

## Virtus Newfleet Tax-Exempt Bond Fund

A: HXBZX (92828W312) | C: PXCZX (92828W296) | I: HXBIX (92828W288)

### MARKET OVERVIEW

Municipal bonds posted a loss in the third quarter, largely a result of the negative performance experienced during the month of September as municipal yields followed U.S. Treasury yields higher. For the three months ended September 30, 2018, the intermediate part of the curve produced positive performance while shorter and long maturity bonds underperformed with negative returns. Additionally, lower quality bonds once again outperformed higher quality bonds as investors were willing to take additional credit risk in their quest for higher yield.

The municipal bond market continued to experience lighter new issuance during much of the third quarter, but the favorable technical conditions (supply/demand) have softened as slower demand and rising Treasury rates resulted in the quarter's negative performance. Municipal issuers have been constrained to issue debt as the new tax code eliminated their ability to advance refund higher cost debt with new tax-exempt debt, while fiscal austerity measures have also made them reluctant to issue debt. Demand for municipals has been mixed as interest rates have risen and the new tax code has lessened the advantage for banks to own tax-exempt bonds. Individuals continue to invest in tax-exempt securities, favoring investments in tax-exempt mutual funds, ETFs, or separately managed accounts over direct ownership. Banks, on the other hand, which had become a sizable buyer of municipal bonds prior to the lowering of the corporate tax rate from 35% to 21%, have continued to reduce their exposure at a steady pace. Overall, the technical picture for municipals remains supportive as lower supply has helped to offset some weakening demand. Looming concerns around an increase in supply levels and investor apathy as interest rates rise could disrupt the strong technical conditions that have been in place for much of the year.

Credit fundamentals for the municipal bond market are showing signs of improvement as a result of strong tax collections and good economic growth across much of the country. While we remain cautious due to the increasing number of municipalities with underfunded pensions, municipalities remain generally sound with defaults very rare in the municipal bond market.

For a more detailed overview of the third quarter and our outlook, please see [Newfleet's 3Q18 Municipal Bond Market Review](#).

### HOW THE FUND PERFORMED

The Fund (Class I) returned -0.35% in the third quarter versus -0.10 % for the Fund's benchmark, the ICE BofA Merrill Lynch 1-22 Year U.S. Municipal Securities Index (ML Index).

#### Contributors

> The Fund's exposure to A-rated securities as well as higher allocation to pre-refunded bonds helped relative performance for the quarter.

#### Detractors

> The Fund's lower allocation to high yield and lighter exposure to current and discount coupon bonds hurt relative performance.

### CURRENT FUND STRATEGY

The Fund's duration was 5.48 years at quarter end, compared to that of the ML Index at 5.57 years.

With credit spreads at historically tight levels, we continue to focus on lower AA and single A-rated bonds in the 15- to 20-year maturity range. We still believe this area of the curve represents reasonable value. The 20-year bond captures 96% of the yield available on a 30-year bond with less duration risk.

At quarter end, the Fund had allocations of 35.4% to AA-rated bonds, 34.7% to A-rated bonds, 10.1% to BBB-rated bonds, and 0.7% to below investment grade bonds.

### OUTLOOK

As we head into the final quarter of 2018, our outlook for municipal bonds remains cautiously optimistic. The current strong economy, rising rates, and strong equity market performance this year have seemed to moderate investor interest in municipal bonds. But valuations of municipal bonds appear increasingly attractive given the rising yields in 2018, especially when considering their taxable-equivalent yields compared to other fixed income investments. Market volatility is expected to increase throughout the remainder of the year, given the uncertainty of interest rates as well as the effects from the 2017 tax law amendments. Finally, while overall market fundamentals have improved, we continue to believe that now is not the time to take on additional credit risk in the municipal market, especially with credit spreads at historically tight levels.

## Virtus Newfleet Tax-Exempt Bond Fund

### INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

### INVESTMENT SUBADVISER

Newfleet Asset Management, LLC

### PORTFOLIO MANAGERS



**Tim Heaney, CFA**  
Industry start date: 1990  
Start date with Fund: 2012



**Lisa Leonard**  
Industry start date: 1986  
Start date with Fund: 2012

### SECTOR ALLOCATIONS

% Fund

Prerefunded / Escrowed to Maturity	13.40
Hospital	11.11
Transportation	9.63
Water & Sewer	9.09
Leasing	7.61
State General Obligation	7.37
Electric	7.34
Special Tax	7.11
Education	6.28
Miscellaneous Revenue	5.66
Local General Obligation	5.41
Airport Revenue	3.99
Housing	2.34
Tobacco Asset-Backed	1.74
Cash	1.29
Tax Allocation	0.63

Sector weights are subject to change.

### AVERAGE ANNUAL TOTAL RETURNS (%) as of 9/30/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 2/23/1996
Fund Class I	-0.35	-0.64	-0.10	1.66	2.94	4.96	4.76
Index	-0.10	-0.23	0.02	1.96	3.07	4.56	4.75

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.

Benchmark since inception performance is reported from 2/29/1996.

The fund class gross expense ratio is 0.77%. The net expense ratio is 0.60%, which reflects a contractual expense reimbursement in effect through 1/31/2019.

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 **Tax-Exempt Bond Linked Benchmark** consists of the ICE BofA Merrill Lynch 1-22 Year U.S. Municipal Securities Index, a subset of the ICE BofA Merrill Lynch U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 22 years, calculated on a total return basis. Performance of the Tax-Exempt Bond Linked Benchmark prior to 6/30/2012 is that of the Bloomberg Barclays Municipal Bond Index. The **Bloomberg Barclays Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market. The index is calculated on a total return basis. Indexes are unmanaged, returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

**Notes on Risk: 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. **Municipal Market:** Events negatively impacting a municipal security, or the municipal bond market in general, may cause the fund to decrease in value. **State & AMT Tax:** A portion of income may be subject to some state and/or local taxes and, for certain investors, a portion may be subject to the federal alternative minimum tax. **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. **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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