MARKET COMMENTARY

General Market Environment
The three asset classes—U.S. equities, convertible securities, and high-yield bonds—utilized in the Income and Growth strategy finished mixed in the period. The Russell 1000® Growth Index advanced 1.2%. The ICE BofA US Convertibles Index and ICE BofA US High Yield Index returned -0.5% and 0.9%, respectively. By way of comparison, the 10-year U.S. Treasury returned -0.3% and the S&P 500® Index gained +0.6%.

During the quarter, investors weighed stronger-than-expected second-quarter earnings results and positive economic data against a confluence of macro risks.

Second-quarter financial results for S&P 500 companies exceeded estimates due to stronger-than-expected earnings and revenues. Earnings and revenues surprised by more than 16% and 4%, respectively, and the percentage of companies beating bottom- and top-line projections equated to 87% and 88%, respectively, according to FactSet. For high-yield issuers, as tracked by J.P. Morgan, leverage fell, coverage rose, and EBITDA growth and revenue growth increased by 80% and 38%, respectively, on a year-over-year basis.

On the economic front, the unemployment rate fell, job vacancies and consumer spending increased, housing-related statistics were constructive, and manufacturing and non-manufacturing surveys remained elevated.

Late in the quarter, a convergence of factors dampened sentiment. Global supply chain bottlenecks persisted on the back of ongoing COVID-driven mandates. The Federal Reserve (Fed) indicated that reducing asset purchases may soon be warranted and minutes revealed that half of the officials expected the first rate hike to occur in 2022. A global energy shock pushed the prices of crude oil, natural gas, and coal to multi-year highs, adding to inflation angst. Other risks included declining consumer confidence, a steepening yield curve, an impending U.S. debt ceiling deadline, and uncertainty around the timing and size of additional U.S. fiscal stimulus. Finally, China-related concerns tied to its property and uncertainty around the timing and size of additional U.S. fiscal stimulus.

FUND PERFORMANCE
For the quarter, the Virtus AllianzGI Income & Growth Fund provided consistent monthly income and returned -0.10% (Class I Shares). For the year, the Fund has posted an overall return of 7.09%.

EQUITY & OPTION-SPECIFIC COMMENTS

Equity and Option Market Environment
The S&P 500® Index recorded seven straight monthly gains through August before declining in September. Large-cap growth stocks outperformed large-cap value stocks for the quarter, but the differential diminished in September when market leadership shifted.

Within the Russell 1000® Growth Index, sector performance was mixed. Financials, healthcare, and telecommunication services led the way. Conversely, the industrials, materials, and real estate sectors lagged.

EQUITY & OPTION-SPECIFIC COMMENTS

Equity volatility finished higher quarter over quarter on the back of stock market weakness in September. The VIX Index started the period at 15.8 and finished at 23.1.

Equity Holdings and Option Specifics
Healthcare, financials, and consumer staples were the top-contributing sectors during the period. Healthcare primarily benefited from positioning in biopharma, life science tools & services, and healthcare equipment & supplies. An outperformer included a diabetes management company that surprised to the upside on strong overseas demand. A financial services stock gained alongside major banks expected to profit from a steepened yield curve. In consumer staples, a wholesale retailer topped estimates on higher membership income.

Industrials, energy, and technology detracted from performance in the period. Industrials positions finished lower, led by an air freight stock facing margin pressures. Energy-related holdings gained with crude oil and natural in September but finished lower for the quarter. Software and fintech companies traded off in technology.

Many option positions expired below strike price and the portfolio was able to retain the set premiums. The number of equities with a covered call structure tactically increased over the quarter given higher implied volatilities and attractive yield opportunities.

Investments included positions in industrials, consumer discretionary, materials, and communications services. Sales included holdings in consumer discretionary, healthcare, materials, industrials, communication services, and information technology.

Convertible Specific Comments

Market Environment
Convertible securities were negatively impacted by underlying equity weakness.

Technology, utilities, and financials were the top-performing sectors, while consumer staples, telecommunications, and industrials were the bottom-performing sectors.

Below-investment grade issuers underperformed investment grade issuers. Equity-sensitive structures outperformed yield alternative (busted) and total return (balanced).

Primary market activity remained steady in the quarter with 22 new deals priced for $12.2 billion in proceeds.

Convertible Holdings Specific
Technology was the only sector that positively contributed to performance in the quarter. Many holdings in software outperformed after reporting better-than-expected quarterly results and positive fundamental outlooks.

Consumer discretionary, healthcare, and media detracted the most from performance. Specialty retail and pharmaceutical positions were the greatest drag on performance in consumer discretionary and healthcare, respectively. Social gaming exposure underperformed in media.

Purchases consisted of asymmetric return opportunities within the primary and secondary markets. Investments included exposure to technology, communications, financials, and industrials. Sells primarily included exposure to technology, consumer discretionary, and materials.

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The conversion premium at quarter-end was approximately 30%. Convertible exposure is well positioned to participate on the upside and protect on the downside.

HIGH YIELD SPECIFIC COMMENTS

Market Environment
High-yield bond prices settled lower and spreads and yields modestly increased relative to the previous quarter.

Performance dispersion among credit quality categories tightened over the quarter as rates moved higher, pressuring low yielding issues in September. For the period, BB, B, and CCC-rated issues returned 1.08%, 0.69%, and 1.01%, respectively.

Energy, trucking & delivery, and restaurants outperformed, while theaters & entertainment, transportation infrastructure/services, and cable & satellite TV underperformed.

The primary market remained active with new issuance totaling $108.5 billion across 155 issues. Year-to-date volume of $409.7 billion is on track to surpass 2020’s record of $449.9 billion. Refinancing remained the greatest use of proceeds at 55% of the quarter’s total. Fund flows were $1.7 billion.

The credit ratings upgrade cycle continued, and default rates declined. The trailing 12-month default rates on an issuer-weighted basis and a dollar-weighted basis fell to 1.65% and 0.92%, respectively.

High Yield Holdings Specific
Industry exposures that contributed the most to performance were financials services, energy, and healthcare. Financial services was driven by consumer finance positioning. Energy holdings, in particular exploration & production, gained alongside crude oil (West Texas Intermediate), which rose to $75.03/barrel. An oil producer was upgraded to BB from BB- in August. Pharmaceutical holdings were a source of strength within healthcare. Retail, technology, and media content detracted the most from performance. Positions in department store retailing, communications infrastructure, and sports broadcasting underperformed during the quarter.

Purchases consisted of attractive total return opportunities within the primary and secondary markets. Investments were in cable & satellite, steel, energy, and telecom, among other industries. Hospital operations, communications, packaged food, and healthcare were among exposures that were reduced.

OVERALL MARKET OUTLOOK
The U.S. economy and corporate earnings are on track for continued growth into year-end.

Expansion in the United States has slowed from robust levels but should remain strong. Growth catalysts include steadfast consumer demand given rising incomes, excess consumer savings, and record household wealth. An increase in business spending and investment, a further recovery in the labor market, and the potential for additional U.S. fiscal stimulus are also supportive.

Against this backdrop, revenues and corporate profits are expected to continue to grow. U.S. companies should benefit from pricing power and operating leverage as well as rising sales, which should more than offset the impact of higher input costs and wages and near-term bottlenecks.

Potential risks include persistently high inflation stemming from upward pressures in wages, rents, and energy prices as well as ongoing global supply chain disruptions and continued COVID-related uncertainties. Other potential risks include China property market contagion, continued power outages, further contention in Congress around future U.S. fiscal stimulus, the potential for corporate tax increases, and tighter monetary policy.

The Fed’s commentary and dot plot forecast suggest a less accommodative stance given ongoing economic improvement and rising inflation. Tapering is projected to start before year-end and end by mid-2022 and the first rate hike could occur in late 2022. However, context is important. During the last two rate cycles, the Fed hiked 17 times between 2004 and 2006 and nine times between 2015 and 2018. Additionally, the 10-year Treasury yield remains very low in absolute and relative terms.

After market weakness in September, U.S. equities are better positioned for gains in the fourth quarter. Notably, over the past five quarters, earnings have topped forecasts by an average of 18% compared to a 4% average over the prior 25 years (per Credit Suisse) as analysts over/underestimate factors impacting bottom lines. The investment bank also observed that over the past four rate hike cycles (’94, ’99, ’04, ’15), the S&P 500 Index gained 9.5% in the 12 months prior to the first hike, and 26.0% over the subsequent three years.

U.S. convertible securities should be a beneficiary of equity market strength. With $68 billion in new issuance through September, annual new issuance for 2021 is on track to meet strategists’ upwardly revised targets of approximately $85 billion. Primary market activity should help to broaden and balance the overall convertible market, which remains well positioned to participate in the upside and provide downside protection.

U.S. high yield is on pace to produce a coupon-like return in 2021. Credit metrics, default rates, and ratings trends should all continue to improve into year-end. Along those lines, many market strategists have reduced their default rate expectations for 2021 and 2022. Robust new supply in 2021 has allowed company managements to reduce interest expenses and push out debt maturities, decreasing near-term refinancing obligations.
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 0.88%.

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 1: 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 index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

Index 2: The Bloomberg U.S. Aggregate Bond Index measures the U.S. investment grade fixed rate bond market. 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 Russell 1000 Index is a stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index.

Notes on Risk: Market Volatility: Local, regional, or global events such as war, acts of terrorism, the spread of infectious illness or other public health issues, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio manager(s) to invest the portfolio’s assets as intended.

Issuer Risk: The portfolio may be affected by factors specific to the issuers of securities and other instruments in which the portfolio invests, including actual or perceived changes in the financial condition or business prospects of such issuers. 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. 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.

Convertible Securities: A convertible security may be called for redemption at a time and price unfavorable to the portfolio. Prospectus: For additional information on risks, please see the fund’s prospectus.

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