

Virtus Seix Total Return Bond Fund

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MARKET REVIEW

Our Q3 recap lamented the bond market's lackluster performance over the first three quarters of 2023, given the elevated expectations coming into the year. After the horrific year that was 2022, expectations were for a respectable bounce in total return for the Bloomberg U.S. Aggregate Bond Index (Agg), but by the end of Q3, the Agg's year-to-date total return was still negative at -1.21%. October offered little hope of any recovery, delivering another -1.58% monthly total return, bringing the YTD return to -2.77%.

Then came November and December, a pretty historic two-month period, even going back to the inception of the Agg in 1976. Total returns for November and December were +4.53% and +3.83%, respectively, or +8.53% for the two-month interval. For context, that two-month total return is the seventh best two-month total return since the inception of the Agg; the six returns that were higher all date back to the early 1980s when rates were significantly higher and the 40-year secular bull market in bonds was just getting started. For 2023, the Agg delivered a +5.53% total return, remarkably closer to the hopes and dreams of market participants earlier in the year. The path to that return, however, did not remotely follow the early 2023 script.

Powering the Q4 returns were significant declines in Treasury yields across the curve, as reflected below:

	09/29/23	12/29/23	4Q23	2023
2-year	5.05	4.25	-0.80	-0.18
5-year	4.61	3.85	-0.76	-0.16
10-year	4.57	3.88	-0.69	0.00
30-year	4.70	4.03	-0.67	+0.06

Source: Bloomberg

The first quarter of the year saw recession fears compounded by a regional banking crisis; rates declined and returns across the bond market were uniformly positive. The second and third quarters witnessed a complete reversal of that initial rate decline, pushing Treasury yields higher and driving total returns negative again. Economic resilience and no material effects from the banking crisis offered hope that expectations of imminent recession were misplaced. The economy saw gross domestic product (GDP) expand by 2.1% annualized over the first half of the year and Q3 upped the ante with a robust 4.9% annualized growth rate. This newfound optimism, in tandem with the Treasury announcing increased coupon issuance (as opposed to just increased T-bill issuance) at the August refunding announcement, pressured Treasury yields higher in Q3, with yields across the curve reaching calendar year highs in mid-October. The 10-year Treasury yield topped out just over 5% intraday on October 19, 2023, before closing that trading session at 4.99%.

The initial catalyst for the rate reversal came on November 1, 2023, the Treasury's latest quarterly refunding announcement. The rise in the term premium seen over Q3, where the yield curve steepened, elicited a response from the Treasury, with the distribution of increased auction sizes altered to limit the impact on the longer end of the yield curve. The overall change was hardly monumental, with the auction increases for 10-, 20-, and 30-year Treasuries each only one billion less than their respective August increases. More impactful, the Treasury intimated that only one additional quarter of increases to coupon auction sizes would be necessary beyond the increases announced that day. Market consensus anticipated two, if not three, more quarters of increased coupon auctions in 2024. With persistent deficits of 6+% of GDP, the Treasury's expectation for only one additional quarter of larger coupon auctions could prove to be overly optimistic, but that debate will continue well into 2024 and beyond.

For more detail, see Seix's full [Market Review and Outlook](#) on Virtus.com.

STRATEGY

The Fund's overall weightings to the primary spread sectors remained broadly unchanged over the past quarter and continued 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) at year-end. The Fund had an overweight to the U.S. Treasury sector relative to the Agg (DC). Within the securitized sectors, the Fund moved to a neutral weight in residential mortgage-backed securities (RMBS) (DC) and added modestly to the asset-backed securities (ABS) sleeve (market value basis).

PERFORMANCE

With the sharp decline in interest rates, particularly in the longer end of the Treasury yield curve, total returns moved decidedly into positive territory during 4Q23. During the quarter, the Fund returned 5.94% (I shares), lagging the Bloomberg U.S. Aggregate Bond Index return of 6.82%. Positive contributions to return from the RMBS and ABS allocations were more than offset by detractors from the corporate allocation (underweight) as well as corporate security selection.

OUTLOOK

The economy and markets have come a long way since the early days of 2023, when fears of recession cast a pall over expectations. Growth expectations (per the Bloomberg monthly economic survey) anticipated little, or even negative, growth in GDP terms for the first three quarters of 2023 and then only a modest pick-up in Q4. The formal accounting for that 2023 GDP consensus was approximately 0.5%. Quarter by quarter, the economy exhibited a resilience no one expected, delivering GDP of approximately 2.5%, with Q4 currently tracking around 2%. It's this resilience that has convinced the market consensus that the soft landing is now the higher probability outcome. Growth should moderate in 2024, but the pall of imminent recession is gone.

Given the Federal Reserve's (Fed) pivot and the expectation of a lower policy rate, risk markets and the Treasury market have rallied nearly uninterrupted since mid-October. While the Fed's updated "dot chart" offered a median target rate in 2024 that implied three rate cuts, market pricing has moved well beyond that. As 2024 gets underway, short-term interest rate markets are oscillating between five or six rate cuts for the full year, with those cuts starting as early as the Fed's March 20, 2024, meeting. Given the evolution of Fed policy in Q4, it's difficult to place a high probability on whether the Fed will deliver the first rate cut that soon. Given the degree to which sentiment and pricing have moved in a noticeably short period of time, there is little room for disappointment as it relates to the fundamental data the Fed will need to see between now and March 20. Should an inflation update, wage data, or labor market data—just to name a few—offer evidence that the pivot was premature, market pricing across rates and risk will be challenged.

Recession or not, economic growth over the next few quarters is likely to slow down as a result of the tighter monetary conditions set by the Fed and the challenged pace of expansion seen globally. The U.S. economy has outperformed in the post-pandemic period, given the aggressive fiscal and monetary policy response seen to date. Remnants of that policy stimulus were a significant component of the resilience seen in 2023, but it would seem overly optimistic to extrapolate that into 2024. Long and variable lags from tighter monetary policy are exactly the element that could surprise going forward. The ability of the economy to navigate this first wave of restrictive policy offers a level of complacency of which all investors need to be cognizant.

Valuations across the investment grade spread sectors are fair-to-rich across varying historical time periods. Given the degree to which these sectors have outperformed in 2023, initially in response to the economy's resilience and consequently in response to the Fed's surprise pivot in Q4, there is little margin for error. The broad macro backdrop of higher leverage, higher refinancing costs, and an uncertain inflation backdrop that may not offer the Fed an easy path for modest policy easing remains front and center. The massive returns of November and December have proven intoxicating—but expecting no hangover seems highly unrealistic.

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AVERAGE ANNUAL TOTAL RETURNS (%) as of 12/31/23

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception (12/30/97)
Fund Class I	5.94	4.65	4.65	-3.69	1.24	1.80	3.99
Index	6.82	5.53	5.53	-3.31	1.10	1.81	4.04

SECTOR ALLOCATION

	% Fund
U.S. Treasury	41.54
Residential MBS	31.96
Corporate	19.14
Asset Backed	5.04
Commercial MBS	1.60
Cash & Equivalents	0.72

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.

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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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