

capital markets review

QUARTERLY

Discipline at the Plate

The equity markets have displayed an unusual degree of tranquility during the first six months of 2004. The S&P 500 has not varied as much as 5% (up or down) since the beginning of the year. We're not exactly going out on a limb to predict that this relative calm will not continue indefinitely. When the customary volatility returns, we have no idea which way the market will turn in the short run. Looking farther out, we continue to believe that rising interest rates and heady valuations will prove to be steady headwinds for the stock market. So far this year we have sold more stocks than we have purchased. We are not finding a plethora of pitches in our "sweet spot," and our experience tells us that it would be prudent to watch a few pitches pass by in such an environment. Discipline and patience — though the value of these virtues is often not fully apparent at the time — tend to provide their just rewards. Michael Lewis' best-selling book, *Moneyball*, describes what it takes to maximize value in Major League Baseball that is similar to successful strategies in the money management business. As for offense, the trick is to avoid swinging at pitches outside the strike zone *and* to check your swing at pitches that may be inside the zone, but not in your sweet spot. Unlike baseball, there are no called third strikes in investment management.

The table below illustrates the quarterly and year-to-date performance of the indices. As you can see, our equity portfolio performance is more or less in line with the standard performance benchmarks.

	<u>2nd quarter</u>	<u>Year-to-date</u>
S&P 500	1.7%	3.4%
NASDAQ	2.8%	2.4%
Dow Jones	1.2%	0.8%
MCM	3.7%	2.5%

While the equity markets have hardly matched the excitement of 2003, the fixed-income markets have been downright disappointing. So far this year investors would have had a choice between earning a pretax 1% risk-free rate of return on short-term fixed-income investments or losing money on longer-term bonds. Clearly, the bond market has already priced in a series of interest-rate increases by the Federal Reserve Board. As such, the bond market has become somewhat more attractive, but we're still reluctant to move meaningful amounts of capital into longer-term and higher-yielding bonds.

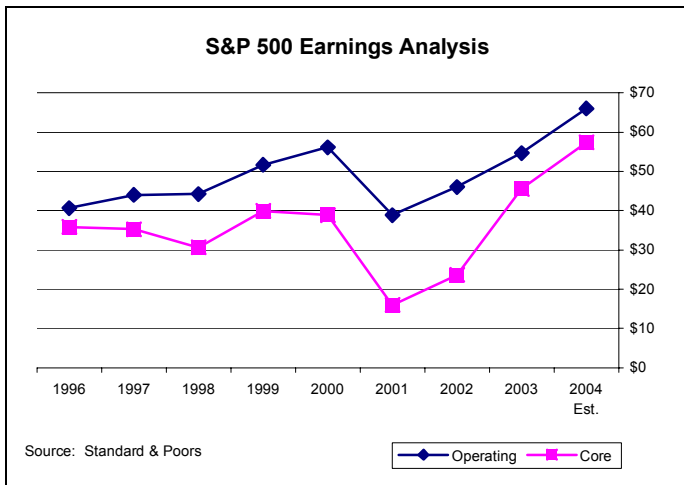
Equity Review

If higher interest rates and lofty valuations are steady headwinds, corporate earnings are doing their best to motor through them. Earnings growth has been outstanding. As can be seen on the accompanying chart on the following page,

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S&P 500 earnings are expected to be at record levels this year, irrespective of whether one is using operating or core earnings (core earnings includes an estimate of options expense and eliminates pension income fluctuations, along with other smaller adjustments). Our portfolio companies are fully participating in the earnings recovery, and we wouldn't be surprised to see 25-30% earnings growth as a whole for 2004. How that will ultimately transfer to stock price performance is anyone's guess, in part because the rate of "normalized" earnings growth is much less than the expected improvement this year. Over the long term, we believe that our companies in the aggregate will grow at a low double-digit rate. By being disciplined in terms of the earnings multiples we are willing to pay for this rate of growth, our portfolio returns should be very respectable over time.



New Holding

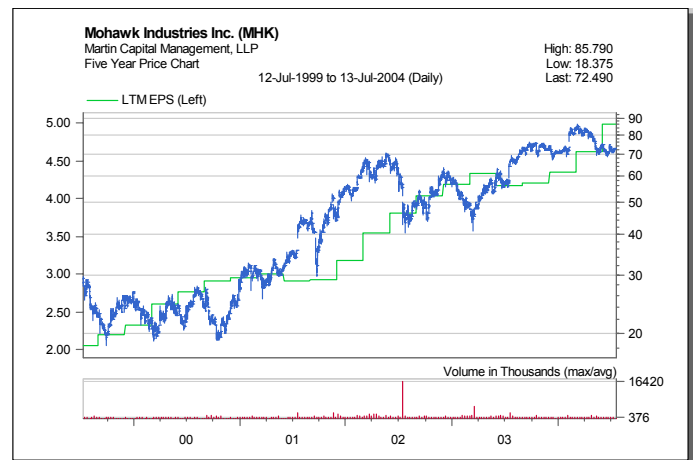
Mohawk Industries (MHK)

MHK is the largest flooring manufacturer and distributor in the world. Over the last several years MHK and the other large competitor in the industry, Shaw Industries (a subsidiary of Berkshire Hathaway), have transformed the industry — largely through consolidation — from a fragmented and disorganized condition into one that is much more efficient and dominated by two very well-managed companies. Both companies have expanded beyond their carpet roots and now offer all types of flooring (hardwood, tile, vinyl, etc.). In addition, their size affords them the opportunity to vertically integrate

profitably into the distribution and warehousing of their products.

MHK and Shaw have made it much easier for independent flooring retailers to operate at a profit. Because MHK can deliver a full line of flooring products on a next-day basis, there is little reason for independent retailers to maintain large inventories and the warehouse space required to house them. In effect, MHK has taken the capital requirements out of the equation for independent dealers. This is a powerful advantage enjoyed only by Mohawk and Shaw.

Approximately 25% of MHK's sales are directed to new residential construction; we're concerned about the potential for lower demand as mortgage rates rise. Somewhat ameliorating our concern is the fact that the repair/remodel market, the industry's largest, has not been hitting on all cylinders for a considerable period of time. Moreover, the commercial market (roughly 20% of industry demand) is down 40% or more from its peak four years ago. Feel free to request a research report on this fine company for a much more thorough analysis. We would certainly add to our relatively modest position if and when lower prices provide the necessary "margin of safety."



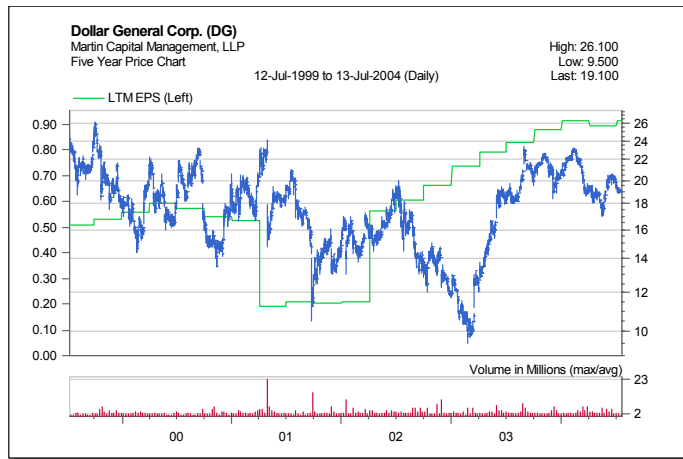
Equity Holdings

Dollar General (DG)

Wall Street has thrown the baby out with the bath water. The entire "dollar store" category has not performed particularly well this year. Dollar Tree and 99-Cents Only

have both come up short of Wall Street expectations. More importantly, Family Dollar (by far the company most comparable to DG) has reported less than stellar results. Finally, whether it's rising gasoline prices or relatively staid employment statistics, it is said that DG's core customer is not participating in the economic recovery. This is nonsense.

DG's comparable-store sales have lagged behind other retail formats, but that is to be expected during periods of strong economic growth. DG does not stock high-ticket consumer durables (flat-screen TVs, exercise equipment, etc.), which helps other retail formats during economic upswings. So far this year, DG's same-store sales are north of 3%, far better than its direct competition. Pretax earnings increased 16% during its most recent quarter, despite significant investments that have been made to grow the business, including opening 250 new stores ... yes, in one quarter.

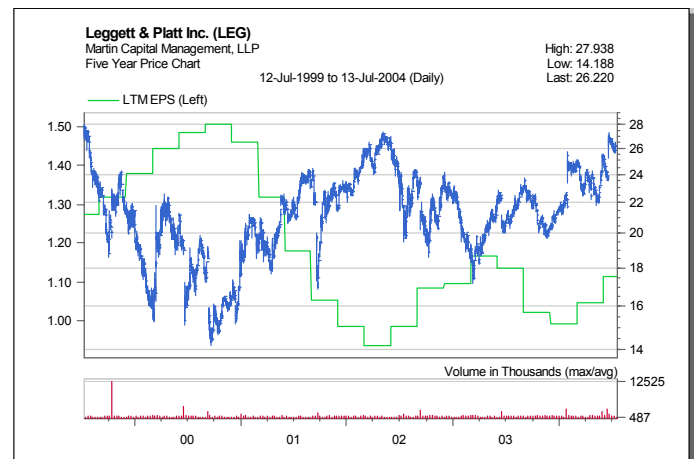


We think the company is very well positioned in the tough retail industry. DG competes on the basis of a powerful combination of price and convenience. Other retail formats offer one or the other, but nobody offers both as well as DG. We remain enthusiastic about this company's long-term prospects.

Dover (DOV) and Leggett & Platt (LEG)

These companies are quite similar in many respects and so, as we have done occasionally in the past, we are lumping them together. Both companies have more than \$4 billion in revenue and operate four basic business platforms. Both companies employ a decentralized management structure.

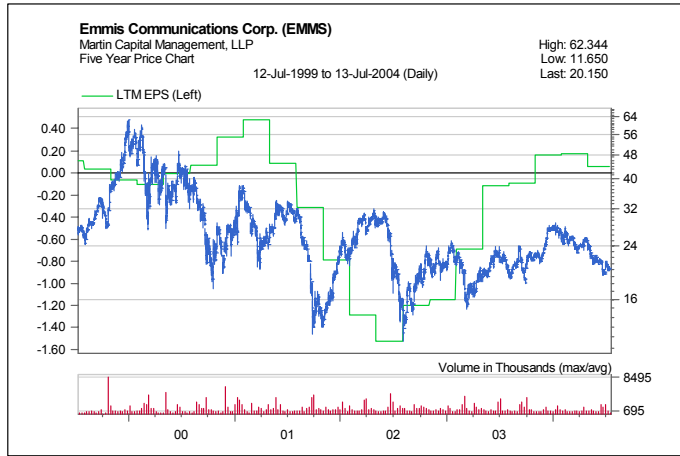
In the last few updates, we have said that earnings should begin to recover in a fairly dramatic fashion as the year rolls forward. That has begun to materialize. As such, we're less concerned that the earnings potential of these companies has been compromised in any material way. What has been relatively disappointing, however, is the slow recovery in the pace of acquisitions. Both companies report that their pipelines are building, but we aren't seeing many deals closed. It's likely that low interest rates have made financial buyers quite competitive with acquisition-minded companies like LEG and DOV. We have high regard for the management teams at both companies, but the lack of progress on the acquisition front calls for more scrutiny of subsequent acquisitions.



Emmis Communications (EMMS)

The radio industry has not demonstrated the kind of rebound that typically marks a recovery in media

spending. Whether it's simply a matter of time or whether other media (newspapers, Internet, cable) have become more effective in selling local advertising is difficult to assess. We're quite sure, however, that the oft-mentioned culprit, satellite radio (which has a very different economic model), is not the problem. There is no evidence that radio has lost its effectiveness from the advertising point of view.

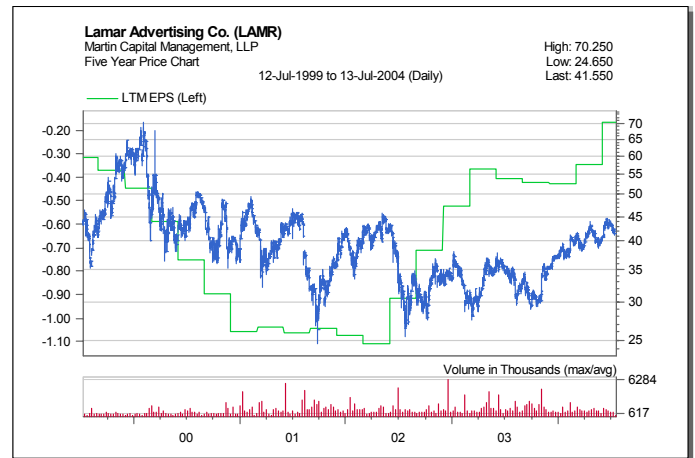


We're still optimistic about radio, which is cheap, effective, and one of the few places an advertiser can place an ad with only a day or two of lead time. More importantly, EMMS has a top-tier group of stations, and they are managed very well. The television group is going to have an outstanding year in 2004. Viewership ratings are up, and the company will benefit from political advertising and the hype surrounding the Summer Olympics.

EMMS is a rather unusual company for Martin Capital to own. The company is highly leveraged and the return on capital is well below other holdings in our portfolio, which makes it difficult to grow intrinsic value per share. The low return on capital has nothing to do with the quality of the businesses. EMMS cash-flow margins are north of 40%! The company has simply paid too much for past acquisitions. EMMS is more of an asset play. The company has wonderful assets that we believe are undervalued. We're willing to wait for the market to reassess the prospects for this company.

Lamar Advertising (LAMR)

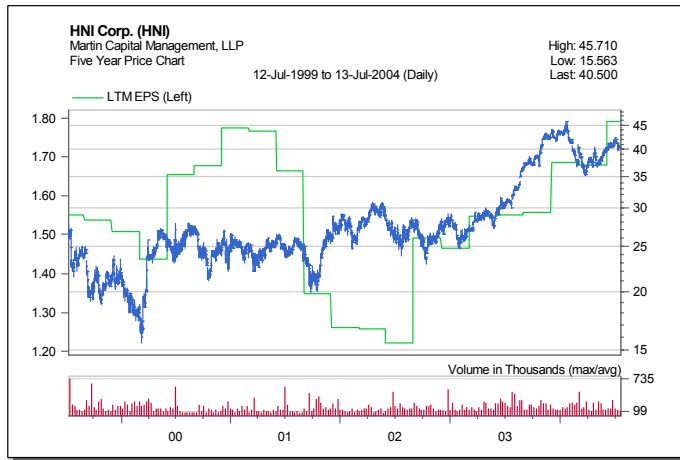
The billboard business is coming back. Occupancy rates are recovering and, if history is any guide, firmer pricing won't be far behind. Given the operating leverage in this business, we should begin to see strong earnings growth over the next few quarters. We like the billboard business, which is simple, lucrative, and not subject to media fragmentation. LAMR will be generating a great deal of free cash flow. We will be interested to see how the management team, which has capably steered this ship through a consolidation period and the most recent advertising recession, will respond to a relatively new challenge. It's the kind of challenge we like our holdings to encounter: What should they do with all the cash they're generating?



HNI Corporation

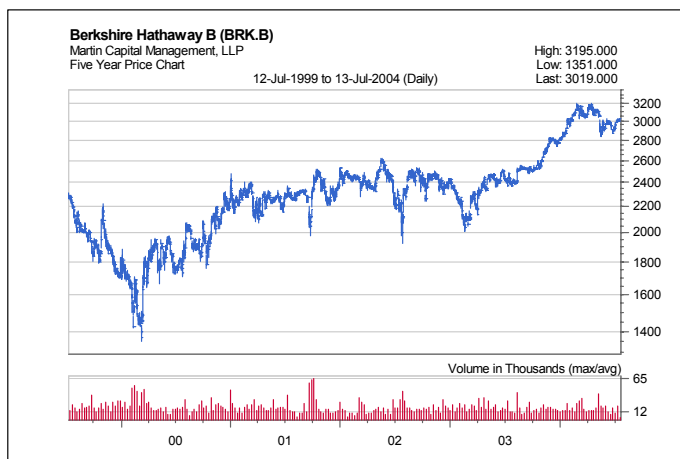
We recently had the pleasure of hosting HNI's CEO, CFO, and Treasurer at our office. We didn't learn anything really new but, as discussed below, members of the management team are focused on redeploying capital in a more aggressive way than has been their practice in the immediate past. The office furniture industry is picking up steam and, given HNI's market-share increases over the past few years, the company's earnings prospects are very good. HNI is executing a well-planned retirement/succession for Jack Michaels, one of our favorite CEOs. He will remain Chairman of the Board, but he has been replaced as CEO by Stan Askren, who appears to come from the same mold.

We will likely see accelerated growth initiatives from HNI. The January acquisition of Paoli is performing above expectations, and the company just purchased a remanufacturer of office furniture that targets a large and fragmented (but very different) market within the office furniture industry. At current prices, we are content to hold our position.



Berkshire Hathaway (BRK.B)

The period of rapid growth of float in the commercial insurance industry is likely to dissipate, though strong underwriting performance should continue for a considerable period of time. That means businesses (current and future) other than insurance will have to keep BRK growing at an adequate rate.

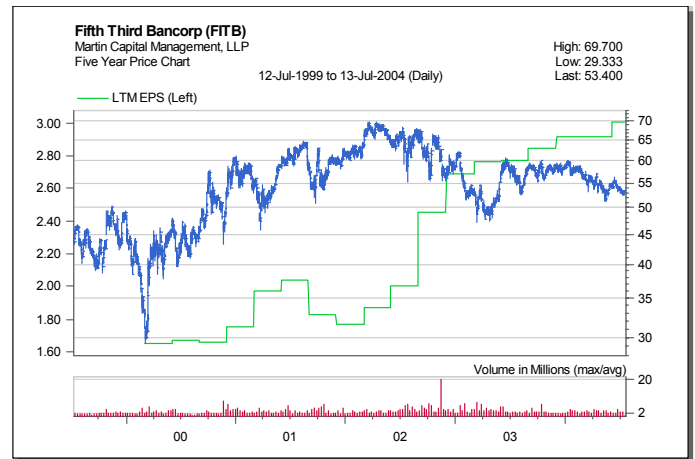


More so than with other companies, earnings progress is likely to be quite erratic. Buffett has plenty of capital

(nearly \$35 billion in cash) and an equal amount of patience. As such, earnings will increase dramatically when and if he's able to redeploy \$35 billion that is currently earning less than 1% after taxes. As we've said in the past, BRK acts as a kind of a hedge against adversity. The worse things get, the easier it will be to find a place for the \$35 billion.

Fifth Third Bancorp (FITB)

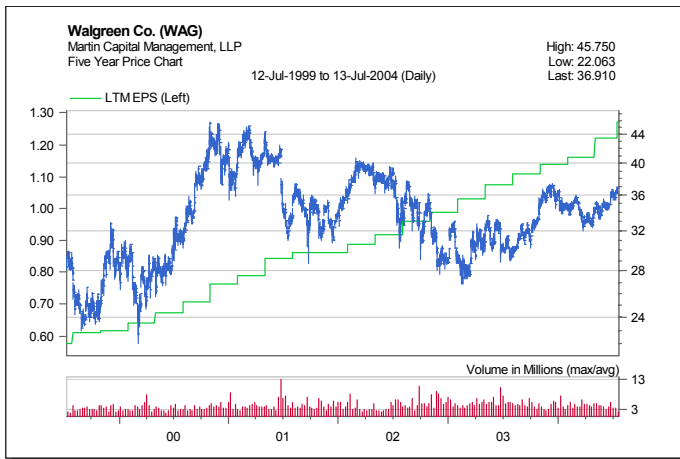
The foundation is being laid for more rapid growth for FITB. EPS growth has slowed to a low double-digit rate over the last several quarters. A number of things are coming together, however, that should accelerate earnings growth. First, the company has been released from its "written agreement" that prohibited it from making acquisitions. Indeed, the company recently closed on Franklin National Bank (Tennessee). In addition, given the strength in the economy, loan growth is sure to accelerate, and bad-debt expense will likely fall from an already low level. Finally, Fifth Third has positioned its balance sheet to benefit from higher interest rates, so interest margin should actually improve as rates move higher. We've been impressed by the company's reluctance to pay premium prices for large regional banking acquisitions and continue to believe that FITB is one of the premier financial institutions in the country.



Walgreen (WAG)

WAG continues to grow hand over fist. Same-store sales have been in the 9-11% range, driven by (1) very high same-store pharmacy sales (10-15%) and (2) a nice recovery in the "front-end," or non-prescription, business. Same-store sales should remain strong given the number of

new stores in the system that take a while to mature. After a few periods of slight margin erosion, the company saw a turnaround during its last quarter. Since faster-growing pharmaceuticals sell at lower margins than the front-end of the store, there is constant pressure on gross margins. Historically, expense leverage at the SG&A (sales, general and administrative) line has allowed operating margins to gradually improve. Offsetting the adverse mix shift (pharmacy growing faster than front-end) has been the substitution of generics for brand-name drugs. The company's negotiating power and the branded drug's pricing umbrella allow WAG to earn much higher gross margins (and gross dollars) even on the lower-priced generics. During the last quarter, there were more branded drugs that went off patent, which helped margins improve. WAG has been a growth machine, and we have little reason to believe that will change anytime soon.



Positions Sold

Merck (MRK)

Merck was sold because we could never be confident enough about its long-term earnings picture. We purchased the stock because we thought Wall Street overreacted to the steady stream of bad news coming from the company. We thought, and still do, that the probabilities favor an improved future research pipeline. The estimated probabilities, however, are iffy at best, which is why MRK never would have become a major position. In retrospect, even though we made a little money, we acknowledge that it was probably a mistake to have purchased it in the first place.



New Ideas

We continue to hunt for businesses that enjoy good economics and durable competitive advantages. Even though we eliminate many apparently good businesses from consideration due to uncertainty with regard to their business model or poor corporate governance, the major challenge is not finding good companies but finding them at sensible prices. New ideas that haven't yet been ruled out include Weight Watchers and Jacobs Engineering Group. Both of these companies have long histories of good growth and profitability but have experienced what could be temporary problems. In the case of Weight Watchers, meeting attendance has been affected by the low-carb craze, and Jacobs has had a few projects canceled or delayed. In any event, problems are usually associated with lower stock prices, which tends to get our attention.

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