Virtus Newfleet Multi-Sector Intermediate Bond Fund

A: NAMFX (92828R677) | C: NCMFX (92828R651) | I: VMFIX (92828R289) | R6: VMFRX (92828W544)

MARKET OVERVIEW

During the second quarter, investors faced multiple challenges and bouts of elevated volatility that carried over from the first quarter. Investors continued to grapple with the potential market implications of the emerging risks of a trade war among major economic powers, geopolitical tensions, the political climate in Washington, and the ongoing evolution of the quantitative easing (QE) programs initiated by the key global central banks in the aftermath of the Financial Crisis. Oil prices moved higher during the three-month period, U.S. economic data modestly improved, the U.S. dollar climbed, and interest rate volatility remained elevated.

As expected, the Federal Reserve (Fed) increased its target rate during the quarter to a range of 1.75%–2.0% at the June Federal Open Market Committee (FOMC) meeting. The European Central Bank and Bank of Japan are expected to continue QE until late 2018 and early 2019, respectively.

During the quarter, yields were higher across the curve although more pronounced at the front end. Overall, the curve flattened.

Most spread sectors underperformed for the quarter with emerging market high yield bonds the largest underperformer. Long duration assets across sectors underperformed on a total return basis as interest rates rose.

For a more detailed review of the second quarter and our outlook, please see Newfleet's 2Q18 Market Review & Outlook.

HOW THE FUND PERFORMED

The Fund (Class I) returned -1.53% in the second quarter versus the Bloomberg Barclays U.S. Aggregate Bond Index return of -0.16%.

Contributors

> Allocation to the **corporate high yield** sector benefited performance. The sector was one of the top performers during the quarter as spreads narrowed as rates rose. Lower credit tiers continued to outperform the longer duration, higher quality BBs. Light new issuance and overall improving fundamentals were supportive of the sector.

> Within the **asset-backed security** (ABS) sector, both allocation and issue selection positively impacted performance. The sector generally offers lower volatility, a diversified collateral base, and attractive valuations relative to many other areas of the fixed income market. Expectations are for range-bound spreads with modest room for tightening.

> Allocation to the **bank loan** sector contributed positively as the sector demonstrated its resiliency in a rising rate environment. The improving fundamental backdrop and positive technical conditions resulting from mutual fund inflows, collateralized loan obligation (CLO) creation, and supply/demand balance also benefited the sector.

Detractors

> The Fund's underweight to **U.S. Treasuries** was a detractor.

> An improving economic outlook and higher rates in the U.S. had a negative impact on the Fund's **non-U.S. dollar** exposure. Allocation to the sector and country/issue selection were both detrimental to performance. In this space, we continue to favor higher yielding countries with an improving fundamental outlook.

> Exposure to the **emerging markets high yield** sector detracted from performance. Rate increases by the Fed and fear of additional hikes led to outflows from the sector and its underperformance. Volatility that began in the later part of April continued into the quarter and was concentrated in idiosyncratic pockets across emerging markets such as Turkey, Brazil, and Argentina. Overall, the fundamental picture in the emerging markets remains positive. GDP growth remains above trend, inflation is contained, and the business cycle is relatively young.

CURRENT FUND STRATEGY

Sector Changes: We reduced our exposure to corporate high yield and U.S. Treasury securities. We redeployed the sale proceeds primarily into high yield bank loans.

Non-U.S. Exposure: Over the quarter, we reduced the overall non-U.S. and emerging market debt exposure within the Fund based on our concerns of continued macro headwinds for the sectors. Valuations in specific countries are attractive, and we expect fundamentals to remain positive. Fundamentals, however, have peaked and are becoming a bit mixed near term. The Fund's non-U.S. exposure could receive an uplift from improving global growth, stronger-than-anticipated Chinese growth, a weaker U.S. dollar, supportive commodity prices, and accommodative monetary policy from major global central banks. In this space, we favor sovereigns in larger capital structures. Total non-U.S. exposure remains below historical averages, and our total emerging market country exposure is below the six-year average for the Fund.

Securitized Product: Our allocation to the securitized product sectors (non-agency residential mortgage-backed securities (RMBS) and ABS) continues to play an important role. These sectors of the market offer a diversified collateral base and attractive valuations relative to many other areas of the fixed income market. They also offer diversification to the portfolio's corporate credit allocation. Our consumer focus within the ABS sector benefits from the U.S. consumer's continued ability to drive the U.S. economy. RMBS benefits from the continuing improvement in the housing market and investor demand for mortgage credit.

OUTLOOK

We continue to see value in spread sectors and expect them to benefit from the projected improvement in global growth this year. As favorable conditions for borrowers remain in place, the positive outlook for corporate and consumer fundamentals is on solid footing and the global demand for yield continues to support fixed income market technicals.

Valuations are fair to rich, given that yields and spreads are inside long-term averages in most areas of the fixed income market. Selection and positioning within sectors thus is critical. Some of the specific sectors where we see value are out-of-index/off-the-run ABS, RMBS, investment grade corporates (BBB rated and financials), and bank loans. As always, we believe it is important to stay diversified, have granular positions, and emphasize liquid investments.

Virtus Newfleet Multi-Sector Intermediate Bond Fund

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David L. Albrycht, CFA
Industry start date: 1985
Start date with the Fund: 1994

SECTOR ALLOCATIONS

	% Invested Assets
Corporate - High Yield	27.16
Corporate - High Quality	21.73
Bank Loans	16.56
Non-Agency Residential MBS	9.68
Emerging Market - High Yield	9.56
Asset Backed Securities	5.84
Yankee - High Quality	4.47
Non-USD	2.85
Mortgage Backed Securities	1.01
Non-Agency Commercial MBS	0.98
Taxable Municipals	0.14
Equity	0.03

Sector weights are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 6/30/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 10/1/2009
Fund Class I	-1.53	-2.12	0.41	3.83	3.84	n/a	6.01
Index	-0.16	-1.62	-0.40	1.72	2.27	n/a	3.09

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 0.88%. The net expense ratio is 0.77%, 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 0.74%.

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.

Index: 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 it is not available for direct investment.

Notes on 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. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities. **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 repayment of underlying collateral. **Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times. **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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