Virtus Newfleet Multi-Sector Bond ETF

1Q19 COMMENTARY

NFLT

NYSE Arca

MARKET OVERVIEW

2019 has begun in stark contrast to how 2018 ended. Major global central banks, including the Federal Reserve (Fed) and the European Central Bank, have reacted to a deceleration in economic activity and tame inflation by pivoting in both tone and policy in a more dovish direction. This significant development in the markets, when combined with improved valuations, has led to a return to favor of risk assets.

The U.S. Treasury curve continues to twist and shift broadly flatter and lower. The volatility in U.S. interest rates resulted in parts of the yield curve inverting during the quarter. We believe that this change in the curve is more indicative of technical factors in the market than a looming U.S. recession.

As expected, the Federal Open Market Committee (FOMC) kept its target rate unchanged in a range of 2.25-2.50%. In addition to signaling that rates are likely on hold for the balance of 2019, the FOMC also announced that the balance sheet wind down will be completed this year and that the composition will shift toward U.S. Treasuries over time. This is likely to support a view of lower U.S. interest rates for the next several quarters.

Most spread sectors outperformed during the quarter led by corporate high yield, emerging markets high yield, and corporate high quality. Within spread sectors, asset classes that were hardest hit in the latter part of 2018 outperformed during the first quarter of 2019. Securitized sectors (asset-backed securities (ABS) and non-agency residential mortgage-backed securities (RMBS)) while still positive, lagged other sectors.

We continue to see value in spread sectors. The dovish turn by central bankers, benign consumer, housing and corporate fundamentals, as well as the global demand for yield, continue to underpin our strategy.

For a more detailed review of the first quarter and our outlook, please see Newfleet's 1Q19 Market Review and Outlook.

PORTFOLIO MANAGEMENT

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

Newfleet leverages the knowledge and skill of a team of investment professionals with expertise in every sector of the bond market, including evolving, specialized, and out-of-favor sectors.

Portfolio Managers

David L. Albrycht, CFA
President and
Chief Investment Officer
Industry start date: 1985
Start date as Fund Portfolio Manager: 2015

Jonathan R. Stanley, CFA
Managing Director and
Portfolio Manager
Industry start date: 1997
Start date as Fund Portfolio Manager: 2015

HOW THE FUND PERFORMED

The Fund returned 4.49% in the first quarter versus the Bloomberg Barclays U.S. Aggregate Bond Index return of 2.94%.

Contributors

- The underweight to U.S. Treasuries and agency mortgage-backed securities benefited performance.
- Exposure to the corporate high yield sector benefited performance. The sector has seen the best start to a year since 2001 with the Fed seemingly on hold and better-than-expected earnings. Solid fundamentals, albeit slowing, and a lack of supply further enhanced a supportive environment during the quarter.
- As a result of the dovish pivot by the Fed, the emerging market high yield sector was among the top performing sectors during the quarter. Fundamentals within the emerging markets are likely entering a cyclical soft patch, but a material deterioration is not expected.
- Issue selection within corporate high quality positively impacted performance during the quarter.

Detractors

- Exposure to ABS detracted from performance during the quarter. Securitized sectors underperformed on a total return basis due to the shorter duration nature of the asset class although they outperformed U.S. Treasuries.

CURRENT FUND STRATEGY

Sector Changes: We reduced our exposure to U.S. Treasury securities, high yield bank loans, and non-U.S. dollar securities. We redeployed the sale proceeds into corporate high quality securities, corporate high yield securities, and RMBS.

Non-U.S. Exposure: Over the quarter, we maintained the overall non-U.S. and emerging market debt exposure within the Fund. We continue to have concerns of macro headwinds for the sector and idiosyncratic risks. Valuations in specific countries are attractive and the long-term fundamental outlook remains favorable. In this space, we favor sovereigns in larger capital structures.

Effective March 1, 2018, this ETF changed its name from Virtus Newfleet Multi-Sector Unconstrained Bond ETF.

Securitized Product: Our allocation to the securitized sectors (RMBS and ABS) continues to play an important role. In addition to 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 steady income growth, full employment, good underwriting, and investor demand for mortgage credit

Investment Grade Corporates: Given the recent spread tightening and current valuations, we expect IG to provide coupon-type returns, with modest room for spread tightening. We favor the BBB segment and, from an industry perspective, banks, REITS, and metals & mining. We have added to non-cyclical exposure through some of the large M&A deals in the healthcare, pharmaceutical, and food & beverage spaces. We are opportunistically repositioning our portfolios into a strong market, selectively selling some high beta outperformers, ensuring our positioning continues to reflect our view on the best relative value within the sector.

Corporate High Yield: After the most recent strength, we have been reducing names where valuations have run ahead of fundamentals and redeploying into names that have either not participated in the rally or have seen an improvement operationally. With idiosyncratic risk so high, correct industry and/or credit calls are imperative to outperforming in the space. Currently, we see select opportunities within technology, pharmaceuticals, banking, and autos while using exposure from the energy complex, electric utilities, media/entertainment, and cable/satellite industries to fund those reallocations within our HY exposure.

OUTLOOK

We continue to look for opportunities in all sectors of the bond market, striving to uncover any out-of-favor or undervalued sectors and securities. We favor spread sectors based on improved valuations and sound fundamentals, and highlight the importance of credit selection and positioning in the current environment. We believe some of the best total return and yield opportunities in fixed income can be found in spread sectors. Some of the specific sectors where we see opportunity are out-of-index/off-the-run ABS, RMBS, investment grade corporates, credit-specific high yield, bank loans, and select emerging markets debt.

Performance—Total Returns (%) as of 3/31/19

	QTD	YTD	1 YR	3 YR	5 YR	10 YR	Since Inception (8/10/15)
NAV	4.49	4.49	2.39	4.41	n/a	n/a	4.06
Market Price	4.26	4.26	2.37	4.41	n/a	n/a	4.01
Benchmark	2.94	2.94	4.48	2.03	n/a	n/a	2.55

Performance data quoted represents past results. Past performance is not a guarantee of future results. Current performance may be higher or lower than performance quoted. Investment return and principal value will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Please visit www.virtus.com for performance data current to the most recent month-end.

Gross Expense Ratio: 0.87%; Net Expense Ratio: 0.81%.

Returns for periods of less than one year are cumulative total returns.

The Fund's investment adviser has entered into an expense limitation agreement to limit the Fund's total operating expenses (excluding certain expenses, including acquired fund fees and expenses, as described in the prospectus) so that such expenses do not exceed 0.80% of the Fund's average daily net assets through February 28, 2019.

The Fund is an exchange-traded fund ("ETF"). The "net asset value" (NAV) of the Fund is determined at the close of each business day, and represents the dollar value of one share of the Fund; it is calculated by taking the total assets of the Fund, subtracting total liabilities, and dividing by the total number of shares outstanding. The NAV of the Fund is not necessarily the same as its intraday trading value. Fund investors should not expect to buy or sell shares at NAV because shares of ETFs such as the Fund are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Thus, shares may trade at a premium or discount to their NAV in the secondary market. Brokerage commissions will reduce returns. NAV returns are calculated using the Fund's daily 4:00 p.m. NAV, and include the reinvestment of all dividends and other distributions (reinvested at the Fund's NAV on distribution ex-date). Market price returns are calculated using the 4:00 pm midpoint between the bid and offer, and include the reinvestment of all dividends and other distributions (reinvested at the 4:00pm bid/offer midpoint on distribution ex-date). Market price returns do not represent the return you would receive if you traded at other times.

The fund's benchmark is the **Bloomberg Barclays U.S. Aggregate Bond Index**, which 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.

The Fund is an actively managed exchange-traded fund and does not seek to replicate the performance of a specified index. The Fund may have a higher portfolio turnover than funds that seek to replicate the performance of an index.

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.

IMPORTANT RISK CONSIDERATIONS

Exchange-Traded Funds (ETF): The value of an ETF may be more volatile than the underlying portfolio of securities it is designed to track. The costs of owning the ETF may exceed the cost of investing directly in the underlying securities. **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. **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. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **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. **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. **Derivatives:** Investments in derivatives such as futures, options, forwards, and swaps may increase volatility or cause a loss greater than the principal investment. **Prospectus:** For additional information on risks, please see the fund's prospectus.

Please consider the Fund's objectives, risks, charges, and expenses before investing. Contact us at 1-800-243-4361 or visit www.virtus.com for a prospectus, which contains this and other information about the Fund. Read the prospectus carefully before investing.

Not insured by FDIC/NCUSIF or any federal government agency. No bank guarantee. Not a deposit. May lose value.

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VIRTUS ETFs