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

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

MARKET REVIEW

In a reversal of sorts from the second quarter, 'risk on' was more the norm in Q3. Credit, both investment grade (IG) and high yield (HY), were beneficiaries of this backdrop and the lower quality segments performed the best in both absolute and excess return terms. Valuation measures for IG corporate bonds over a one-year time frame snapped back from 'extremely cheap' levels (over two standard deviations cheap to their one-year mean) at the end of the second quarter to a 'fair' valuation (within one standard deviation to their one-year mean); the longer term three- and ten-year time frames still show corporate credit valuations were unchanged and remain 'fair.' Securitized assets (residential mortgage-backed securities (RMBS)/commercial mortgage-backed securities (CMBS)/asset-backed securities (ABS)) also modestly outperformed over the quarter in excess return terms, but they were relatively muted when compared to IG corporate bond performance. Valuations here remain fair to rich on short to intermediate/long-term time frames. During the quarter, there was no change in our opinion regardless of the lower volatility, risk-on environment; in the context of where we are in the cycle, in tandem with ever-expanding 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 remained underweight through the third quarter of 2018.

The strength of the HY market is remarkable amidst the pockets of volatility seen in emerging markets (EM); HY recorded positive nominal and excess returns each month this quarter to generate 2.40% and 2.48% total return and excess return, respectively. Year-to-date, the HY credit sector has now outperformed IG credit by 338 basis points (bps). Technical factors are providing support for the HY bond market as supply is down considerably versus 2017, as leveraged loan issuance has been favored by corporate treasurers given the attractive terms offered by the relentless collateralized loan obligation (CLO) bid. Complacency still seems to prevail every time another flurry of volatility flares and threatens the risk markets. The market has been exceptionally efficient at compartmentalizing the various spikes in volatility seen over the course of the calendar year, seemingly very comfortable viewing everything as 'idiosyncratic' and seeing nothing through a potentially 'systemic' risk lens. A China growth slowdown in tandem with a pending trade war, EM risks and currency crises in Argentina, Turkey, and Brazil, as well as another potential Euro-area sovereign debt crisis via Italy, all fail to resonate for more than a 24-hour news window. The modest volatility spike seen in Q1 remains the high-water mark as stock volatility declined even further in Q3. The VIX Index average in Q3 was 12.9 compared to the VIX Index average in Q2 and Q1 of 15.3 and 17.4, respectively. The stronger dollar persisted modestly in the third quarter (the U.S. Dollar Index (DXY) returned 0.7% for Q3 and 3.3% YTD) and remains the lone "pain trade" of 2018 relative to how the market was positioned coming into 2018, as the consensus trade was for continued dollar weakness similar to what we saw in 2017.

For more on our market commentary, read Seix's third quarter Investment Grade Market Review and Outlook.

PERFORMANCE

The Virtus Seix U.S. Government Securities Ultra-Short Bond Fund (Class I) return of 0.42% underperformed the Bloomberg Barclays 3-6 month T-Bill Index return of 0.50% during the third quarter. While the Fund continued to benefit from the ongoing rate hiking cycle as short-term rates moved higher, a small amount of spread widening modestly offset the additional interest "carry" of the Fund, relative to its T-Bill Index.

CURRENT STRATEGY

The Fund's floating rate exposure increased to 87% during the quarter as short-term LIBOR rates continued to move higher. The three largest sector exposures remain agency CMBS floaters (37.1%), agency collateralized mortgage obligation (CMO) floaters (29.3%), and post-reset adjustable-rate mortgages (ARMs) (11.8%). The overall duration remains near the lower end of the band at 0.28 years, given the ongoing tightening cycle and consequent higher short-term market rates. Given that the Federal Reserve (Fed) hiked rates again as expected in September, short-term market rates adjusted accordingly. The third quarter saw one-month and three-month LIBOR rates increase by 27 bps and 6 bps, respectively. Current market expectations are for the Fed to hike rates again in December.

OUTLOOK

With 87% in floating rate securities, the Fund should be well positioned for further Fed interest rate increases in December, as well as into 2019. As has been the case for many quarters, our allocation to agency floating rate securitized assets continues to represent safe income at a reasonable price.

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

INVESTMENT ADVISER

Virtus Fund Advisers, LLC

INVESTMENT SUBADVISER

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PORTFOLIO MANAGERS

James F. Keegan
Industry start date: 1982
Start date with Fund: 2014

Perry Troisi
Industry start date: 1986
Start date with Fund: 2014

Michael Rieger
Industry start date: 1986
Start date with Fund: 2014

SECTOR ALLOCATIONS

	% Fund
Mortgage Backed	88.46
Asset Backed	6.07
Government Related	2.53
U.S. Treasury	1.98
Cash & Equivalents	0.96

Sector weights are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 9/30/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 4/11/2002
Fund Class I	0.42	1.14	1.51	0.95	0.84	1.46	2.16
Index	0.50	1.31	1.57	0.88	0.57	0.45	1.44

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 0.50%. The net expense ratio is 0.42%, 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 0.41%.

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 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.

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. **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 fund's shares. **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. **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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