Virtus Newfleet Multi-Sector Short Term Bond Fund

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

MARKET OVERVIEW

Fixed income investors faced substantially similar market themes during the third quarter as in the prior two quarters of 2018. Market participants continued to wrestle with periods of volatility caused by geopolitical developments, trade rhetoric, mixed global economic signals, and the evolution of quantitative easing programs that began in the aftermath of the now decade-old Financial Crisis. During the quarter, oil prices continued their ascent, driven by the outlook for supply/demand dynamics. U.S. economic data stayed on a positive trend, which contrasted with other global economies. Primary inflation readings remained in check, but pressure in key components (i.e., wages) has started to build.

As expected, the Federal Open Market Committee (FOMC) increased its target rate at the September meeting to a range of 2.00-2.25%. The pace of the Federal Reserve's (Fed) balance sheet adjustment remains as originally deployed. The European Central Bank remains on track to end its monthly bond purchases at the end of 2018 while reinvesting proceeds from maturities and maintaining key policy rates well into 2019 and beyond if deemed necessary by incoming economic data. The Bank of Japan made some minor adjustments to its purchase program during the quarter, but no substantial changes are expected for the next 12-18 months.

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

Most spread sectors outperformed during the quarter led by high yield corporates and bank loans, both demonstrating their resilience in a rising rate environment. Across other spread sectors, tightening spreads offset price declines from rising rates to a greater degree for longer duration assets relative to their shorter duration counterparts. Additionally, lower credit ratings outperformed higher quality on a total return basis. Non-U.S. dollar was the largest underperformer during the period.

For a more detailed review of the third quarter and our outlook, please see Newfleet's 3Q18 Market Review & Outlook.

HOW THE FUND PERFORMED

The Fund (Class I) returned 0.98% in the third quarter versus the ICE BofAML 1-3 Year A-BBB U.S. Corporate Index return of 0.74%.

Contributors

> The Fund's underweight to **U.S. Treasuries** benefited performance.

> Exposure to the **corporate high yield** sector contributed positively. The sector was among the top performers during the quarter despite emerging markets instability, specifically in Argentina and Turkey. Solid earnings, lack of supply, and inflows into the sector in the past couple of months have been beneficial.

> Within the **asset-backed security** (ABS) sector, both allocation and issue selection positively impacted performance during the quarter. 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 **non-agency residential mortgage-backed security** (RMBS) sector versus agency mortgages helped performance as did issue selection. Similar to ABS, RMBS generally offers lower volatility and a diversified collateral base. In addition, the sector typically is less sensitive to global macro volatility.

> Allocation to the **bank loan** sector contributed positively. One of the quarter's best-performing sectors, loans continue to provide a compelling investment due to the strong fundamental backdrop, protection against rising rates, and attractive income carry profile.

Detractors

> Rising idiosyncratic risks and attractive U.S. growth and rate dynamics have negatively impacted the **non-U.S. dollar** exposure within the Fund. Allocation to the sector and country/issue selection were both detrimental to performance. In this space, we continue to favor higher-yielding countries with improving fundamental outlooks.

> Allocation to and issue selection within the **emerging market high yield** sector was a detractor as the sector was one of the worst performers during the period, pressured by rate increases by the Fed and strong U.S. dollar. Fundamentals have peaked near term (though favorable longer term) and retail flows have turned negative year to date. Countries with large funding needs have been stressed most, specifically Argentina and Turkey.

CURRENT FUND STRATEGY

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

Non-U.S. Exposure: Over the quarter, we reduced the overall non-U.S. and emerging market debt exposure based on continued macro headwinds for the sector and rising idiosyncratic risks. Valuations in specific countries are attractive and long-term fundamental trends are favorable. Fundamentals, however, have peaked and are becoming a bit mixed near term. The Fund's non-U.S. exposure could receive an uplift from positive global 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 (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 markets. They also offer diversification to the corporate credit allocation within the portfolio. Our consumer focus within the ABS sector has been beneficial as the U.S. consumer continues to show the ability to lift the U.S. economy. RMBS benefits from the continued strength in the housing market and investor demand for mortgage credit.

The Fund maintains its higher quality focus and short duration to limit both spread and interest rate volatility.

OUTLOOK

We continue to see opportunity in spread sectors. Benign consumer, housing, and corporate fundamentals as well as the global demand for yield continue to underpin our strategy. Recognizing that valuations are fair to rich given that spreads are inside long-term averages in most areas of the fixed income market, selection and positioning within sectors are critical. Some of the specific sectors where we see opportunity are out-of-index/off-the-run ABS, RMBS, investment grade corporates (BBB rated and financials), and leveraged finance (bank loans and corporate high yield), with the allocation mix driven by each fund's risk tolerance.

Virtus Newfleet Multi-Sector Short Term Bond Fund

INVESTMENT ADVISER

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PORTFOLIO MANAGER

David L. Albrycht, CFA
Industry start date: 1985
Start date with the Fund: 1993

SECTOR ALLOCATIONS

	% Invested Assets
Corporate - High Quality	23.74
Asset Backed Securities	22.81
Non-Agency Residential MBS	15.93
Bank Loans	12.34
Corporate - High Yield	9.41
Non-Agency Commercial MBS	4.42
Treasury	2.95
Mortgage Backed Securities	2.77
Emerging Market - High Yield	2.09
Non-USD	1.74
Yankee - High Quality	1.71
Taxable Municipals	0.06
Equity	0.03

Sector weights are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 9/30/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 6/6/2008
Fund Class I	0.98	0.17	0.32	2.92	2.45	5.35	4.65
Index	0.74	0.84	0.83	1.76	1.66	3.59	2.90

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 0.75% and reflects the direct and indirect expenses paid by the Fund.

The gross 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 **ICE BofA Merrill Lynch 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.

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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