Virtus Seix Total Return Bond Fund

A: CBPSX (92837F805) | I: SAMFX (92837F870) | R6: SAMZX (92837F862)

MARKET REVIEW

2023 was eagerly billed as the year of the bond after enduring the historically bad year that was 2022. The Bloomberg U.S. Aggregate Bond Index suffered a -13% total return last year and given the consensus expectation for an economic slowdown and inevitable pivot from the Federal Reserve (Fed)'s current tightening cycle, the bond market was expected to deliver a more compelling positive total return in 2023. Given that the Index started the year with a 4.68% yield, the anticipated Fed pivot would add capital appreciation to that income, such that even modestly lower yields could ultimately deliver a total return in excess of 7% this year. What could go wrong?

> Q1 delivered a nearly 3% total return for the Index, as rates declined moderately amidst the fear of recession, which became an even higher probability after the regional bank crisis flared in March.

> Q2 offered no follow-through, as economic resilience and the fading effects of the banking crisis saw rates move higher once again. The Index only suffered -0.84% as the sell-off in rates was a "bear flattener," where the front end of the yield curve underperformed while longer rates only rose by a modest amount.

> Q3 shattered all hopes of the early 2023 dreams for better total return from the Index, as rates continued to move higher, but this time selling off in a steepening fashion, where the long end of the yield curve underperformed, driving long-term Treasury rates to levels not seen since before the global financial crisis (GFC).

> The underperformance of the long end—where greater interest rate sensitivity resides—led to very disappointing total returns across the investment grade bond market.

> Treasury rates moved as follows over the quarter:

	06/30/23	09/29/23	3Q23
2-year	4.90	5.05	+0.15
5-year	4.16	4.61	+0.45
10-year	3.84	4.57	+0.73
30-year	3.86	4.70	+0.84

Source: Bloomberg

> This shift to higher Treasury yields drove the Index total return to -3.23% for the quarter, dragging the year-to-date return to -1.21%.

> The long period of low rates after the Global Financial Crisis (GFC) left the investment grade bond market unattractive and offering what many characterized as "return-free risk." At the end of the third quarter, the Index offered a 5.39% yield, a level last seen in late 2008, and a return to the "old normal" after a decade-plus of talking about the "new normal."

STRATEGY

The Fund's overall weightings to the primary spread sectors remained broadly unchanged over the past quarter and continue to reflect a cautious approach to the credit sector. The Fund maintained an underweight to the investment grade corporate sector relative to the benchmark on a duration contribution-basis (DC) and held no below-investment grade securities (high yield). Additionally, the Fund had an overweight to the U.S. Treasury sector, relative to the index (DC). Within the securitized sectors, the Fund maintained its overweight to the residential mortgage-backed securities (RMBS) (DC) and asset-backed securities (ABS) (market value-basis) sectors but was underweight the commercial mortgage-backed securities (CMBS) sector relative to the index. The Fund continued to hold a short position in the Markit HYCDX at quarter-end.

PERFORMANCE

The quarter saw another shift higher in interest rates along with a shift to a steeper—or less inverted—yield curve. Consequently, returns were once again negative across much of the fixed income spectrum, as the Virtus Seix Total Return Bond Fund (Class I) declined 3.46%, slightly below the Bloomberg U.S. Aggregate Bond Index return of -3.23%. Positive contributors to returns from RMBS, ABS, and corporate security selection were offset by modest detractors from asset allocation (credit underweight), yield curve positioning, and the RMBS overweight. The Fund's Markit HYCDX position was neither a contributor nor a detractor over the quarter.

OUTLOOK

As the tightening cycle reaches its conclusion, higher for longer has become the emphasis for policymakers and market participants alike. The inflation backdrop has seen continued incremental improvement since the spring, and many point to the three-month annualized core PCE (personal consumption expenditures) deflator hitting 2.16% through August as proof that the Fed is indeed slaying the inflation dragon. While encouraging, the evidence will need to be sustained for much longer than a single three-month interval. Caution is warranted given the very different macro backdrop today versus the more benign inflation backdrop that persisted in the post-GFC period. The inflation backdrop was shifting structurally before the pandemic, and these shifts were accelerated by the COVID-19 experience. Broadly, the economy is confronting an end of cheap labor, cheap capital, cheap goods, and cheap energy. These changes are all happening at their own pace, but collectively they represent formidable headwinds that will challenge the expectation of returning to the pre-2020 backdrop that saw core inflation struggle to meet the 2% price stability target set by the Fed.

Recession or not, economic growth over the next few quarters is primed to slow down as a result of the tighter monetary conditions set by the Fed and most other central banks globally. The backdrop of late has also been challenged by various labor strikes, the UAW being the most prominent, a resumption of student loan payments after a prolonged suspension tied to the pandemic, mortgage rates around 7.5%, and significant dysfunction in Washington that threatens to shut down the government in the middle of Q4. Globally, the EU region has seen essentially little to no growth over the last three quarters, and the eagerly anticipated 2023 reopening in China, the world's second largest economy, has dramatically underwhelmed most analysts.

Most sectors and companies will have to navigate this more challenged macroeconomic backdrop with more leverage, higher refinancing costs, and the aforementioned inflation backdrop that could prevent central banks from shifting to an easing stance as quickly as markets have become accustomed to since the GFC.

Q3 23 Virtus Seix Total Return Bond Fund
QUARTERLY COMMENTARY

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PORTFOLIO MANAGERS

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Start date as Fund Portfolio Manager: 2002

Michael Rieger
Industry start date: 1986
Start date as Fund Portfolio Manager: 2007

Carlos Catoya
Industry start date: 1987
Start date as Fund Portfolio Manager: 2015

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Industry start date: 1991
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AVERAGE ANNUAL TOTAL RETURNS (%) as of 09/30/23

SECTOR ALLOCATION

SECTOR ALLOCATION	% Fund
U.S. Treasury	39.84
Residential MBS	33.83
Corporate	17.30
Asset Backed	5.55
Commercial MBS	2.51
Cash & Equivalents	1.07
Credit Default Swaps	-0.09

Sector weightings are subject to change.

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The fund class gross expense ratio is 0.58%. The net expense ratio is 0.46%, which reflects a contractual expense reimbursement in effect through 4/30/2024.

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.

Index: The **Bloomberg 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. The **Bloomberg U.S. Treasury Bond Index** includes public obligations of the US Treasury, i.e., US government bonds. Certain Treasury bills are excluded by a maturity constraint. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. The **Markit High Yield Credit Default Swap Index** (HYCDX) is composed of one hundred (100) liquid North American entities with high yield credit ratings that trade in the credit default swap market.

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Notes on Risk: Credit & Interest: Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Foreign & Emerging Markets:** Investing in foreign securities, especially in emerging markets, subjects the portfolio to additional risks such as increased volatility, currency fluctuations, less liquidity, and political, regulatory, economic, and market risk. **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 non-repayment of underlying collateral, including losses to the portfolio. **High Yield Fixed Income Securities:** There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities than investment grade securities. **Derivatives:** Derivatives may include, among other things, futures, options, forwards and swap agreements and may be used in order to hedge portfolio risks, create leverage, or attempt to increase returns. Investments in derivatives may result in increased volatility and the fund may incur a loss greater than its principal investment. **Market Volatility:** The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Local, regional, or global events such as war or military conflict, terrorism, pandemic, or recession could impact the portfolio, including hampering the ability of the portfolio's manager(s) to invest its assets as intended. **Prospectus:** For additional information on risks, please see the fund's prospectus.

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