Third Quarter, 2012

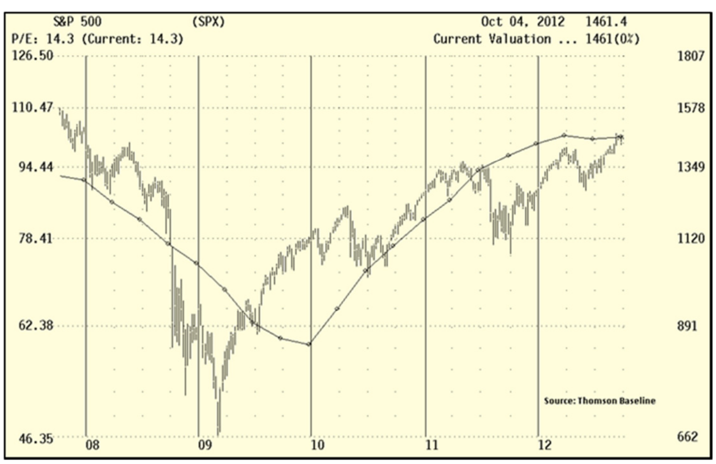
Summary
The S&P 500 Index finished September at its highest level since 2007. Intra-quarter, both the S&P Mid Cap 400 and the S&P Small Cap 600 indices established all-time highs. For the quarter and year-to-date, respective total returns were as follows: S&P 500, 6.4% and 16.4%; S&P 400, 5.4% and 13.8%; and S&P 600, 5.4% and 13.8%.

The last twelve months have marked material positive shifts in domestic, traditionally "early cycle" businesses that did not rise earlier in the recovery. For example, retail sales and existing home sales advanced 4.7% and 9.3%, respectively, through August (year-over-year basis). Other domestic improvements can be found in higher construction spending, building permits, the National Federation of Independent Business (NFIB) Small Business Optimism Index, and The American Institute of Architects' Work-on-the-Boards Survey.

The Federal Open Market Committee (FOMC) extended its Federal Funds Rate target of 0.0%-0.25% to at least through mid-2015. According to Federal Reserve Chairman Bernanke, *"This is a Main-Street policy because what we're about here is trying to get jobs going. We're trying to meet our maximum employment mandate."*

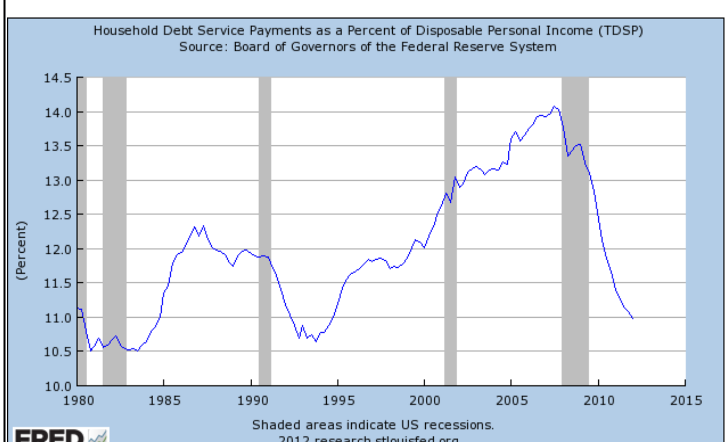
Over the course of the S&P 500 Index's upward progression from March 2009, mutual fund investors have steadily been exiting domestic equity funds, according to the Investment Company Institute. Conditions for a potential rebalancing into equities appear favorable, but stability in corporate earnings will be critical. Barring a collapse in earnings, we believe that equities remain attractive long-term, particularly when compared to other asset classes.

Against the Storms
Even as concerns mounted over the litany of world problems and uncertainties – the financial crisis in Europe, mounting tensions across the Middle East, slowing growth in Asia, stubbornly high unemployment in the U.S., the upcoming presidential election, etc. – the S&P 500 Index finished September at its highest level since 2007. Intra-quarter, both the S&P Mid Cap 400 and the S&P Small Cap 600 indices established all-time highs. For the quarter and year-to-date, respective total returns were as follows: S&P 500, 6.4% and 16.4%; S&P 400, 5.4% and 13.8%; and S&P 600, 5.4% and 13.8%. International markets fared well also, with the MSCI All-Country World Index ex USA (net) advancing 7.4% QTD.



Since the beginning of the current economic recovery, now in its fourth year, terms such as "muted", "below-average", and "sub-par" have accurately described the slow pace of economic improvement and growth. U.S. unemployment, for example, has remained above the 8% mark for 44 consecutive months, the longest streak since 1948. Unemployment across the 17 countries that constitute the Eurozone remains at 11.4%, the highest since the euro was created in 1999. Alarmingly, unemployment rates are 10.7% in Italy and 25.1% in Spain. With 20% of China's exports and 30% of emerging market exports destined for Europe, the sustained weakness in European demand has created knock-on effects around the globe. Deleveraging here at home and calls for austerity abroad exacerbate these trends.

U.S. consumers have demonstrated a startling commitment to debt reduction over the last five years. Presently, household debt service payment as a percentage of personal income has dropped to 10.98%, the lowest level since 1994. By comparison, U.S. government debt has surged by more than 50% over the same timeframe. However, the pace of the public sector's contribution is slowing. In fact, Federal, state,

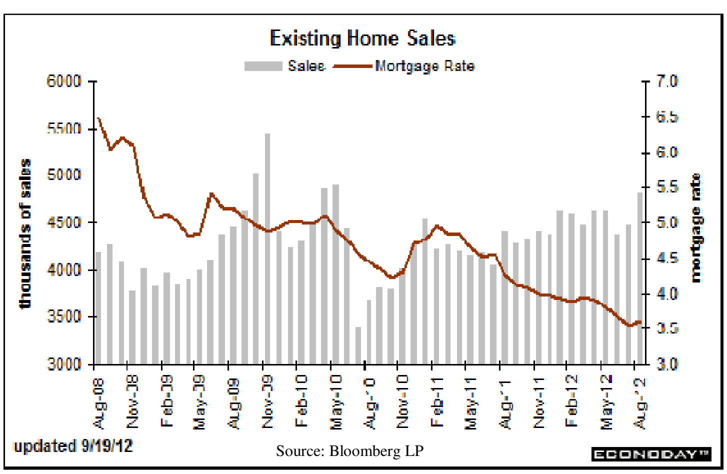


and local government consumption expenditures - which exclude social security and health care transfer payments - now have declined for eight consecutive quarters. This trend, along with deleveraging in the private sector, partially explains the duration of the "sub-par" recovery, the current weakness in real Gross Domestic Product ("GDP"), and the high rate of unemployment. Given the general concern over the national deficit and debt, the inability in Washington to compromise on logical steps forward, and weakness abroad, the U.S. economy may continue to drag anchor for a while yet.

Current Economic Trends

Not all the economic news has been bad. U.S. manufacturing, in particular, has been a strong contributor to economic growth since 2009. Early in the recovery, export orders were the key driver to U.S.-based manufacturing strength, while domestic growth suffered under the overhangs of excessive consumer debt, a bulge in "for sale" housing inventory, an impaired auto industry, slow retail growth, and generally weak confidence and demand. Even with the weakness here at home, international orders were enough to push manufacturing, as measured by the ISI Manufacturing Index, up from a twenty-year low into expansion mode. By early 2010, U.S. manufacturing job growth had resumed. Although the manufacturing index has contracted in 2012 amidst European financial stress, data from the last 30-60 days provide some indications that new orders may be expanding domestically.

Additionally, the last twelve months have marked material positive shifts in domestic, traditionally "early cycle" businesses that did not rise earlier in the recovery. Retail sales, for example, rose 4.7% (year-on-year basis) through August, largely driven by gasoline expenditures, auto sales, and respectable back-to-school sales. North American autos sales, in fact, are on track to surpass the annualized 15 million units per month mark, representing a dramatic increase from the 9.6 million unit rate of January, 2009. Housing trends appear to be strengthening as well. Existing home sales advanced 9.3% year-over-year in August, just slightly down from a strong 10.4% increase in July. The tightening supply inventory in "homes for sale" also suggests improvement. Other domestic improvements can be found in higher construction spending, increases in new home sales and building permits, another uptick in the NFIB Small Business Optimism Index, and improvements in The American Institute of Architects' Work-on-the-Boards Survey. Collectively, these trends reflect improving consumer confidence.



Source: Bloomberg LP

Still, significant economic headwinds persist. Declining global growth will remain a drag on exports. Fiscal contraction and/or reduced levels of stimulus emanating from Federal, state, and local governments will negatively affect real GDP. Between now and the presidential election in November, meaningful initiatives from Washington will be scarce. And, post-election, the fight over the "fiscal cliff," meaning the range of temporary tax-break expirations and government spending cuts that will ensue if no action is taken before year-end, promises to be contentious. Not surprisingly, corporations already have expressed trepidation over making long-term capital spending and hiring decisions when the short-term appears uncertain. Thus, the potential for weakening an already fragile recovery exists.

Financial Conditions/Monetary Trends

Less than eighteen months ago, most emerging markets were attempting to restrain growth and fight rising material and import prices, with many raising interest rates and restricting the inflow of foreign capital. Today, nearly every country and central bank in the world is embracing dovish monetary policy, and most have flip-flopped on fiscal policy as well. From Australia to China to the Czech Republic, interest rates have been cut. China's monetary base reportedly has been growing of late at a 13.5% annual rate; additionally, bank reserve requirements have been lowered. The Bank of Japan recently expanded it asset purchase program in an attempt to prompt more money to flow through its economy. In Europe, the ECB Bank President, Mario Draghi, unveiled the "outright monetary transactions" (OMTs) plan, aiming to cut the borrowing costs of debt-burdened Eurozone members. He also declared that the ECB "is ready to do whatever it takes to preserve the euro." In sum, world leaders are desperate to prime the pump for domestic growth in their respective home countries or economic blocs.

In the U.S., the FOMC announced a third round of quantitative easing. The Fed's plan, referred to as "QE3", will purchase mortgage-backed securities, injecting up to $40 billion per month into the economy – with no end-date presently specified. Additionally, the FOMC extended its Federal Funds Rate target of 0.0%-0.25% to at least through mid-2015. According to Federal Reserve Chairman Bernanke, *"This is a Main-Street policy because what we're about here is trying to get jobs going. We're trying to meet our maximum employment mandate."*

Someday, interest rates must rise and stimulus be withdrawn. We do not see either outcome as likely in the near future.

Sentiment Indicators/Market Trends

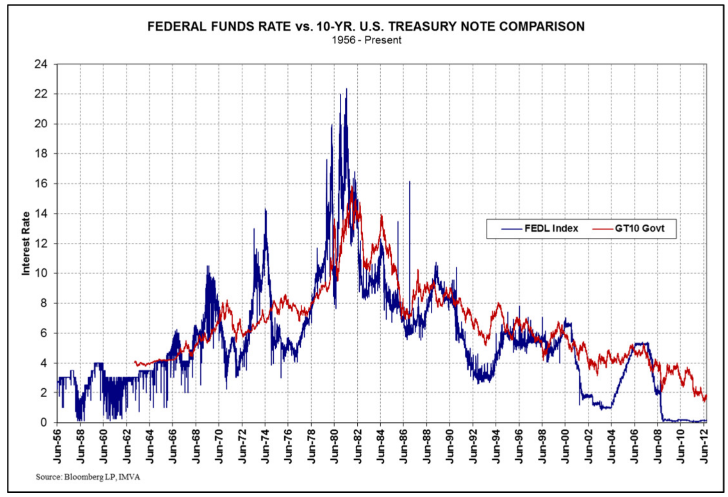
Over the past several years of this recovery, the markets repeatedly have danced between extreme optimism and extreme pessimism, often spending little time in between. When the headline news is good or improving, the "risk on" market prevails. When the headline news is less sanguine, the "risk off" market takes back the gains. Although some ebb and flow is the natural state of the markets, the volatility of the swings has been exceptional during this recovery.

Presently, our sentiment and market trend indicators have moved or are moving in the direction of short-term over-bought conditions. Bullishness is rising, put-to-call ratios have normalized, and volatility indexes appear complacent. Accordingly, we suspect that equity markets could be choppy over the short-term. We again caution that these are short-term measures of risk expectations, not market timing tools.

Equity Market Valuations & Earnings

In the U.S., corporate earnings growth is slowing, and profit margins likely have peaked in many cases. Generally, this path of corporate earnings and margin growth would be typical of the fourth year of a recovery cycle. According to Standard & Poor's, the S&P 500 companies, excluding financial institutions and utilities, held near record levels of cash, totaling $1.01 trillion, earlier in 2012. Presently, corporate balance sheets appear to be sound and reflect high potential/flexibility for investing in growth or weathering a downswing. With the S&P 500 Index trading at 14.2 times trailing earnings, valuations are not as compelling as they were mid-year; still, present valuations fall in the mid-range of historical norms. In this environment, thoughtful stock selection, based on identification of superior earnings and sales growth is critical.

Interestingly, and perhaps perversely, over the course of the S&P 500 Index's upward progression from its March 2009 low of 676.53 (now roughly 1460), mutual fund investors have steadily been exiting domestic equity funds, withdrawing some $343 billion, as of September 19, 2012, according to the Investment Company Institute. Over the same period, total inflows to bond mutual funds exceeded $931 billion. As interest rates dropped to sixty-year lows, early bond investors generally have done very well. Looking ahead, numerous veteran bond managers are cautioning that bond market conditions today reflect the mirror image of those three decades ago, when long-term interest rates peaked. Other sources note that, in addition to retail investors' flight from equity mutual funds, many institutional investors, namely, endowments and pension funds, are materially underinvested in equities. Conditions for a potential rebalancing into equities appear favorable, but stability in corporate earnings will be critical. Barring a collapse in earnings, we believe that equities remain attractive long-term, particularly when compared to other asset classes.



Conclusion

Clearly, the world is on course to reflate. In the U.S. financial system alone, Money of Zero Maturity (MZM) is approaching $11.2 trillion, and it is earning a zero to near-zero percent interest rate. To some extent, the Fed's projected plan of raising wealth through growth in asset values (including stocks) is working. With an apparent turn/advance in domestic growth and home valuations, improvements in the Wealth Index are broadening. The true tests, from this point forward, will rest in the economy's ability to 1) stave off another severe down-turn, 2) generate real and sustainable growth, and 3) avert excessive rises in long-term inflation. In any case, absent a recession, equities are a favored investment asset class in this environment.

For an in depth review of our Market Pillars and Charts, visit: http://www.imva.net/market-pillars/.

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