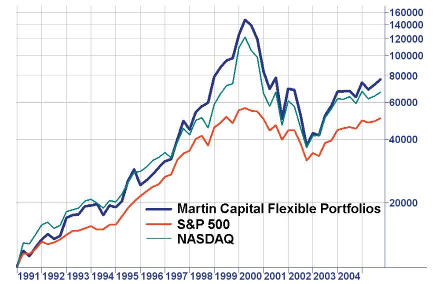
THE COMPASS

October 2005 | A Quarterly Newsletter of Martin Capital Advisors, LLP

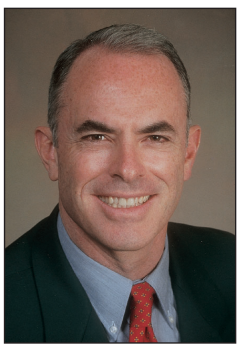
Stocks Edged Higher in the Third Quarter, but Fed Tightening May Dampen Fourth Quarter Returns



See Important Disclosure Notice on back page.

October 17, 2005

Stocks performed well in the third quarter as corporate earnings and economic activity remained strong despite a long list of concerns from natural disasters to rising interest rates. The stock market has been able to shrug off this litany of issues because valuations relative to other assets are quite compelling, especially relative to bonds. Although core inflation did not heat up during the quarter, surging energy prices drove total inflation significantly higher and were the primary catalyst for higher interest rates and lower bond prices.



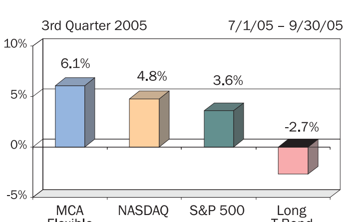
As we enter the fourth quarter, prospects for the stock market and economy are positive for the long-term, but the uncertainty of whether higher energy costs will eventually translate into higher core inflation and further Fed tightening may dampen short-term returns. The disinflationary forces of global competition and advances in information technology should lessen the impact of higher energy costs; however, the conundrum (to use one of Greenspan's favorite words) of how high the Fed will raise rates to achieve a neutral monetary policy and whether a tight monetary policy may be the Fed's ultimate target will probably weigh on the economy and financial markets through early next year. Until then, stock prices may stay in a trading range and bond prices will probably fall as interest rates climb higher.

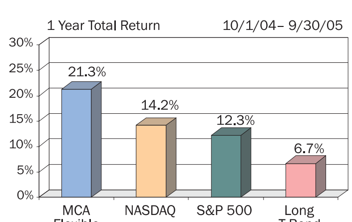
While there are many problems facing the stock market today, these problems are largely factored into current prices. Of course, more problems may emerge and negatively impact the stock market, but sentiment already reflects a great deal of pessimism, so the likelihood of a severe drop in stock prices is low. Conversely, if some problems start to show signs of improvement, stock prices have the potential to respond favorably as investor sentiment improves. An old Wall Street saying sums up the present situation best: "Bull markets climb a wall of worry." This is because anxiety forms the base from which prices eventually rise as sentiment improves. Although no one can say when the troubles facing the financial markets may begin to be resolved, it seems fairly safe to say that standing on the sidelines will not be the place to be when signs start to point to better times ahead. Another Wall Street adage goes, "No one rings a bell at the bottom," so even though stocks may trade lower in the near-term and the next big advance may be a little further down the road, now is the time to prepare for it.

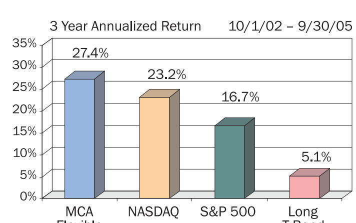
MCA Flexible Portfolios
12-month Tax Efficiency: 91.0%
(After Tax Return divided by Before Tax Return)

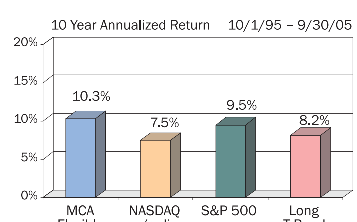
INVESTMENT RESULTS

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







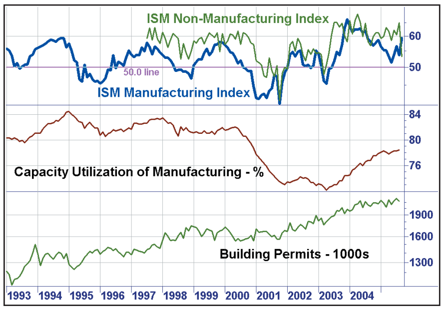


—— See Important Disclosure Notice on back page. ——

The third quarter experienced strong growth that was hampered in the latter part by the effects of two large hurricanes, which put a relatively minor dent in a strong economy. Second quarter GDP was up an annualized 3.3%, and the third quarter will probably show a little less, perhaps just below 3%. The major stock indexes showed modest gains in the third quarter and, with the exception of the Dow, were all up at least 10% in 12 months. Short interest rates continued their steady march upward, propelled by the Fed, while long rates changed only a little, with the 30-year T-bond yield up a little and the FNMA 30-year mortgage rate down a little. The labor market was hurt by the hurricanes as people were displaced, but job prospects are good as Gulf Coast reconstruction begins. Inflation appears to be the biggest potential problem on the horizon for the economy, largely due to Katrina's catastrophic effects on oil production in the Gulf of Mexico, refining in the Gulf Coast area and devastation of our largest seaport, New Orleans.

INDUSTRY

The manufacturing sector is strong, as indicated by the Institute of Supply Management's Manufacturing Index, which rose to 59.4 in September from 53.6. Eight of the indicator's ten components were up, led by new orders and production. Capacity utilization of manufacturing in September was 78.4%, the highest since December 2000. The destruction caused by the hurricanes is stimulating demand for all kinds of products, both for industry and for homes in the reconstruction process along the Gulf Coast. Services industries, however, were a different story. The ISM Non-Manufacturing or Services Index fell

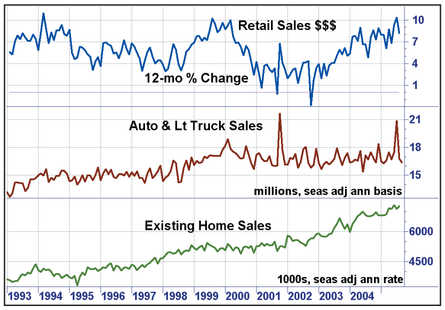


from 65.0 to 53.3 in September. Though still above 50.0, indicating growth rather than contraction, eight of ten index components were down, one unchanged and one up: prices. Only eight of the 17 industries surveyed were reporting increased activity. High oil and natural gas prices were the main concern in this survey, along with the scarcity of some other products due to the hurricanes.

Construction of commercial and government buildings has slowed, while single-family home building has remained exceptionally strong as consumers are continuing to take advantage of low mortgage rates by buying homes. These rates will continue to sustain the housing market until they rise substantially.

SALES

Total retail sales have remained strong this year, up 8.2% in 12 months through August, though down 2.1% in that month. Auto and light truck sales spiked to 20.9 million units (annualized) in July, as manufacturers' big

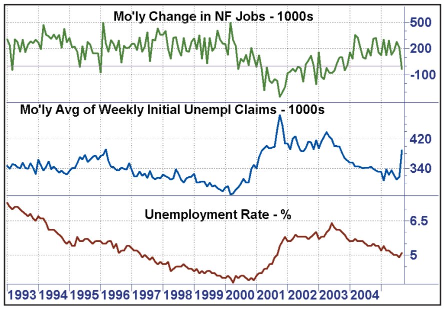


price discounts drew consumers into showrooms to buy. When the incentives went away, monthly sales fell back to more normal levels of 16.8 and 16.4 million in August and September. As auto sales make up about a quarter of total retail sales, the total figures followed vehicle sales up and down to some degree. Excluding vehicle sales, total retail dollars spent were up 1.0% in August and 9.3% in 12 months. Home sales overall continued their trend of strength, with existing homes reaching an annualized rate of 7.29 million in August, the second highest monthly figure in history, while new homes fell back to an annualized 1.237 million, the lowest since January of this year. Nothing in particular stands out to explain the difference between existing and new home sales performance.

LABOR

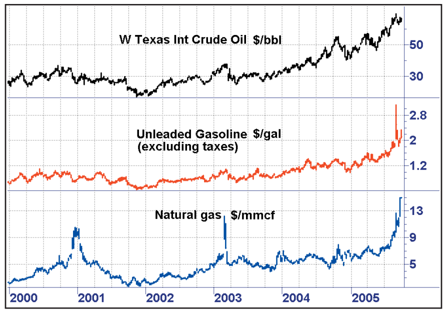
The September employment figures show the big hits inflicted by the two hurricanes, with the loss of 75,000 non-farm jobs, weekly initial unemployment claims up to an average of 389,000, and the unemployment rate up to 5.1% from 4.9%. The number of jobs actually lost won't be known for several months because if the phone survey was not answered, the assumption was no change in jobs. Few phones were in service on the Gulf Coast after the hurricanes. The monthly average of hours worked per week by employees was unchanged at 33.7.

The Labor Department estimates the initial unemployment claims due to the hurricanes to be about 363,000, leaving non-hurricane adjusted numbers very low. This means that outside the areas affected by the hurricanes, the job market is still strong in the rest of the country. In any case, reconstruction of the buildings and infrastructure damaged or destroyed by the hurricanes along the Gulf Coast will require many workers in many fields. The numbers of dollars projected to be spent in the reconstruction process is north of $200 billion, a large portion of which will go toward labor. We may expect this to help maintain a tight labor market in the US as a whole.



INFLATION

The potential for inflation has increased due to sharply higher crude oil, gasoline and natural gas prices. These prices are up because hurricane damage to offshore production platforms, pipelines bringing oil and gas to shore from offshore platforms, refineries and other onshore facilities. We were fortunate that the Louisiana Offshore Oil Port (LOOP), a gateway for about 900,000 barrels/day of crude oil imported by tankers plus 500,000 from an offshore platform, survived the storms without major damage and resumed pumping on September 1, immediately after Katrina passed by. Prices of oil and gasoline have probably peaked and will come down as facilities are repaired and replaced. Also, higher prices for gasoline have caused motorists to drive less. Natural gas prices have already risen more sharply than those of oil or gasoline. We import very little natural gas so, as demand increases next winter, prices may also increase if offshore platforms and pipelines are not brought back on line in time. Other prices that have risen to record highs are those of materials used in construction. We've been experiencing a boom in housing and demand for materials, anything wood, for example, has been strong, so prices were relatively high before the hurricanes. We will soon see reconstruction begin over broad areas of the Gulf Coast that were devastated by the storms, including public, private and commercial buildings. As a result, we can expect building materials to become even more costly. It is also possible that labor costs will go up faster than we have seen in the recent past, as demand for workers in Gulf Coast reconstruction brings a boost in wages.



SUMMARY AND OUTLOOK

It was easy to get depressed watching TV news of Katrina and Rita, then come away feeling like our economy must be about to come to an end. Forget it, it's just not going to be anything like that. It is true that in a short time, we took a hit on our national wealth in the form of destruction of property, while businesses were destroyed and people lost jobs as well as homes. This only took place in a relatively small area. Outside of the devastated areas, the rest of the US is experiencing a strong economy. The principal economic effects of the hurricanes were a sudden slowdown in our economy, which will be followed by a boost from reconstruction activity and spending. We've also experienced an inflationary pulse from higher energy prices. The Fed will continue to raise rates in order to counteract what they see as a potentially inflationary situation, which will create a headwind for the economy. High prices for petroleum and natural gas products are creating still more of a headwind, but they will eventually come back down as repairs are completed. Meantime, the spending for reconstruction will provide a big stimulus to our economy. Granted, there are a lot of uncertainties remaining, such as how soon the Port of New Orleans, important to our national economy, will be able to function again. The US economy in 2004 consisted of 14.1% manufacturing and 78.3% services, a far cry from the 1970s, when manufacturing made up the majority of the economy. Services are far less energy intensive, which is why higher energy prices are having less of a negative effect today than they did in the 1970s. Considering of all these things, our economy has not received a crippling blow and it is unlikely that we will slip into a recession next year.

MARKET AND ECONOMIC STATISTICS

as of Market Close September 30, 2005, with 3-month and 12-month changes

2nd Qtr. '05	Final	3 mo	12 mo
GDP-Bil$	11089	3.3% apr	3.6%
GDP Deflator	111.6	2.6% apr	2.4%
Empl Cost Index	177.9	0.7%	3.1%
NF Productivity	135.1	1.8% apr	2.2%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10569	2.9%	4.8%
S&P 500	1229	3.1%	10.2%
NASDAQ Comp	2152	4.6%	13.4%
NASDAQ 100	1602	7.2%	13.4%
NYSE Comp	7633	5.8%	16.2%
Wilshire 5000	12289	3.5%	12.8%
Russell 2000	668	4.4%	16.6%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	3.56%	13.0%	109.4%
30-yr T-Bond Yld	4.57%	9.1%	–6.5%
FNMA 30yr mortg	5.85%	7.9%	4.5%
Prime Rate	6.75%	8.0%	42.1%
Fed Funds Trgt	3.75%	15.4%	114.3%
Fed Disc Rate	3.25%	18.2%	160.0%
S/L Long T-Bnd Ind	13546	–2.7%	6.7%

PRICES, INFLATION		3 mo	12 mo
CPI, Aug	196.1	1.0%	3.6%
PPI, Aug	156.0	1.6%	5.1%
Gold, cash	469.4	7.8%	12.1%
W Tx Int Cr Oil	66.25	17.3%	33.4%
Copper $/lb	1.80	16.0%	28.7%
CRB Futures Ind	333.0	11.0%	16.8%
CRB Raw Indust	328.3	–0.3%	3.1%

MONEY		3 mo	12 mo
M2, Bil Curr$, Aug	6550	1.0%	3.9%
Free Reserves	1.940	32.4%	57.6%
Money Mkts-Bil$	1944	2.6%	1.1%
US $$$ Index	89.5	0.4%	2.3%

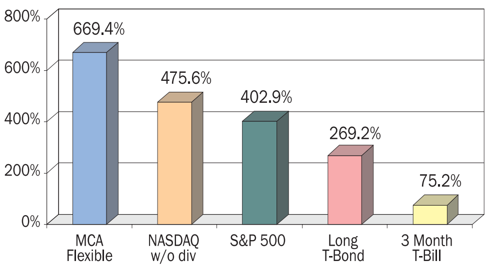
INDUSTRY		3 mo	12 mo
ISM Index, Sep	59.4	5.6	0.9
Indus Prod Ind, Aug	119.7	1.0%	3.2%
Cap Utiliz, Aug	79.8%	0.6%	1.5%
Bldg Permits, Aug	2124K	3.0%	3.2%

LABOR – Sep '05		3 mo	12 mo
Unemployment Rate	5.1%	0.1%	–0.4%
New Non-Farm Jobs	–75K	+453K	+2381K
Avg Hourly Wages	16.18	0.7%	2.5%
Avg Init Unempl Clms	390K	+69K	+41K

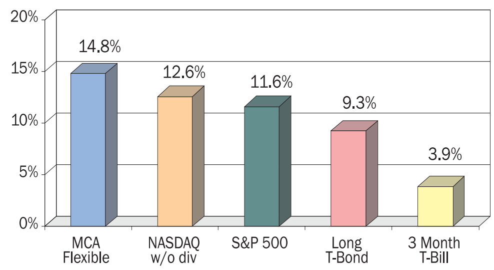
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2005

Total Return



Annualized Return



THE COMPASS

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FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Inc	34.20	6	Tiffany	39.77	11	Intel	24.65	16	CitiGroup	45.52
2	Whole Foods Market	134.45	7	Electronic Arts	56.89	12	Centex	64.58	17	Oracle Systems	12.40
3	Starbucks	50.10	8	Applied Materials	16.96	13	Nasdaq 100	39.46	18	Advanced Micro Dev	25.20
4	Texas Instruments	33.90	9	Charles Schwab	14.43	14	Cisco Systems	17.92	19	S&P Depositary Rcpt	123.04
5	Williams-Sonoma	38.35	10	Sandisk	48.24	15	LAM Research	30.47	20	Bear Stearns	109.75

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	Dow Jones Industrial Avg.	S&P 500	NASDAQ[2]	Dow Jones Wilshire 5000	Long-Term T-Bond	3 Month T-Bill	Consumer Price Index
1991	33.9%	24.5%	30.6%	56.9%	34.2%	18.5%	5.6%	3.1%
1992	26.8%	7.3%	7.7%	15.5%	9.0%	8.0%	3.5%	2.9%
1993	14.5%	17.0%	10.0%	14.8%	11.3%	17.3%	2.9%	2.8%
1994	-2.1%	5.0%	1.3%	-3.2%	-0.1%	-6.9%	3.9%	2.7%
1995	27.5%	36.9%	37.4%	40.0%	36.5%	30.7%	5.6%	2.5%
1996	29.4%	28.7%	23.1%	22.7%	21.2%	-0.8%	5.2%	3.3%
1997	41.4%	24.9%	33.4%	21.6%	31.3%	15.1%	5.3%	1.7%
1998	78.8%	18.1%	28.6%	39.6%	23.4%	13.5%	4.9%	1.6%
1999	58.2%	27.2%	21.0%	85.6%	23.6%	-8.7%	4.7%	2.7%
2000	-33.0%	-4.9%	-9.1%	-39.3%	-10.9%	20.1%	5.9%	3.4%
2001	-17.4%	-5.4%	-11.9%	-21.1%	-11.0%	4.6%	3.8%	1.6%
2002	-38.3%	-15.0%	-22.1%	-31.5%	-20.9%	17.2%	1.7%	2.4%
2003	56.8%	28.3%	28.7%	50.0%	31.63%	2.1%	1.0%	1.9%
2004	10.7%	5.3%	10.9%	8.6%	12.6%	8.0%	1.4%	3.6%
2005	3.4%	-0.3%	2.8%	-1.1%	3.9%	5.4%	2.3%	3.2%
Total[3]	669.4%	474.0%	402.9%	475.6%	420.9%	229.2%	75.2%	46.8%
Avg.[4]	14.8%	12.6%	11.6%	12.6%	11.8%	9.3%	3.9%	2.7%

[1]Total Annual Performance, net of commissions, fees, and expenses, of all Martin Capital Advisors flexible investment portfolios. Audited 1991-99 by Carpenter & Langford, P.C., Certified Public Accountants. [2]Without dividends. [3]Total compounded return, including reinvestment of dividends and interest. [4]1991-2005 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. 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 37 individual portfolios and 38.8% of all funds under management by MCA on 9/30/05. 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.