VIRTUS MUTUAL FUNDS

Virtus Seix High Income Fund

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

MARKET REVIEW

The Bloomberg Barclays U.S. Corporate High Yield Bond Index turned in a positive return of 1.03% for the second quarter, roughly matching the decline of the first quarter. BBs continued to underperform while CCCs were the biggest outperformers. This performance is not surprising in an environment in which rates are moving higher. BBs are more interest-rate sensitive and CCCs benefit from a growing economy and improving issuer fundamentals.

Year-to-date, spreads on CCCs have tightened by more than 100 basis points (bps), with the bulk of that coming in the second quarter. Spreads on BBs have widened by about 40 bps and again most of that came in the second quarter.

The credit quality of the market continues to improve while the size of the market continues to shrink. CCCs now make up just 12.5% of the index, down 150 bps year-to-date. The fair market value of the high yield sector has declined about $60 billion this year largely due to declining issuance.

Issuance during the quarter amounted to $53.5 billion, down from $72.7 billion in the first quarter. Year-to-date, issuance totaled $126.3 billion, off more than 28% from the first half of 2017. Most of the issuance (64%) went to refinancings in the first half while 19% was used for acquisitions and 14% went to general business purposes. The issuance in the high yield market is in marked contrast to both the bank loan market and to the investment grade corporate market, both of which have seen robust issuance in 2018.

On the demand side, outflows continued during the quarter as investors sought to de-risk their portfolios. Year-to-date mutual fund outflows amounted to $25.5 billion, or about 8.3% of the asset class. Of that, $19.7 billion came from actively managed funds, and $6.9 billion came from exchange-traded funds. These were the largest outflows since 2014, and they cumulatively reversed about 92% of the flows that came into the market after the credit crisis between 2009 and 2012.

These large outflows might be expected to present a challenge for high yield, but other technical factors are counterbalancing the drop in demand. First, dealer inventories are relatively small, at about $3 billion, and second, issuance has been very light.

Defaults for the first half of the year roughly matched those of the same period last year, at 2.06%. Excluding one large issuer, iHeart Communications, the default rate was just 1.33%.

PERFORMANCE

The 1.53% second quarter return of the Virtus Seix High Income Fund was 50 bps ahead of the 1.03% return of the Bloomberg Barclays U.S. Corporate High Yield Bond Index. The outperformance was partially due to both an overweighting and favorable security selection in energy, especially the offshore drilling subsector, which profited from the strength in oil prices. The portfolio also benefited from the recovery of a lower quality retail issuer as well as a void in a defaulting auto supplier. Partially offsetting these factors was unfavorable security selection in finance.

CURRENT STRATEGY

We continue to look for potential opportunities to move the portfolio toward higher credit quality. The CCC-rated part of the market has clearly been pricing in solid economic news, so we have been able to shift out of the lower rated segment and into BBs without giving up much yield. In fact, the allocation to CCCs is near to the lowest in the history of the portfolio.

We continue to find potential opportunities in the cable sector and in the energy sector. We believe that given current energy prices, fundamentals are better than the market is reflecting. But, in general, our focus is more on quality than on yield. This should ensure that if a difficult market emerges, we will be well-positioned to handle it.

OUTLOOK

We are always on the lookout for developing excesses, such as the LBO frenzy prior to the 2008 financial crisis or the elevated borrowing in energy in from 2013 to 2015 and technology/telecom in the early 2000s, but we see few troubling signs in the current high yield market. Supply has been able to adapt to a lower level of demand and, despite a significant sell-off in the investment grade market, absolute returns year-to-date are positive (albeit only slightly). Although spreads are relatively tight, they are not at their narrowest level and should absorb a portion of another increase in Treasury rates. Given these conditions and the relatively solid fundamentals, we would expect the Fund to be able to produce a mid-single-digit return over the next 12 months.

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 6/30/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 10/3/2001
Fund Class I	1.53	0.62	4.38	5.22	5.03	7.83	7.86
Index	1.03	0.16	2.62	5.53	5.51	8.19	8.27

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

SECTOR ALLOCATIONS	% Fund
Energy	20.03
Financial Institutions	14.31
Healthcare/Pharmaceuticals	8.98
Cable/Satellite	7.80
Telecommunications	7.06
Transport/Auto/Aerospace/Defense	6.01
Building/Construction	5.14
Rest/Food/Beverage/Supermkts	4.37
Gaming/Leisure	3.92
Metals/Mining	3.43
Retailers	3.32
Technology	2.86
Div Mfg/Other Ind	2.59
Services/Environmental	1.80
Media/Entertainment	1.71
Consumer Products/Tobacco	1.60
Chemicals	1.56
Utility	1.16
Cash	1.11
Hotels/REITs	1.05
Paper/Packaging	0.18

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.

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.