VIRTUS FUNDS

Emerging Markets for the Long Haul: The Small-Cap Opportunity

Emerging market equity was one of the most volatile asset classes in 2018 as headwinds such as tariff concerns, a rising U.S. dollar, and political uncertainty contributed to severe losses. Despite these challenges, the case for EM remains strong.

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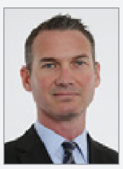

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Virtus KAR Emerging Markets Small-Cap Fund

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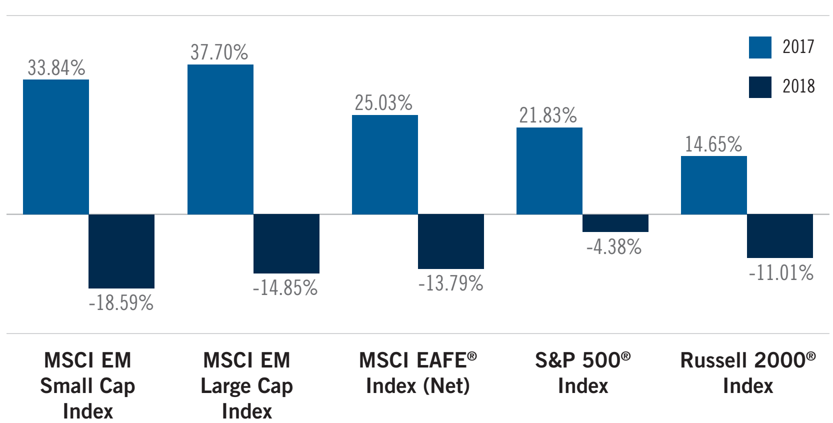
Long-term investors should know that volatile and sometimes outsized swings in performance are quite the norm when it comes to emerging markets, and that the asset class—particularly the small-cap segment—can be a long-term winner and an important component of a well-diversified portfolio, thanks to its improving fundamentals and potential for outperformance.

Emerging Markets in 2018—What Happened and Why?

Emerging market (EM) stocks posted impressive absolute and relative performance in 2017, with the MSCI Emerging Markets Small Cap Index gaining 33.84% and the MSCI Emerging Markets Large Cap Index up 37.70%—versus 25.03% by developed market stocks (MSCI EAFE® Index), 21.83% by U.S. large-cap stocks (S&P 500® Index), and 14.65% by U.S. small-cap stocks (Russell 2000® Index). Not long after, however, EM stocks about-faced, with the EM small-cap index falling 18.59% and the EM large-cap index falling 14.85% in 2018.

The decline in EM stocks throughout 2018 was the result of a combination of factors that played out globally.

FIGURE 1: GLOBAL PERFORMANCE SWINGS



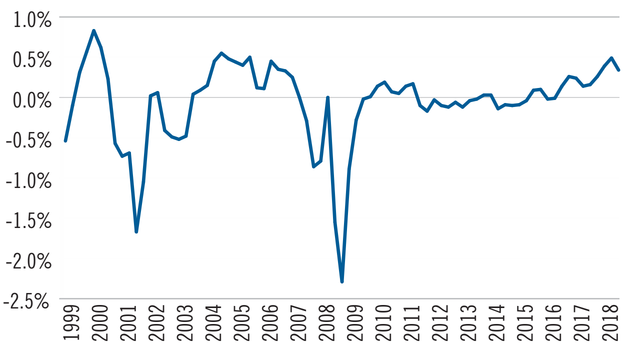
Past performance is no guarantee of future results. Data is obtained from FactSet Research Systems and is assumed to be reliable.

1. Global liquidity

Central banks around the world continued to tighten their monetary policies by raising interest rates, draining available global liquidity at a faster clip. The graph below charts the 6-month rolling differences in the central bank rates of developed economies tracked by Bloomberg. The December 2018 figure rose to a level not seen since before the Great Recession of 2008.

FIGURE 2: DEVELOPED ECONOMIES (OECD) CENTRAL BANK RATE (%)

6-Month Rolling Difference



Past performance is no guarantee of future results. Data presented is for the period ended December 31, 2018. Data is obtained from Bloomberg and is assumed to be reliable.

EM economies saw growing inflows of capital as investors chased higher yields in those regions during years of low interest rates in the U.S. and elsewhere. The drying up of global liquidity, and particularly U.S. dollar liquidity, is likely to present a headwind for those EM economies which generally have been on the receiving end of monetary policy tightening.

2. U.S. dollar strength

The U.S. dollar strengthened steadily in 2018, putting pressure particularly on EM currencies. The U.S. Dollar Index (DXY), which measures the U.S. dollar against a basket of major world currencies, rose 4.40% in 2018. The dollar's strength is influenced by various factors, including a stronger U.S. economy relative to other countries. Trade rhetoric, particularly the ongoing conflict with China, also has driven investors to flock to the dollar, viewed as a safe-haven asset. A continued dollar rally could exacerbate vulnerabilities in emerging markets, which will feel pressure as the cost of servicing dollar-based commodities and debt becomes more expensive.

3. Country-specific risks

Turkey's lira currency plunged throughout 2018, losing 34% of its value against the U.S. dollar from January into August, while recovering slightly in recent months. Currency depreciation helped fuel inflationary pressure—consumer price growth hit 25% in October—and the stock market also suffered, losing 20.86% over the course of 2018. Factors contributing to Turkey's economic decline are concerns that Turkish companies that borrowed heavily may struggle to repay loans in dollars; worsening relations with the U.S. administration including sanctions and tariffs; and concern over central bank independence from President Recep Tayyip Erdogan's efforts to lower borrowing costs.

Argentina's peso also experienced a run in 2018, plunging against the dollar by more than 50% through September and gaining back some ground later in the year. The primary causes were investor concern on the government's ability to deal with its budget deficit and to control inflation, as well as the strengthening U.S. dollar. In September, Argentina's central bank received $50 billion in a bailout fund from the International Monetary Fund (IMF).

4. China and trade tariff friction

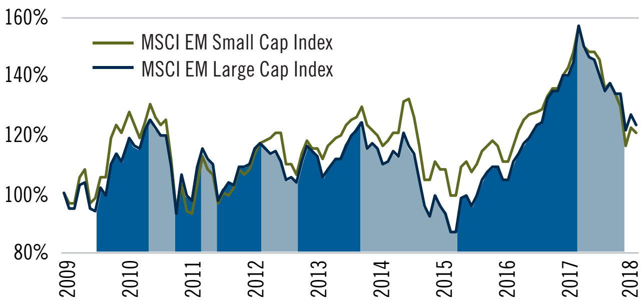
China's growth slowed by a number of measures. The country's GDP grew 6.9% year over year in 2017 and 6.6% in 2018, the slowest pace in 28 years. The slowdown is expected to continue, with the 2019 expansion rate forecast at 6.2%. Stricter financial regulation and a general tightening of financial conditions due to higher interest rates globally combined to create a less favorable economic backdrop for the country, with investments and confidence falling, evidenced, in part, by generally cooling industrial production and retail sales. The world's largest exporter also has seen foreign sales threatened as the trade spat with the Trump administration continues.

The Long-Term Story for EM Still Stands

Despite various near-term challenges, the long-term case for emerging markets remains intact.

For one, historical data show that steep losses in EM stocks are often followed by swift recoveries. The following graph shows performance of both the small- and large-cap EM indexes over the last decade. The shaded areas represent periods of double-digit gains (dark blue) and declines (light blue) exhibited by the EM large-cap index. It is evident that the small-cap EM index has historically closely tracked—usually slightly above—the large-cap index.

FIGURE 3: A HISTORY OF DOUBLE-DIGIT CHANGES



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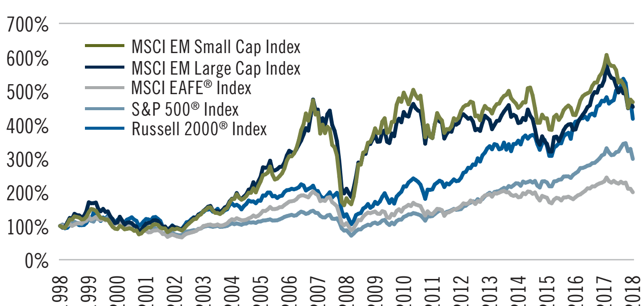
Dips and recoveries are part of a normal pattern for EM equities. There is nothing unusual about episodic drawdowns, as unwelcome as they are, amid what has proven to be longer-term outperformance versus developed market assets.

FIGURE 4: LONG-TERM OUTPERFORMANCE OF EM, PARTICULARLY SMALL CAPS



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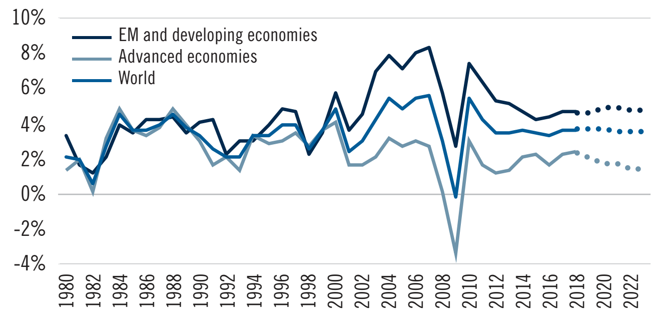
Growth in emerging markets is expected to outpace that of advanced economies and the world overall. The IMF estimates annual real growth of EM and developing economies at 4.5% for 2018 and generally headed up in the future, versus 2.2% for 2018 and a slowing down for advanced economies.

FIGURE 5: REAL GDP GROWTH (ANNUAL % CHANGE)
1980–2018, Projected through 2022



Past performance is no guarantee of future results. Data accessed May 30, 2019. Data is obtained from the International Monetary Fund and is assumed to be reliable.

Furthermore, the trend of middle-class growth is favorable for emerging economies. One study[1] estimates the growth rate at about 6%, describing it as "far more dynamic" than for advanced economies, for which it projects middle-class growth at between 0.5% and 1% a year.

Macro factors could also change. The U.S. dollar rally could subside, and interest rate increases could slow (which they have recently done). Emerging markets themselves could start to raise rates, and any country-specific issues are largely that—brought on by each country's own set of circumstances and not necessarily representative of a regional slowdown. Further, tariff issues will eventually get resolved, though it remains uncertain as to how and when.

In sum, the long-term story supporting emerging markets has been in place for decades, and we believe it should continue, given that structural and fundamental trends look to be moving in the right direction. EM equities merit consideration as a key

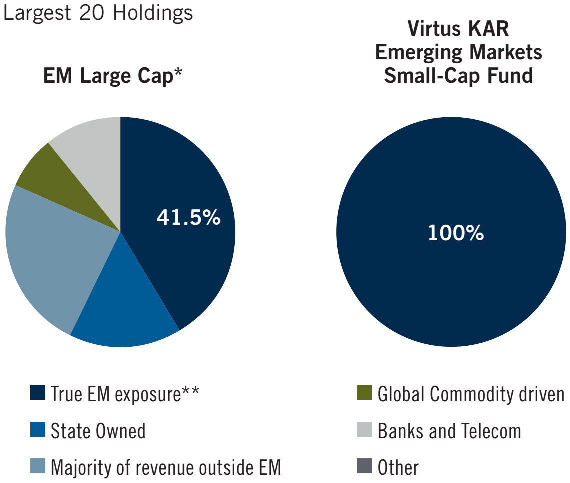
[1] "The Unprecedented Expansion of the Global Middle Class" by Homi Kharas, the Brookings Institution, February 2017, the latest update available.

component of a well-diversified portfolio, as they may benefit from the current positive developments in credit fundamentals, strong demographic trends, and higher growth potential that are characteristic of emerging markets.

Virtus KAR Emerging Markets Small-Cap Fund

Given the fundamentally positive outlook for emerging markets, Kayne Anderson Rudnick (KAR) takes a focused, active approach, specifically in the small-cap segment. The conviction behind this approach is largely twofold: KAR believes that an active approach allows skilled managers to better leverage the advantageous characteristics of emerging markets while steering clear of issues likely to pressure broader indexes that track stocks. In addition, the managers believe a focus on small caps allows them to capture "true" EM exposure, compared to the large-cap segment which exhibits a higher concentration of state-owned companies and consists of highly regulated industries and companies that make the majority of their revenues outside of emerging markets. In contrast, the small-cap space provides exposure to sectors and businesses that are more closely aligned to secular growth trends within the EM countries themselves.

FIGURE 6: SMALL CAPS BETTER CAPTURE EM GROWTH
Largest 20 Holdings



*EM Large Cap includes all common stocks in countries included in the MSCI Emerging Markets Index with a market cap greater than $5B. Data as of June 30, 2019. Data is obtained from FactSet Research Systems and is assumed to be reliable.

**True EM exposure is defined as businesses that generate the majority of revenue and cash flow in emerging markets.

Of note, EM small-cap stocks have historically had a better return and risk profile relative to EM large-cap stocks, as measured by their respective MSCI indexes.

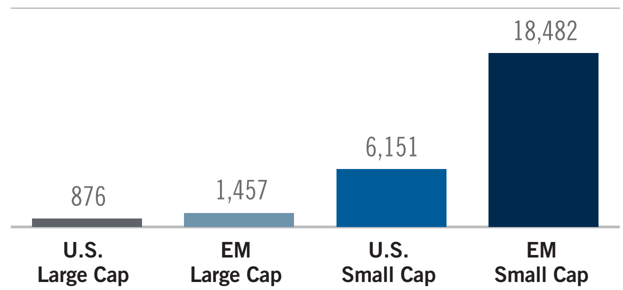
FIGURE 7: EM RISK/RETURN PROFILES

	ANNUALIZED RETURN	ANNUALIZED STANDARD DEVIATION	BETA
MSCI EM Small Cap Index	7.02%	21.74%	0.92
MSCI EM Large Cap Index	6.75%	21.97%	1.00

Past performance is no guarantee of future results. Data presented is based on monthly returns from July 1, 1999 through June 30, 2019. Data is obtained from Morningstar Direct and is assumed to be reliable.

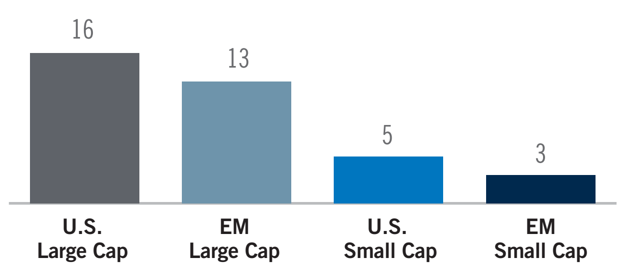
The EM small-cap universe of investable companies is larger than one might expect and less efficient in terms of analyst coverage, providing a relatively untapped market for skilled active investors to identify high-quality stocks at attractive prices.

FIGURE 8: INVESTABLE UNIVERSE
Number of Companies



Data as of June 30, 2019. Data is obtained from FactSet Research Systems and is assumed to be reliable.

FIGURE 9: EQUITY RESEARCH COVERAGE
Average Number of Analysts Covering Individual Stocks



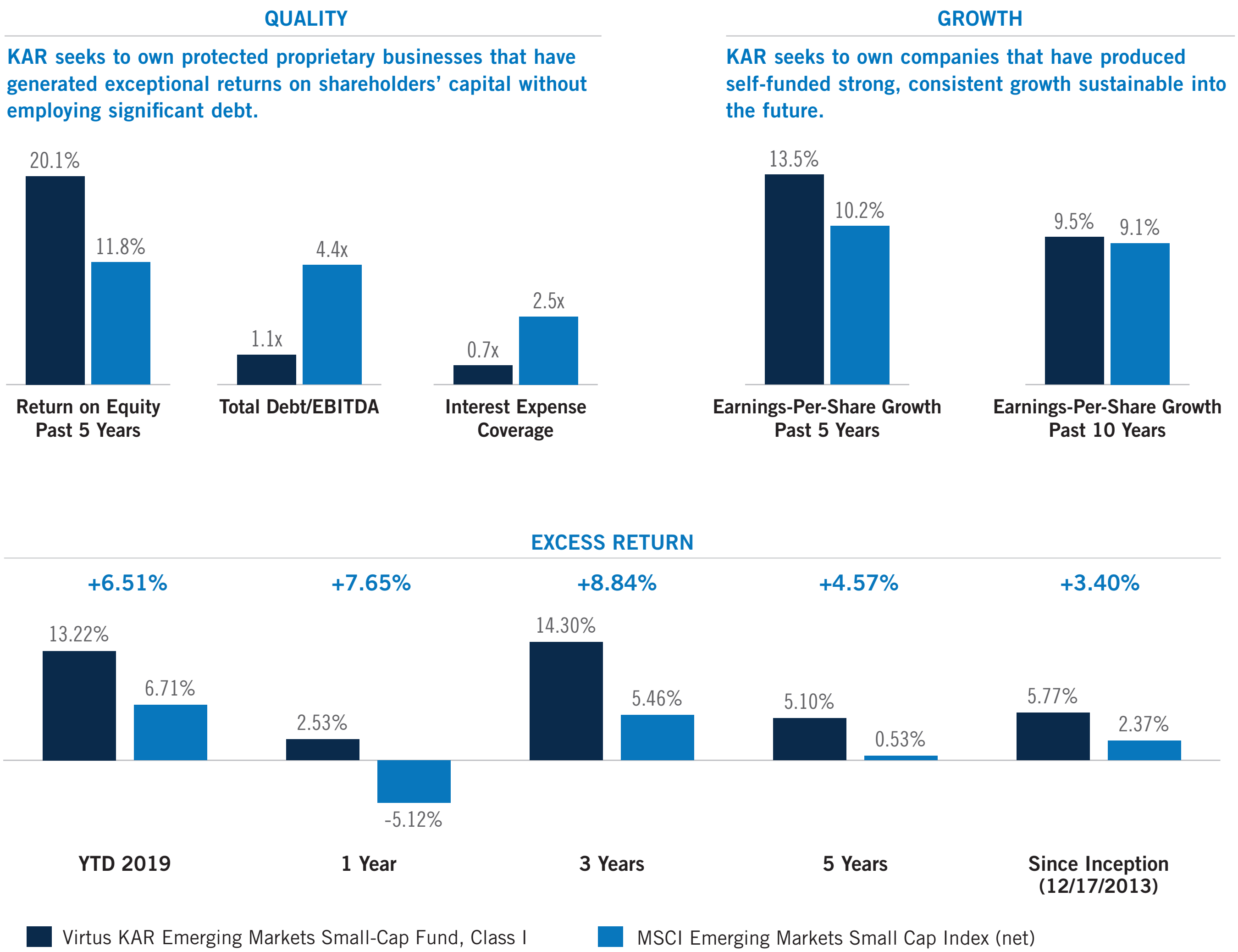
Data as of June 30, 2019. Data is obtained from FactSet Research Systems and is assumed to be reliable.

Adding Value to EM Small-Cap Investing

KAR believes their strict focus on high-quality companies, rigorous research, and degree of conviction in each business they own combine to support strong, consistent performance over the long term. The KAR EM team seeks to identify companies with quality characteristics: high return on capital over a full economic cycle, long and resilient earnings history, and minimal debt. The team looks for competitive protection, capital efficiency, growth prospects, and solid corporate governance, among other factors.

As a result of this disciplined approach, the Virtus KAR Emerging Markets Small-Cap Fund has exhibited stronger fundamental quality and growth characteristics and performance relative to its benchmark.

FIGURE 10: PORTFOLIO CHARACTERISTICS AND PERFORMANCE



Past Performance is no guarantee of future results. Data presented is for the periods ended June 30, 2019. Data is obtained from FactSet Research Systems and is assumed to be reliable. See page 6 for definitions of financial terms.

Average Annual Total Returns (%) Class I as of 6/30/19

Virtus KAR Emerging Markets Small-Cap Fund

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Incep. 12/17/2013
NAV	0.49	13.22	2.53	14.30	5.10	n/a	5.77
Index[1]	-0.98	6.71	-5.12	5.46	0.53	n/a	2.37

The fund class gross expense ratio is 1.97%. The net expense ratio is 1.64%, which reflects a contractual expense reimbursement in effect through 1/31/2020. 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 1.60%.

MORNINGSTAR RATINGS

World Large Stock Category

Time Period	# of Stars	# of Funds
Overall	★★★★★	712
3 Year	★★★★★	712
5 Year	★★★★★	560
10 Year	NA	—

Strong ratings are not indicative of positive fund performance. Morningstar ratings are based on risk-adjusted returns.

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.

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.

[1]Index: MSCI Emerging Markets Small Cap Index (net)

Morningstar Rating™ for funds, or "star rating," is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. Ratings do not take into account the effects of sales charges and loads.

DEFINITIONS

Earnings-per-Share (EPS) Growth indicates the earnings available to each common share. Earnings-per-share growth is the growth rate of these earnings per share. On a portfolio level, this statistic measures the trailing earnings per share growth of a portfolio's holdings.

Interest Expense Coverage Ratio measures how many times over a company could pay its outstanding debts using its earnings. The lower the ratio, the more the company is burdened by debt expense.

Return on Equity (ROE) relates how well a company is using the money invested in it so that it can bring a return to its investors. A high portfolio ROE indicates that the portfolio is invested in historically profitable companies.

Total Debt/EBITDA is calculated by dividing total debt by earnings before interest, taxes, depreciation, and amortization. It is a measure of a company's ability to pay off its incurred debt.

The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **S&P 500® Index** is a free-float market-capitalization weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **MSCI Emerging Markets Large Cap Index (net)** is a free float-adjusted market capitalization-weighted index designed to measure large cap equity market performance in the global emerging markets. The **MSCI Emerging Markets Small Cap Index (net)** is a free float-adjusted market capitalization-weighted index designed to measure small cap equity market performance in the global emerging markets. The index is calculated on a total return basis with net dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. The **MSCI EAFE® Index (net)** is a free float-adjusted market capitalization-weighted index that measures developed foreign market equity performance, excluding the U.S. and Canada.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

About Kayne Anderson Rudnick

High quality at a reasonable price is the guiding principle at Kayne Anderson Rudnick (KAR). The firm manages investment solutions for individuals and institutions, with a focus on companies across market caps that are characterized by market dominance, excellent management, financial strength, and consistent growth. Founded in 1984, and an affiliate of Virtus Investment Partners since 2001, Los Angeles-based KAR has $29.5 billion in assets under management, as of June 30, 2019.

About Virtus Investment Partners

Virtus Investment Partners (NASDAQ: VRTS) is a distinctive partnership of boutique investment managers singularly committed to the long-term success of individual and institutional investors. The company provides investment management products and services through its affiliated managers and select subadvisers, each with a distinct investment style, autonomous investment process, and individual brand.

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To learn more about the Virtus KAR Emerging Markets Small-Cap Fund, visit virtus.com or call us at 1-800-243-4361.

IMPORTANT RISK CONSIDERATIONS
Equity Securities: The market price of equity securities may be adversely affected by financial market, industry, or issuer-specific events. Focus on a particular style or on small or medium-sized companies may enhance that risk. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **Industry/Sector Concentration:** A fund that focuses its investments in a particular industry or sector will be more sensitive to conditions that affect that industry or sector than a non-concentrated fund. **Limited Number of Investments:** Because the fund has a limited number of securities, it may be more susceptible to factors adversely affecting its securities than a less concentrated fund. **Non-Diversified:** The fund is non-diversified and may be more susceptible to factors negatively impacting its holdings to the extent that each security represents a larger portion of the fund's assets. **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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