VIRTUS MUTUAL FUNDS

Virtus Seix Core Bond Fund

A: STGIX (92837F102) | I: STIGX (92837F300) | R: SCIGX (92837F201) | R6: STGZX (92837F409)

MARKET REVIEW

Short-term rates continued to rise as they did in the first quarter, though more moderately, and the yield curve continued to flatten. Rates on the front end of the curve rose while those on the back end were nearly unchanged. Altogether, 14 basis points (bps) of flattening occurred during the quarter, as represented by the spread between 2-year and 10-year Treasuries, bringing total flattening for the year to 19 bps.

Against this backdrop of rising short-term rates, total returns were relatively muted, and the Bloomberg Barclays U.S. Aggregate Bond Index posted a total return of -0.16% for the quarter and -1.62% for first half of the year. Investment grade corporate bonds remained the underperformer, registering -100 bps of excess return, slightly worse than the first quarter's -79 bps. (Excess return removes the influence of the duration of the asset by measuring returns relative to a duration-neutral risk-free asset.) Weakness came predominantly in longer maturities, which suffered -288 bps of excess return. Among intermediate maturities, the excess return came to only -11 bps.

For more on our market commentary, read Seix's second quarter Investment Grade Market Review and Outlook.

PERFORMANCE

The Virtus Seix Core Bond Fund (Class I) returned -0.17% in the quarter, essentially tracking the Bloomberg Barclays U.S. Aggregate Index return of -0.16%. The corporate bond sleeve of the Fund was a positive contributor to relative performance, as positive contributions from the Fund's overall underweight to the corporate sector (asset allocation) was partially offset by a small drag from security selection within the sector. The securitized sector, on average, was a positive contributor to relative performance, as gains due to security selection were partially offset by allocation to the sector. Yield curve positioning was a small contributor to relative performance, as was the Fund's void allocation to the government-related sector.

CURRENT STRATEGY

During the second quarter of 2018, the Fund's corporate allocation remained unchanged at a weighting of 0.8x the Index weight on a duration contribution (DC) basis. The residential mortgage-backed security (RMBS) allocation declined modestly to 0.6x from 0.7x (DC). The commercial mortgage-backed security (CMBS) weighting increased to 2.8x from 1.9x (DC). The Fund's allocation to the asset-backed security (ABS) sector also increased to 6.0% from 5.2% on a market value basis. The Fund's allocation to the U.S. Treasury sector was relatively unchanged at 1.4x the Index from 1.5x on a DC basis.

OUTLOOK

Valuations continued to cheapen modestly within the corporate credit sector during the second quarter of 2018. Valuation measures for investment grade (IG) corporate bonds over a one-year timeframe have actually shifted to an 'extremely cheap' level (meaning over two standard deviations cheap to their one-year mean). The longer term three- and 10-year timeframes still show corporate credit valuations as 'fair,' which probably speaks more to the low volatility environment we have experienced over the last 18 months or so, as the Bloomberg Barclays Corporate Index widened only 14 bps (from OAS +109 to +123) during the quarter. Securitized assets (RMBS/CMBS/ABS) performed better than IG credit and as such, remain fair to rich on short- to intermediate/long-term timeframes. Similar to our views entering the second quarter, regardless of this continued modest 'valuation relief' and in the context of where we are in the cycle (in tandem with ever-expanding macro/political uncertainty), we remain disenchanted with the risk/reward profile of the primary spread sectors (corporates/RMBS). As a result, our corporate bond and RMBS sector weightings remain underweight through the first half of 2018. Given this backdrop, corporate bonds offered the worst performance for the quarter with -98 bps of excess return; within the securitized sub-categories, RMBS delivered +15 bps of excess return, ABS earned +17 bps of excess return, and CMBS was flat in excess return terms.

The softness in IG credit was even more glaring when looking at the high yield (HY) market, where there was still +96 bps of excess return generated, leaving a near 200 bps excess return differential between the IG and HY credit sectors. Despite the increased macro/political backdrop that is seemingly fueled on a daily basis by President Trump's Twitter feed, complacency still reigns supreme in a market that remains comfortable looking past the potential for a more significant trade war. In fact, the modest volatility spike seen in Q1 seems like a distant memory, as equity market volatility declined on average in Q2 (the CBOE Volatility Index (VIX) average in Q2 was 15.3 vs. 17.4 in Q1). A stronger dollar in the second quarter also added fairly significant stress in many emerging market (EM) economies, causing the EM debt sector to suffer -242 bps of excess return. Consequently, the traditional "plus" sectors offered divergent fortunes in Q2.

Given this backdrop, there were no significant allocation changes to the Fund's spread asset exposure during the quarter, but we are more likely to further lighten our weightings to the primary spread sectors. The Fund's modest CMBS/ABS overweight still represents a continuation of the 'safe income at a reasonable price' theme with the Fund's exposure predominately high quality, top of the capital structure type risk.

Virtus Seix Core Bond Fund

INVESTMENT ADVISER

Virtus Fund Advisers, LLC

INVESTMENT SUBADVISER

Seix Investment Advisors LLC

PORTFOLIO MANAGERS

James F. Keegan
Industry start date: 1982
Start date with Fund: 2008

Perry Troisi
Industry start date: 1986
Start date with Fund: 2004

Michael Rieger
Industry start date: 1986
Start date with Fund: 2007

Carlos Catoya
Industry start date: 1987
Start date with Fund: 2015

Jonathan Yozzo
Industry start date: 1991
Start date with Fund: 2015

SECTOR ALLOCATIONS

	% Fund
U.S. Treasury	49.68
Mortgage Backed	24.16
Corporate	18.92
Asset Backed	6.03
Cash & Equivalents	1.21

Sector weights are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 6/30/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 7/16/1992
Fund Class I	-0.17	-1.69	-0.86	1.49	2.13	4.05	5.06
Index	-0.16	-1.62	-0.40	1.72	2.27	3.72	5.32

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.

The fund class gross expense ratio is 0.62%. The net expense ratio is 0.50%, which reflects a contractual expense reimbursement in effect through 7/31/2019.

Average annual total return is the annual compound return for the indicated period and reflects the change in share price and the reinvestment of all dividends and capital gains. Returns for periods of one year or less are cumulative returns. Class I shares have no sales charges or distribution or service fees, therefore their returns do not reflect these expenses. Fees and expenses vary, and other share classes are subject to sales charges and fees. Class I shares are offered primarily to eligible institutional investors who purchase the minimum amounts required as described in the prospectus and may not be available to all investors. For fund performance on other share classes, please visit www.virtus.com.

Index: The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

Notes on Risk: Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **ABS/MBS:** Changes in interest rates can cause both extension and prepayment risks for asset- and mortgage-backed securities. These securities are also subject to risks associated with the repayment of underlying collateral. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **Prospectus:** For additional information on risks, please see the fund's prospectus.

The commentary is the opinion of the subadviser. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

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