Virtus Stone Harbor Strategic Income Fund

A: VSHFX (92828Y490) | I: SHSIX (92828Y482)

MARKET REVIEW

U.S. government bond prices drifted higher to start the quarter as manufacturing activity disappointed, barely remaining in expansion territory and reversing some firmer results in August. Yields popped as labor market data showed strong and steady job growth. The unemployment rate edged back down to a more than 50-year low of 3.5%, validating the Federal Reserve's aggressive tightening campaign, which, so far, has not set back the other half of its dual mandate—namely, maximum employment. The selloff in the Treasury market was sustained by upside surprise in the CPI, which rose 8.2% year-over-year amid a large jump in rents and food prices. Ongoing hawkish rhetoric from the Federal Open Market Committee (FOMC), financial and political instability in the UK, and weak consumer sentiment and housing market data, all of which renewed recession concerns, weighed further on U.S. debt prices. The bond rout persisted into November as weak economic indicators fueled hopes for a Fed pivot. The central bank, however, remained resolute, taking its short-term borrowing rate to a target range of 3.75%-4%—the highest level since January 2008.

However, momentum in the Treasury market reversed course amid a pullback in inflation from a multi-decade high, supporting views that a peak may have been reached. U.S. government debt prices extended gains as market participants focused on the timing of a potential slowdown in the pace of interest rate increases rather than Chair Powell's signaling of a higher-for-longer terminal rate. Despite stronger-than-expected data, yields extended losses into December as investors expected that the FOMC would look past incoming data and focus instead on the lagged effects of earlier rate hikes. Treasuries rallied across the curve, although demand was biased towards longer-dated maturities, sending the 2s10s inversion further into negative territory to a new multi-decade low of -84 bps.

Duration weakened but retraced sharply as headline inflation decelerated more than expected, falling from 7.7% year-over-year in October to 7.1% year-over-year in November, buoying expectations of a more dovish tone from the central bank. Those hopes were dashed following the December FOMC meeting. Although committee members voted unanimously to increase its key policy rate by 50 bps to 4.50% – a downshift from the previous four consecutive 75 bps moves – the central bank downgraded its economic outlook and warned that interest rates will climb higher and stay there longer than many might have hoped. Powell acknowledged the improving inflation data but emphasized it will take "substantially more evidence" to ensure inflation is on a sustained downward trajectory. He also stressed that the robust labor market increases the risks of inflation remaining elevated. U.S. bond prices declined into year-end amid conflicting data signals, thin trading, and uncertainty over monetary policy direction and economic growth for 2023.

FUND PERFORMANCE REVIEW (As of 12/30/22)

The Fund (Class I) returned 5.22% in the fourth quarter, materially outperforming the Bloomberg Global Credit Hedged USD Index return of 3.31%.

Positive Contributors

> Issue allocation was the largest positive contributor for the period, with duration management also adding to overall performance.

> The Fund's emerging markets (EM) hard sovereign debt allocation meaningfully outperformed its benchmark due to strong issue selection.

Performance Detractors

> The Fund's allocation to EM local currency underperformed its benchmark due to weak issue selection.

FUND STRATEGY AND POSITIONING (As of 12/30/22)

It was a rare quarter where there were no shifts in broad sector allocation in the fund. Spread tightening has persisted from the fourth quarter to early 2023. Given that the potential for additional spread tightening is limited, this makes us reluctant to add additional risk to the portfolio. We have already shortened duration modestly and adjusted yield curve positioning, so reduction in risk would most likely come from the high yield or investment grade (IG) corporate sectors.

> **Investment Grade (IG):** IG produced positive excess returns of +289 bps for the quarter, and total returns of 3.63%. However, total returns finished the year at -15.76%—the worst on record.

> **U.S. High Yield (USHY):** USHY rebounded to return 3.98% in the quarter. The improving macro sentiment and falling Treasury yields sparked a return of retail fund inflows, which further supported the market.

> **European High Yield (EHY):** EHY rallied with a return of 5.33% as mild weather helped to ease the European energy crisis, averting a potential near-term recession in Europe. Additionally, inflation data improved, and China began to fully reopen its economy.

> **Leveraged Loans:** Loans delivered a 2.74% fourth quarter return, mostly on the back of strong October and November returns, finishing the full year with a -0.60% return.

> **Emerging Markets (EM) Local Currency:** The EM local currency debt benchmark returned 8.45% for the quarter, reflecting the depreciation of the U.S. dollar and Euro strength.

> **EM Hard Sovereign:** The EM sovereign debt benchmark returned 8.11%, outperforming EM corporate bond benchmarks and indexes for U.S. HY and investment grade corporate debt and reversing some of its underperformance in the previous quarter.

> **EM Corporate Debt:** EM hard currency investment grade and sub-investment grade corporate debt posted total returns of 2.99% and 7%, respectively. Spread compression in both sectors drove the positive results.

SECTOR ALLOCATIONS (%)

	% Fund
High Yield	29.56
Treasuries/Cash	22.02
Investment Grade Corporate	16.45
EMD Hard	14.30
Securitized	10.14
EMD Corporate	4.96
EMD Local	2.57

Holdings and sector weightings are subject to change. Weightings may not add up to 100% as a result of the use of certain financial instruments, including derivatives, which may be used to gain or reduce market exposure and/or for risk management purposes.

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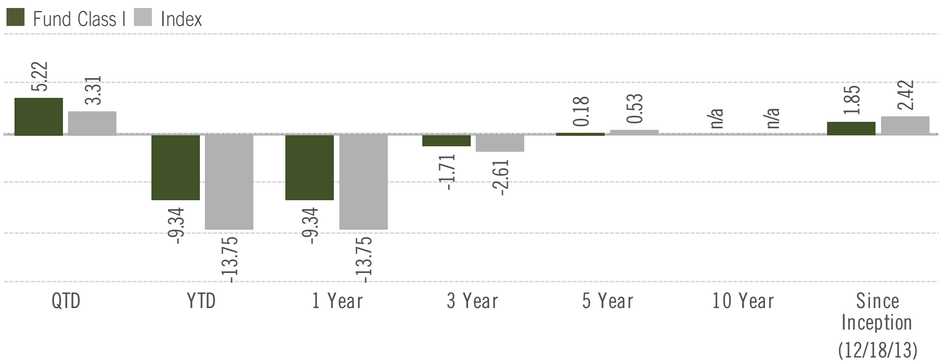
OUTLOOK

While investors have embraced the theme that a soft economic landing is increasingly likely, and we believe there is some justification for the U.S. rates rally given the proximity to Fed terminal pricing, the corresponding rally in Europe has begun to feel overdone, in our view. The biggest question mark for developed markets government bonds is still Japan, where many market participants have assumed the end of yield curve control (YCC) policy by the Bank of Japan. The rates market seems to have adjusted for the change in policy, so we see limited downside. On the other hand, the Japanese yen would appear to offer more potential gains should a new policy be announced. One other positive sign for bond investors moving forward is a decline in financial market volatility measures. Long stretches of range-bound trading would be welcome, considering the bad experiences of 2022. One of our strongest conviction corporate trade ideas for 2023 is an overweight to banks. Banks were big underperformers in 2022, mainly because they contributed to heavy supply in a poor investment environment. Relative valuations now favor financials over non-financials during a period where bank supply is expected to be notably less versus 2022.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 12/30/22



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 1.47%. The net expense ratio is 0.70%, which reflects a contractual expense reimbursement in effect through 4/7/2024.

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.

INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

Stone Harbor Investment Partners

PORTFOLIO MANAGERS

Peter J. Wilby, CFA
Industry start date: 1980
Start date as Fund Portfolio Manager: 2013

James E. Craige, CFA
Industry start date: 1988
Start date as Fund Portfolio Manager: 2013

David Torchia
Industry start date: 1984
Start date as Fund Portfolio Manager: 2013

David Scott
Industry start date: 1983
Start date as Fund Portfolio Manager: 2013

Roger Lavan, CFA
Industry start date: 1985
Start date as Fund Portfolio Manager: 2013

Index: **The Bloomberg Global Credit Hedged USD Index** is a subset of the Global Aggregate Index and is subject to the same quality, liquidity and maturity requirements and exclusion rules of the latter. Constituents must be rated investment grade by at least two of the three major ratings agencies. Constituents must have a remaining maturity of at least one year. The index does not include convertibles, floating rate notes, fixed rate perpetuals, warrants, linked bonds and structured products. 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.

Notes on Risk: Affiliated Fund: The risk that the adviser's authority to select and substitute underlying funds from a variety of affiliated mutual funds may create a conflict of interest. **Allocation:** The risk that the portfolio's exposure to equities and fixed income securities, or to different asset classes, may vary from the intended allocation or may not be optimal for market conditions at a given time. **Fund of Funds:** The risk that the fund's performance will be adversely affected by the assets owned by the other mutual funds and ETFs in which it invests, and that the layering of expenses associated with the fund's investment in such other funds will cost shareholders more than direct investments would have cost. **Emerging Markets Investing:** Emerging markets securities may be more volatile, or more greatly affected by negative conditions, than those of their counterparts in more established foreign markets. **Foreign Investing:** Investing in foreign securities subjects the portfolio to additional risks such as increased volatility; currency fluctuations; less liquidity; less publicly available information about the foreign investment; and political, regulatory, economic, and market risk. **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. **Counterparties:** There is risk that a party upon whom the portfolio relies to complete a transaction will default. **Currency Rate:** Fluctuations in the exchange rates between the U.S. dollar and foreign currencies may negatively affect the value of the portfolio's shares. **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. **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. **Liquidity:** Certain instruments may be difficult or impossible to sell at a time and price beneficial to the portfolio. **Income:** Income received from the portfolio may vary widely over the short- and long-term and/or be less than anticipated if the proceeds from maturing securities in the portfolio are reinvested in lower-yielding securities. **U.S. Government Securities:** U.S. government securities may be subject to price fluctuations. An agency may default on an obligation not backed by the United States. Any guarantee on U.S. government securities does not apply to the value of the portfolio's shares. **ABS/ MBS:** Changes in interest rates can cause both extension and prepayment risks for asset- and mortgage-backed securities. These securities are also subject to risks associated with the non-repayment of underlying collateral, including losses to the portfolio. **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. Price changes may be short- or long-term. Local, regional or global events such as war or military conflict (e.g., Russia's invasion of Ukraine), acts of terrorism, the spread of infectious illness (e.g., COVID-19 pandemic) 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's manager(s) to invest the portfolio's assets as intended. **Prospectus:** For additional information on risks, please see the fund's prospectus. Distribution Rate is calculated by summing all distributions over the preceding 12 months, and dividing by the NAV on the last business date of the period.

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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