

Virtus KAR Small-Cap Core Fund

A: PKSAX (92828N551) | C: PKSCX (92828N536) | I: PKSFX (92828N528) | R6: VSCRX (92828N429)

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 outperformed the Russell 2000® Index during the quarter, with a return of 10.03% (Class I) versus 3.34% for the benchmark. The outperformance was primarily driven by positive stock selection in the financial services and producer durables sectors. Performance was hurt by poor stock selection in the consumer discretionary and materials & processing sectors.

Primerica and Copart were the biggest contributors to performance during the quarter.

- > Earlier financial results of Primerica, an insurance and financial services company, had led to some concern among analysts and investors that new life insurance policies being sold were of lower quality (i.e., terminating faster than normal, referred to as “lapsation”). Management had stressed this was not the case and that recent experience was well within the historical range. Lapsation declined in the most recent quarter (supporting management’s comments) and earnings were better than expected, both of which drove the stock higher. We continue to expect Primerica’s unique distribution model and good stewardship of capital to result in sustainable long-term earnings growth, so we remain shareholders.
- > Copart, which operates an online vehicle auction site, outperformed in the most recent quarter as end-market tailwinds, such as more technologically complex vehicles and auto body shop consolidation, drove salvage volumes higher. Copart’s advantaged business model is expected to position the company to capitalize on these positive industry dynamics for many years into the future.

Fox Factory Holding and WABCO Holdings were the biggest detractors from the portfolio during the quarter.

- > Fox Factory, which manufactures “ride dynamics” products for mountain bikes and other vehicles, saw a slowdown following atypically high growth rates driven by the initial production and early success of the Ford Raptor pickup truck for which Fox supplies suspension products.
- > Shares of WABCO, a supplier of commercial vehicle parts, initially reacted favorably to better-than-expected third quarter results, but then spent the rest of the quarter falling. The decrease was largely driven by valuation concerns rather than worries about business fundamentals. WABCO continues to benefit from new safety standards implemented in key markets like the U.S. and China and an improving economy in Europe. We believe WABCO has a long runway of revenue growth and margin expansion ahead as safety standards globally continue to rise. As a result, we remain owners of the business.

PORTFOLIO CHANGES

No new purchases were made for the portfolio during the quarter, and we sold our positions in Polaris Industries and NVR.

- > Polaris, which manufactures recreational vehicles, has largely completed a significant recall effort while new product introductions and improving industry demand led to a rebound in business. Consequently, the shares rose and the stock was priced at an attractive multiple. We took the opportunity to reduce our position and ultimately sold our holdings completely.
- > Since our last trim of homebuilder NVR shares more than two years ago, the business has performed strongly relative to the Russell 2000® Index. NVR’s market cap was approaching \$14 billion, well over the \$10 billion largest market cap of the Index. Given this and other companies we want to add to the portfolio, we sold our position.

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.

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INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

Kayne Anderson Rudnick Investment Management, LLC

INVESTMENT PROFESSIONALS



Jon Christensen, CFA
Industry start date: 1995
Start date with the Fund: 2008



Todd Beiley, CFA
Industry start date: 1999
Start date with the Fund: 2009

TOP TEN HOLDINGS

	% Fund
Autohome, Inc. Sponsored ADR	8.12
Copart, Inc.	5.37
Primerica, Inc.	5.23
Old Dominion Freight Line, Inc.	4.83
Teledyne Technologies Inc.	4.80
CDW Corp.	4.68
WABCO Holdings Inc.	4.44
HFF, Inc.	4.33
Rightmove plc	4.17
Graco Inc.	3.62

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 10/18/1996
NAV	10.03	34.98	34.98	16.99	16.83	11.37	10.20
Index	3.34	14.65	14.65	9.96	14.12	8.71	8.69

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 1.10% 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 1.09%.

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® Index** is a market capitalization-weighted index of the 2,000 smallest 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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