VIRTUS MUTUAL FUNDS

Virtus KAR Small-Cap Value Fund

A: PQSAX (92828N684) | C: PQSCX (92828N676) | I: PXQSX (92828N668) | R6: VQSRX (92828N411)

MARKET REVIEW

Global equities continued to climb in the fourth quarter of 2017, capping off a year of stellar performance. The broad U.S. equity market, as measured by the S&P 500® Index, returned 6.64% in the quarter, bringing its full-year gain to 21.83%. U.S. small-cap stocks, as measured by the Russell 2000® Index, returned 3.34% for the quarter and 14.65% for the year. Foreign equities, as measured by the MSCI EAFE® Index, posted a gain of 4.23% for the quarter, for a full-year return of 25.03%. Emerging markets stocks, as measured by the MSCI Emerging Markets Index, rose 7.44% in the quarter, helping drive a 37.28% gain for the year, a notable surge following several years of underperformance.

Key factors that pushed markets along into record territory in 2017 included strong corporate earnings, low inflation, and improving optimism for a more pro-business environment, especially with the tax cuts in the U.S. Markets were also broadly characterized by low levels of volatility and minimal performance declines throughout the year.

PERFORMANCE

The Fund's return of 4.58% (Class I) outperformed the 2.05% return of the benchmark Russell 2000® Value Index during the quarter. Outperformance was largely driven by strong stock selection in the consumer discretionary and financial services sectors. Performance was hurt by negative stock selection in the consumer staples and healthcare sectors.

SiteOne Landscape Supply and Thor Industries were the most positive contributors to performance in the quarter.

> Landscape supplier SiteOne continues to consolidate the industry and has seen accelerating organic daily sales growth. Given its increased scale and initiatives like improving supply chain, SiteOne has been able to expand gross margins, which over time should translate into improving operating margin. The company has a 10% share of the wholesale landscape market and, in the long run, should have plenty of runway for growth and further margin leverage.

> RV manufacturer Thor Industries' stock increased over the quarter after it reported strong new unit sales and additional progress in improving the margins of recently acquired Jayco. Thor, along with the overall industry, continues to benefit from younger buyers of entry-level towable units, which is not only beneficial to current sales but represents future sales as these customers eventually upgrade. As such, we expect Thor's revenue, margin, and return on equity to continue to increase.

National Beverage and RE/MAX Holdings detracted the most from performance during the quarter.

> While National Beverage has seen weak performance in its carbonated soft drink brands like the rest of the industry, the declines have been more than offset by growth in its sparkling water portfolio, particularly the LaCroix brand, where strong sales have helped drive share price for most of the year. While National Beverage's latest financial results showed growth in revenue and earnings per share, the stock price declined during the quarter due to valuation concerns, not business fundamentals. We believe LaCroix has significant additional opportunities to grow distribution, and the recent launch of a new Shasta-branded line of flavored sparkling water may be rewarding as well, so we remain shareholders.

> Realtor RE/MAX shares fell during the quarter as an internal investigation resulted in a delayed third quarter earnings report. A group of independent directors is looking into an undisclosed loan from the founder to the co-CEO and other potential employment practice violations. Despite this investigation, RE/MAX affirmed business fundamentals remain solid, and we expect this to continue going forward. We remain confident in RE/MAX's capital-light business model and its ability to generate superior returns over the long term.

PORTFOLIO CHANGES

No new purchases were made for the portfolio during the quarter, and we completely closed our position in Monotype Imaging Holdings.

> Digital typesetter Monotype provides communications design technology and controls some of the world's most popular fonts. Though the company has seen some stabilization in its core font business, it once again lowered its guidance for its acquired business Olapic. The fact that the company realized this after nearly a year of Olapic ownership speaks to the fast-changing nature of the industry, and thus gives us less conviction in the long-term operating model of this new business segment. The stock reacted positively to the stabilization of the core business, and we used this strength to sell the stock.

OUTLOOK

The outlook for 2018 is favorable overall, but to expect another 2017 would be unreasonable. More volatility and performance drawdowns are anticipated in the year ahead as markets return to more normal conditions. 2018 should continue to provide investors with mid-to-high single-digit equity returns but most likely not without a bumpy ride along the way. Now may be a good time for investors to review their asset allocation and make sure they can "sleep at night" with their current equity exposure. For our part, we will continue to own high-quality businesses with competitive advantages that we believe can shine in good and bad times.

Effective May 8, 2017, the Fund's name was changed from Virtus Quality Small-Cap Fund.

Virtus KAR Small-Cap Value Fund

INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

Kayne Anderson Rudnick Investment Management, LLC

INVESTMENT PROFESSIONALS

Julie Kutasov
Industry start date: 2001
Start date with the Fund: 2008

Craig Stone
Industry start date: 1989
Start date with the Fund: 2009

TOP TEN HOLDINGS

TOP TEN HOLDINGS	% Fund
SiteOne Landscape Supply, Inc.	5.00
Thor Industries, Inc.	4.95
Cheesecake Factory Inc.	4.31
Scotts Miracle-Gro Co.	4.13
MGM Growth Properties LLC	4.08
National Beverage Corp.	3.91
RBC Bearings Inc.	3.91
Bank of Hawaii Corp.	3.69
Core Laboratories NV	3.63
RE/MAX Holdings, Inc.	3.42

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 6/28/2006
NAV	4.58	18.89	18.89	13.47	15.82	9.81	9.71
Index	2.05	7.84	7.84	9.55	13.01	8.17	7.60

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 1.05% 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 1.04%.

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: The **Russell 2000® Value Index** is a market capitalization-weighted index of value-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. 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: 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. **Limited Number of Investments:** Because the fund has a limited number of securities, it may be more susceptible to factors adversely affecting its securities than a less concentrated fund. **Industry/Sector Concentration:** A fund that focuses its investments in a particular industry or sector will be more sensitive to conditions that affect that industry or sector than a non-concentrated fund. **Prospectus:** For additional information on risks, please see the fund's prospectus.

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