VIRTUS FUNDS

# Virtus Seix High Yield Fund

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

## MARKET REVIEW

The year 2023 began with the strong consensus view that we were imminently entering a recession. The Federal Reserve (Fed) was tightening into a slowing economy and a recession was required to get inflation to the Fed's target. The prophets seemed to have gotten it correct in March as a few regional banks experienced runs that rendered them insolvent. The 10-year Treasury bond began the year at 3.88% and traded to a low of 3.31% in April as the market determined the fallout from the regional banks issue. The Fed continued to increase rates at 25 basis point (bps) increments into July.

We saw a significant reversal from the beginning of 4Q23, with the market initially projecting continued inflationary worries and the possibility of the Fed either holding rates steady or raising rates further, then suddenly later expecting an economic slowdown and rate cuts. The 10-year Treasury generally continued to rise from its April low and hit 4.99% on October 19. Around that time, the market began to price in Fed rate cuts for 2024 with a soft landing for the economy. As a result, the Goldman Sachs Financial Conditions Index had its largest month of easing in November for any single month in at least 40 years. Financial conditions continued to ease in December and were helped by Chairman Jerome Powell's surprising pivot in December. The result for the 10-year Treasury was a complete round trip, ending the year where it began at 3.88%. In December alone, J.P. Morgan reported that high yield returned +3.63%, with CCCs leading the way with a +5.50% performance, single-Bs gaining +3.57%, and BBs coming in at +3.14%. In terms of spreads, the ICE BofA U.S. High Yield Index (H0A0) tightened by 64 bps to +339, with BBs tightening 70 bps to +205, single-Bs tightening 78 bps to +341, and CCCs coming in 21 bps to +902. The H0A0 Index returned 13.46% for the year, surpassing expectations of most market participants. Triple-Cs, as measured by the ICE BofA CCC & Lower U.S. High Yield Index (H0A3), led the way with returns for the year of 20.36%, followed by single-Bs, as measured by the ICE BofA Single-B U.S. High Yield Index (H0A2), returning 13.96%, and double-Bs, as measured by the ICE BofA BB U.S. High Yield Index (H0A1), returning 11.44%. Segments of the market that outperformed included distressed high yield, which returned 24.41%, as measured by the ICE BofA U.S. Distressed High Yield Index (H0DI), and longer-duration high yield, which returned 17.20%, as measured by the ICE BofA 10+ Year U.S. Cash Pay High Yield Index (J9A0). Interestingly, the J9A0 Index returned 12.97% in the fourth quarter alone.

The H0A0 Index began the year with a yield-to-worst (YTW) of 8.99% and an option-adjusted spread (OAS) of 481 bps, ending the year with a YTW of 7.69% and an OAS of 339 bps. The H0A1 Index began the year with a YTW of 7.26% and OAS of 308 bps, ending the year with a YTW of 6.37% and OAS of 205 bps. The H0A2 Index began the year with a YTW of 9.34% and OAS of 515 bps and ended the year with a YTW of 7.76% and OAS of 341 bps. The H0A3 Index began the year with a YTW of 15.87% and OAS of 1,170 bps and ended the year with a YTW of 13.03% and OAS of 902 bps.

## PERFORMANCE

The Virtus Seix High Yield Fund, which we sub-advise, increased 12.87% (Class I) for the year 2023—29 bps more than the Fund's benchmark, the ICE BofA BB-B US High Yield Constrained Index, which increased 12.58%.

Top contributors to performance from a sector perspective included financials, telecommunications, and healthcare/pharmaceuticals. Top detractors to relative performance included transportation/automotive/aerospace, metals and mining, and chemicals.

For 4Q23, the Virtus Seix High Yield Fund increased 6.44%—68 bps less than the Fund's benchmark, which increased 7.12%.

Top contributors to performance from a sector perspective included retailers, gaming and leisure, and financials. Top detractors to relative performance included metals and mining, building construction, and energy.

Our longer-term objective is to provide a smoother ride with outperformance through the full credit cycle and the strongest relative performance during periods of dislocation when the market is offering a plethora of attractively priced securities.

## CURRENT STRATEGY

We continue to find value in the higher-quality part of the high yield market. Further, we continue to look for and find value in fallen angels, orphan credits, small cap issuers, sectors that do not fit a traditional high yield analysis such as financials, and out-of-favor sectors or segments of the market.

We continue to believe that the higher-quality segments of high yield offer the best risk-adjusted relative value. The new issue market provided some potential new opportunities in double-B and strong single-B credits with what we believe are attractive coupons. Our core strategy is determined by where we find the best risk-adjusted return opportunities. We continue to focus on current income generation with downside protection while searching the market for mispriced and/or oversold opportunities.

## OUTLOOK

The high yield market began 2023 pricing in a decent probability of a recession. The economy has proven to be more resilient than most had anticipated, and we are now pricing in a decent probability of a Fed easing into a soft landing or mild recession. While this ultimately remains our base case, we do realize that the probabilities of an alternative scenario remain reasonably high. We recognize that declining rates, lower inflation, easing financial conditions, the likelihood that interest rates have peaked, and a stronger economy are not regular bedfellows. We are factoring this into our credit analysis given where valuations ended the year.

Nevertheless, fundamentals for high yield issuers, while having weakened somewhat, remain at comfortable levels, and we would anticipate defaults to run at about 3% for the year. The technical outlook should remain more balanced as fallen angels and rising stars settle into a more balanced position. With all of this considered, we do believe high yield can generate a return consistent with long-term returns.

## INVESTMENT ADVISER

Virtus Fund Advisers, LLC

## INVESTMENT SUBADVISER

Seix Investment Advisors

## PORTFOLIO MANAGERS

**Michael Kirkpatrick**
Industry start date: 1991
Start date as Fund Portfolio Manager: 2007

**James FitzPatrick, CFA**
Industry start date: 1996
Start date as Fund Portfolio Manager: 2013

## SECTOR ALLOCATION

| | % Fund |
|---|---|
| Energy | 18.37 |
| Financial | 12.27 |
| Building Construction | 8.81 |
| Cable Satellite | 8.17 |
| Transportation/Automotive/Aerospace | 8.17 |
| Gaming & Leisure | 8.10 |
| Healthcare/Pharmaceuticals | 3.72 |
| Retailers | 3.71 |
| Diversified Manufacturing/Other Industrial | 3.34 |
| Hotels & REITS | 3.24 |
| Telecommunication | 3.07 |
| Metals & Mining | 2.99 |
| Technology | 2.96 |
| Consumer Products/Textile/Tobacco | 2.94 |
| Services/Environmental | 2.63 |
| Cash & Equivalents | 1.82 |
| Utility | 1.34 |
| Paper & Packaging | 1.30 |
| Media Non Cable | 1.26 |
| Chemicals | 0.89 |
| Restaurants/Food/Beverage/ Supermarkets | 0.88 |

Sector weightings are subject to change.

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

| | QTD | YTD | 1 Year | 3 Year | 5 Year | 10 Year | Since Inception (12/29/00) |
|---|---|---|---|---|---|---|---|
| Fund Class I | 6.44 | 12.87 | 12.87 | 1.62 | 5.43 | 4.21 | 6.14 |
| Index | 7.12 | 12.58 | 12.58 | 1.73 | 5.19 | 4.53 | 6.54 |

**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 0.75%. The net expense ratio is 0.64%, 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 **ICE BofA 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.

The **ICE BofA US High Yield Index (H0A0)** tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating and an investment grade rated country of risk.

The **ICE BofA BB U.S. High Yield Index (H0A1)** is a subset of H0A0 that includes all securities with a given investment grade rating BB.

The **ICE BofA CCC & Lower U.S. High Yield Index (H0A3)** is a subset of is a subset of H0A0 that includes all securities with a given investment grade rating CCC or below. The ICE BofA Single-B U.S. High Yield Index is a subset of H0A0 that includes all securities with a given investment grade rating B.

The **ICE BofA Single-B US High Yield Index (H0A2)** subset includes all securities with a given investment grade rating B. The ICE BofA U.S. Distressed Index is a subset of the ICE BofA High Yield Index, which includes any performing issues trading at an option-adjusted spread over 1000 basis points.

The **ICE BofA 10+ Year US Cash Pay High Yield Index (J9A0)** measures the performance of USD-denominated, noninvestment grade, fixed rate, taxable corporate bonds with maturities of 10 years or more.

The **ICE BofA High Yield Distressed Index (H0DI)** is a sub-index of the ICE BofA U.S. High Yield Index whose constituents only includes the bonds whose OAS (Option Adjusted Spread) is greater than or equal to 1,000 at the rebalance lock-in date.

**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. **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. **Foreign Investing:** Investing in foreign securities subjects the portfolio to additional risks such as increased volatility; currency fluctuations; less liquidity; less publicly available information about the foreign investment; and political, regulatory, economic, and market risk. **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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