

## Virtus KAR Small-Cap Value Fund

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

### MARKET REVIEW

Stocks got off to a very strong start in the quarter but shifted into correction mode in early February and stayed there on concerns over inflation, trade, and large technology stocks. The S&P 500® Index closed the quarter down 0.76%. Growth stocks outperformed value stocks, and small stocks slightly outperformed their larger counterparts. Developed foreign markets, represented by the MSCI EAFE® Index, were down 1.53%, and emerging markets, as measured by the MSCI Emerging Markets Index, were up 1.42%. Equity volatility, represented by the CBOE Volatility Index (VIX®), staged a pickup, which was expected coming off of 2017's exceptionally low levels. On the fixed-income front, the Bloomberg Barclays U.S. Aggregate Bond Index fell 1.46%. The 10-year U.S. Treasury yield rose during the quarter from 2.40% to 2.74%, which pressured many fixed-income issues and bond proxies in the equity market.

### PERFORMANCE

For the quarter, the Fund (Class I) returned -2.69%, underperforming the -2.64% return of the Russell 2000® Value Index. Strong stock selection in financial services and technology was positive for performance, while weak stock selection in healthcare and consumer discretionary detracted from performance.

RE/MAX Holdings and Cinemark Holdings provided the most positive contributions to performance in the quarter.

- > Realtor RE/MAX's stock price recovered in the quarter after the company completed its delayed filings stemming from an investigation into the actions of the co-CEOs, primarily related to a \$2.4 million personal loan. A special committee determined that no corporate funds were used but that the loan had violated company policies. There was no impact to historical financials.
- > Movie theater chain Cinemark reported strong year-end results that outpaced the broader box office. Upgraded seating and concessions appear to be helping drive higher admissions. The launch of its new Movie Club to its most loyal customers was met with solid interest. We expect the company to benefit from a strong film slate in the first quarter.

Thor Industries and Scotts Miracle-Gro Company were the biggest detractors from performance in the quarter.

- > RV manufacturer Thor was a strong outperformer for much of last year as the company benefited from robust demand for entry-level, towable RV units. The stock pulled back recently due to concerns of a top in the RV cycle and the potential for an inventory glut. While these are valid concerns for a cyclical industry, there isn't much tangible evidence to support this fear. More important, they have nothing to do with the underlying competitive advantages in Thor's business. As a result, we remain shareholders.

- > Scotts Miracle-Gro's quarterly earnings in January disappointed investors looking for continued growth of the company's Hawthorne division, which caters to the cannabis industry. The transition of California from a purely medical-marijuana state to one that also allows for recreational use has hit a pothole. A recent *Wall Street Journal* article cited that fewer than 3% of the state's marijuana farmers have been issued licenses due to a complex and ill-conceived permitting process. Demand is now outstripping legal supply and sending the previously legal but unregulated market underground, bolstering the black market—the exact opposite intention of the legalization mandate. While this may take some time to sort out, we believe that it will eventually benefit the Hawthorne unit. In the meantime, the company's core brands—Miracle-Gro, Ortho, Roundup, and Scotts—continue to perform.

### PORTFOLIO CHANGES

We purchased Brooks Automation and Houlihan Lokey (HLI), and completely sold Cognex and Patterson Companies.

- > Brooks Automation engages in automation and cryogenic solutions for multiple markets, primarily semiconductor capital equipment and life science biological sample management and storage. In both segments, the company has leveraged its market-leading positions, supplemented with acquisitions to drive growth.
- > HLI has established itself as the preeminent middle-market global investment bank and one of the top restructuring advisors in the world.
- > Cognex has enjoyed strong double-digit revenue and earnings growth with its machine-vision products benefiting from an increased focus on industrial automation. While we believe there is still good growth opportunity ahead, its \$12 billion market cap is too large for the portfolio.
- > We sold Patterson after another disappointing quarter. Given Amazon's efforts to get more into healthcare, the structure of Patterson's business and perhaps of this industry is being questioned, and we chose to exit our position.

### OUTLOOK

We want to underscore that market corrections, while unpredictable, sharp, and painful, are necessary to remove excessive speculation and to shake out weak stockholders. We still believe that businesses will be growing their earnings over the next couple of years and that the market will ultimately reward this growth with positive returns in the mid-to-high single-digit range. The shape of the yield curve is certainly worth monitoring over the next year or two, and we would like to see it steepen. As always, we remain focused on investing in high-quality businesses that we believe offer a sustainable competitive edge.

## 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 with Fund: 2008



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

### TOP TEN HOLDINGS

% Fund

SiteOne Landscape Supply, Inc.	5.16
Cheesecake Factory Inc.	4.56
Scotts Miracle-Gro Co. Class A	4.46
MGM Growth Properties LLC Class A	4.45
RE/MAX Holdings, Inc.	4.21
Thor Industries, Inc.	4.00
HFF, Inc. Class A	3.87
RBC Bearings Inc.	3.80
Bank of Hawaii Corp.	3.78
Core Laboratories NV	3.69

Holdings are subject to change.

### AVERAGE ANNUAL TOTAL RETURNS (%) as of 3/31/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 6/28/2006
Fund Class I	-2.69	-2.69	10.63	11.31	12.84	11.11	9.24
Index	-2.64	-2.64	5.13	7.87	9.96	8.61	7.19

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](http://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 1.03%.

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](http://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.

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