

Virtus Multi-Sector Short Term Bond Fund

What factors have contributed to the weakness in fixed income spread sectors over the past two months?

We believe that the primary factors causing a sell-off across fixed income spread sectors are largely macro concerns, including:

- > European sovereign debt concerns
- > Heightened concern over the U.S. and global economic trajectory
- > Concern that the U.S. is entering another recession

These macro concerns have contributed to technical weakness in some sectors of the bond market.

How has this affected the Virtus Multi-Sector Short Term Bond Fund?

The weakness in spread sectors has had a negative effect on the Fund's performance during the last two months, as our investment in spread sectors has weakened along with the market. Even the higher quality bonds within sectors on which the Fund focuses have weakened along with lower quality spread product.

The Fund has added high quality issues in spread sectors during the year, at spreads wider than their historical long-term averages. However, spreads have continued to widen, further disconnecting from the fundamental value of the asset. This selling pressure has been especially pronounced in the high yield bank loan and corporate high yield sectors.

In this type of environment, we will continue to favor fundamentally sound spread product at attractive valuations that we believe will perform over time.

How would you characterize the current fundamentals within the fixed income market compared with what spreads are implying?

Overall fundamentals are much stronger than current spread levels imply. In the investment grade corporate sector, technicals remain supportive as issuance is expected to decline in 2011 from 2010 levels. Additionally, fund flows and demand from insurance companies and pension funds remains strong. Valuations remain attractive both in historical context and on a risk-adjusted basis; however, the eurozone crisis and historically low corporate yields are current headwinds to broad-based spread tightening. Also of note, the spread-per-leverage ratio, a measure of how much you are getting paid for the amount of debt a company has, is well through the 2002 peak of 105 basis points (bps) at 112.5 bps currently; however, this is not nearly as high as the 2008 level of 240bps/unit of leverage.

Within corporate high yield, spreads are currently at 736 bps, telling a compelling valuation story at this stage of the credit cycle. Fundamentals continue to improve as gross leverage continues to trend lower to 3.8x from a recent peak of 4.5x. Net leverage is close to historical lows (3.3x vs. 3.7x average) as corporations continue to maintain high cash balances on their balance sheets (12% cash/debt ratio). The ratings agencies have recognized the fundamental improvements in high yield issuers; there have been 231 upgrades vs. 147 downgrades so far in 2011. Additionally, according to Moody's data, default rates decreased to 1.9% in July. The default rate is expected to end this year at 1.5% and then rise slightly to 1.8% in the next twelve months, according to the Moody's forecast, which is well below the historical average of 4+%.

Within the high yield bank loan sector, the loan market is pricing in a 70% chance of recession at a spread of LIBOR +844 bps, according to JP Morgan. Current spreads price in a default rate of roughly 14%, which is about nine times the current 12 month trailing default rate. Defaults are running at approximately 1.2% as of the end of July versus the long-term average of close to 4% and are expected to remain in the 2-3% range over the next 12 months. Under recessionary conditions, the default rate is projected to be closer to 5%. Either way, spreads have overshot the expected default rate for the bank loan market.

SYMBOL (CUSIP)

A: NARAX (92828R644)
 C: PSTCX (92828R628)
 I: PIMSX (92828R610)
 T: PMSTX (92828R594)

INVESTMENT PROFESSIONAL

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 Multi-Sector Fixed Income Strategies
 Industry start date: 1985
 Start date with the fund: 1993

The Virtus Multi-Sector Short Term Bond Fund seeks diversification with an emphasis on maintaining low volatility and overall short duration by investing in higher-quality, more liquid securities across 14 bond market sectors.

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How has the Virtus Multi-Sector Short Term Bond Fund Performed Following Periods of Prolonged Spread Widening?

Historical data shows that the Fund has performed well coming out of periods when spreads are at wide levels.

During 2007-2008, fixed income spread sectors significantly underperformed U.S. Treasuries, as the subprime mortgage market meltdown and subsequent credit crunch led investors to seek the shelter of U.S. government debt. In 2009-2010, as liquidity returned to the market, spread sectors significantly outperformed Treasuries, and the Fund's performance benefited from its overweight to spread sectors.

In 2002, many fixed income spread sectors significantly underperformed Treasuries as sectors saw spreads widen due to high default rates, accounting scandals, and an uncertain economic and geopolitical outlook. In this environment, corporate credit underperformed, as it did in 2007 and 2008. However, the following two years after the significant spread widening of 2002, the Fund performed well. Similar to the second half of 2007 and 2008, in 2002 the Fund took advantage of widening spreads in many sectors to buy undervalued assets. Looking at another period, the Fund generated strong performance in the three years after the Long Term Capital Management debacle in 1998. We believe that our value approach to investing—overweighting undervalued sectors and underweighting overvalued sectors—will continue to be a successful strategy.

How is the Current Situation Different Than 2008?

2008 was a crisis of the financial system. Currently, spread widening has resulted from macro issues, such as European sovereign concerns, global growth concerns, and the possibility of the U.S. entering another recession, which have led to negative technical conditions. Overall, market technicals are in much better shape currently and corporate liquidity is in much better shape, relative to 2008. The composition of issuance since 2008 has been more focused on refinancing and the maturity wall has been pushed out with minimal debt maturities over the next 18 months. New deals in the prior cycle were more levered than the last two years as the excesses of the market are much more limited due to the shortened cycle.

How is the Fund Currently Positioned?

The Virtus Multi-Sector Short Term Bond Fund continues to maintain an overweight to spread sectors, and continues to focus on holding the highest quality within sectors, selectively adding BB-rated corporate high yield, high yield bank loans, and high quality structured product (i.e. CMBS, RMBS, and ABS). We also anticipate keeping powder dry, i.e. keeping cash and/or Agency mortgage backed securities on hand for future purchases as the markets stabilize. We will continue to look for opportunities, however we remain cautious about buying certain bonds until bid-ask spreads further tighten.

Annualized Performance Class A as of 6/30/11 in percent

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 7/6/1992	
NAV	1.38	3.40	9.65	8.80	6.60	5.96	6.26	<i>QTD, YTD and 1 Year performance is not annualized. Benchmark since inception performance is reported from 6/30/1992. Class A operating expenses are 1.07%.</i>
POP	-0.90	1.08	7.18	7.98	6.11	5.72	6.13	
Index	1.06	1.87	4.42	5.35	5.33	4.79	5.67	

Average annual total returns reflect the change in share price and the reinvestment of all dividends and capital gains. Net Asset Value (NAV) returns do not reflect the deduction of any sales charges. POP (Public Offering Price) performance reflects the deduction of the maximum sales charge of 2.25%. A contingent deferred sales charge of 0.50% may apply on certain redemptions made within 18 months following purchases on which a finder's fee has been paid.

Performance data quoted represents past results. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate so your shares, when redeemed, may be worth more or less than their original cost. Please visit Virtus.com for performance data current to the most recent month-end.

Notes on Risk: As interest rates rise, existing bond prices fall and can cause the value of an investment to decline. Changes in interest rates will affect the value of longer-term fixed income securities more than shorter-term securities. Investing in high yield bonds may subject the portfolio to greater credit and market risks. Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic and market risk. The principal on mortgage- or asset-backed securities may normally be prepaid at any time, which will reduce the yield and market value of these securities.

Index: The BofA Merrill Lynch 1-2.99 Year Medium Quality Corporate Bonds Index measures performance of U.S. corporate bond issues rated BBB and A by Standard and Poor's with maturities between one and three years. The index is calculated on a total return basis. The index is unmanaged and not available for direct investment.

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