

## Virtus Seix Total Return Bond Fund

A: CBPSX (92837F805) | I: SAMFX (92837F870) | R: SCBLX (92837F888) | R6: SAMZX (92837F862)

### MARKET REVIEW

The consensus view of “more of the same” low volatility and easy monetary conditions that rewarded markets in 2017 was challenged in the first quarter. The dominant themes in the early months of 2018 included the return of market volatility, the reappearance of the reflation trade and rising interest rates, and the start of the post-peak era of global central bank liquidity.

Absent throughout 2017, volatility spiked in the first quarter. VIX®, a measure of equity market volatility, increased 80% from the beginning of the year through the end of the first quarter. Notably, the volatility spike did not carry over to the bond market, where there was minimal movement in the MOVE Index, the bond market equivalent of VIX.

U.S. Treasury yields rose over the quarter, led by the short end of the yield curve. The 2-year Treasury, fueled by Federal Reserve (Fed) policy, was up 38 basis points (bps) for the quarter, while the 30-year was up just 23 bps. The curve thus flattened over the quarter, ending at its tightest level since 2008 as measured by the 47 bps spread between the 2- and 10-year Treasury notes.

Global central bank liquidity peaked in 2017 as the G3 (U.S., Euro Area, and Japan) central banks moved to tighten monetary conditions or, more appropriately put, to become “less loose.” The U.S. Fed is well into its “unloosening cycle” after executing another 25 bps hike in March (sixth hike of this cycle) with two more hikes anticipated in 2018.

For more on our market commentary, read our [first quarter Investment Grade Market Review and Outlook](#).

### PERFORMANCE

The primary detractor from relative performance over the quarter was attributed to the Virtus Seix Total Return Bond Fund’s allocation to global strategies, specifically to the Fund’s holding in Argentine bonds. Additional drags on relative performance were attributed to security selection within the corporate allocation. The lack of an allocation to the government-related sector was a modest drag. Partially offsetting these detractors were positive contributions from the Fund’s short position in High Yield CDX and single name Credit Default Swap (CDS) exposure. Within the securitized sleeve, security selection was a primary contributor to relative performance while asset allocation was a secondary contributor. The underweight allocation to the corporate sleeve was a modest contributor to relative performance. Overall, yield curve positioning was not a meaningful driver of relative return.

### CURRENT STRATEGY

During the first quarter of 2018, the Fund’s corporate allocation remained unchanged at a weighting of 0.8x the Bloomberg Barclays U.S. Aggregate Bond Index weight on a duration contribution (DC) basis, while the residential mortgage-backed security (RMBS) allocation was trimmed modestly to 0.7x the

Index versus 0.8x last quarter (DC). The commercial mortgage-backed security (CMBS) weighting declined to 1.9x from 2.1x (DC). The Fund’s allocation to the asset-backed security (ABS) sector increased to 5.6% on a market value basis, versus 5.2% at the end of last quarter. Exposure to the emerging market sector was eliminated during the quarter from 5.1% in market value terms. These sector changes resulted in the U.S. Treasury allocation increasing to 1.5x the Index weight, up from 1.3x at the end of 4Q17, on a DC basis.

### OUTLOOK

With modest option adjusted spread (OAS) widening over the quarter, valuation measures have shifted closer to fair value from more uniformly rich or very rich levels at the start of the year. Intermediate and long-term valuations remain tilted to rich (negative z-scores) but just not breaching the full one standard deviation metric that defines rich. To the extent there were any movements in valuations in Q1, they were to the cheaper side of the equation (no relative value model scores on the spread sectors shifted “richer”). Regardless of this modest “valuation relief” in Q1, in the context of where we are in credit cycle (in tandem with ever present 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 modestly underweight versus the Index through the first quarter of 2018. Equity market volatility has returned somewhat in 2018 and this has given risk markets a brief reason for pause, hence the moderately negative excess returns for both corporate bonds (-79 bps excess return) and RMBS (-39 bps of excess return). The degree to which this volatility shift has unsettled the risk markets remains somewhat muted in our view and the ability for risk assets to recover/retrace in relatively short order leaves us more convinced the volatility “regime change” we anticipated for the 2018 calendar year has only just begun. Complacency remains the watchword as the equity market volatility has yet to fully translate to the bond or currency markets. To the extent spreads tread water or further retrace the modest widening seen in Q1, we would view that as an opportunity to further lighten our weightings to the primary spread sectors. Modest CMBS/ABS overweight represents a continuation of safe income at a reasonable price theme with the Fund’s exposure predominately in high quality, “top of the capital structure” type risk. Our emerging market exposure, which was solely to Argentina to start the year, was eliminated over the quarter. Our only global overlay exposure at the end of Q1 was to the Japanese yen (approximately 1.7% notional exposure). The Fund’s high yield short via HYCDX remains in place (approximately 10%) as does a single name CDS position, as the Fund bought credit protection on Deutsche Bank (approximately 3%).

Despite the upward cyclical pressure on rates over Q1, our secular view of “lower for longer” remains intact for long-term rates. We think that long-term rates will remain relatively range bound over the next few quarters.

**Virtus Seix Total Return Bond Fund**

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**PORTFOLIO MANAGERS**



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Start date with Fund: 2008



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Start date with Fund: 2002



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**Carlos Catoya**  
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Industry start date: 1991  
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**SECTOR ALLOCATIONS**

**% Fund**

U.S. Treasury	46.71
Mortgage Backed	25.70
Corporate	19.57
Asset Backed	5.60
Cash & Equivalents	2.28
Other	0.15

Sector weights are subject to change.

**AVERAGE ANNUAL TOTAL RETURNS (%) as of 3/31/18**

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 12/30/1997
Fund Class I	-1.62	-1.62	-0.08	0.90	1.55	4.12	4.77
Index	-1.46	-1.46	1.20	1.20	1.82	3.63	4.86

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](http://virtus.com) for performance data current to the most recent month-end.

The fund class gross expense ratio is 0.61%. The net expense ratio is 0.47%, which reflects a contractual expense reimbursement in effect through 7/31/2019. 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 0.46%.

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](http://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. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities. **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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