2	Whole Foods Market	38.11	7	Tiffany	96.31	12	Texas Instruments	47.69	17	Sotheby's	35.72
3	Starbucks	75.46	8	Oracle	38.28	13	MasterCard	73.92	18	Visa	213.37
4	SanDisk	97.95	9	Charles Schwab	29.39	14	Intel	34.82	19	Costco Wholesale	125.32
5	Williams-Sonoma	66.57	10	DaVita	73.14	15	Cisco Systems	25.17	20	ARM Holdings	43.69

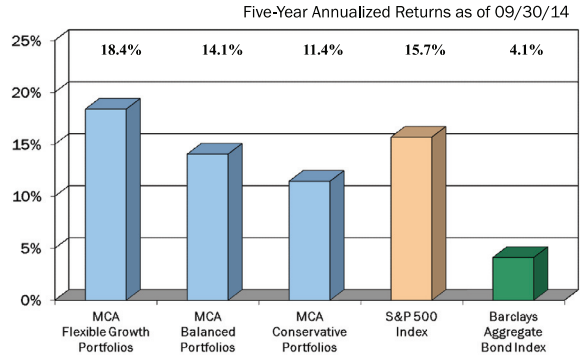
INVESTMENT RESULTS

Martin Capital Advisors' Investment Portfolios vs. 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. 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 9/30/2014, the MCA Flexible Growth/Balanced/Conservative Portfolios' returns represent, respectively, 33/6/1 individual portfolios and 68%/27%/2% 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 Robert Godines at (210) 694-2100, ext. 2, or robert@martincapital.com.

ADDITIONAL DISCLOSURE NOTICE

MARTIN CAPITAL ADVISORS, LLP (MCA) is a registered investment advisor based in Austin and San Antonio, Texas, founded in 1989. MCA specializes in managing customized equity and balanced investment portfolios with an all-cap equity strategy to grow capital, as well as balanced strategies to grow capital with less volatility.

MCA claims compliance with the Global Investment Performance Standards (GIPS®). Martin Capital Advisors, LLP has been independently verified for the periods January 1, 2000 to June 30, 2014 by Dabney Investment Consulting Associates, Inc. The verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Returns are shown in U.S. dollars net of fees.

Leverage (margin) is not normally used except temporarily or at client request. Derivatives such as options may be used occasionally as a risk reduction measure.

The GIPS standards allow firms to link non-GIPS-compliant performance to their compliant history provided that no non-compliant performance is shown for periods beginning on or after 1 January 2000. Performance for periods prior to 1/1/2000 is not GIPS-compliant, but has been linked to the subsequent GIPS-compliant performance for cumulative periods.

MCA Flexible Growth Portfolios are invested in publically traded companies with the goal of maximizing long-term returns. These portfolios are classified as an all-cap core strategy, but predominately invest in large and mid-cap stocks, blending the characteristics of both growth and value investing. Each portfolio typically invests in 30 to 40 stocks that are rigorously selected to meet our core philosophy of investing in companies with an enduring competitive advantage that offer growth at a reasonable price. These portfolios are for investors who are willing to accept significant short-term volatility in the pursuit of superior long-term returns. The benchmark for this composite is the S&P 500 Index, which is an index of the 500 leading companies in the U.S. and is designed to reflect the risk and return characteristics of the large-cap U.S. equities universe.

MCA Balanced Portfolios are invested in equities and fixed income securities with a target asset allocation of 75% equities and 25% fixed income. These portfolios are for investors with a long-term investment horizon who seek to grow capital, but want to do so with less short-term volatility than the MCA Flexible Growth Portfolios. The equity investments in the portfolios are classified as an all-cap core strategy and are managed in the same way as the MCA Flexible Growth Portfolios. Fixed income investments include both individual and ETF fixed income securities. The benchmark for this composite is a blend of 75% S&P 500 Index and 25% Barclays U.S. Aggregate Bond Index, rebalanced monthly. The S&P 500 is an index of the 500 leading companies in the U.S. and is designed to reflect the risk and return characteristics of the large-cap U.S. equities universe. The Barclays U.S. Aggregate Bond index is made up of the Barclays U.S. Government/Corporate Bond Index, Mortgage-Back Securities Index, and Asset-Backed Securities Index, and only includes securities that are investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

MCA Conservative Portfolios are invested in equities and fixed income securities with a target asset allocation of 50% equities and 50% fixed income. These portfolios are for investors who prefer to significantly reduce short-term volatility in their investments rather than maximize long-term returns. The equity investments in the portfolios are classified as an all-cap core strategy and are managed in the same way as the MCA Flexible Growth Portfolios. Fixed income investments include both individual and ETF fixed income securities. The benchmark for this composite is a blend of 50% S&P 500 Index and 50% Barclays U.S. Aggregate Bond Index, rebalanced monthly. The S&P 500 is an index of the 500 leading companies in the U.S. and is designed to reflect the risk and return characteristics of the large-cap U.S. equities universe. The Barclays U.S. Aggregate Bond index is made up of the Barclays U.S. Government/Corporate Bond Index, Mortgage-Back Securities Index, and Asset-Backed Securities Index, and only includes securities that are investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

To receive a list of composite descriptions of MCA and/or a compliant presentation, contact Robert Godines at (210) 694-2100, ext. 2, or robert@martincapital.com.