MARKET VOLATILITY NOTE

August 24, 2015

Summary

- August 2015 has witnessed increased volatility dominated by the decline in the Chinese financial market, possibility of the Fed raising rates in September, falling commodity prices and to a lesser extent, persistent concerns over Greece.
- During the week of August 17-21, 2015, global stock markets experienced a sharp sell-off with the US stock market experiencing its largest loss in 4 years (since Nov 2011). Market volatility spiked and government bonds and gold soared as investors sought out safer havens.
- Obviously this has been – is – a very nasty episode, violent in both its severity and speed. But equity market “corrections” are not that unusual. And we do believe that this is what is happening at present. It is ugly and painful, but it is far from unprecedented. The bottom line is that we do not believe that this presages a significant global downturn or recession. The macro outlook is pretty good and has evolved slowly not changed markedly in recent months/quarters.
- The Virtus Multi-Strategy Target Return Fund is an outcome-orientated fund that is less dependent upon the direction of the markets or the team’s ability to predict the future of markets. In selecting strategies, we seek for them to generate positive performance in our central view of capital markets and also to interact and provide diversification and positive returns in cases when the future proves different to our expectations, including when market volatility levels are high. As a result, the fund has stood up well relative to global and local equity markets during this recent period of market volatility and provided capital preservation to clients.
- In uncertain times and periods of heightened market volatility, the fund’s goal is to allow clients to navigate adversity with a greater success of achieving a positive outcome and downside protection. This fund can play an important role in portfolios by providing an alternative to equities and fixed income if there is a large correction in the equity market, such as last week.

What has happened in the markets?

- August 2015 has witnessed increased volatility dominated by the decline in the Chinese financial market, possibility of the Fed raising rates next month, falling commodity prices and to a lesser extent, persistent concerns over Greece.
- The Asian markets have focused on the intervention of the People’s Bank of China (PBoC) and changes to the Yuan fix. This is the result of slower growth in China and the subsequent decisions have had dramatic impacts on emerging market currencies including Malaysia, Taiwan, the Philippines, Indonesia, and Thailand. Regulators and central authorities, including China’s Central Bank and Taiwan’s financial watchdog, are looking to intercede by limiting short-selling (Taiwan) and lower the reserve requirement ratio (China) in efforts to stem capital outflows and support financial markets.
- During the week of August 17-21, 2015, the US stock market suffered its largest loss in 4 years (since Nov 2011). The US observed its worst day since November 2011 as the S&P 500 fell -3.2% on August 21, 2015 and the DJIA plunged more than 500 points (or 3%) for the day, taking it down more than 10% from its last high.
- The options-derived index of volatility known as the VIX more than doubled, including a 46 percent increase on Friday alone, leaving it at the highest level since 2011. Bond yields on the US 10 year are now below 2%. Elsewhere in Europe, financial markets were also affected as the DAX, CAC, and IBEX all experienced declines of approximately 3% in a single day (last Friday). Commodities prices remain depressed[1] .

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[1] Commodity index = S&P GSCI. The S&P GSCI is designed to be a “tradable” index, providing investors with a reliable and publicly available benchmark for investment performance in the commodity markets. The index comprises the principal physical commodities that are traded in active, liquid futures markets.

What do we think of the correction?

- Obviously this has been – is – a very nasty episode, violent in both its severity and speed. But equity market "corrections" are not that unusual. And we do believe that this is what is happening at present. It is ugly and painful, but it is far from unprecedented.
- In the event of these episodes, explanations flourish everywhere, none of which provide total clarity. The proximate causes this time were basically two: worries about the Fed's first interest rate rise for almost a decade and concerns about the magnitude of the slowdown in China. Both are legitimate, but both have been around for a while.
- We do not believe that Fed tightening would derail recovery and push us back into a major global downturn. And while we recognize and acknowledge the China slowdown, we have also recognized its probability. And it should continue – in 10 years' time China will probably be growing at 4% or 5%, perhaps less. Granted the secular slowdown is one thing, the worry of something nastier is understandable. But we remain upbeat in a relative sense – China should continue to grow and the authorities, which include China's Central Bank and securities regulator, have policy ammunition to use if they want to.
- In recent history the S&P 500 has been characterized by low volatility and not observed this magnitude of daily instability since August 8, 2011. It doesn't feel like it when you're in them, but these are often cathartic processes, the market equivalent of the tropical storm that clears the air. Of course they can be something far more sinister, but our strong belief is that this is not the start of a bear market.

How did the Virtus Multi-Strategy Target Return Fund perform during this period, and what should you expect?

- The Virtus Multi-Strategy Target Return Fund has provided capital preservation during the month of August and during the sell-off of August 21, 2015. In selecting strategies, we seek for them to generate positive performance in our central view of capital markets and also to interact and provide diversification and positive returns in cases when the future proves different to our expectations, including when market volatility levels are high.
- As should be expected, the fund has stood up well relative to global and local equity markets during this recent period and provided capital preservation to clients.
- The fund benefits from portfolio construction in the form of "risk-reducing" strategies that are intended to stabilize the fund in risk off environments. This is evidenced by the strong recent positive contribution from our Australian rates strategy (Forward-start AUS Rates). The position aims to benefit from a slowing Chinese economy that prompts weaker Australian output and a worsening outlook for Australian bond yields. Risk-reducing strategies aim to generate positive returns on a three-year time horizon even when our 'House View' does not play out, and flat to mildly positive returns when our House View does play out.
- Additionally, the smart implementation of "market return" strategies has limited losses attributed to traditional market exposure. For example, the fund has exposure to Chinese equities which position is approximately flat for the month, despite the broader correction in the Chinese equity market. This is possible as the strategy is implemented through a call spread option, which contains two calls with the same expiration but different strikes. The strike price of the short call is higher than the strike of the long call, which means this strategy will always require an initial outlay. The short call's main purpose is to help pay for the long call's upfront cost. Up to a certain stock price, the bull call spread works a lot like its long call component would as a standalone strategy. However, unlike with a plain long call, the upside potential is capped. That is part of the tradeoff; the short call premium mitigates the overall cost of the strategy but also sets a ceiling on the profits.

Some key points regarding the fund given the current market

- The fund has a different approach to what is offered by most other money managers and other multi-strategy funds in that the strategy seeks to generate a positive return in all market environments over a rolling three year period, and is therefore less dependent upon the direction of the markets or the team's ability to predict the future.
- To achieve the above, the fund seeks to gain not just exposure to traditional market betas, such as global stocks and credit, etc., but it also seeks out a multitude of non-traditional risk exposures (such as relative value and directional) and risk-reducing positions. This range of 25-35 different investment ideas are expected to work well together whether markets are rising or falling so the fund can meet its investment target, including when market volatility levels are high.

- As the fund managers believe that it is difficult to predict exactly what will happen next in the markets, they use a three year time horizon instead of focusing on the next few weeks or months. This outlook is significantly longer term in nature than many market participants, allowing the fund to benefit from the resulting market inefficiencies. This provides an opportunity to find investment ideas and capture returns more consistently over a three-year investment period. As a result of the market volatility, we added to equity positions in continental Europe, Japan and the US in recent days, and view any further bouts of extreme volatility as an opportunity to add exposure to these regions.
- Risk management is in the DNA of the fund, and every underlying investment strategy is viewed in terms of its contribution to risk and behavior in different market scenarios. All strategies are held in sufficient size to be meaningful in terms of contribution to returns or diversification benefits, while ensuring that no single strategy dominates the risk profile of the fund. This helps to provide diversification and capital preservation. In addition, we stress test and rigorously analyze the fund against a range of historical and potential risk scenarios.

Outlook and positioning going forward

- The bottom line is that we do not believe that this presages a significant global downturn or recession. The macro outlook is pretty good and has evolved slowly not changed markedly in recent months/quarters. In our view there is no macro outlook that justifies this sell-off. Some valuations may well have been stretched and there are always some clouds on the horizon. Our opinion is that recovery is ongoing, if fragile in some geographies and slow because of legacies from the financial crisis. But is not stopping or reversing.
- As a result we remain constructive on the key positions within the fund on a longer time horizon. The fund used the recent volatility to add to equity positions in continental Europe, Japan and the US in recent days, and view any further bouts of extreme volatility as an opportunity to add exposure to these regions.
- The above being said, we believe that many events that have significant impacts on markets are unforeseeable. Therefore the fund is constructed to perform irrespective of market conditions and our central view.
- If the current market volatility does continues, which may be likely given the ongoing risks to the global economy, the fund has exposure to a number of risk reducing strategies that would be expected to generate a positive performance and provide downside protection. This include positions designed to benefit from increased volatility in the market and positions in various rates and currency markets that would generate positive returns if there was a “flight to quality” during a period of market stress.
- In uncertain times and periods of heightened market volatility, the Virtus Multi-Strategy Target Return Fund’s goal is to allow clients to navigate adversity with a greater success of achieving a positive outcome and downside protection. This fund can play an important role in portfolios by providing an alternative to equities and fixed income, if there is a large correction in the equity market, such as last week.

Index Definitions

The **MSCI All Country World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes.

The **Standard & Poor's 500 Index**, widely referred to as the S&P 500 Index, tracks the performance of 500 widely held large-cap US stocks in the industrial, transportation, utility, and financial sectors.

IMPORTANT INFORMATION:

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. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market 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. **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. **Derivatives:** Investments in derivatives such as futures, options, forwards, and swaps may increase volatility or cause a loss greater than the principal investment. **Leverage:** When a fund leverages its portfolio, the value of its shares may be more volatile and all other risks may be compounded. **Counterparties:** There is risk that a party upon whom the fund relies to complete a transaction will default. **Portfolio Turnover:** The fund's principal investments strategies will result in a consistently high portfolio turnover rate. A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes when fund shares are held in a taxable account. **Prospectus:** For additional information on risks, please see the fund's prospectus.

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Except where stated as otherwise, the source of all information is Aviva Investors as of August 24, 2015. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested. Past performance is no guarantee of future results.

Due to the fact the strategy will make significant use of financial derivatives, the following risk factor is particularly relevant:

Derivative risks: As a result of the high degree of leverage typically employed when trading financial derivatives, a relatively small price movement in the underlying asset may result in substantial losses to the portfolio's assets.

Portfolio holdings are subject to change at any time without notice and information about specific securities should not be construed as a recommendation to buy or sell any securities.

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