VIRTUS FUNDS

Virtus KAR Small-Cap Value Fund

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

MARKET REVIEW

Stocks recovered with a vengeance in the first quarter from the late sell-off in 2018. It was the stock market's strongest start in a calendar year since 1991, with growth stocks leading the way. Small stocks slightly outperformed large stocks with the Russell 2000® Index returning 14.58% for the quarter, while the S&P 500® Index returned 13.65%. By comparison, international stocks continued to lag U.S. markets with the MSCI EAFE® Index advancing 9.98% and the MSCI Emerging Markets Index returning 9.92%.

Fixed income had a robust quarter for returns as well. The 10-year U.S. Treasury yield continued its descent in the quarter, moving from 2.69% to 2.41% at quarter-end. This decline allowed various fixed income asset classes to generate positive returns. The Bloomberg Barclays U.S. Aggregate Bond Index returned 2.94% for the quarter with credit-sensitive strategies leading the returns.

PERFORMANCE

The Fund (Class I) returned 10.88% during the quarter, underperforming the Russell 2000® Value Index which returned 11.93%. Weak stock selection in consumer staples along with weak stock selection and an underweight in technology detracted from performance, while strong stock selection in financial services and producer durables contributed positively to performance.

Stocks that contributed the most to performance were HFF and Scotts Miracle-Gro.

> Commercial realtor HFF's stock price had been under pressure most of last year due to the fear that a slowing economy and higher interest rates would dampen the commercial real estate market. The broad market sell-off in the fourth quarter added to the downward pressure on HFF's stock. However, HFF's recent quarterly results, which included 17% revenue growth, helped assuage these concerns, sparking a strong recovery in the stock price. The stock appreciated further after the company announced on March 19 that it was being acquired by Jones Lang LaSalle.

> Scotts Miracle-Gro's hydroponics business was adversely affected in 2018 by California's cannabis licensing law, which caused many cannabis growers to exit the market during that year. In January 2019, hydroponic sales ceased to decline and returned to year-over-year growth in following months, giving market participants increased confidence that the grower disruption had dissipated. We view the franchise strength of Scotts Miracle-Gro's core lawn and garden brands, including its hydroponics segment, as intact and we remain owners of the business.

Stocks that detracted the most from performance were National Beverage and Cass Information Systems.

> In early October 2018, a class action lawsuit was filed against National Beverage alleging that the company's sparkling water brand LaCroix, its largest and fastest-growing brand, contains harmful artificial ingredients. The company's most recent quarterly release and Nielsen data showed a decline in LaCroix sales after years of double-digit growth. This served to increase investor concerns over the impact of the lawsuit on consumer perception of the brand as well as a general increase in competitive offerings, particularly Pepsi's marketing push of its Bubly sparkling water in late 2018. While we continue to monitor any further developments closely, we believe National Beverage's position as one of the leaders in the growing sparkling water category remains intact, and we remain owners of the business.

> Payment processor Cass Information Systems' financial results had accelerated most of last year due to the uptick in domestic trucking activity. Cass is paid on the number and size of invoices it processes. However, the recent quarter's results showed a slowdown in transactions processed, and commentary from trucking companies indicates this may continue into the next quarter. This caused downward pressure on the stock price. In addition, the tailwind Cass was expected to enjoy from rising interest rates is on hold given the Federal Reserve's recent pause on rate hikes. None of these headwinds diminish the company's entrenched position as the largest trucking invoice processor, and we remain owners of the business.

PORTFOLIO CHANGES

During the quarter, we sold out of our position in Artisan Partners, and made no new stock purchases.

> Investment management firm Artisan Partners has been suffering from negative net asset flows driven by underperformance in a number of the firm's larger investment strategies, coupled with capacity constraints in several other strategies. Even if we assume these performance issues are mostly temporary, industry experience leads us to expect any asset-flow improvement to take meaningful time, particularly considering that the majority of the firm's larger strategies are currently facing unfavorable Morningstar-rating dynamics. With these considerations in mind, we exited our position.

OUTLOOK

We believe the likelihood of an outright, meaningful recession over the next 12 to 18 months is low. Within the last 10 years, we have had rolling recessions in cyclical areas like energy, industrials, and materials from 2014 to 2016. Europe is close to or has already entered a recession over the last six months due to slow exports and Brexit fears adversely affecting business confidence. Although the current economic expansion has been lengthy, it hasn't been robust by historical standards. Classic signals of excess business confidence, such as elevated capital spending, inventory buildup in anticipation of robust sales, and additional labor hiring, don't appear prevalent. Even in a slower economic environment (1.5-2.5% GDP growth), we believe U.S. companies should be able to grow earnings in the 5-8% range. This kind of growth, combined with business confidence improving, has the potential to lead to double-digit returns for stocks in 2019.

Virtus KAR Small-Cap Value Fund

INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

Kayne Anderson Rudnick Investment Management, LLC

PORTFOLIO MANAGERS

Julie Kutasov
Industry start date: 2001
Start date as Fund Portfolio Manager: 2008

Craig Stone
Industry start date: 1989
Start date as Fund Portfolio Manager: 2009

TOP TEN HOLDINGS

TOP TEN HOLDINGS	% Fund
MGM Growth Properties LLC	6.06
The Scotts Miracle-Gro Co.	5.29
The Cheesecake Factory Inc.	4.97
SiteOne Landscape Supply Inc.	4.73
RBC Bearings Inc.	4.56
Primerica Inc.	4.40
Houlihan Lokey Inc.	3.93
Cinemark Holdings Inc.	3.89
Brooks Automation Inc.	3.83
Watsco Inc.	3.78

Holdings are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 3/31/19

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 6/28/2006
Fund Class I	10.88	10.88	-4.20	9.30	7.68	15.27	8.12
Index	11.93	11.93	0.17	10.86	5.59	14.12	6.62

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 0.99%.

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 **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.

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.

Please carefully consider a Fund's investment objectives, risks, charges, and expenses before investing. For this and other information about any Virtus mutual fund, contact your financial representative, call 1-800-243-4361, or visit virtus.com for a prospectus or summary prospectus. Read it carefully before investing.

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

Distributed by **VP Distributors, LLC**, member FINRA and subsidiary of Virtus Investment Partners, Inc.