VIRTUS FUNDS

Virtus Seix U.S. Government Securities Ultra-Short Bond Fund

A: SSAGX (92837X681) | I: SIGVX (92837F821) | R6: SIGZX (92837F813)

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 (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.
> The shorter duration Bloomberg U.S. Treasury Bill 3-6 Month Index generated a positive return of 1.35% for the quarter and 3.67% year-to-date.
> 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

STRATEGY

As broadly expected, the Fed hiked the overnight Fed Funds rate an additional 0.25% in July, with other short duration market rates following suit. The SOFR (Secured Overnight Financing Rate) ended the quarter at 5.31%, up 0.25%. The duration of the Fund remained relatively stable at 0.33 years.

The Fund's floating rate allocation (including cash) decreased slightly to 84.7% at the end of the quarter. The largest allocations were agency commercial mortgage-backed securities (CMBS) floaters at 24.2%, agency collateralized mortgage obligation (CMO) floaters at 24.8%, and mortgage-backed securities (MBS) post-reset adjustable-rate mortgages (ARMs) at 24.1%.

The main allocation changes during the quarter were agency CMBS floaters down 5.2%, MBS post-reset ARMs up 3.9%, MBS hybrid ARMs down 4.3%, and U.S. Treasuries up 4.9%.

PERFORMANCE

The Virtus Seix U.S. Government Securities Ultra-Short Bond Fund (I shares) generated a positive return of 1.24%, closely tracking the Bloomberg U.S. Treasury Bill 3-6 Month Index return of 1.35% for the quarter ending 9/30/23.

The higher coupons from the Fund's underlying securitized assets provided additional income that helped to offset modest spread widening in those assets. The agency CMBS and shorter duration ARM sectors were the largest contributors to relative performance, while CMO floaters and longer duration hybrid ARMs were the primary detractors from performance. The Fund continues to utilize 2- and 5-year interest rate futures to hedge rate risk.

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.

INVESTMENT ADVISER

Virtus Fund Advisers, LLC

INVESTMENT SUBADVISER

Seix Investment Advisors

PORTFOLIO MANAGERS

Perry Troisi
Industry start date: 1986
Start date as Fund Portfolio Manager: 2014

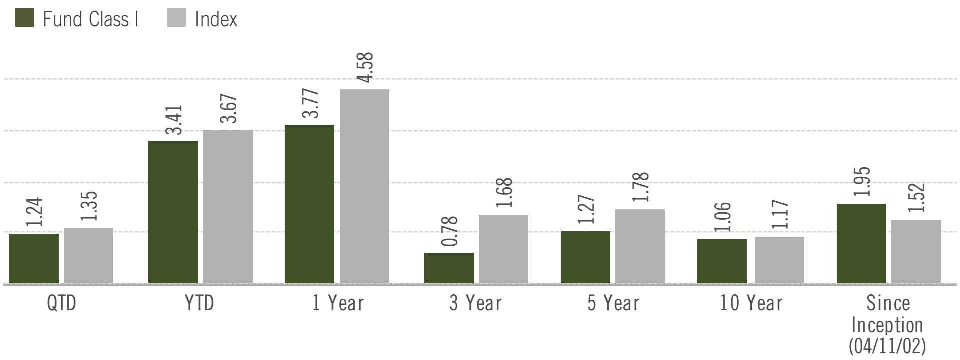
Michael Rieger
Industry start date: 1986
Start date as Fund Portfolio Manager: 2014

SECTOR ALLOCATION

	% Fund
Residential MBS	73.12
Commercial MBS	17.32
U.S. Treasury	4.86
Cash & Equivalents	4.70

Sector weights are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 09/30/23



Performance data quoted represents past performance. Past performance does not guarantee future results. Investment return and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Please visit virtus.com for performance data current to the most recent month end. This share class has no sales charges and is not available to all investors. Other share classes have sales charges. See virtus.com for details.

The fund class gross expense ratio is 0.55%. The net expense ratio is 0.41%, 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. Treasury Bill 3-6 Month Index** measures performance of U.S. Treasury bills with a remaining maturity from one up to (but not including) 12 months. The index excludes zero coupon strips. 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. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis.
The **Bloomberg U.S. Corporate Investment Grade Bond Index** measures performance of investment grade corporate bond funds. The index is calculated on a total return basis.
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 **Bloomberg 1-3 Year Government/Credit Index** is an index consisting of Treasury or government agency securities and investment grade corporate debt securities with maturities of one to three years. It is unmanaged and unavailable for investment.

Seix Investment Advisors is a division of Virtus Fixed Income Advisers, LLC (“VFIA”), an SEC registered investment adviser.

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. **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. **U.S. Government Securities:** U.S. government securities may be subject to price fluctuations. An agency may default on an obligation not backed by the United States. Any guarantee on U.S. government securities does not apply to the value of the portfolio’s shares. **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.

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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