Virtus Seix Investment Grade Tax-Exempt Bond

A: SISIX (92837F615) | I: STTBX (92837F599)

MARKET REVIEW

Investors flocked to the tax-exempt market in 1Q19, largely driven by the cap on state and local tax (SALT) deductions under The Tax Cuts and Jobs Act of 2017 (TCJA). As the muni yield curve flattened, spreads narrowed and volatility increased—all of which led to robust demand for bonds with longer maturities and lower credit ratings, particularly in high tax states.

From a fundamental perspective, upgrades continued to outpace downgrades, with states largely reporting increased tax revenue. As a result, we feel comfortable that most states are able to continue to operate within the confines of their current taxing authority. Looking at governors' state-of-the-state addresses, we see that 25 states are considering additional tax proposals. Five of the 25 states are actually considering new or increased taxes; 11 want to lower, and four have initiatives that would actually do both.

From an investor's perspective, the good news is that fiscally strapped states are becoming more proactive and creative in solidifying and firming up their budgets. What may be concerning, however, is that some of these proposals are one-time shots, and some have yet to materialize. Illinois, for instance, is banking on legalizing—and taxing—marijuana, but projected tax revenues may be overly optimistic, and actual revenue generation could take some time as the logistics of implementation are ironed out. (Note: In both California and Colorado, taxes on legalized marijuana did not add as much to the states' budgets as initially anticipated.)

Most states are fairly well positioned from a revenue standpoint. Municipal bond investors will continue to monitor Puerto Rico's restructuring, particularly in the wake of recent rulings surrounding the redistribution of highway tax revenue, which went in the face of the bankruptcy code.

While many states face infrastructure issues, the chances of Congress reaching agreement on a legislative package appear slim. That raises the question of whether Congress will push infrastructure improvements down to states and municipalities already saddled with other fiscal challenges.

PERFORMANCE

The broad municipal market (Bloomberg Barclays Municipal Bond Index) returned 2.90% for the first quarter of 2019. Insatiable demand coupled with low absolute yields and moderate supply sent many investors further out the yield curve. As expected, the strongest returns were the Long Bond Index at 3.85% and the Baa Index at 3.59%. While at the other end of the spectrum, the One-year Index returned a mere 0.81% and the AAA Index gained 2.85%. As would be expected, sectors with longer duration and lower average credit quality performed well this quarter: tobacco and hospital bonds generated returns in excess of 3.25%.

Partially driven by the Federal Reserve's signal that it is done raising rates and by the cap on SALT deductions, investors added more than $25 billion to mutual funds in 12 straight weeks during the first quarter, causing lower yields and narrowing credit spreads across the curve. These dynamics are most visible in the change of the yield curve this quarter as the 10s-2s slope flattened from 50 to 37, while the 30s-10s remained unchanged at 74.

The Fund's I shares outperformed the Bloomberg Barclays 1-15 Year Blend Index by seven basis points, largely a result of the Fund's overweight to 15-years-and-longer parts of the curve. Versus the Index, the Fund is overweight special tax and water/sewer sectors, which were also contributors to performance.

CURRENT STRATEGY/OUTLOOK

At the end of the quarter, the Fund's effective duration was slightly shorter at 5.37 from 5.78 years. There were no significant changes to the credit profile as the Fund maintained its overweight to higher quality assets given the tightness of credit spreads. The Fund continues to be overweight versus the Index to water/sewer and special tax sectors and underweight local GOs, leasing, transportation and education sectors.

From a technical point of the view, the market is likely to continue to receive support from constrained supply. Fundamentally, we continue to believe that credit spreads are too narrow and investors may want to consider higher credit quality securities.

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Start date as Fund Portfolio Manager: 1992

Dusty Self
Industry start date: 1992
Start date as Fund Portfolio Manager: 2018

SECTOR ALLOCATIONS

	% Fund
Special Tax	19.11
Local General Obligation	16.68
State General Obligation	14.83
Pre-Refunded	14.74
Water & Sewer	10.11
Education	6.81
Transportation	6.75
Power	6.15
Cash & Equivalents	2.93
Lease	1.74
Hospital	0.17

Sector weights are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 3/31/19

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 10/21/1993
Fund Class I	2.58	2.58	4.38	1.90	2.77	3.98	4.87
Index	2.51	2.51	5.09	2.31	3.05	3.84	n/a

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 0.82%. The net expense ratio is 0.61%, which reflects a contractual expense reimbursement in effect through 4/30/2020. This ratio reflects the direct and indirect expenses paid by the Fund.

The net expense ratio minus the indirect expenses incurred by the underlying funds in which the Fund invests is 0.60%.

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 Municipal 1-15 Yr Blend (1-17) Index** is a market capitalization-weighted index of investment grade tax-exempt bonds with maturities of 1-17 years. The index includes investment grade bonds, general obligations, revenue bonds, insured bonds, and pre-refunded bonds. 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. **State & AMT Tax:** A portion of income may be subject to some state and/or local taxes and, for certain investors, a portion may be subject to the federal alternative minimum tax. **Municipal Market:** Events negatively impacting a municipal security, or the municipal bond market in general, may cause the fund to decrease in value. **Prospectus:** For additional information on risks, please see the fund's prospectus.

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