Virtus Market Review & Outlook Call with
Kayne Anderson Rudnick CIO Doug Foreman
Conducted on November 16, 2016
Transcript edited for clarity

Paul Cahill: *Thanks for taking the time to join us this afternoon. My name is Paul Cahill. I'm the managing director and national sales manager at Virtus Investment Partners. It's my pleasure to welcome you all to today's call. Joining me on the line are Joe Terranova, Virtus' chief market strategist, as well as Doug Foreman from Virtus' affiliated manager, Kayne Anderson Rudnick Investment Management.*

I'm sure many of you are already familiar with Joe, or you recognize him from his role as a member of CNBC's "Halftime" program, while Doug is the chief investment officer at Kayne Anderson Rudnick where he's been with the firm since 2011. He also serves as portfolio manager for the Virtus Mid-Cap Growth, Strategic Growth, Strategic Allocation, and Tactical Allocation Funds. Kayne Anderson Rudnick, for those of you not familiar, was established as a family office back in 1984 to manage the founder John Anderson's capital. Many of you may recognize the name John Anderson as the benefactor of UCLA School of Business.

Today, the firm continues to place a high priority on wealth preservation while pursuing growth strategies. The portfolio management approach centers on the idea that purchasing high-quality businesses with competitive protections at attractive valuations will help achieve excess returns over a complete and full market cycle for investors.

At Virtus, we're committed to driving better client outcomes and that's really the foundation of our relationship with the folks at Kayne Anderson Rudnick and with Joe Terranova as well. We believe that insightful market perspective is key to helping investors meet their objectives.

Gentlemen, we certainly are faced with interesting times here. I think it's safe to say given the recent events of Brexit as well as the U.S. presidential election results, we could probably call 2016 the year that conventional wisdom died. So with that as the backdrop, we'll want to talk a little bit from a macro perspective how we look at the world post these events, and then how the investment team at Kayne Anderson Rudnick looks at them from the portfolio construction level. So Joe, let's start with you and talk about the U.S. election results. What are your thoughts about the impact of the Republican victory in the markets, both near term and as we approach 2017?

Joe Terranova: Thank you, Paul. There have been three macro shocks to the global markets over the last 18 months. In August 2015, we had the fears emanating with the Chinese currency markets which lasted a total of 48 hours. Then forward to Brexit this past summer, which lasted two or three weeks. And now look at what has happened surrounding the election here in the U.S. Yes, it was certainly unconventional. The market was down 1,000 points in after-hours trading and by the time 11:00 rolled around we were higher again. So I want to emphasize in terms of portfolios that these macro events seem to happen a lot faster and dissipate a lot faster too.

Now, to your question as it relates to what has gone on since President-elect Trump was declared the winner of the election. To borrow a line from Nelson Peltz that he shared with us on CNBC, I think markets are taking President- elect Trump seriously, but not literally. And there is this expectation —a much needed one if you listen to global central bankers over the last couple of years — that we're at the end of the road for monetary policy.

As I've often said, I believe that if you open the medicine cabinet for central bankers, there's no more medicine left for central bankers. They've done a great job of telegraphing that to investors and to money managers and basically said we need fiscal policy. I think markets right now, looking at the formation of this election, Republican Congress, Republican Senate, and obviously President-elect Trump, the belief is that we will have some form of fiscal policy if we need it.

I think the market is trying to anticipate what fiscal policy ultimately could look like. We've heard a lot about infrastructure spending, and we've heard a lot about tax relief both on the corporate and personal level. But there is a belief by the market that we'll stimulate growth in what has been a very muted global growth story over the last few years. So markets right now are taking Donald Trump seriously but not literally and I think applauding the concept that yes, fiscal policy could be there if we needed it because monetary policy is at the end of the road.

Paul Cahill: *Doug, Kayne Anderson's approach is really more of a bottom-up, fundamental high conviction process. How do you factor in these types of macro events into your security selection process and to your approach overall?*

Doug Foreman: Well, in the small-cap world, Paul, it's really not that important to us. I don't disagree with a lot of what Joe just said. I think that the market is clearly imputing a little bit higher growth rate next year for the economy that has some implications for interest rates and for economically sensitive businesses.

Since we're quality investors first and foremost at Kayne Anderson Rudnick, we're always looking for businesses that can do well in both good and bad times. If the economy takes off, it's typically something that isn't great for our portfolios because our companies tend to be the more Steady Eddie plodders that do well over long periods of time. They're not speculative businesses that suddenly do better if the economy is growing at, say 3% or 4%, as opposed to 1% or 2%.

But the bottom line, particularly in small-cap investing, that we've learned over the years is that the economy – whether it's good, bad, or indifferent – it doesn't bail you out. You have to get the company right. You have to get the individual company's business prospects correct, and a macro data point, -- good, bad, or indifferent -- isn't going to help a small business for the most part. Small businesses really make it or break it on their own. They usually have small enough market shares and are small enough players in their respective industries. If we hear a small-cap company say that they can't grow because the economy is growing at 1.5% as opposed to 2.5%, then we've got a problem with the company. That's not an excuse in our book because it doesn't have much to do with whether or not the company is successful or not.

So we have to stay focused, as we always have, on the bottom-up, on the business itself, and make sure that we own a business that's profitable, that's successful and growing, and is maintaining its competitive position over long periods of time and generating good returns on invested capital. If we do that over a full market cycle, we know we're going to get paid. It's just a matter of when the market chooses to pay us.

Paul Cahill: *Doug, you mentioned small caps, which Kayne Anderson Rudnick has been really known for since the inception of the firm. Can you talk about your management style in funds and separately managed accounts across your value, core, and growth strategies and where you are year to date, including some of the positive attribution and some of the detractors? Also, are there any changes you have been making based on short-term events or any sectors you feel either benefit from or are hindered by the recent macro headwinds or tailwinds?*

Doug Foreman: Year to date, we've had a good year across the board in our small-cap funds. We had solid double-digit returns before the election, and we had solid double-digit returns since the election. Stocks that have recovered or done very well since the election are things like Primerica that we own in the small-cap value portfolio (Virtus Quality Small-Cap Fund; also in Virtus Small-Cap Core Fund). There's a lot of concern about their distribution model being changed because of the Department of Labor ("DOL") regulations that were possibly going to go into effect. There's a question mark now about whether or not that happens or not. So you've got a huge relief rally in the stock because of that.

You saw that in many of the financials, banks in particular, not just because of the possibility of less regulatory burden going forward, but also because the yield curve has steepened a fair amount since the election. So that is unequivocally positive for the banks in terms of their fundamentals. We own the highest-quality banks we can find. We're not huge bank players in our portfolios but we clearly have benefited from some of those doing well, like Bank of Hawaii, et cetera, since the election.

The small-cap growth portfolio (Virtus Small-Cap Sustainable Growth Fund) has done really well year-to-date. MarketAxess is a financials stock we've owned for several years (also in the Virtus Small-Cap Core Fund). It's essentially a bond trading operation. What has happened historically in the bond trading market has really been phone and paper-based, and this is an electronic trading system that more and more investors are finding useful for liquidity and the marketplace is improving dramatically in terms of buyers and sellers. So the ability to do these trades in the bond market electronically, not just in investment grade corporate debt but also increasingly in emerging market debt and high-yield debt, and even muni debt, this company seems to have a clear lead there. And it's a network-advantaged business so it's done very well for us.

In the small-cap core portfolio (Virtus Small-Cap Core Fund), we've owned Shutterstock, which has done very well. There were a lot of competitive issues that people were worried about Adobe putting them out of business and taking the upper hand in the photo stock business, and that clearly hasn't happened. So the stock has recovered somewhat since then. That's been a very good stock for us this year.

So it's really company by company, stock by stock. We've had some stocks that haven't worked out. It happens to us every year, whether we're up double-digits, or flat, or more. I can go through those if you'd like or just pause here.

Paul Cahill: *No, I think we'll stop there for the sake of time. The idea that we want to get across that we're talking about here is that these things don't change. The types of stocks and securities that are at the top of your portfolios won't change simply because of the macro headwinds, tailwinds, things that have taken place here recently. We still believe these are the ones that are best suited to meet the long-term return objectives of investors and do it in a way with substantially less risk than many of the benchmark-like funds or more benchmark-aware products in our categories.*

Joe, I'll jump back to you. Do you want to touch on the initial spike in interest rates we've recently seen? We went from 1.6% on the 10-year Treasury to just over 2.2% currently. Where do you see this shaking out and what do you think the effects of President-elect Trump's policies will have on rates going forward?

Joe Terranova: Well, I think the good thing about rates is that we've neutralized the notion that negative rates needed to spread globally. I was never a big believer in that and I think you're bearing witness now as the U.S. 10-year Treasury rises to 2.21% that yields globally are being lifted away from that strategy. So I think that's a good condition.

I would highlight, though, that the effect on taxable fixed income has been relatively muted. If you think about where we are month to date, investment-grade corporates is down probably 2%, 2.5%. High yield corporates is down 2% and that's with energy significantly underperforming the rest of the S&P 500 sectors. Muni bonds are down about 2% as well. So I think the taxable fixed income space has held up well and, as I've been saying for a while now, you can make a compelling argument for each individual asset class. And I think there's your evidence for that.

As far as the trajectory and where rates go from here, the reality is the need for inflation, and the first step is taking the world out of the deflationary effects of technology. I don't believe that policymakers in D.C. understand the true impact of technology on the economy and on incomes, and the ability to grow jobs. Predicting where the 10-year Treasury is going to go has proven to be a fool's game over the last six or seven years. I would focus more, as I said before, on high-yield -- the investment-grade.

The one hot spot I think is emerging markets, and it's warranted to take a second look right now at emerging market debt. The obvious reason is the significant appreciation we've been seeing in the last couple weeks of the U.S. dollar. That's going to lead to some capital outflows for emerging market currencies. So EM debt is one area that I would look at, but again overall I think there's been a fairly muted response in the taxable fixed income space and I am not going to abandon that strategy of making a compelling argument for each and every asset class. I'd like to see economic evidence presented to us that the next leg of this Treasury yield unwind can move towards 3% on solid global economic growth.

Paul Cahill: *Great point. Doug, to come back to you on that, given the way you all look at stocks and the definition of quality and concentrated portfolios that you run, what impact do rising rates have on your portfolios? Is that a detractor or do your stocks benefit in this world?*

Doug Foreman: Well, that's a complicated question but let's take basics first. What ends up happening is that since our companies are high-quality, they typically have little to no debt. They have little to no need for capital markets. Many of them aren't even followed by Wall Street because they don't need Wall Street for equity or debt offerings because they've got high returns on capital. They can self-finance their businesses, et cetera.

Also, leverage is usually almost nonexistent in most of our holdings. So for these companies the cost of capital rising over time really doesn't mean anything to their fundamentals in terms of their ability to earn money. Their interest expense doesn't float around because they don't have any debt.

Now, there's a secondary effect, though, which is important. It depends on why rates are rising. If they're rising because growth is picking up domestically, then what tends to happen is investors at least in the short run will typically run into more cyclically-oriented areas. We don't own cyclically-oriented areas in a big way. There's certainly less in the small-cap Russell 2000® Index overall. But our companies are much more stable, have much less earnings variance, et cetera.

So we typically do okay in terms of absolute returns. We usually make a little bit of money, but we typically lag the market, the benchmark, in that type of environment because people are going to go where there's more operating leverage in the business where the margins and business can really do well in a higher growth-type environment.

So when this happens to us, we typically underperform for a little while because people's interest is elsewhere. But inevitably that growth rate will slow down. The fiscal stimulus or whatever it is that's causing the accelerated growth rate will mitigate, will go back to more trend-line type growth, and then our businesses will come back into favor very quickly.

Paul Cahill: *But is it safe to say that the way you look at stocks and the way you pick stocks helps to insulate them from any interest rate shocks or helps them absorb that because of those characteristics. Is that safe to say?*

Doug Foreman: Yes. There's nothing that we own in a portfolio because of interest rate spread, thinking it's going to contract or expand. There's nothing that we own that we think is going to do better than expected because it’s going to be able to pay down debt faster, because they've got a lot of debt and their cash flow is going to accelerate, because business is going to pick up. We just don't invest or even think about it that way. So yes, it's really not an issue.

Paul Cahill: *The other big question right now, then, given the strength of small caps and the fact that the Russell 2000 Index has just hit its highest level since June of 2015, how do we look at valuations? Have they become stretched over this time period?*

Doug Foreman: People may be familiar with the term “active share.” Active share, simply defined, is the amount of overlap that you have between your portfolio and the benchmark, with zero being you're an index fund and have complete overlap, 50% meaning about half your holdings overlap with the index, and 100% means that none of your holdings overlap with the index.

Our active share for all of our small-cap strategies is in the high 90’s. So we don't really act and behave like the Russell 2000. We are very active. We have very concentrated, high-quality portfolios. Our portfolios tend to march to the 10-12% earnings growth that we generate in the portfolio over long periods of time.

With the Russell 2000, the companies in the index are so volatile. Typically about a third of that benchmark doesn't even make money. Those stocks go all over the place, biotech being the best example of that within the Russell 2000. As we've seen in the last week, what typically happens is when the Russell 2000 rockets up 10% in four or five trading days, we're typically going to lag in that type of environment. In fact, I'm surprised we've kept as good a pace as we have with the index over the last five days. We'll typically lag and then inevitably that will slow down, and it will come back. Our portfolios will continue to plod along and we'll catch back up at some point and surpass the index again at some other point in time.

So to answer your question, we don't spend a lot of time worrying about the Russell 2000. The price-to-earnings ratio (“P/E”) on the index is in the 30,s -- 34 times earnings. Our portfolios are in the low 20’s in terms of P/E and how we look at the world and look at our companies. So I don't want to say it's irrelevant but it really doesn't matter to us over long periods of time. We only own about 30 companies out of the 2,000 that are in the Russell 2000 index, and very little overlap weighting-wise.

Paul Cahill: *Joe, you said earlier, we can really build a case for and against all asset classes. One of the asset classes you talked about earlier in the year is the tech sector. What's your outlook there and then can you also touch on the international markets versus domestic going forward?*

Joe Terranova: When I say you can make a compelling argument for each asset class, to me that’s your diversification tool. You're basically acknowledging that you're not sitting with a predictive model on which way the S&P 500 Index is going to go or where yields might be going. That's the wrong strategy. That’s almost a defense mechanism and it speaks to exactly what Doug was just talking about where he's running numbers in the 90’s on his stock selection that really don't have that high degree of correlation to the overall Russell 2000 Index.

That's the environment that I believe we're in right now because there is uncertainty. There is uncertainty surrounding the ability to stimulate economic growth. There is uncertainty surrounding the global economy, which we seem to have forgotten about. Let me point out that on December 4 there's a pretty large-size referendum in Italy. You have elections coming up next year; in the late spring in France, and in the early/late summer in Germany. These are conditions that are not going to go away. I want to be diversified. I want to be invested and that's my mechanism to do it.

Now, you mentioned technology, which at the beginning of the year, we talked about being one of the favorite sectors. Well, why is that? Predictable revenues, proven sustainability of those revenues over multiple quarters, growing in certain cases in excess of 20% in some conditions, and a tremendous amount of cash on the balance sheet. What has happened here in the last 10 days is you're really not seeing cash come off the sidelines.

That's not the situation we're in right now. What you're really seeing is a rotation. Technology having been a very strong performer in particular during the third quarter is really being used as an ATM right now. We're not selling positions off completely but we're paring back positions to buy other things.

Now, fundamentally, not much has changed for technology. You're still talking about the ultimate growth sector. You're also talking about a sector that if capital does return in a repatriation capacity that has a tremendous ability, if you're not growing your revenue organically, to go out and pursue revenue growth through acquisitions. So for technology, nothing has changed in the secular positive story that it presents. We're looking at an environment right now where we're paring back holdings to buy other things in the marketplace. I wouldn't pay too much attention to it.

Paul Cahill: *Okay. Fair enough. Doug, I'll come to you with the international versus domestic question. I know Kayne Anderson back in 2012 also started an international small-cap fund (Virtus International Small-Cap Fund), which has done quite well and just received a five-star rating from Morningstar (Class I, as of 10/31/16) and has been in the top 2% in its Morningstar category over the trailing 12 month period. See disclosures at the end of this document. But of the few indices that have been down year to date is the international side, more large-cap than small-cap, but how do you look at the world of international small caps versus domestic knowing that good news and cheap stock prices don't happen in the same sentence?*

Doug Foreman: It's interesting. We started the strategy of investing in international small caps about five years ago, and rolled out the fund about four years ago. But the strategy has actually been around for five years and we started it with the goal of applying the same investment philosophy that we apply domestically and put into practice overseas, and hopeful that given thousands more companies and an even more inefficient universe with less eyes on it and less research, it would look to a lot of us like the U.S. small-cap universe did back in the 1960s and 1970s. So far we've found that to be the case.

So if you look at P/E ratios in our small cap core fund (Virtus Small-Cap Core Fund), which is our flagship fund domestically, the P/E is about 22 versus the Russell 2000 index at about 34, 35 as I mentioned earlier. And internationally, we feel we're getting similar quality companies for about 15 times earnings. The dividend yield is 1% domestically and about 3.4% overseas given a similar type of quality company. So we're very excited about our international small-cap capability, the success that we're having so far finding companies that are great businesses at very reasonable prices.

We don't do any currency hedging. We don't do any country allocation. We don't do macro forecasting of any type. We simply try to go find the best small-cap companies in the world, not unlike how we approach the U.S. market. We believe over time that investors who basically started initially investing overseas, both in international and in emerging markets, just throw money at large-cap ETFs or large-cap indices to get exposure. We felt that there'd be more attention paid and some segregation between large and small, just like there's been in the domestic market for years, and that would eventually come to pass overseas.

We're seeing some of that this year where most of the international markets are flat to down. I think the indices are actually down a little bit in the large-cap space, and in the small-cap space they're flattish too, but our strategies have managed to do solid double-digit returns in the mid-15-16% range. We've been pretty consistent with that for most of the year.

We're excited about the international area and like the domestic space, the macro doesn't matter that much. You've got to pick the right business and if you do over time, you'll be rewarded. So far, we've been able to demonstrate that we can do that overseas as well as domestically.

Paul Cahill: *One of the big themes the last several years has been the active-passive debate. Do either one of you see any trends in terms of what the actions of 2016 portend for the "active vs. passive" debate?*

Doug, I'll ask you to talk specifically about the small-cap arena and how your funds set up there. And Joe, if you want to take a more broader approach to the markets, what are your thoughts?

Joe Terranova: Yes, everyone likes passive investing when volatility is at historic lows and the market continues to move higher. Talk to me when we have a nice sizable correction and volatility remains elevated for a significant period of time. Look forward to 2017. Do you see any of the characteristics I just defined as possibly being present in 2017? Well, raise your hand. I'm raising mine. I think there's a need for active management. It scares me that there is such an intense conversation about passive versus active right now. Certainly, if you look at the cycles of the marketplace, there's usually one strategy that is favored above another for a period of time. But I think looking forward to 2017, I wouldn't be walking away from active investing at all.

Paul Cahill: *Certainly, there is a case to be made for both active and passive investing. It's not an either/or question, I guess. It seems like all of the momentum has been on the passive side, which is the reason we are trying to focus on that.*

Joe Terranova: Let me interject for a second that it is suggested right now that it is a binary choice, and being presented as "let's abandon active strategies and let's go straight passive."

Paul Cahill: *Doug, how do you see this debate shaking out for the asset classes that you cover – small caps in particular?*

Doug Foreman: Well, it's clearly present. We get a lot of questions from our clients about it. Fortunately for us, we've had good active performance over time in all of our strategies that have been around a long time. We've not only been able to beat the relevant benchmark, like the Russell 2000, we've been able to beat it by a substantial amount over any reasonable time period and with a lot less risk. That's usually appealing to people. That's what a happy management is supposed to be doing and so far, we've been able to do that over the long haul. So we're optimistic. Our business has continued to grow this year, although many active managers are not.

Ours has continued to grow quite nicely. So I think this is less of an issue in the small-cap space where you can clearly demonstrate that active management has added value. I think it's a little tougher in the large-cap area when you're dealing with a lot more managers and numbers. But I think it's a huge mistake for investors to take all of these academic studies and points of view that are based on large-cap data and apply them to all other segments of the market and act like passive is now the new Nirvana.

Quite frankly, it reminds me of the hedge fund/private equity rage two, three, four years ago, post the meltdown in the markets in 2007 and 2008. Everybody had to be in hedge funds, had to be hedged, and had to be careful, when what you really should have been doing was buying a passive index fund or anything in the equity market at that particular point in time. You would have been much better off and now there isn't a day that goes by that somebody isn't in the newspaper disappointed with the performance of their hedge fund manager who they're now firing.

And now the rage is passive and it will be interesting to see what the headlines read in three to five years. And passive has generated great returns, but people tend to chase what's been hot the last four or five years. That becomes the new savior of investing and it rarely works that way longer term.

Paul Cahill: *Yes, we've yet to repeal the law of market cycles is our point of view for sure. Well, we'll leave it with that. I appreciate everybody's time. If you have any other questions regarding any of the products from Kayne Anderson Rudnick that Doug talked about, please feel free to contact us here at Virtus Investment Partners at 800-243-4361, or by logging onto Virtus.com. You can check out our blog or our website as well for further commentary from Joe Terranova and insights from Doug and his team as well. So thank you very much.*

Virtus Small-Cap Core Fund (A: PKSAX, C: PKSCX, I: PKSFX, R6: VSCRX)
Virtus Small-Cap Sustainable Growth Fund (A: PSGAX, C: PSGCX, I: PXSGX)
Virtus Quality Small-Cap Fund (A: PQSAX, C: PQSCX, I: PXQSX, R6: VQSRX)
Virtus International Small-Cap Fund (A: VISAX, C: VCISX, I: VIISX, R6: VRISX)

Morningstar Ratings for Class I shares as of 10/31/16: **Virtus Small-Cap Core Fund:** For the Overall, 3-, 5-, and 10-year periods, respectively, the Fund (PFSFX) was rated 4, 5, 4, and 4 stars among 655, 655, 591, and 435 funds within the Small Growth category. **Virtus Small-Cap Sustainable Growth Fund:** For the Overall, 3- , 5-, and 10-year periods, respectively, the Fund (PXSGX) was rated 5, 5, 5, and 5 stars among 655, 655, 591, and 435 funds within the Small Growth category. **Virtus Quality Small-Cap Fund:** For the Overall, 3-, 5-, and 10-year periods, respectively, the Fund (PXQSX) was rated 4, 4, 3, and 4 stars among 655, 655, 591, and 435 funds within the Small Growth category. **Virtus International Small-Cap Fund:** For the Overall and 3- year periods, respectively, the Fund (VIISX) was rated 5 and 5 stars among 74 and 74 funds within the Foreign Small/Mid Blend category.

For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for a variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in an investment category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its 3-, 5-, and 10-year (if applicable) Morningstar Rating metrics. Ratings are for the I Shares as shown only; other share classes bear different fees and expenses, which affect performance.

Morningstar Percentile Rankings for Class I shares as of 10/31/16: **Virtus Small-Cap Core Fund** (PKSFX) ranked in the 9th, 9th, 47th, and 30th percentile for 1-, 3-, 5-, and 10-year performance among 655, 655, 591, and 435 funds within the Small Growth category. **Virtus Small-Cap Sustainable Growth Fund** (PXSGX) ranked in the 1st, 1st, 3rd, and 3rd percentile for 1-, 3-, 5-, and 10-year performance among 655, 655, 591, and 435 funds within the Small Growth category. **Virtus Quality Small-Cap Fund** (PXQSX) ranked in the 7th, 20th, 54th, and 40th percentile for 1-, 3-, 5-, and 10-year performance among 655, 655, 591, and 435 funds within the Small Growth category. **Virtus International Small-Cap Fund** (VIISX) ranked in the 2nd and 3rd percentile for 1- and 3-year performance among 74 and 74 funds within the Foreign Small/Mid Blend category.

The **Morningstar Percentile Ranking** compares a Fund's Morningstar risk and return scores with all the Funds in the same Category, where 1% = Best and 100% = Worst. Rankings shown are for the I share. Rankings for other share classes may vary.

IMPORTANT RISK CONSIDERATIONS

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. **Limited Number of Investments**: Because the fund has a limited number of securities, it may be more susceptible to factors adversely affecting its securities than a less concentrated fund. **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. **Foreign & Emerging Markets**: Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **Prospectus**: For additional information on risks, please see the fund's prospectus.

CLASS I PERFORMANCE, as of 9/30/16

Virtus Small-Cap Core Fund (PKSFX)

Average Annual Total Returns

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Incept 10/18/1996
NAV	2.63	9.99	18.39	8.11	13.35	7.89	8.87
POP	2.63	9.99	18.39	8.11	13.35	7.89	8.87
Index	9.05	11.46	15.47	6.71	15.82	7.07	8.05

Class I operating expenses are 1.12%.

Index: The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 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.

Virtus Small-Cap Sustainable Growth Fund (PXSGX)

Average Annual Total Returns

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Incept 6/28/2006
NAV	9.02	19.18	31.79	11.29	17.00	9.13	8.77
POP	9.02	19.18	31.79	11.29	17.00	9.13	8.77
Index	9.22	7.48	12.12	6.58	16.15	8.29	8.46

Class I operating expenses are 1.25% and gross operating expenses are 1.26%. Operating expenses reflect a contractual expense reimbursement in effect through 7/31/2017. Operating expenses do not include indirect expenses incurred by the underlying funds in which the Fund invests.

Index: The **Russell 2000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 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.

Virtus Quality Small-Cap Fund (PXQSX)

Average Annual Total Returns

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Incept 6/28/2006
NAV	1.10	11.89	18.25	7.93	13.75	7.94	7.97
POP	1.10	11.89	18.25	7.93	13.75	7.94	7.97
Index	8.87	15.49	18.81	6.77	15.45	5.78	6.39

Class I operating expenses are 1.05%.

Index: The **Russell 2000® Value Index** is a market capitalization-weighted index of value-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 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.

Virtus International Small-Cap Fund (VIISX)

Average Annual Total Returns

	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Incept 9/5/2012
NAV	10.88	17.81	24.94	5.41			11.59
POP	10.88	17.81	24.94	5.41			11.59
Index	7.91	7.70	13.38	3.52			8.71

Class I operating expenses are 1.35% and gross operating expenses are 1.50%. Operating expenses reflect a contractual expense reimbursement in effect through 1/31/2017. Operating expenses do not include indirect expenses incurred by the underlying funds in which the Fund invests.

Index: The **MSCI ACWI ex U.S. Small Cap Index (net)** is a free float-adjusted market capitalization-weighted index that measures small-cap equity performance of developed and emerging markets, excluding the U.S. The index is calculated on a total return basis with net dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

Average annual total returns reflect the change in share price and the reinvestment of all dividends and capital gains. Net Asset Value (NAV) returns do not reflect the deduction of any sales charges. POP (Public Offering Price) performance reflects the deduction of the maximum sales charge of 5.75%. A contingent deferred sales charge of 1% may be imposed on certain redemptions within 18 months on purchases on which a finder's fee has been paid.

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.

TOP 10 HOLDINGS AS OF 9/30/16 (I shares)

Virtus Small-Cap Core Fund (PKSFX)	
Shutterstock, Inc.	6.48
CDW Corp.	4.73
Copart, Inc.	4.57
Primerica, Inc.	4.44
Landstar System, Inc.	4.28
Teledyne Technologies Incorporated	4.26
Abaxis, Inc.	4.05
MarketAxess Holdings Inc.	3.80
Autohome, Inc. Sponsored ADR Class A	3.72
Polaris Industries Inc.	3.60

Virtus Small-Cap Sustainable Growth Fund (PXSGX)	
Shutterstock, Inc.	8.35
Aspen Technology, Inc.	5.33
Fox Factory Holding Corp.	5.16
Ollie's Bargain Outlet Holdings Inc	5.08
Abaxis, Inc.	4.42
Autohome, Inc. Sponsored ADR Class A	4.31
Old Dominion Freight Line, Inc.	4.24
NVE Corporation	4.03
HEICO Corporation Class A	3.82
Copart, Inc.	3.66

Virtus Quality Small-Cap Fund (PXQSX)	
Cinemark Holdings, Inc.	4.44
Core Laboratories NV	4.26
RE/MAX Holdings, Inc.	4.04
Landstar System, Inc.	3.91
Monotype Imaging Holdings Inc.	3.85
Graco Inc.	3.78
Primerica, Inc.	3.74
Bank of Hawaii Corporation	3.69
Patterson Companies, Inc.	3.67
Thor Industries, Inc.	3.65

Virtus International Small-Cap Fund (VIISX)	
Lumax International Corp.	5.11
WIN-Partners Co., Ltd.	4.83
Scout24 AG	4.42
Transpaco Limited	4.07
Euler Hermes Group S.A.	3.86
Euroz Limited	3.77
Tegma Gestao Logistica S.A.	3.60
Autohome, Inc. Sponsored ADR Class A	3.43
Proship Incorporated	3.27
AIT Corporation	3.11

Holdings are subject to change.

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Kayne Anderson Rudnick's small-cap core, growth, and value strategies are also available through separately managed accounts. For more information, please visit Virtus.com.

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