

Virtus Newfleet Multi-Sector Short Term Bond Fund

A: NARAX (92828R644) | C: PSTCX (92828R628) | C1: PMSTX (92828R594) | I: PIMSX (92828R610) | R6: VMSSX (92828W247)

FIXED INCOME MARKET REVIEW

2023—the recession that never was. Few economists or strategists saw 2023 playing out the way it did in financial markets and the fourth quarter of the year did not disrupt that narrative. While economies slowed around the globe and geopolitical events remained top of mind, central bankers appeared close to declaring victory over the inflation that has ravaged the landscape since the COVID-19 pandemic. The U.S., in particular, has defied expectations for an economic slowdown and a more meaningful increase in the unemployment rate following 11 increases in Fed Funds for a total of 525 basis points (bps) since March of 2022. The consensus is that the Federal Reserve (Fed) has pulled off the elusive “soft landing.” As this consensus built over the course of the quarter, financial markets responded in kind with rallies in risk assets as well as risk-free rates. We are optimistic that we have seen the peak in interest rates this cycle, but caution that the impact of monetary policy acts on the economy with variable lags and in unpredictable ways, so we will be paying close attention to the incoming data in the weeks and months ahead.

Meanwhile, the ever-evolving situation with Russia and Ukraine was superseded by the October 7th terrorist attack in Israel and the associated response by the Israeli government during the quarter. Any further escalation of the conflict could prove disruptive to the improving global inflation picture. Though the geopolitical environment remains complicated and difficult to forecast, most disruptions tend to be absorbed over relatively short time periods. Political activity will ramp up as we enter 2024, with research from Wall Street highlighting that 2024 will see the largest proportion of the world population in history head to the polls.

Financial market performance was strong during the quarter. We have seen significant progress on headline inflation readings as supply chains healed, demand shifted from goods to services, and energy prices rebalanced. Core readings of inflation, while still stubbornly above targets, are annualizing towards levels that are consistent with central bank goals. 2024 seems likely to deliver the first interest rate cuts from policymakers across developed markets, though they will likely be desynchronized. The Fed's latest summary of economic projections still shows meaningful deviation from market expectations for the timing and magnitude of rate cuts next year. All of the above will likely create interesting investment opportunities for investors in the coming quarters.

With the positive tone in both risk and risk-free assets, fixed income sectors had positive total returns in the fourth quarter. Spread sectors outperformed U.S. Treasuries and spreads tightened. Within spread sectors, longer duration and risk asset classes outperformed. The U.S. Treasury curve shifted lower during the quarter. The 2-year Treasury yield decreased 80 bps, the 5-year Treasury yield decreased by 76 bps, the 10-year Treasury yield decreased by 69 bps, and the 30-year Treasury yield moved 67 bps lower.

We continue to see value being restored across most of the fixed income sectors in which we invest. Yields remain elevated and bond prices are broadly discounted. We expect the Fed will be successful in returning inflation to acceptable levels over time. We continue to watch data releases to inform our views on the global economic trajectory.

As the markets digest economic and geopolitical developments, we continue to believe active sector and issuer selection is critical to take advantage of market volatility as it arises. Our approach to fixed income—the approach we have implemented for over three decades—enables us to scan the bond market for the most attractive investment opportunities and is, in our view, ideally suited for the current environment.

For more detail on the macroeconomic backdrop and specific sectors, see [Newfleet's 4Q23 Market Review & Outlook](#) on Virtus.com.

FUND PERFORMANCE REVIEW

The Fund (Class I) returned 3.70% in the fourth quarter versus the ICE BofA 1-3 Year A-BBB US Corporate Index return of 3.06%.

Positive Contributors:

> **U.S. Treasury Securities:** The Fund's underweight to U.S. Treasuries had a positive impact during the period as most spread sectors outperformed during the quarter. While credit spreads had been grinding tighter with economic data that was consistent with a soft landing, the pace of tightening accelerated following the Fed's mid-December meeting commentary citing that more tightening might not be needed due to easing inflation and slowing growth.

> **Corporate High Yield (CPHY):** The Fund's allocation to CPHY had a positive effect on performance during the period as risk assets rallied.

> **Emerging Markets (EM) High Yield:** Allocation to and positioning within EM high yield had a positive impact on performance. Within EM, high yield outperformed investment grade (IG) during the period. The drivers are still very much macro in nature and centered on the Federal Open Market Committee's (FOMC) inflation-fighting path, global growth, and geopolitics.

> **Bank Loans:** Allocation to bank loans had a positive impact on performance. Loans rallied early in the quarter on the back of growing expectations for a soft landing, a change in market sentiment to a higher-for-longer view on rates, and limited new issue supply in the face of surging loan repayments. Later in the quarter, bank loans underperformed most interest rate-sensitive sectors on a total return basis as rates rallied.

Performance Detractors:

> **Asset-Backed Securities (ABS):** Allocation to and issue selection within the ABS sector had a negative impact on performance in the fourth quarter. Fundamentals are positive with a low unemployment rate of 3.9%, close to 9 million job openings, historically high savings and checking account balances, and strong compensation growth. Credit spreads tightened across securitized products during the period, though securitized product did not keep pace with IG corporate debt. Historically, securitized product lags IG credit in a widening or tightening event. The asset class remains attractive versus IG corporate alternatives.

> **Non-Agency Residential Mortgage-Backed Securities (RMBS):** Allocation to RMBS over agency mortgage-backed securities (MBS) and positioning within the RMBS sector had a negative impact on performance during the quarter as RMBS underperformed given the tremendous rate rally and the longer duration nature of MBS. We continue to prefer non-agency residential exposure as credit performance remains stable, prepayments stay muted, and credit spreads are still wide of averages. With higher mortgage rates and a subsequent fall in housing activity, we see solid fundamental and technical backdrops.

> **CPHY Selection:** While the allocation to the CPHY sector had a positive impact on performance, issue selection was negative.

CURRENT FUND STRATEGY AND POSITIONING

- Increased exposure to corporate IG bonds and commercial mortgage-backed securities (CMBS).
- Reduced exposure to U.S. Treasuries, cash, and Yankee high-quality securities.
- In addition to changes to the Fund's sector allocation during the quarter, we continue to optimize positioning within sectors based on our view of the best relative value.

EM Debt and Non-U.S. Exposure: EM had a rocky start to the fourth quarter. Weakness spilled over from the end of September, and then on October 7, the Israel-Hamas conflict began with Hamas terrorists entering Israel, taking hostages, and inflicting mass casualties on the civilian population. Higher Treasury yields prompted the underperformance of the IG space in EM relative to its high yield counterpart. However, by the end of the month, the sentiment had turned, U.S. Treasuries rallied, and EM followed suit. With more data indicating the FOMC has finished raising rates, softer landing scenarios for 2024 seemed more attainable and risk caught a bid. Also in October, the U.S. lifted several sanctions on Venezuela, including the ban on secondary trading, resulting in a massive rally in Venezuela and Petróleos de Venezuela, S.A. bond prices, which in aggregate were up 99% for the month. While our bias is still for external debt, we did initiate a position in local currency Brazil bonds as we viewed rates and currency levels as opportunistic.

IG Corporates: The fourth quarter of 2023 was one of the strongest quarters on record, with the Bloomberg U.S. Corporate Bond Index returning 8.5% as spreads compressed 22 bps to 98 bps while yields fell from over 6% to closer to 5%. All industries were tighter with little differentiation by industry. Financials remain near historical wides relative to industrials and managed slight outperformance during this rally. Fundamentals are stable and technicals are strong. Long-dated industrials have extremely high demand with low supply—those are trading at their post-Global Financial Crisis tight. Valuations are the bottleneck in an otherwise positive outlook; the market is priced for a very favorable macroeconomic outcome. Ford was upgraded by S&P in late October, becoming the largest rising star on record with over \$40 billion of debt outstanding. Walgreens was the most notable fallen angel of the quarter. For the full year, rising stars eclipsed \$120 billion versus \$21 billion of fallen angels. We see buying opportunities in banking and utilities, both of which have lagged. An overweight to BBB-rated bonds remains prudent, especially considering the pace of ratings improvements within that category.

CPHY: The Bloomberg High Yield 2% Index returned 13.4% for 2023. The fourth quarter was strong, with the combination of falling Treasury yields and declining credit spreads leading to over 7.1% in total returns. Credit spreads have tightened 73 bps during the quarter to +323 bps, a new low for the year. All industries were positive during the quarter, and while the market exhibits strong leverage metrics, they are starting to roll over as EBITDA growth has slowed. Interest coverage will continue to decline as low coupon debt is refinanced. If the decline in spreads and U.S. Treasury rates hold, the impact will be much more muted than expected a few months ago. Technicals are very favorable due to continued low levels of issuance, seven straight weeks of inflows, and bonds migrating to IG. In the Fund, we added some high-quality Permian-focused E&Ps, trimmed a real-estate-exposed financial position, and added short bonds of an oil field services firm in December after its underperformance. Notably, we had a large position called and expect a meaningful pickup in bonds being called in 2024 given the maturities of most holdings and an expectation that issuers will get aggressive in pushing out maturities at these spread and Treasury rate levels. This should help performance, as many of these bonds still trade below par and may exhibit a similar dynamic to the IEP bond whose call was announced a few weeks ago.

Securitized: Declining inflation and increasing likelihood of a soft landing caused our investments within consumer- and credit-sensitive sectors to perform well versus alternatives. As in the third quarter, we continued to invest our marginal dollars into the more conservative parts of the capital structure as we get longer into the economic cycle. We maintained our overweight in ABS and RMBS as fundamentals and technical factors were both tailwinds for performance. As the slow repricing within the commercial real estate market continues, we judiciously added to our CMBS exposure via the new issue market. Lastly, we modestly increased our exposure to the agency MBS market as spreads remained wide to long-term averages versus their corporate IG counterparts. In our view, agency MBS affords our portfolios liquidity with attractive yields.

OUTLOOK

Our multi-sector relative value approach enables us to take advantage of opportunities when events that trigger volatility, such as inflation worries or geopolitical concerns, affect valuations. In the current environment, we believe some of the best total return and yield opportunities can be found in spread sectors. However, given the risk of a possible recession and spreads largely pricing in a soft landing, the Fund's exposure to spread sectors that would typically be more negatively impacted, such as corporate high yield and emerging markets, are below long-term averages. Credit selection and positioning remain key. Specific sectors that we consider the best relative value for us include out-of-index/off-the-run ABS, non-agency RMBS, and the BBB-quality tier within corporate investment grade.

The Fund maintains its higher-quality focus and short duration to limit both spread and interest rate volatility. As always, we aim to stay diversified, maintain granular positions, and emphasize liquid investments.

INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

Newfleet Asset Management

PORTFOLIO MANAGER



David L. Albrycht, CFA

Industry start date: 1985

Start date with the Fund: 1993

SECTOR ALLOCATION

% Fund

| | |
|------------------------------|-------|
| Asset Backed Securities | 25.71 |
| Corporate - High Quality | 19.81 |
| Non-Agency Residential MBS | 18.78 |
| Bank Loans | 9.17 |
| Treasury | 7.51 |
| Corporate - High Yield | 6.93 |
| Non-Agency Commercial MBS | 4.94 |
| Mortgage Backed Securities | 2.74 |
| Emerging Market - High Yield | 2.11 |
| Cash | 1.24 |
| Yankee - High Quality | 0.87 |
| Non-USD | 0.10 |
| Taxable Municipals | 0.08 |
| Equity | 0.00 |

Sector weights are subject to change.

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

| | QTD | YTD | 1 Year | 3 Year | 5 Year | 10 Year | Since Inception (06/06/08) |
|--------------|------|------|--------|--------|--------|---------|----------------------------|
| Fund Class I | 3.70 | 7.47 | 7.47 | 0.69 | 2.58 | 2.33 | 3.86 |
| Index | 3.06 | 5.70 | 5.70 | 0.46 | 2.21 | 1.94 | 2.68 |

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 0.71%. The net expense ratio is 0.65%, which reflects a contractual expense reimbursement in effect through 1/31/2024.

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.

Index: The **ICE BofA 1-3 Year A-BBB U.S. Corporate Index** measures performance of U.S. corporate bond issues rated A1 through BBB3, inclusive (based on an average of Moody's, S&P, and Fitch), with a remaining term to final maturity less than three years. 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.

The **Bloomberg U.S. Corporate Bond Index** is a component of the U.S. Aggregate Bond Index. It measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility, and financial issuers.

The **Bloomberg U.S. High-Yield 2% Issuer Capped Bond Index** is a market capitalization-weighted index that measures fixed rate noninvestment grade debt securities of U.S. and non-U.S. corporations. No single issuer accounts for more than 2% of market cap.

Newfleet Asset Management is a division of Virtus Fixed Income Advisers, LLC ("VFIA"), an SEC registered investment adviser.

Notes on 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. **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. **Bank Loans:** Bank loans may be unsecured or not fully collateralized, may be subject to restrictions on resale, may be less liquid and may trade infrequently on the secondary market. Bank loans settle on a delayed basis; thus, sale proceeds may not be available to meet redemptions for a substantial period of time after the sale of the loan. **Foreign & Emerging Markets:** Investing in foreign securities, especially in emerging markets, subjects the portfolio to additional risks such as increased volatility, currency fluctuations, less liquidity, and political, regulatory, economic, and market risk. **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. 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.

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