

## Virtus Duff & Phelps Real Estate Securities Fund

A: PHRAX (92828R586) | C: PHRCX (92828R560) | I: PHRIX (92828R552) | R6: VRREX (92828W528)

### MARKET REVIEW

In a challenging environment, REITs outperformed the broader market in the fourth quarter, finishing roughly in line with the broader market for the year. For the quarter, the S&P 500® Index returned -13.52% while the benchmark FTSE Nareit Equity REITs Index returned -6.73%. For the year, REITs returned -4.62% versus -4.38% for the S&P 500.

Numerous economic and geopolitical factors contributed to the challenging performance, including the impact of trade tariffs on the global economy and China in particular, broader market earnings growth concerns, the Federal Reserve's December actions and messaging, confidence in elected officials, and the U.S. government shutdown.

Amid global growth concerns, the Fed increased rates in December for the fourth time in 2018, and articulated two probable rate increases for 2019 and further balance sheet unwinding. However, Fed Chair Powell articulated a more reassuring message on January 4, noting the central bank would be receptive to using all of its tools, depending on the economic data and market environment.

The Q4 selloff led to significant discounts for REITs versus private market valuations. Capital continued to be raised for private real estate funds, boosting the potential of M&A. REITs had solid Q3 earnings and are demonstrating more consistent earnings drivers as we begin 2019. Most companies beat and/or raised 2018 earnings guidance. REITs, as measured by Evercore ISI, posted 3.1% same-store net operating income growth in Q3, consistent with the past four quarters. Also, REITs continued to prune their portfolios of high quality real estate into the robust private bid, further strengthening their balance sheets while demonstrating patience for redeployment opportunities.

Within the FTSE Nareit Equity REITs Index, freestanding retail and healthcare were the top-performing property sectors on a total-return basis, as more defensive REITs outperformed in the quarter and year as in the broader market. Healthcare continued to experience notable positive multiple expansion while earnings estimates were revised downward again. The sector has faced operator challenges within senior housing and skilled nursing facilities, increased labor costs/margin pressures, and excess supply concerns in senior housing. Additional catalysts include M&A, portfolio transformations, and operator renegotiations. Freestanding retail also experienced multiple expansion and took advantage of share appreciation to issue equity to fund acquisitions, experiencing modest downward earnings revisions on the year.

The quarter's bottom-performing property sectors included lodging, given its economic sensitivity and economic concerns, as well as data centers, which experienced undue pressure when technology stocks sold off in the quarter.

### PERFORMANCE

For the quarter, the Fund (Class I) returned -8.02%, underperforming the benchmark's -6.73% return. Although the portfolio benefited

from security selection, it lagged overall due to property sector allocation.

The strongest sector contributors were data centers due to security selection, regional malls due to security selection and an underweight allocation, and apartments and manufactured homes, both due to a positive benefit from an overweight allocation, as well as stock selection in the case of manufactured homes. Among the largest security contributors were Digital Realty Trust due to our overweight position and its outperformance versus the benchmark and data centers, and Equinix due to our underweight and its underperformance in data centers.

The largest detractors were healthcare and freestanding retail due to our underweight allocation, and industrial and lodging due to security selection, and to a lesser extent, allocation. Included among the largest security detractors were Health Care Trust of America, due to our overweight position and its underperformance within healthcare. Still, it did outperform the benchmark and helped overall. Boston Properties also detracted. Even though it underperformed the benchmark, we were underweight and it outperformed the office sector.

### OUTLOOK

We expect continued variance in global growth and regional real estate fundamentals. Regionally, we are looking to Ireland, Australia, and the U.S. for growth leadership. We expect opportunities for active managers such as ourselves, who are focused on owner-operators of high quality real estate, with solid balance sheets and proven management teams, to deliver outperformance versus the broader REIT market. Overall, we expect cash flow and dividend growth for global real estate securities to be solid once again in 2019.

Key themes include:

- > *Rents, not rates*: While there is likely to be upward pressure on interest rates in many markets, rental rate growth—particularly for high quality real estate—will continue to support further cash flow and dividend growth.
- > *New supply*: While new supply levels are generally catching up to years of undersupply, selective geographic markets and property sectors will remain impacted by new development.
- > *Balance sheet health*: Cash flow and dividend growth rates are converging across many global markets, but U.S. balance sheets are benefiting from more active pruning and remain better positioned with less leverage than most international markets.
- > *M&A tailwind*: M&A activity picked up in 2018, driven by healthy discounts to NAV in public real estate security markets, as well as large pools of private equity real estate capital looking to be put to work. We expect this to continue.

**Related Reading:** [Global Listed Real Estate: 2018 Review & 2019 Outlook](#), available on [virtus.com](#).

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INVESTMENT ADVISER

Virtus Investment Advisers, Inc.

INVESTMENT SUBADVISER

Duff & Phelps Investment Management Co.

PORTFOLIO MANAGERS



**Geoffrey P. Dybas, CFA**  
Industry start date: 1989  
Start date with Fund: 1998



**Frank J. Haggerty, Jr., CFA**  
Industry start date: 1996  
Start date with Fund: 2007

TOP TEN HOLDINGS

% Fund

Prologis, Inc.	7.65
Digital Realty Trust, Inc.	6.00
Simon Property Group, Inc.	5.80
Alexandria Real Estate Equities, Inc.	4.81
AvalonBay Communities, Inc.	4.71
Mid-America Apartment Communities, Inc.	4.15
Extra Space Storage Inc.	4.11
Sun Communities, Inc.	4.05
Duke Realty Corp.	4.01
Regency Centers Corp.	3.70

Holdings are subject to change.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 12/31/18

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception 12/29/2006
Fund Class I	-8.02	-6.50	-6.50	1.99	7.42	11.71	3.99
Index	-6.73	-4.62	-4.62	2.89	7.90	12.12	4.24

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 1.08%.

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 **FTSE Nareit Equity REITs Index** is a free-float market capitalization-weighted index measuring equity tax-qualified real estate investment trusts, which meet minimum size and liquidity criteria, that are listed on the New York Stock Exchange, the American Stock Exchange and the NASDAQ National Market System. 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.

The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the 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 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. **Real Estate:** The fund may be negatively affected by factors specific to the real estate market, including interest rates, leverage, property, and management. **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.

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