

FOCUS ON: VIRTUS STRATEGIC INCOME FUND

A: VASBX / C: VSBCX / I: VISBX



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The global bond market is now very difficult to navigate. Multiple factors are to blame: Historically low yields, the prospect of increased interest rates lowering bond prices, and diminished market liquidity driven by regulatory changes. Still, bonds remain an essential element of investors' portfolios—and always will. Thus the question is not “if” to own bonds, but “how.” One answer is a portfolio management style which can flexibly exploit opportunities and manage risks.

What is the rationale for an “unconstrained” fixed income portfolio?

As the fixed income market stands today, traditional bond portfolios have the potential to fall short of meeting investors' total return objectives and providing protection from the threat of rising interest rates. As the primary example, the Barclays U.S. Aggregate Bond Index, representative of a “core” bond holding, has seen both its interest rate sensitivity (duration) rise and its total return potential diminish. A fixed income manager benchmarked to the Index can have difficulty meeting investors' return objectives.

Unconstrained, “go anywhere” funds strive to address the limitations of traditional approaches by expanding the opportunity set of investments beyond those represented in the Index. Because these funds are not forced to mimic a benchmark, they don't have to take on its interest rate or credit risk profile. Rather, they can search for pockets of opportunity in all corners of the fixed income market, using a variety of instruments and tools.

What is the Virtus Strategic Income Fund?

The Virtus Strategic Income Fund seeks to identify undervalued opportunities across a broad universe of fixed income investments in any interest rate or market environment.

Leveraging the core Newfleet approach, the portfolio invests in up to 14 sectors of the bond market—not only the core sectors of the Barclays U.S. Aggregate Bond Index, but also an extended universe that includes high yield bonds, bank loans, residential mortgage-backed securities, emerging markets bonds, and non-U.S. dollar issues.

The Fund invests without duration, sector, quality, or geographic limitations. Derivatives can be used to manage portfolio duration and risk, as well as to enhance the portfolio managers' highest convictions.



How is it different from other unconstrained portfolios?

Our Fund has a number of distinguishing characteristics amid a great variety of unconstrained offerings.

- > First, our approach stems from an already-established investment program with a 23 year history. We focus on top-down sector allocation and bottom-up security selection, both driven by relative valuation and rooted in deep fundamental analysis.
- > Second, by relaxing arbitrary portfolio constraints, the Fund represents our strongest convictions.
- > Third, our equities exposure is very limited (<5%); a larger equities stake, which some portfolios or funds take, would alter the risk profile of the Fund and may not align with investor expectations for a fixed income portfolio.
- > Fourth, we can employ a conservative options-based strategy to generate incremental income.

What return objective does the Fund seek to achieve?

The Fund seeks to achieve a positive total return, regardless of the market environment. It is not managed against a benchmark.

How does the Fund work?

The key features of the strategy are:

- > a multi-sector approach,
- > unlimited flexibility in exposures,
- > conservative use of derivatives, and
- > an additional source of income through an option overlay strategy.

The process begins with top-down sector analysis, with an eye toward identifying the most attractive relative values out of all possible opportunities. This determines overweight and underweight allocations *across* sectors. The sector allocation targets, in combination with the interest rate outlook, establish the duration range of the portfolio. *Within* sectors, issue selection is a function of bottom-up fundamental, value-driven research, and thorough company and credit analysis.

There are no restrictions on below-investment-grade or non-U.S. securities, or other out-of-index sectors. The Fund can use derivatives in some instances to mitigate targeted risks and in others to express our conviction in specific sectors and securities. This approach allows us to implement certain decisions quickly and efficiently.

The Fund will use credit default swaps (CDS), both single name and Index (CDX), to go long or short individual securities or a credit or asset-backed index. As an example, we recently used a CDX position to short the high yield market, which, at the time, was under severe pressure, while opportunistically buying issues in the BB high yield segment where we saw attractive valuations.

In addition to deploying capital into sectors that historically have shown low or even inverse correlations to rising interest rates (e.g., bank loans), the Fund can also short U.S. Treasury futures to hedge interest rate risk. Alternatively, U.S. Treasury futures can also be used to quickly add duration to benefit the portfolio in times of falling interest rates. Lastly, the Fund can employ an option overlay strategy in order to add incremental income by selling option premiums.

How does the Fund view credit risk versus interest rate risk?

The portfolio managers do not look at either credit risk or interest rate risk in isolation, but rather as important interdependent inputs into the overall process. The portfolio is constructed from the bottom up based on where perceived value lies within the many sectors of the bond market. Each sector's relative attractiveness is based on our views on the primary drivers (fundamentals, technicals, and valuations), and both credit and interest rate risk play a large part in that analysis. Even within sectors, credit risk and interest rate risk play a large role.

Let's use high yield as an example. Within high yield, additional alpha can be derived from having exposure to the segments that the team believes will outperform. If the sole concern is that credit risk is rising, for example, then the appropriate allocation within the sector would be heavily weighted towards "BB" rated securities (i.e., the highest credit rating of the high yield market). Then, considering our view of potential interest rate risk, the final "BB" weighting might be tweaked up or down as such bonds tend to have more interest rate risk than other high yield issues.

What specifically is the role of the option overlay strategy in the portfolio?

This strategy can generate incremental income through earning option premiums. We may choose to use this tool based on our assessment of its potential attractiveness during various market environments, especially in terms of volatility levels. We can also vary the amount of the notional exposure on which the overlay is set in order to manage the risks/rewards associated with being under- or overexposed to the strategy.

The overlay strategy utilizes S&P 500® Index options, which are highly liquid and exchange traded. The strategy writes credit put and call option spreads and features a clearly defined target return and maximum downside.

The key risk to the option overlay strategy occurs when implied volatility (investors' expectations for future volatility) is lower than the subsequent realized volatility during the duration of a trade. In an environment where realized volatility frequently is greater than implied volatility, the strategy may not achieve its income objectives.

How does the Fund manage risk?

A comprehensive risk management framework is particularly important for the range and depth of decisions that a flexible, high-conviction strategy requires. We utilize the risk management process Newfleet has refined across the multi-sector line-up over two decades of portfolio management.

Risk control focuses first and foremost on rigorous credit analysis—based not just on models, but on the experience of the team. Our 11 sector specialists have an average of 21 years of investment experience. Each analyst is directly involved in all aspects of the investment decision making and is responsible for both initial research and ongoing monitoring of portfolio holdings.

Our team continually reviews the portfolio in an effort to uncover any potential problems with credit quality, liquidity, legislative impact, or valuation levels. Securities with deteriorating fundamentals are immediately flagged and, if appropriate, sold.

The process incorporates a strong sell discipline that takes into account a number of factors including a change in sector outlook; change in prepayment outlook; security relative valuation; anticipated deterioration of credit/subordination quality; and assessment of leading indicators such as equity pricing, default swap levels, and delinquencies. These checks are executed through a formal daily, monthly, and quarterly risk management protocol. Likewise, we exercise a comparable approach at the sector allocation level, reviewing where there are headwinds and opportunities, which will lead us to shift the portfolio accordingly.

We also stress test the portfolio to estimate the impact of rising rates, spread widening, curve flattening, and curve steepening. Thus, we can better understand how the portfolio will behave across changing market environments, which then guides our decision-making.

Unconstrained portfolios are relatively new and therefore untested. What resources and experience does Newfleet have that underlie the credibility of the Strategic Income Fund?

The Fund is a logical extension of the multi-sector investment approach that we have honed over 23 years at Newfleet. Our team of experienced sector specialists and analysts is critical to the success of our process. The sector heads, who manage dedicated strategies in their areas of expertise, participate fully in all aspects of the investment process. The Fund's portfolio managers benefit from this range of perspectives, and they can rely confidently on the specialists' expertise to act nimbly and opportunistically.

Newfleet has been quick to identify and invest in newer opportunities throughout its history. We were early entrants to commercial mortgage-backed securities in the early 1990s, Brady Bonds in the mid-1990s, and bank loans in the early 2000s; more recently, we have enhanced and built out our distressed debt capabilities. Our innovative and entrepreneurial culture has been critical to the firm's success over the years.

Further, our size works to our advantage—we are large enough to have meaningful relationships with Wall Street, but small enough to participate in a wide range of opportunities.

Does being “unconstrained” result in a high level of portfolio turnover?

No. Being unconstrained does not mean frequent and large moves into and out of sectors and securities. Though we can act nimbly, we follow a disciplined process of allocating among sectors.

To learn more about the Virtus Strategic Income Fund, contact your financial advisor or visit Virtus.com.



About the Author:

Jonathan Stanley is managing director, portfolio manager, and sector manager of high yield credit at Newfleet Asset Management.

Mr. Stanley is co-portfolio manager of the Virtus High Yield Fund and the Virtus Strategic Income Fund. He is also the manager of a flexible credit/leveraged finance strategy and two actively-managed ETFs, including the Newfleet Multi-Sector Unconstrained Bond ETF (NYSE: NFLT). Mr. Stanley is responsible for credit analysis of the restaurant and retail industries for the Newfleet team.

Prior to joining Newfleet in 2011, Mr. Stanley was on the fixed income team at Goodwin Capital Advisers, an investment management company and former Virtus subsidiary, over two separate periods. From 1997 to 2001, he served in several capacities, including as an analyst on the emerging markets team, left the firm to pursue other opportunities for five years, and rejoined in 2006 as a member of the corporate credit group. He assumed responsibilities for the high yield sector in 2008.

Mr. Stanley's additional investment experience includes serving as a research analyst at Hollister Investment Management, and as a portfolio manager at FA Asset Management and Global Financial Private Capital.

Mr. Stanley earned a B.S. in accounting from Fairfield University and an M.B.A. from the University of Florida. He holds the Chartered Financial Analyst® (CFA®) designation. He began working in the investment industry in 1997.

The **Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

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 indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

One **basis point (bp)** is equal to 1/100th of 1%, or 0.01% (0.0001), and is used to denote the percentage change in a financial instrument.

OPTION OVERLAY STRATEGY DEFINITIONS AND RISKS

Call: an option contract that gives the buyer the right to purchase the specified shares of the underlying stock or index at the given strike price. This creates an obligation to sell for the seller. **Implied volatility:** the estimated volatility of a security's price which is used by option traders to price an option, based on a particular option-pricing model. **Notional:** the value of an asset expressed in dollars used to construct derivative transactions. **Option spreads:** an option position that is constructed of equal number of options of same class (calls or puts) and underlying asset but differ in either strike price or expiration. **Premium:** the amount of money the buyer pays and the seller receives to engage in an option transaction. **Put:** an option contract that gives the buyer the right to sell the specified shares of the underlying stock or index at the given strike price. This creates an obligation to purchase for the seller. **Realized volatility:** the actual fluctuation of an underlying security's price, either up or down. **Volatility:** the tendency of the underlying security's market price to fluctuate up or down.

If the S&P 500 Options Index becomes more volatile, causing more of the short calls and puts to settle in-the-money, there may be a negative impact on performance.

If the S&P 500-listed options become unavailable to trade, Newfleet may be unable to implement the strategy.

There is no assurance that the option overlay strategy will be successful.

IMPORTANT RISK CONSIDERATIONS

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. **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. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times. **ABS/MBS:** Changes in interest rates can cause both extension and prepayment risks for asset- and mortgage-backed securities. These securities are also subject to risks associated with the repayment of underlying collateral. **Derivatives:** Investments in derivatives such as futures, options, forwards, and swaps may increase volatility or cause a loss greater than the principal investment. **Call/Put Spreads:** Buying and selling call and put option spreads on the SPX Index risks the loss of the premium when buying, can limit upside participation and increase downside losses. **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.

Investors should carefully consider the investment objectives, risks, charges, and expenses of any Virtus Mutual Fund before investing. The prospectus and summary prospectus contain this and other information about the Fund. Please contact your financial representative, call 1-800-243-4361, or visit www.virtus.com to obtain a current prospectus and/or summary prospectus. You should read the prospectus and/or summary prospectus carefully before you invest or send money.

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