

Virtus Newfleet Tax-Exempt Bond Fund

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

MARKET OVERVIEW

Municipal bonds posted a positive return in the fourth quarter, despite strong issuance and uncertainty over the final tax reform package. Faced with the possibility that hospitals, universities, and other private activity bond issuers would no longer be able to issue debt in the tax-exempt market, issuers rushed to the market. This proposed element of the tax reform bill ultimately did not make it into the final legislation, but investors were not taking any chances. At the same time, municipalities sought to refinance their higher-cost debt before their ability to advance refund was halted. The rush to complete issuance before year end caused a sizable spike in supply levels. Instead of causing the market to soften, anticipation of limited supply in 2018 provided strong performance heading into the end of 2017.

During the quarter, performance was strongly correlated to positioning along the yield curve as longer-maturity bonds significantly outperformed shorter-maturity bonds. With the Federal Reserve starting to unwind its balance sheet and raising its benchmark rate for the third time in 2017, yields on the front end of the curve rose while limited supply in the long end caused yields in that part of the curve to decline. The result was a flatter yield curve. In addition, lower-rated issues continued to outperform higher quality alternatives as municipal investors still favored yield, keeping credit risk spreads historically tight.

For a more detailed overview of the fourth quarter and our outlook, please see [Newfleet's 4Q17 Municipal Bond Market Review](#).

HOW THE FUND PERFORMED

The Fund (Class I) returned 0.55% in the fourth quarter versus 0.25% for the Fund's benchmark, the ICE BofA Merrill Lynch 1-22 Year U.S. Municipal Securities Index (ICE BofAML Index). For the year, the Fund returned 4.68% versus 4.53% for the Index.

Contributors

- > The larger contributors to relative performance during the quarter were tobacco bonds, bonds in the 10+ year maturity range, and lower-rated issues.
- > The Fund's exposure to Illinois bonds helped performance during the quarter, albeit to a lesser degree than it did in the third quarter.

Detractors

The Fund's lower allocation to the 20-year-plus maturity range and higher coupon profile detracted from performance relative to peers during the quarter.

CURRENT FUND STRATEGY

The Fund's duration was 5.2 years at quarter end, compared to that of the Index at 5.3 years.

At quarter end, the Fund had a 35.7% allocation to A-rated bonds, 9.8% exposure to BBB-rated credits, 1.3% to below investment grade bonds, and 4.7% to not rated (NR) bonds that are pre-refunded and backed by U.S. obligations.

With credit spreads reaching historically tight levels, we are focusing 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 15-year and 20-year bonds capture 90% and 96%, respectively, of the yield available on a 30-year bond with less duration risk.

OUTLOOK

With tax legislation behind us, we will carefully monitor the impact of lower tax rates on the demand for tax-exempt bonds. We otherwise believe that the market is positioned to perform well. Limited supply to start 2018 should prove to be quite bullish for municipal bond evaluations, unless Treasury yields spike higher and cause investors to become leery of the broader bond market. With credit spreads at historically tight levels, we also believe that now is not the time to take on credit risk in the municipal market. Fundamentals remain challenged for many municipalities, so we continue to focus on higher quality investments. Thorough credit analysis is imperative as not all issuers are created equal.

Virtus Newfleet Tax-Exempt Bond Fund

INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

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INVESTMENT PROFESSIONALS



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



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

SECTOR ALLOCATIONS

	% Fund
Prerefunded / Escrowed to Maturity	15.93
Hospital	11.57
Water & Sewer	11.40
Transportation	9.49
Leasing	8.22
Education	7.03
Special Tax	7.02
Electric	6.92
Miscellaneous Revenue	6.09
State General Obligation	4.80
Airport Revenue	4.48
Local General Obligation	2.40
Housing	2.04
Tax Allocation	1.56
Tobacco Asset-Backed	1.06

Sector weights 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 2/23/1996
NAV	0.55	4.68	4.68	2.37	2.35	4.41	4.96
Index	0.25	4.53	4.53	2.60	2.70	4.24	4.93

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.

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 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 **Tax-Exempt Bond Linked Benchmark** consists of the BofA Merrill Lynch 1-22 Year U.S. Municipal Securities Index, a subset of the 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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