Virtus Seix High Yield Fund

A: HYPSX (92837F698) | I: SAMHX (92837F672) | R: HYLSX (92837F680) | R6: HYIZX (92837F664)

MARKET REVIEW

The high yield market performed poorly in the fourth quarter in a risk-off environment that saw the S&P 500® Index plummet 9.0% in December, the worst end-of-year performance since the Great Depression. Slowing global economic growth trends, falling oil prices, and disappointing signals from the Federal Reserve contributed to the slump. The market, though, was primarily reacting to factors external to high yield and a large part of the sell-off was driven by liquidity rather than fundamental concerns. While falling oil prices could cause difficulty for certain sectors of energy and the business models for retail and wireline telecom are in transition, the remaining three-quarters of high yield issuers are not challenged. Average leverage ratios and interest coverage for high yield issuers continue to improve, as per data collected by J. P. Morgan. We would expect that valuations would better reflect actual fundamentals in 2019.

The yield spread over Treasuries rose dramatically in December, rising 96 basis points (bps) to 459 bps, or 194 bps above the low reached in early October. Yield on the ICE BofAML U.S. High Yield BB-B Constrained Index rose to 7.14% in December, its highest level since April 2016. For the quarter, the Index fell -3.87%, bringing the return for the year to -2.04%.

As for market technicals, the market continues to shrink as new issuance remains on a downward trend. In December, no new issues were priced, only the second month that has ever happened, while the previous time was at the height of the financial crisis in November 2008. For the quarter, issuance amounted to just $19 billion, a 10-year low and down from $73 billion in the fourth quarter of 2017. For the year, issuance came to just $187.4 billion, down 43% from 2017, according to J.P. Morgan.

On the demand side, December saw mutual fund outflows of -$7.2 billion, the 10th largest ever, bringing the total for the quarter to -$20.2 billion. For 2018, outflows came to -$45.1 billion, making flows negative for the second straight year. In 2017, flows amounted to -$20.3 billion while in 2016 they were positive at $9.6 billion.

Default activity rose somewhat in 2018, but with fundamentals still strong, it continued to be relatively low. The par-weighted U.S. default rate reached 1.81% (excluding iHeart Media, it was just 1.08%), up from 1.28% in 2017. Compared to 2016, however, when the rate hit 3.57%, and to the long-term average of 3.46%, this rate remains low.

PERFORMANCE

The Fund's -4.05% return lagged the -3.87% return of the BofAML U.S. High Yield BB-B Constrained Index for the quarter. The underperformance was largely due to unfavorable security selection in energy linked to the drop in oil prices. Adding to the shortfall were underweightings in paper & packaging and broadcasting—two industries that avoided the worst of the credit sell-off. Largely offsetting these negative factors were the modest cash position in a falling market and positive security selection in chemicals, cable, and diversified manufacturing.

CURRENT STRATEGY

As the calendar turned to 2019, the market appeared to be stabilizing. However, we do not believe there will be a return to the calm conditions of 2017. Macro factors are expected to remain uncertain. However, with both fundamentals (improving leverage and interest coverage) and technicals (very restrained issuance) continuing to be favorable, we expect to take advantage of periods of volatility to add exposure to solid, well-priced credits.

We expect to see more bouts of volatility in 2019, and we will continue to capitalize on these potential opportunities to buy high quality issues cheaply. More specifically, we are looking at shorter duration, higher quality companies with good free cash flow generation.

OUTLOOK

With the December sell-off, the yield on the Index rose to 7.3%, and then the market rebounded pretty solidly, so we believe the 7.3% yield may represent a floor on prices of sorts. The cheaper valuations that emerged in December also presented us with new potential opportunities, so we are taking advantage of those while remaining highly selective.

While 2018 was a challenging year, it's interesting to note that the market has never posted two calendar years with back-to-back negative returns. So, we believe that given the still-healthy fundamentals, a mid-single-digit return is not unreasonable in 2019.

Virtus Seix High Yield Fund

INVESTMENT ADVISER

Virtus Fund Advisers, LLC

INVESTMENT SUBADVISER

Seix Investment Advisors LLC

PORTFOLIO MANAGERS

Michael Kirkpatrick
Industry start date: 1991
Start date with Fund: 2007

James FitzPatrick, CFA
Industry start date: 1996
Start date with Fund: 2013

SECTOR ALLOCATIONS

	% Fund
Energy	15.08
Cable & Satellite TV	10.54
Healthcare	10.00
Telecom	9.95
Bank/Finance/Insurance	9.23
Building/Home	7.17
Broadcasting/Diversified Media/Publishing	5.84
Supermarkets/Restaurants/Food/Drug	5.15
Cash	4.06
Gaming/Leisure/Entertainment	3.40
Environmental/Services	2.67
Hotels/Lodging/REITs	2.64
Steel/Metals	2.62
Automotive/Airlines/Shipping/Rail	2.53
Technology	2.09
Dept Stores/Spec Retail	2.09
Utilities	1.39
Chemicals	1.21
Personal & Household Products	0.91
Containers/Paper	0.76
Capital Goods/Aerospace	0.67

Sector weights are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 12/31/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 12/29/2000
Fund Class I	-4.05	-1.70	-1.70	6.01	3.02	8.57	6.34
Index	-3.87	-2.04	-2.04	6.33	3.88	9.99	6.92

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 0.77%. The net expense ratio is 0.65%, 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 0.64%.

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 **ICE BofAML US High Yield BB-B Constrained Index** measures performance of BB/B U.S. dollar denominated corporate bonds publicly issued in the U.S. domestic market, and is restricted to a maximum of 2% per issuer. 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. **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.

Please carefully consider a Fund's investment objectives, risks, charges, and expenses before investing. For this and other information about any Virtus mutual fund, contact your financial representative, call 1-800-243-4361, or visit virtus.com for a prospectus or summary prospectus. Read it carefully before investing.

Not insured by FDIC/NCUSIF or any federal government agency. No bank guarantee. Not a deposit. May lose value.

Distributed by **VP Distributors, LLC**, member FINRA and subsidiary of Virtus Investment Partners, Inc.
2194 01-19