

Quarterly Capital Markets Review

This, the first Quarterly Capital Markets report on the heels of the 2004 Martin Capital Management annual report, adds flesh to the bones of the words of caution offered little more than a month or two ago. As you will recall, we concluded that, at current prices, common stocks in today's investment environment, *in general and on average*, do not provide the compelling margins of safety that call us to action. Moreover, with a record 7,000 hedge funds with \$1 trillion in assets falling all over themselves sleuthing for pricing disparities and anomalies in the marketplace, the flattish market of the last year or so (S&P 500 was at 1126 on 3/31/04 and 1180 on 3/31/05) has spawned more yawns than mouthwatering opportunities. The lack of variation in the valuation of stocks is not only noticeable, it's conspicuous by its absence. While we do not forecast markets or individual stock prices, we would not be surprised (although we have no precise idea about when) if prices, again *on average*, regressed to the mean — and more than likely beyond. Such a decline would likely be meaningful enough to warrant our taking action in advance to minimize portfolio losses should that event occur.

The degree to which we are deemed genuinely conservative investors should be measured, we believe, in how well we protect your capital when stock prices retreat to a noteworthy extent. Because of the extreme bifurcation in the market in early 2000, our equities actually produced double-digit, compounded positive returns over nearly three years when the S&P 500 surrendered almost half its value from peak to

trough. No such two-tiered market exists today, practically regardless of asset class. There are few places to hide and fewer yet places to shop for investments that meet our 15% threshold rate of return. So, what's a conservative investor to do?

Obviously, the first action is to rid portfolios of holdings whose prices do not imply a significant margin of safety for the test that may lie ahead. Every holding whose price may depreciate materially — say, 50% — represents a reduction in available cash that we could've used to purchase it (or other more attractive candidates) at much lower prices if tomorrow's opportunity set proves more attractive than today's. To be sure, this is at best a highly inexact art/science. For example, it's impossible to know until well after the fact whether a downward move in a stock's price is what we call a "quotational loss" (reflecting nothing more than the natural and frequent tendency of stocks to fluctuate in sympathy with the never-linear markets' short-term trading pattern), or whether the drop represents something more serious, fomented by either adverse internal or external developments. Of course, we must do our best to reconcile the opportunities possibly forgone with the low returns available on cash today. This conundrum no doubt explains the widespread reluctance of most investors to become proactive in preserving capital. "Why should I liquidate equities from my portfolios when the returns on alternative investments are so low?" is a common refrain we hear. That kind of reasoning, however, does not pass the rationality test — in our judgment.

Second, the flattish market described above has actually provided us with a relatively low cost alternative that allows us to very roughly immunize our equity holdings against the aforementioned risks. Before explaining the alternative, we recognize that while many of our clients are familiar with put and call options, some are not, and a brief explanation therefore follows. An American-style call option on a stock or index gives the buyer the right to purchase the option at a set price during a set period of time. A put option is a bit more complex, allowing the buyer of the put option to force the seller to buy the stock or index from him at a predetermined price prior to the predetermined expiration date of the option. Call options are generally purchased with the expectation that the price of the asset in question will subsequently rise. Put options, conversely, are acquired to capitalize on falling prices. Options can be purchased for a variety of reasons, the most conservative of which is to purchase put options to ensure a position or portfolio against loss in a declining market.

It's also important to know that for every option buyer there must be an option seller. The premium or price paid for the option is a function of a number of variables and is ultimately determined by the interaction of the buyers and sellers in the marketplace. One of the major determining variables is the market's expectation of the future volatility of the asset in question. This brings us back to the rather unspectacular market environment during 2004. As a result, option premiums are near 20-year lows. In the more volatile markets of several years ago, premiums for identical options were often more than twice the price of current options. The rearview-mirror investment mentality seems to apply in the option market, like most of the markets. What we do know is that we can purchase a rather imprecise form of portfolio insurance at comparatively low premiums. The success we might have in anticipating outcomes, a risky venture at best, will largely determine how well your portfolio is protected. Although there are a number of outcomes that could be considered ho-hum, if sweeping losses in the stock market occur within the timeframe of the options, we think we are reasonably well, but not totally, protected.

In the meantime, should prices continue upward, our upside will not be significantly truncated, to the extent that our companies participate. Our overall returns under that scenario will, of course, be reduced by the premiums

we paid for the insurance that proved in the end not to be needed.

Equity Holdings Review

First-Quarter Performance

As you can see from the table below, the performance of our equity holdings did slightly better than the indices during the first quarter. A maturing profit cycle, higher gasoline prices, and rising interest rates were often mentioned as issues negatively affecting the market. There will always be contemporaneous "explanations" for the markets' behavior at any given point in time. By serious investors, these should be considered short-term noise. We will continue to focus on the progress of our portfolio holdings as businesses.

	<u>1st quarter</u>	<u>Year-to-date</u>
S&P 500	-2.1%	-2.1%
NASDAQ	-8.0%	-8.0%
Dow Jones	-2.1%	-2.1%
MCM equities*	-1.4%	-1.4%

**net of fees*

Business Updates

We were generally pleased with the earnings performance of our portfolio holdings during 2004. Last year we said we wouldn't be surprised if the earnings from our holdings surpassed the 21% reported during 2003. Indeed, earnings growth was slightly better than 22% during 2004. As was the case in 2003, some of the earnings advance was still the result of some recovery from the recessionary-level earnings trough of 2002.

As was discussed in this year's annual report, our investment results (total return) in 2003 far exceeded the growth in intrinsic value of our investments. The opposite was true in 2004. Growth in intrinsic value exceeded, by at least several percentage points, our actual investment results. At this time last year, we said many of our holdings were no longer cheap. Currently, we feel better about the overall valuation of our portfolio holdings. While we can't claim to have a portfolio full of bargain stocks, they seem reasonably priced and the valuations are more favorable than they were at the same point last year. Moreover, we think the earnings of our portfolio holdings will continue to grow at a good clip. How this translates into investment return, however, is

anyone's guess. As the introductory comments made clear, we continue to expect headwinds until the overall market valuation becomes more conducive to a long-term buy-and-hold strategy.

Dollar General (DG)

DG made good progress during 2004. Square-footage growth increased roughly 9%, and comparable store sales increased 3.2%. This performance surpassed nearly all of the discount-store competitors. Gross margin increased modestly during the year but was more than offset by higher operating expenses associated with heavy investments in store operations. EPS increased 13%.

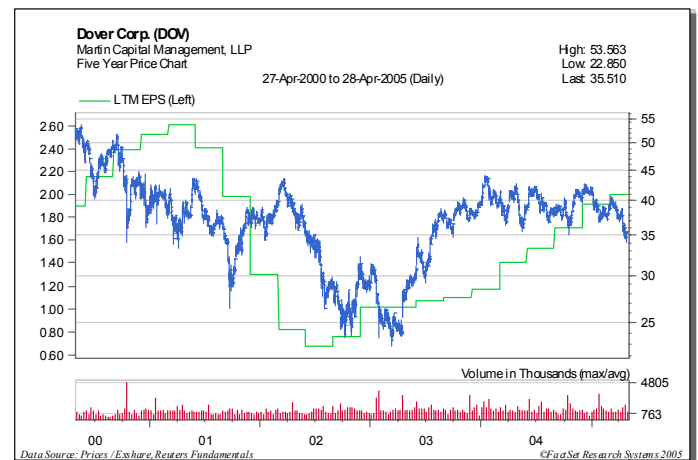
The discount-store channel did not perform as well as the retail channels that serve the middle and upper classes of our society. While the unemployment rate improved across the country, it remained stubbornly high for those with only high school or less educations. The "gasoline tax" has an outsized impact on the lower economic tiers of society. Nonetheless, we believe that the lower-income classes will continue to increase and embrace Dollar General's positioning as a convenient and price-competitive retailer.



We're optimistic about DG's prospects for 2005. Many of the investments made during 2004 that held back results are likely to be contributory in 2005. Efforts to improve store manager training, logistics, electronic payments, and merchandising, along with continued 9 to 10% square-footage growth should continue to propel earnings growth during 2005 and beyond.

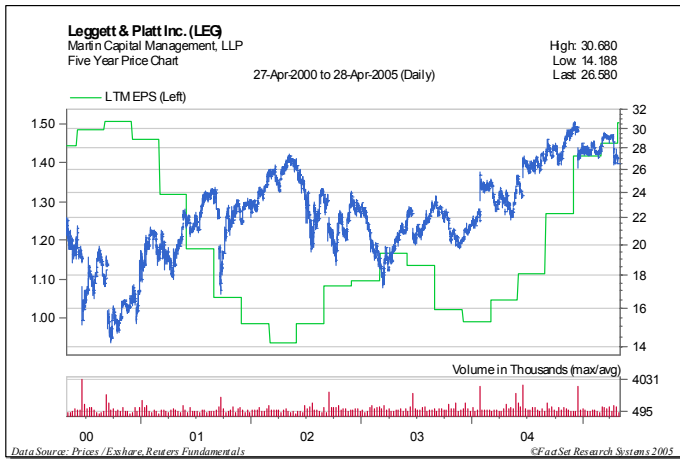
Dover (DOV)

Dover continued to report much-improved results during 2004. EPS increased more than 40% from the depressed levels of 2002 and 2003. Even so, the pace of recovery has been somewhat disappointing. Perhaps more problematic over the long term is what appears to be reduced opportunities for reinvested capital. Acquisitions have become more expensive and, therefore, the return on invested capital is likely to fall over time. Given the recovery in the stock price over the last two years, we have opted to reduce our holdings at these levels.



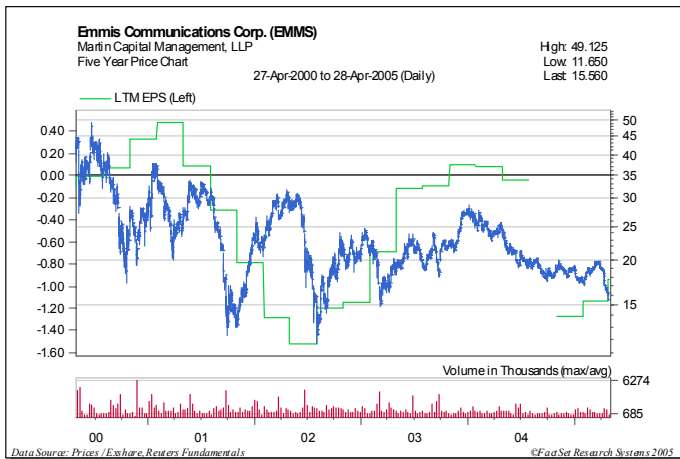
Leggett & Platt (LEG)

What was said about Dover can be dittoed for LEG. The company has a long and proud history of growth that came to end during the last five-year stretch. The problems are twofold. First, the company invested roughly \$1 billion in capital in the commercial fixtures division that has not come close to earning an economic return. Second, as is the case with Dover, the opportunities for reinvested capital are scarce. It's possible that both of these negatives could prove to be temporary, but given the appreciation of the stock, we have chosen to wait for an opportunity where we can be more confident of future growth. The position, with few exceptions, has been sold. These decisions are always difficult because we are very fond of the people who run the company.



Emmis Communications (EMMS)

Emmis has grown its earnings at a very acceptable rate over the last few years. By and large, the company’s radio and television stations have witnessed increased audience levels (ratings) that helped the company

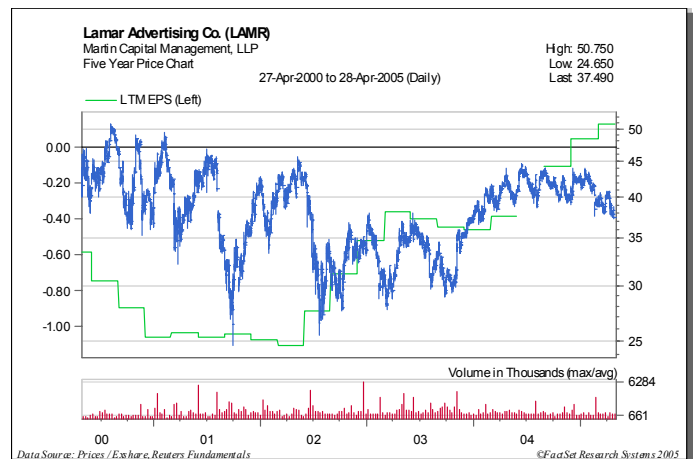


outperform its competitors. The stock price, on the other hand, tells a different story. The radio industry has been dogged by threats from satellite radio, Internet radio, iPods, and other alternative music channels. We aren’t dismissive of any of these threats but are rather convinced that the threats are exaggerated, particularly over the short to intermediate timeframe. We believe that the root of the trouble in the radio industry has been self-inflicted. Over the last few years, too many radio stations adopted bland programming and increased the number of commercials. This has led to the slowest period of growth the industry has experienced in a number of years. Radio stocks, which have historically traded at relatively rich multiples, cratered during 2004.

It has been a long time since Emmis has traded at a rich multiple (the stock sold for \$60 in early 2000). We believe that the current stock price is well below any reasonable approximation of private market value. Emmis did not commit the same mistakes that other larger radio companies were guilty of. As such, it has been one of the few radio companies that has been able to increase advertising rates. Emmis has an impressive legacy of excellent station management, and we believe that the CEO is more determined to unlock the value of its media properties. Stay tuned!

Lamar Advertising (LAMR)

LAMR continues to generate acceptable levels of earnings growth (+15% last year). Billboard occupancy and pricing continue to improve, which should provide a nice tailwind for earnings over the course of the year. The billboard industry is unique within the media world in that it has been largely unscathed by technological change and audience fragmentation. The number of eyeballs that see a billboard increases at a rate that reflects population growth and increased driving. Billboards, because of the relatively limited media capability (no sound or video), are the cheapest form of advertising in terms of cost per thousand. It also has lacked demographic information that is important to advertisers. Both of these are beginning to change. Rating agencies have begun to collect demographic information in select markets, and that should increase the value of billboard advertising. Second, and of lesser significance, is the increasing use of digital billboards, which enjoy wonderful economics, but many communities are concerned with the potential distractions for drivers.

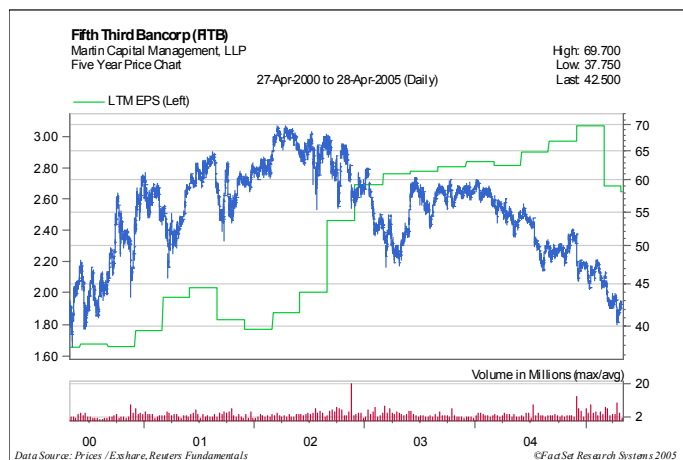


In any event, Lamar is a very well-run company in a highly profitable industry. The biggest challenge for the management team will be in redeploying the prodigious cash flow the company generates. We remain optimistic about the prospects of Lamar.

Fifth Third (FITB)

FITB was probably our biggest disappointment during 2004. The business performance was less than satisfactory, and the stock suffered accordingly. In the spirit of full disclosure, we are still evaluating the degree to which the management team at FITB should be held accountable for the lackluster results. An explanation follows.

FITB possesses three distinct competitive advantages that we still believe are important and sustainable. First, the company has one of the lowest overhead rates in the banking industry as reflected by the so-called efficiency ratio. Second, FITB has a unique and low-cost mix of funding costs as reflected in an unusually high percentage of demand deposits and other low-cost, transaction-oriented deposits. Finally, the company has a sales-oriented culture that is defined by rigorous accountability and flexibility.



There is no question that the unique interest-rate environment that was encountered as we entered 2004 presented special challenges for FITB. In effect, the competitive advantage of having a large proportion of low-cost deposits became less valuable, if not problematic, as interest rates fell. Since transaction accounts pay lower rates to begin with, as rates fell FITB hit a floor (close to zero) in how far the bank could lower its funding cost even as its asset yields (72% of the loan

portfolio reprices in less than a year) fell. The result was a contraction in the net interest margin that was more conspicuous than the rest of the banking industry, which has a different (and more expensive) funding mix. The FITB management team can hardly be held culpable for this reality.

The management team's response to this reality is more open to debate. FITB has always maintained a stellar balance sheet in terms of capital structure. During this period of time, a strong equity ratio became even more pronounced, and even conservative types would have considered the bank overcapitalized. Our opinion is that the bank chose to use the excess capital by engaging in what is known as the "carry trade." The bank borrowed money to buy securities. While the interest spread was much narrower than the spread between deposits and loans, we estimate that this activity added roughly \$400 million in net interest income on a pretax basis. Earlier this year, as rates began to rise, the "problem" of lower rates began to dissipate, and the company unwound the carry trade at a cost of \$400 million.

Whether it was wise to engage in the carry trade is debatable. While the numbers seem large, one must keep in mind that this is a \$100 billion bank, and in no way did management put the company's strong capital position at risk. In the end, the carry trade didn't generate any large profits or losses in the aggregate. Compounding the issue of the carry trade was the bank's purchase of First National Bankshares of Florida. While it may make strategic sense, it was acquired at an uncustomarily high price. If the Florida operation continues to grow at past rates, it will justify the purchase price, but that is far from certain.

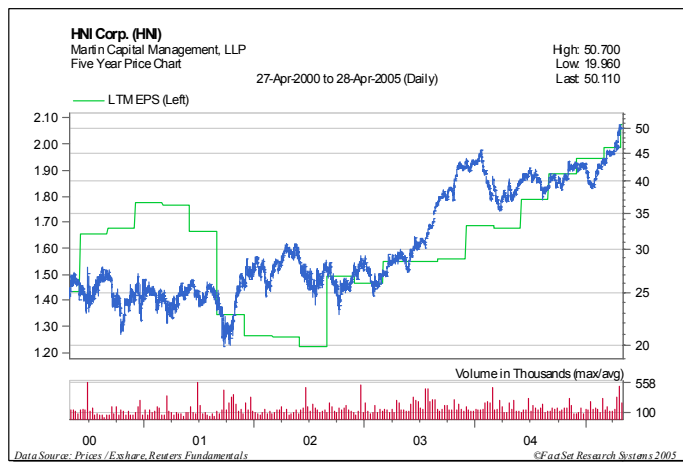
In the end we still believe that FITB's competitive advantages are sustainable and will drive superior results well into the future. Strong loan and deposit growth, which continues, corroborates this view. We hope, however, at this time next year we'll have clear-cut praise for the management team and the performance of the bank.

Hon Industries (HNI)

HNI performed well in 2004. The company's office furniture division executed admirably in what was still a relatively soft market. The hearth division results were exceptional, driven in part by a stiff tailwind of record

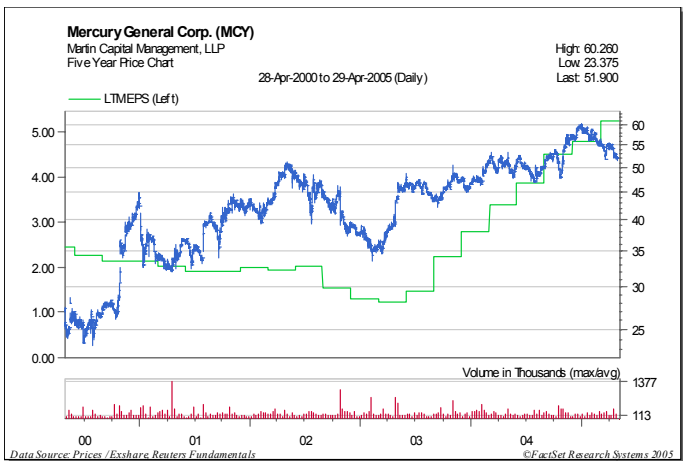
housing starts. Both divisions were significantly impacted by higher raw-material costs.

While we admire this company, the stock price became more richly priced over the course of the year. We have been reducing our position, but the lack of trading volume has hindered our progress. A deal to sell our shares back to the company remains hung up in technical details unrelated to the economics of the arrangement. We will continue to try to reduce our holdings at current prices.



Mercury General (MCY)

It has been a while since we have purchased stock in this company, so not all clients own this security. If the impending softer business environment for auto insurance offers us a chance to buy more of Mercury (or Progressive, for that matter), we will certainly take advantage of any such opportunity. Earnings have exploded at MCY over the last few years. Indeed,

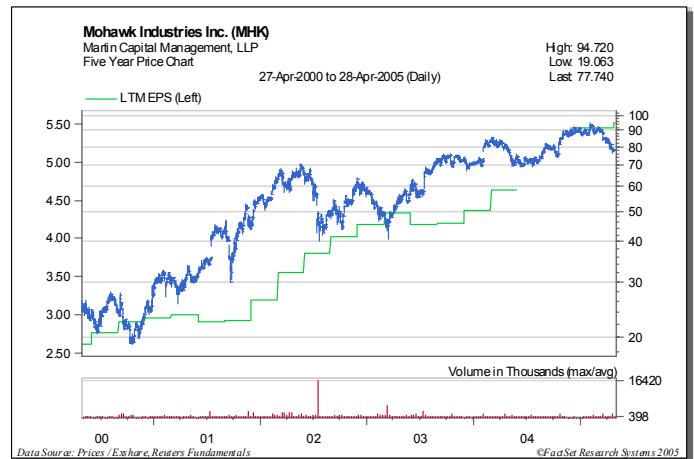


margins are currently unsustainably high. We have held onto the stock because of the company’s ability to expand outside of its home state of California. There is plenty of room for further growth.

Mohawk (MHK)

EPS grew 18% last year in an industry environment that was more mixed than many people realize. While new residential construction was strong, the other two important end markets (commercial construction and repair/remodel) did not get much traction until later in the year.

The changing industry structure of the floorcovering business manifested itself in 2004. Mohawk and Shaw have cut out the wholesale layers of distribution as they consolidated the industry and now control much of the value chain in the floorcovering industry. This allowed industry leaders to pass along raw-material price increases (most of the raw materials for carpet are petroleum-based). Indeed, there were four carpet price increases during the year. In spite of rising raw-material costs, MHK’s gross margin actually increased modestly last year.



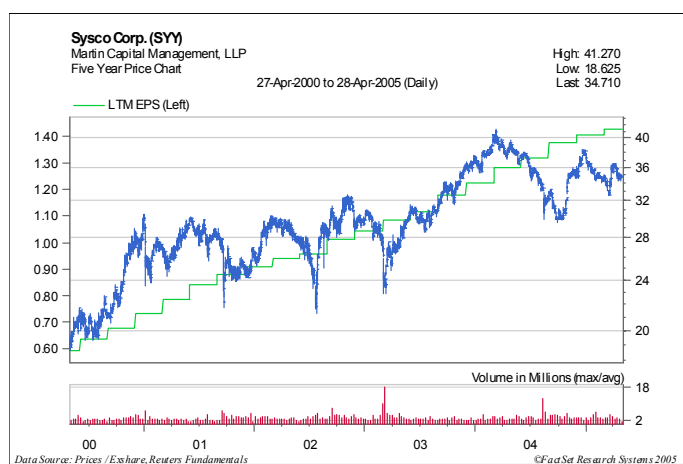
MHK’s earnings progress will not be straight-lined. The company is sensitive to economic developments. We believe, however, that margins can increase (especially at the Dal-Tile division), and the company will continue to grow over the long term.

Sysco (SYF)

Sysco is the dominant force in the food-service business. The company managed to grow earnings 17% last year in

spite of lackluster growth in many of its markets. The business of supplying “away from home” eating establishments is a highly fragmented industry. Sysco has the largest market share at 14%, followed by United Foodservice (a division of Ahold) with 12%. The third-largest competitor is substantially smaller. Significantly, United Foodservice, to put it charitably, is a mess. It is a product of a poorly executed acquisition strategy where the operating subsidiaries have not been consolidated. As a result, they have not been able to generate economies of scale remotely comparable to Sysco.

Sysco continues to invest in ways that enhance its competitive advantage. The company has started a program to reinvent its entire logistics system. SYO is converting from 140 distribution centers (each profit and sales center has its own warehousing capability) to a regional structure. This new structure will lead to lower total inventories and reduce the cost of goods sold, as the vendors achieve the savings that full truckload deliveries offer. We look forward to continued growth at this company.



Walgreen (WAG)

Walgreen keeps growing at a mid-teens rate. New-store openings and market-share increases, especially in pharmaceuticals (irrespective of the growth of mail order), are driving the growth. Walgreen dispenses more prescriptions per store per day (by some margin) than any other pharmacy retailer in the United States. The company has invested in convenient locations in the faster-growing parts of the country. Its growth, however, comes at a high price. The average Walgreen store takes 4-5 years to achieve break-even results. This is a level of

investment that few competitors are willing or able to make. Still, the company has the best returns on capital in the industry, even after absorbing the substantial costs of new-store openings.

These costs are also a source of future growth and profitability. As the stores mature, earnings improve dramatically. That is but one reason we're confident in the future growth rate of this first-rate retailer.



New Ideas

We have never been busier in our quest to find new opportunities. We are currently looking at businesses that are involved in commercial fleet transaction processing (fuel cards and the like), computer/electronics wholesale distribution, insurance brokerage, water purification/processing, specialized software, medical waste disposal, student loans, veterinarian supplies, and a host of others. We'll keep you updated.

Fixed-Income Strategy

The rise in interest rates is a happy occasion for MCM clients, whereas this development elicits the opposite response among most fixed-income investors. As interest rates rise, bond prices fall. We've kept our portfolios very short for the last few years, unwilling to invest capital in long-term bonds at relatively low rates. As a result, we can actually celebrate, at least for a time, the enhanced returns now available. We still aren't enthusiastic about long-dated maturities, but we've begun to move out beyond three- and six-month Treasuries. In fact, we're moving out into the two- and three-year range

and have included, at least for some clients, inflation-indexed bonds. Fixed-income portfolios tend to be unique to each client, so please call us if you have questions.

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