VIRTUS FUNDS

# The Merger Fund®

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## MARKET REVIEW

Looking at the year as a whole, 2023 presented a mixed picture of the mergers and acquisitions (M&A) landscape, especially considering the challenges faced in the previous year. Given the difficult conditions in 2022, it was no surprise that merger activity began in a subdued manner. Rising rates, increased financing costs (particularly relevant to private equity deals), ongoing geopolitical tensions, and a potential banking crisis in the first quarter contributed to a more cautious approach by company boards toward corporate reorganizations, particularly in the first half of the year.

However, as the year progressed, CEO confidence improved noticeably. This positive shift was aided by greater transparency and predictability in the regulatory environment. Several high-profile transactions, including Horizon Pharmaceuticals/Amgen, Activision/Microsoft, and VMware/Broadcom, were completed despite initial regulatory pushback, boosting confidence in the market. This positive development paved the way for a solid second half of the year, with M&A volume reaching over $1.7 trillion out of the total global value of $3.1 trillion for the entirety of 2023.

Despite the earlier challenges, the market demonstrated resilience and adaptability. The improved regulatory environment (as enforced by the Courts in the Activision and Horizon deals) played a crucial role in instilling confidence among corporate boards, leading to this increase in mega-cap deals. The late-year transaction momentum contributed to the year-end strength, which has also carried forward into January.

Diving deeper into overall activity, there are several noteworthy attributes both domestically and internationally. North America continued to be a driving force in M&A activity, accounting for a record 58% of global volume in 2023. This rebound was primarily propelled by strategic (as opposed to financially driven) transactions, with deals over $20 billion accounting for a record 28% of the total volume alone, as reported by Dealogic.

Internationally, cross-border transactions accounted for 28% of overall volume, surpassing the average of 25% for the past four years. This increase in cross-border activity can be attributed to the recently improved regulatory predictability. A notable reflection of this is that deals valued at $10 billion contributed to 21% of cross-border volume, a significant jump from 12% in the previous year.

The uptick in cross-border activity indicates that many of the previous uncertainties and obstacles that hindered such combinations are gradually being overcome. It also signifies a growing confidence among companies that they can navigate the regulatory complexities and secure the necessary approvals to move forward with these transactions. This is encouraging, as it demonstrates a willingness to invest in strategic partnerships on a global scale.

## PERFORMANCE

The Merger Fund® advanced by 1.95% during the fourth quarter, bringing its year-to-date performance to 4.51%, marking the Fund's 110th gain in the 140 quarters since its 1989 inception. We held 70 investments during the quarter and experienced one terminated deal. Reflecting a nearly 5:1 ratio of winners to losers, 59 positions posted positive gains, while only 11 had negative marks-to-market. In addition, we took advantage of new opportunities by investing in 12 new situations during the quarter. As of the end of December, we held 50 positions and were approximately 89% invested.

The top two contributors came from closed deals: Seagen Inc./Pfizer Inc. (+0.42%) and VMware Inc./Broadcom Inc. (+0.37%). Additional contributions came from SPACs (+0.27%), Abcam PLC/Danaher Corp. (+0.17%), and technology-related transactions, Splunk Inc./Cisco Systems Inc. (+0.13%), and Activision Blizzard Inc./Microsoft Corp. (+0.13%).

Given S&P 500®'s 11.69% advance during the quarter, our market hedge cost the Fund 0.14% but remains in place for disaster insurance purposes. Additional mark-to-market losses due to spread widening came from Hess Corp./Chevron Corp. (-0.15%), Westrock Co./Smurtfit Kappa Group PLC (-0.08%), Capri Holdings Ltd./Tapestry Inc. (-0.08%), Origin Energy Ltd./Mid-Ocean Partners LP (-0.04%), and Sovos Brands Inc./Campbell Soup Co. (-0.02%).

With regard to fixed income, it certainly was a challenging year for typical bond investors. Even as stocks and bonds posted gains for the year, volatility was elevated—especially in the bond market, which whipsawed during the year yet ended with a fourth quarter surge. Driving that volatility was the shifting outlook for Federal Reserve Bank (Fed) actions. During the fourth quarter, as the Treasury bond market swung from a large mid-year sell-off to a sharp rally, volatility jumped to its highest level in at least five years. The catalyst behind this reversal of fortune was the shift in Fed policy from interest rate increases (tightening) to prospective cuts (loosening) in 2024, resulting in a sharp rally that reversed bond market performance from negative to slightly positive for the year.

While there is cause to be optimistic, there are some equally legitimate reasons why risk management and diversification should be top concerns for investors in 2024. Notably, the correlation between stocks and bonds is close to its highest level in the past 50 years. Given this, exploring alternative investment options to manage risk and seek new avenues for generating returns may be beneficial.

## OUTLOOK

Looking ahead to 2024, we are optimistic about a continued increase in M&A activity following the strong fourth quarter. Uncertainty is among the biggest challenges to M&A, but with more regulatory clarity, stabilized funding rates, and a positive track record of wins in the courtroom, we expect the fourth quarter deal momentum to continue. Additionally, this predictability will likely tighten the bid-ask spread between corporate buyers and sellers. There is now approximately $1.8 trillion in cash on corporate balance sheets, and with an estimated $1.5 trillion in dry powder in the hands of private equity sponsors, there are $3.3 trillion reasons to transact. With a predictable cost of capital and ongoing pressure to look for opportunities to keep up with innovation across all industry groups, we anticipate an increase in corporate activity in 2024, a trend we have already begun to see in the first few weeks of the new year.

## INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

## INVESTMENT SUBADVISER

Westchester Capital Management, LLC

## PORTFOLIO MANAGERS

**Roy D. Behren**
Industry start date: 1987
Start date as Fund Portfolio Manager: 2007

**Michael T. Shannon, CFA**
Industry start date: 1988
Start date as Fund Portfolio Manager: 2007

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

| | QTD | YTD | 1 Year | 3 Year | 5 Year | 10 Year | Since Inception (8/01/13) |
|---|---|---|---|---|---|---|---|
| Fund Class I | 1.95 | 4.51 | 4.51 | 1.85 | 3.39 | 3.15 | 3.24 |
| Index 1 | 1.37 | 5.01 | 5.01 | 2.15 | 1.88 | 1.25 | 1.20 |
| Index 2 | 6.82 | 5.53 | 5.53 | -3.31 | 1.10 | 1.81 | 1.77 |
| Index 3 | 2.72 | 5.60 | 5.60 | 2.78 | 4.43 | 3.34 | 3.51 |

**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 1.36%. The net expense ratio is 1.25%, which reflects a contractual expense reimbursement in effect through 4/30/2024. This ratio reflects the direct and indirect expenses paid by the Fund. The net expense ratio minus dividend and interest expense on short sales and indirect expenses incurred by the underlying funds in which the Fund invests is 1.17%.

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 ICE BofA US Treasury Bill 3 Month Index** measures performance of the three-month Treasury bill, based on monthly average auction rates. The index is calculated on a total return basis.

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.

Index 3: **The Morningstar US Fund Event Driven Category Average** contains strategies that attempt to profit when security prices change in response to certain corporate actions, such as bankruptcies, mergers and acquisitions, emergence from bankruptcy, shifts in corporate strategy, and other atypical events. Activist shareholder and distressed investment strategies also fall into this category. These portfolios typically focus on equity securities but can invest across the capital structure.

## TOP TEN HOLDINGS

| | | |
|---|---|---|
| 1 | Pioneer Natural Resources Co. | |
| 2 | Splunk Inc. | |
| 3 | Hess Corp. | |
| 4 | WestRock Co. | |
| 5 | Spirit Realty Capital, Inc. | |
| 6 | Capri Holdings Ltd. | |
| 7 | Virtus Westchester Event-Driven Fund | |
| 8 | Amedisys, Inc. | |
| 9 | Altaba Inc. | |
| 10 | JSR Corp. | |
| **Top 10 Positions as % of fund** | | 39.92 |

Holdings are subject to change.

## TOP FIVE CONTRIBUTORS

| | % Contribution |
|---|---|
| Seagen Inc./Pfizer Inc. | 0.42 |
| VMware Inc./Broadcom Inc. | 0.37 |
| SPACs | 0.27 |
| Abcam PLC/Danaher Corp. | 0.17 |
| Splunk Inc./Cisco Systems Inc. | 0.13 |

## TOP FIVE DETRACTORS

| | % Contribution |
|---|---|
| Hess Corp./Chevron Corp. | -0.15 |
| Macro Portfolio Hedge | -0.14 |
| Westrock Co./Smurfit Kappa Group PLC | -0.08 |
| Capri Holdings Ltd./Tapestry Inc. | -0.08 |
| Origin Energy Ltd./Mid-Ocean Partners LP | -0.04 |

% Contribution: Absolute weighted contribution.

To obtain the top/bottom holdings calculation methodology, call 800-243-4361.

**Notes on Risk: Fundamental Risk of Investing:** There can be no assurance that the portfolio will achieve its investment objectives.An investment in the portfolio is subject to the risk of loss of principal; shares may decrease in value. **Merger-arbitrage & Event-driven investing:** Merger-arbitrage and event-driven investing involve the risk that the adviser's evaluation of the outcome of a proposed event, whether it be a merger, reorganization, regulatory issue, or other event, will prove incorrect and that the Fund's return on the investment may be negative. **Short Sales:** The portfolio may engage in short sales, and may incur a loss if the price of a borrowed security increases before the date on which the portfolio replaces the security. **Foreign Investing:** Investing in foreign securities subjects the portfolio to additional risks such as increased volatility, currency fluctuations, less liquidity, and political, regulatory, economic, and market risk. **Portfolio Turnover:** The portfolio's principal investment strategies may result in a consistently high portfolio turnover rate. A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes when the portfolio is held in a taxable account. **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. **Derivatives:** Derivatives may include, among other things, futures, options, forwards and swap agreements and may be used in order to hedge portfolio risks, create leverage, or attempt to increase returns. Investments in derivatives may result in increased volatility and the portfolio may incur a loss greater than its principal investment. **Hedging:** The portfolio's hedging strategy will be subject to the portfolio's investment adviser's ability to correctly assess the degree of correlation between the performance of the instruments used in the hedging strategy and the performance of the investments in the portfolio being hedged. **Technology Concentration:** Because the portfolio is presently heavily weighted in the technology sector, it will be impacted by that sector's performance more than a portfolio with broader sector diversification. **Sector Focused Investing:** Events negatively affecting a particular industry or market sector in which the portfolio focuses its investments may cause the value of the portfolio to decrease. **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.

**Please consider a Fund's investment objectives, risks, charges, and expenses carefully before investing. For this and other information about any Virtus Fund, contact your financial professional, call 800-243-4361, or visit virtus.com for a prospectus or summary prospectus. Read it carefully before investing.**

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