VIRTUS MUTUAL FUNDS

Virtus Herzfeld Fund

A: VHFAX (92828W874) | C: VHFCX (92828W866) | I: VHFIX (92828W858)

MARKET REVIEW

Closed-end funds (CEFs) produced mixed returns for investors in the fourth quarter of 2017 even though the underlying net asset values (NAVs) of the seven fund categories we track produced positive gains ranging from 0.54% to 3.28%. Discounts widened for equity, taxable fixed income, and municipal CEFs by 46, 136, and 198 basis points, respectively. In light of the discount-widening headwind across all asset classes, the CEF market as a whole returned a meager 0.51% for the quarter.

Historically an excellent month for CEF trading, December's tax-loss selling and buying was overshadowed by the federal tax law and how it would affect MLP CEFs that were registered as C-corps. For some MLP funds, the reduction in the maximum federal corporate tax rate from 35% to 21% would change the accounting calculation for deferred tax liabilities and thereby create a one-time windfall increase to NAV. Following the passing of the tax bill into law, multiple funds announced their NAV adjustments, creating major winners and losers in the last month of 2017 for MLP CEF investors. Gains ranged from 1.60% to 24.35%, with an average gain of 10.42%, as identifying which funds would have large NAV adjustments became more appetizing to investors than focusing on December tax trading.

PERFORMANCE

For the fourth quarter, the Fund (Class I) returned 3.73%, outperforming the 3.57% return of the composite benchmark. At quarter-end, the average weighted discount of the CEF holdings in the portfolio was -9.66%, compared with -9.90% in the previous quarter — a narrowing of 24 basis points.

Top contributors to performance were almost identical to those in the prior quarter with BlackRock Science & Technology Trust (BST) and NexPoint Credit Strategies Fund (NHF) leading the way again. In addition, our increased allocation to C-Corp MLP CEFs in December generated outsized gains.

- NHF, our largest holding, rallied 12.46% in the quarter as the discount narrowed from -6.87% to -4.02%. We trimmed the position into strength from 8.07% to 6.83%. NHF should benefit from the changes in the tax code as its private real estate holdings make up about 25% of the portfolio. NHF is still awaiting a final decision on an appeal of a $51 million judgment plus interest from September 2015 that could boost NAV significantly.
- BST gained 10.69% as technology continued to produce outsized gains. It was the best performing CEF in 2017, gaining 57.42%. BST increased its dividend 18.2% in the quarter and 30% year over year. We trimmed the position as the discount narrowed from -7.36% at the start of the quarter to -3.75% as we saw better opportunities in December.
- We increased our MLP CEF holdings from 4.76% to 11.99% in the quarter, with the majority of buying in December ahead of the new tax bill. Funds we added had upward NAV revisions between 3% and 12% in December, producing significant gains following the 40% cut to the corporate tax rate.

Top detractors from performance were our allocations to healthcare CEFs, the Mexico Equity and Income Fund (MXE), and AllianzGI NFJ Dividend, Interest & Premium Strategy Fund (NFJ).

- Tekla World Healthcare Fund (THW) and Tekla Healthcare Opportunities Fund (THQ) dropped 4.12% and 3.83% in the quarter, respectively, as the healthcare market was hurt by weakness in specialty pharma and generics due to the FDA's push for more competition, which should drive prices down, and by weakness in biotechs mainly due to Celgene's collapse from a failed drug trial and subsequent weak earnings and guidance.
- MXE was the worst performer, dropping 11.06% as NAFTA negotiations, the Mexican presidential election cycle, peso weakness, and tepid growth weighed on the Mexican stock market. At a discount of -13.35%, we see activist City of London Investment Management and its 40% stake possibly forcing liquidation.
- We added to NFJ following its 25% dividend cut in mid-December. NFJ continued to sell off and ended the year trading at a discount of -11.47% versus -7.20% at the start of the fourth quarter.

OUTLOOK

We entered the quarter with a higher level of cash than usual (9.97%) and a large weighting to undervalued MLP CEFs. We expect the new tax legislation to provide significant tax relief in the material, industrial, healthcare, financial, and energy sectors and so have rebalanced our portfolio to take advantage of expected earnings and sales growth as the economy continues to chug along. We carried more cash into 2018 than normal as we foresee some volatility in the CEF fixed income market as short-term rates continue to rise.

Virtus Herzfeld Fund

INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

Thomas J. Herzfeld Advisors

INVESTMENT PROFESSIONALS

Thomas J. Herzfeld
Industry start date: 1968
Start date with the Fund: 2012

Erik M. Herzfeld
Industry start date: 1998
Start date with the Fund: 2012

TOP TEN HOLDINGS

	% Fund
Nexpoint Credit Strategies Fund	6.83
Central Securities Corp.	6.21
Boulder Growth & Income Fund Inc.	5.50
Eagle Point Credit Company Inc. 7% Notes due 12/31/2020	5.39
Tekla Healthcare Opportunities Fund	5.08
PIMCO Dynamic Credit and Mortgage Income Fund	3.89
Tekla World Healthcare Fund	3.79
Adams Natural Resources Fund Inc.	3.50
Alpine Total Dynamic Dividend Fund	3.05
Western Asset/Claymore Inflation-Linked Opportunities & Income Fund	2.61

Holdings are subject to change.

AVERAGE ANNUAL TOTAL RETURNS as of 12/31/17 in percent

I Share	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 9/5/2012
NAV	3.73	17.66	17.66	8.75	8.81	n/a	8.97
Index	3.57	15.41	15.41	6.57	7.37	n/a	7.73

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 2.37%. The net expense ratio is 2.35%, which reflects a contractual expense reimbursement in effect through 1/31/2019. 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 1.35%.

Average annual total returns reflect the change in share price and the reinvestment of all dividends and capital gains. Class I shares have no sales charge and therefore their returns do not reflect the deduction of a sales charge, which if applied, **would reduce the performance quoted**. Fees and expenses vary among share classes and other share classes do carry sales charges. Class I shares are offered primarily to eligible institutional investors who purchase the minimum amounts required and may not be available to all investors. For Fund Performance on other share classes, please visit www.virtus.com.

Index: Composite: **60% MSCI AC World Index (net) / 40% Bloomberg Barclays U.S. Aggregate Bond Index**. The MSCI AC World Index (net) is a free float-adjusted market capitalization-weighted index that measures equity performance of developed and emerging markets. The index is calculated on a total return basis with net dividends reinvested. The Bloomberg Barclays 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.

Notes on Risk: Closed-end Funds: Closed-end funds may trade at a discount from their net asset values, which may affect whether the fund will realize gains or losses. They may also employ leverage, which may increase volatility. **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. **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. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **Fund of Funds:** Because the fund can invest in other funds, it indirectly bears its proportionate share of the operating expenses and management fees of the underlying fund(s). **Prospectus:** For additional information on risks, please see the fund's prospectus.

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