FOCUS ON: VIRTUS MULTI-STRATEGY TARGET RETURN FUND

A: VMSAX / **C:** VCMSX / **I:** VMSIX

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Building a truly diversified portfolio that performs well across all market conditions is the great investing challenge of our time. This edition of the "Focus" series tackles the topic by discussing how a multi-strategy approach may help investors meet their return objectives while also managing the impact of volatility.

What do you see as the key challenges for today's investor?

Over our team's decades of combined experience, we have found that clients—whether they are pensions, corporations, financial advisors, or individual investors—share the same objectives: achieving consistent asset growth; securing a reliable income stream; obtaining a return that exceeds inflation; or increasing the likelihood that a specific future financial liability will be met.

These goals don't change over time, but the challenges in meeting them do. First and foremost, we face the prospect of low returns in the years to come. Global equities have produced very strong returns in the post-2008 crisis era, meaning that there are pockets of overvaluation and risk. We face record low bond yields globally. And more highly correlated asset prices make diversification harder to achieve. Furthermore, markets have grown more volatile as both the period of record-low U.S. interest rates seemingly draws to a close and major central banks begin to diverge in their policies. For all these reasons, seeking to position portfolios to provide consistent, positive risk-adjusted returns is not straightforward. Not only do we need to take extra caution in selecting the right equity and fixed income investments, but we also need to consider other, less correlated "building blocks" for a portfolio.

Why is Aviva Investors well-positioned to address these challenges?

Aviva Investors is one of the world's largest and most sophisticated investment firms. The investment arm of Aviva plc, a UK-listed multinational financial services company, Aviva Investors manages $427.3 billion, with 405 investment professionals located in 15 different countries.[1]

The group is led by Euan Munro, Chief Executive Officer of Aviva Investors, who has responsibility for harnessing the firm's global expertise in delivering

Source: Aviva Investors and Aviva plc. [1]Data as of 12/31/2015. Aviva Investors Americas LLC (AIA) is the named subadviser to the Fund and utilizes the services of Aviva Investors Global Services Limited (AIGSL) and its other affiliates (collectively, Aviva Investors) to manage the Virtus Multi-Strategy Target Return Fund. These affiliates are Participating Affiliates as that term is used in relief granted by the SEC.

outcome-oriented investments for investors. Euan is considered a pioneer in the field of liquid Absolute Return type strategies, helping bring them to the mainstream, and a key "architect" of Standard Life's Global Absolute Return Strategy. Euan chairs the Strategic Investment Group (SIG), which serves as the central investment committee for Aviva's multi-strategy offerings.

What are some distinguishing features of the "multi-strategy" approach you believe serve as a solution for today's challenges?

Time and again, our clients have told us what matters most is not whether their investments outperformed an arbitrary benchmark or peer group. Instead, most important was consistently growing the value of their capital in a way that allows them to meet their financial goals. That also means doing so with lower volatility than traditional risk assets, such as equities.

Traditionally, portfolios have been managed against benchmarks or the performance of their peers. In contrast, our multi-strategy portfolio targets a specific outcome. Outcome-oriented strategies do not have an index bogey, but instead seek to deliver a specific return and risk target over time. We aim to achieve these outcomes by investing in a highly diversified portfolio of approximately 25-35 liquid strategies, some directional, some non-directional or relative value, and some risk-reducing.

The multi-strategy nature of the Virtus Multi-Strategy Target Return Fund means we believe it should perform in all market conditions. In selecting strategies, we seek for them to generate positive performance in light of our central view of markets, and also to provide diversification and positive returns in cases when the future proves different from our expectations. The way our investment strategies are expected to interact with each other across a range of potential market conditions is crucial to the way in which we manage the Fund.

Ultimately, the Fund is structured to offer a core "return engine" in an investor's overall portfolio.

What are the main objectives of the Virtus Multi-Strategy Target Return Fund?

The Fund aims to achieve a targeted return of 5% above the Fed Funds rate (which is the historical equity risk premium), gross of fees, on average, over any rolling three-year period, in all market conditions. The expectation is to achieve the Fund's return objective with less volatility than an investment in global equities, as measured by the MSCI All Country World Index over any rolling three-year period. The Fund has a cash benchmark which means that it can invest into a potentially unrestricted investment universe.

What are the keys to success for the Virtus Multi-Strategy Target Return Fund?

We see success relying on three integrated pillars: Commitment, Creativity, and Construction. First, Aviva Investors has a company-wide focus on delivering investment outcomes clients need. We bring together our full global investment capabilities across a wide range of disciplines. The entire organization is incentivized to contribute to the process, which we see as quite unique. Second, we devote these resources to generating ideas focused on delivering target returns and managing volatility in varied market environments over a rolling three-year investment horizon. These ideas are not tethered to benchmark, asset class, or geographical constraints. Third, portfolio construction and risk management are elevated to the same importance as idea generation. The portfolio is built to address the fear of uncertainty and the fact that no one holds a crystal ball on the future. Through portfolio construction, we can assemble and steer the bottom-up idea generation process toward meeting investors' risk-adjusted return objectives.

What is the Aviva "House View"?

The Aviva Investors House View provides a summary of global economic and market outlooks and risks. It provides a macroeconomic framework for the investment decisions at Aviva Investors that underpin many of the underlying strategies of the Virtus Multi-Strategy Target Return Fund. The House View is formed by the Multi-Asset Investment Strategy Team, with input from the broader global investment platform at Aviva Investors.

What are the key attributes of the portfolio?

The Fund will typically hold between 25 and 35 underlying investment strategies and these ideas are broadly grouped into "Market Return Strategies," "Opportunistic Strategies," and "Risk-Reducing Strategies."

Market Return strategies

Our focus here is on harvesting the risk premia from traditional asset markets which we believe offer attractive long-term returns. We do not use a strategic benchmark.

The Fund managers rely on the work of our Investment Strategy Team to analyze where we are in the business cycle. Using the House View as the starting point, we look at where our view differs from what the rest of the market believes, and search for opportunities offering value compared to the price set by the market. For example, we might believe the economy is entering a period of growth earlier than many in the market expect. In this instance we may look to capitalize on this by buying equities or a particular equity index. So this portion of the Fund aims to generate positive returns over the medium term, in this case three years, if our House View is correct.

Opportunistic strategies

These strategies aim to profit from market mispricing that may exist due to market segmentation, central bank intervention, or regulatory changes. We believe opportunities can be created by market panics or beliefs driven by external events. For instance, a particular market or sector may become undervalued compared to others due to overreaction to a short-term event. In addition, opportunities can also be created by interventions from non-profit seeking market participants like regulators or central banks. For example, we might believe that a central bank is going to intervene and cut interest rates. In this instance, there are a number of strategies we might use to help us generate return. We could buy bonds, equities, or currencies, or combine these approaches to generate a return from the movement in prices the central bank's action will generate. So, this portion of the Fund aims to generate positive returns over the medium term, irrespective of the business cycle.

Risk-Reducing Strategies

A risk-reducing strategy aims to add positive returns in difficult market conditions. This is an essential component to the Fund, as we look to identify and include strategies that may generate positive returns on a rolling three-year time horizon even when our House View does not play out. For example, to offset potential losses in our market strategies, we could take a long position in a country's bonds. As per our "House View," we might believe that these bonds are correctly valued at the moment, and therefore under this scenario we would earn a positive return on the bond (the bond yield or a coupon). However, in a market recession, the return on that bond could increase dramatically, as investors sell equities and buy bonds, driving up bond prices. In this instance, the value of the bonds is increased, providing us with positive returns and thus offsetting the losses from any equities we may hold in our market strategies.

Because the Fund is benchmark agnostic, there is no fixed or target level of exposure to these three buckets. Understanding how each is constructed and how they interact with each other is the key to understanding how the Fund manages risk in attempting to reach the desired outcome.

Why does the portfolio use derivatives?

While the Fund's portfolio managers are agnostic to benchmarks or traditional asset allocation, they carefully select how to implement a particular strategy. Some ideas are expressed outright in the market, while some portfolio positions are in derivatives, allowing the Fund's portfolio managers to take both long and short positions. Derivatives are among the most cost efficient way to express a trade as well as a means to limit risk.

Because we seek to deliver a target outcome on a risk-adjusted basis, there will often be an opportunity to express ideas where we can quantify the downside, such as when we buy options. In that scenario, we know the most we can lose is the option premium while still retaining upside profit potential. Due to the flexibility derivatives provide, multi-strategy approaches free portfolio managers from putting all their ideas into the same high-beta baskets. With the help of our dedicated team of risk managers, we construct a diverse portfolio focused on meeting its return objective in various investment climates while staying cognizant of any structural or liquidity risks associated with derivatives.

What are the biggest risks to the portfolio?

We seek for the Fund to be highly diversified and robust in all market conditions. However, if multiple risk factors detract from performance at the same time, such as in the later part of the global financial crisis in 2008, it is unlikely that the Fund would meet its performance target at that time. However, even in this type of market regime, the Fund is expected to experience much lower performance detraction than traditional portfolios with the same return objective.

To learn more about the Virtus Multi-Strategy Target Return Fund, contact your financial advisor or visit Virtus.com.

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About the Authors:

Peter Fitzgerald heads the multi-asset investment team at Aviva Investors, overseeing the fund managers, strategists, and researchers. He also is responsible for the firm's return-targeted multi-manager strategy and manages a number of risk-targeted, unit-linked, and pension portfolios. Mr. Fitzgerald serves as a co-portfolio manager of the Virtus Multi-Strategy Target Return Fund, which is subadvised by Aviva.

Mr. Fitzgerald has extensive international investment experience having worked in Asia, Latin America, and Europe. Prior to joining Aviva in 2011, Mr. Fitzgerald was on the multi-asset team at BNP Wealth Management. He began his investment career at Old Mutual in 1995.

Mr. Fitzgerald holds a postgraduate diploma in education from Trinity College Dublin and a degree in European studies from the University of Cork. He is a CFA charterholder.

Rahul Khasgiwale is an investment specialist director at Aviva Investors, representing the firm's multi-strategy and outcome-oriented offerings. He works closely with the firm's multi-strategy investment team to represent the investment process, portfolio positioning, and performance to clients and consultants in North America.

Prior to joining Aviva in 2015, Mr. Khasgiwale was investment director for multi-asset solutions at Manulife Asset Management. Previously, he was an absolute return investment director at Standard Life Investments, focused on retail and institutional clients and consultants in Canada. He began his career at HSBC Global Asset Management, where he held a variety of senior investment roles based in the U.K., Switzerland, Middle East, and Canada over a 12-year period.

Mr. Khasgiwale is a CFA charterholder and also holds the CAIA designation. He studied medicine and surgery at Nottingham University, U.K., and also holds a bachelor of sciences degree from Nottingham University. He practiced as a medical doctor in the U.K. National Health Service before a career change to the investment industry in 2001.

The **Federal Funds Rate** is the interest rate paid on overnight loans made between depository institutions. This index is the weighted average of rates on brokered trades and represents the arithmetic mean of all daily rates for a given month.

The **MSCI AC World Index (net)** is a free float-adjusted market capitalization-weighted index that measures equity performance of developed and emerging markets. The index is calculated on a total return basis with net 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.

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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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