Virtus Seix High Income Fund

A: SAHIX (92837F748) | I: STHTX (92837F722) | R: STHIX (92837F730) | R6: STHZX (92837F714)

MARKET REVIEW

In the third quarter, the high yield market continued to benefit from an improving economy, as issuers experienced growth in revenue and operating income, rising interest coverage ratios, and slightly declining leverage levels. A healthy economy and positive financial results contributed to a narrowing of yield spreads.

The high yield market advanced 2.40% during the quarter, according to the Bloomberg Barclays U.S. Corporate High Yield Bond Index, with CCC-rated issues leading. But CCCs outperformed BBs by just 41 basis points (bps), down from 304 bps in the second quarter. Spreads tightened across the rating spectrum, with CCCs narrowing the most. In September, the spread on the Index compressed to the narrowest level in 10 years. Leading sectors for the quarter were cable & satellite and healthcare, while retail and autos lagged.

Year-to-date, the market overall advanced 2.57%, with lower quality issues leading the way. CCCs were up 5.99%, Bs up 3.17%, and BBs up just 0.55%.

Along with strong fundamentals, technical factors have been favorable. Data shows that on the demand side, outflows from mutual funds continued, but at a less rapid pace.[1] In the third quarter, they totaled $1 billion, down from $24.5 billion in the previous two quarters.

Despite the outflows, the technical factors generally remain supportive of the market. Gross issuance year-to-date amounted to just $168.3 billion, down from $255.6 billion over the same period in 2017.[1] Issuance during the quarter shrank, amounting to $42.1 billion, or about half the quarterly average of the past seven years. Historically a strong month, September was particularly weak, with issuance of $18.2 billion, down from $43.3 billion in September 2017. With the decline in issuance, the high yield market has continued to contract, declining by approximately $5 billion in the third quarter, while year-to-date, the market is down about $64 billion. In fact, this year has seen the largest supply shortfall, since 2004.[1]

PERFORMANCE

The Fund's net return of 1.96% lagged the 2.40% return of the Barclays US Corporate High Yield Index by 44 bps. The performance shortfall was largely due to unfavorable security selection in retail and metals & mining. Partially offsetting the negative factors was positive security selection in energy, especially E&P companies and offshore drillers, and finance, particularly mortgage servicers.

CURRENT STRATEGY

During the quarter, we sold select CCC healthcare positions and reduced exposure to certain fully priced defense and technology issuers. A portion of the proceeds was reinvested in attractively priced energy and telecom new issues. Given the relatively tight spreads on high yield bonds, we continue to opt for quality over yield. The Fund remains overweighted in the two industries where we have successfully found value in the last several years: energy and finance. We continue to remain cautious about the technology sector.

OUTLOOK

Given the strong fundamentals, we believe valuations are roughly within the range of fair value. In addition, the strong technicals reinforce our opinion that, although spreads are unlikely to break out of their range on the downside, the probability of their widening significantly is also not high. Much of the issuance that would normally occur in high yield appears to be going to the leveraged loan market. With overall interest rates increasing, borrowers have been taking advantage of investors' demand for floating rate assets.

We see more appealing valuations in the higher quality segment of the market and are focused on quality over yield. Nevertheless, we continue to employ our bottom-up approach and are always looking for potential opportunities to buy lower quality issues if they represent attractive values.

[1] Source: J. P. Morgan

Virtus Seix High Income 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: 2011

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

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

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 10/3/2001
Fund Class I	1.96	2.59	3.88	8.04	5.06	8.80	7.86
Index	2.40	2.57	3.05	8.15	5.54	9.46	8.30

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 0.91%. The net expense ratio is 0.81%, 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 0.80%.

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. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, 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.

SECTOR ALLOCATIONS

	% Fund
Energy	19.25
Financial Institutions	12.12
Cable/Satellite	10.11
Telecommunications	7.87
Healthcare/Pharmaceuticals	7.72
Transport/Auto/Aerospace/Defense	5.40
Building/Construction	5.14
Rest/Food/Beverage/Supermkts	4.70
Gaming/Leisure	3.67
Cash	3.28
Metals/Mining	3.24
Div Mfg/Other Ind	2.76
Retailers	2.68
Technology	2.40
Consumer Products/Tobacco	1.99
Services/Environmental	1.86
Chemicals	1.71
Media/Entertainment	1.63
Hotels/REITs	1.15
Utility	1.09
Paper/Packaging	0.19

Sector weights are subject to change.

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. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **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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