

# THE QUIET POWER OF QUALITY: KAYNE ANDERSON RUDNICK

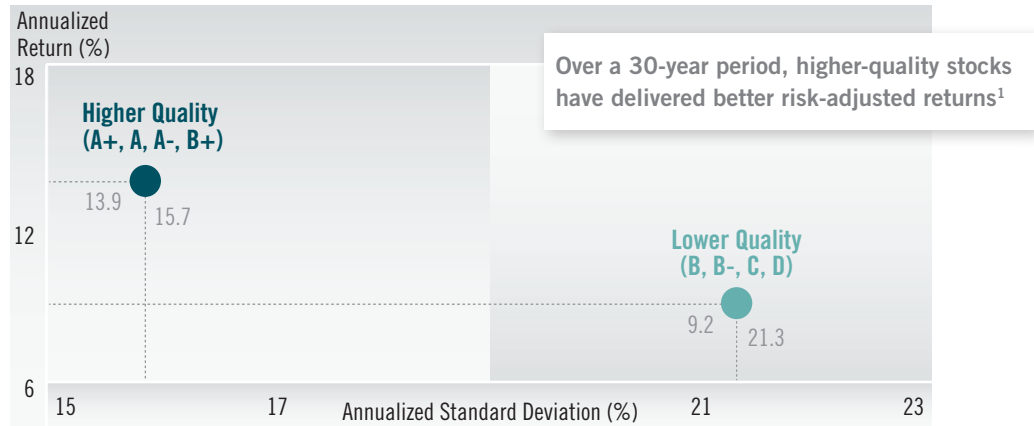
Owning equities for the “long term” is harder than often recognized. Choosing “high-quality” stocks is one powerful solution to the puzzle.

Long-term outperformance doesn’t mean winning in every instance.

## Quality’s Long-term Importance

“Quality” businesses have an unmistakable profile: durable earnings growth, high return on capital, strong balance sheets and cash flows, and management acumen at maintaining a competitive advantage. Of course these attributes—which are different than value or growth—sound attractive, but do they make a difference? Yes.

### OUTPERFORMANCE BY HIGHER-QUALITY STOCKS: JANUARY 1987–MARCH 2017

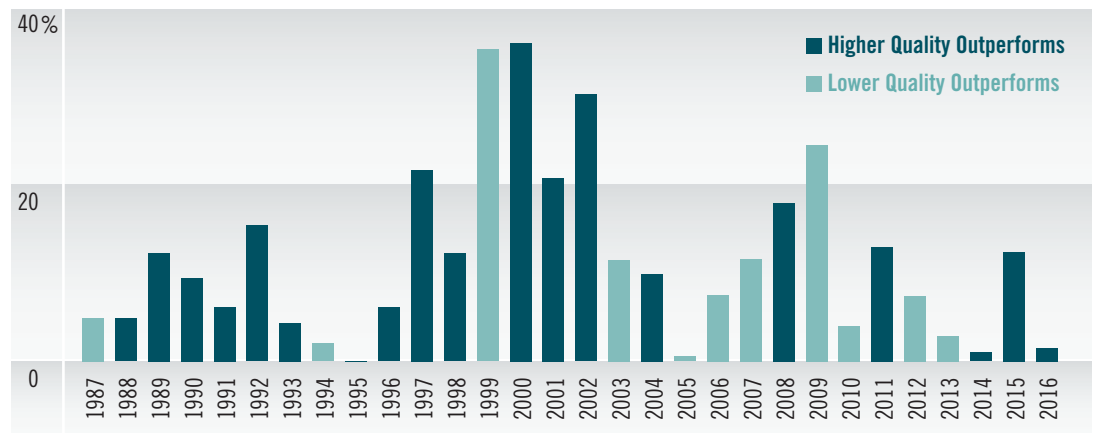


Stocks in the Russell 2000® Index. Source: FactSet. Past performance is not indicative of future results.

## Quality Wins, But Not All the Time

All investing styles underperform at times. The chart below shows that higher-quality stocks consistently outperformed in down markets. However, in momentum-driven markets such as 1999, 2003, and 2009, this strategy was outpaced by others.

### DIFFERENCE IN RETURN BETWEEN HIGHER- AND LOWER-QUALITY STOCKS IN THE RUSSELL 2000® INDEX



As of 12/31/16. Source: FactSet. Past performance is not indicative of future results.

Investing styles swing in and out of favor—sometimes dramatically. A bet on quality requires long-range thinking.

<sup>1</sup>Asness, Clifford S. and Frazzini, Andrea and Pedersen, Lasse Heje, Quality Minus Junk (June 19, 2014). Available at SSRN: <http://ssrn.com/abstract=2312432> Higher quality is defined as stocks with S&P Stock Rankings of B+ or above. Lower quality is defined as stocks with S&P Stock Rankings of B or below.



Kayne Anderson Rudnick

A VIRTUS INVESTMENT PARTNER

No one claims that they want to own “low quality” companies. The facts don’t lie: KAR’s portfolios have historically generated compelling quality statistics.

## When Culture Drives the Solution

The solution of owning quality is much easier said than done. Kayne Anderson Rudnick (KAR) has tackled the issue since 1984. Its origins start with John Anderson, entrepreneur and billionaire, who joined like-minded partners to focus on growing their own wealth responsibly. They built an investment culture centered on owning businesses, not stocks. They found the balance between enhancing and preserving wealth—for themselves and then for many others—by undertaking an unambiguous commitment to owning quality business, which pervades the firm’s domestic and international equity portfolios.

## Walking the Walk

We can powerfully show a portfolio’s quality features by focusing on ratios such as return on equity and invested capital, return on assets, and net profit margins. These measures reflect a company’s commitment to running an efficient, profitable enterprise.

	Return on Equity (%)	Return on Assets (%)	Return on Invested Capital (%)	Net Margin (%)
<b>VIRTUS KAR SMALL-CAP CORE FUND (PKSFX)</b>	<b>27.77</b>	<b>13.39</b>	<b>16.04</b>	<b>14.10</b>
RUSSELL 2000® INDEX	7.26	0.89	-1.23	7.18
PEER GROUP	9.74	2.66	4.68	7.45
PERCENTILE ▶	1%	1%	1%	2%
<b>VIRTUS KAR SMALL-CAP VALUE FUND (PXQSX)</b>	<b>23.14</b>	<b>8.92</b>	<b>16.03</b>	<b>13.22</b>
RUSSELL 2000® VALUE INDEX	4.67	0.80	1.48	8.73
PEER GROUP	9.74	2.66	4.68	7.45
PERCENTILE ▶	1%	2%	1%	3%
<b>VIRTUS KAR SMALL-CAP GROWTH FUND (PXSGX)</b>	<b>19.79</b>	<b>14.41</b>	<b>14.84</b>	<b>16.33</b>
RUSSELL 2000® GROWTH INDEX	10.17	0.98	-3.08	5.43
PEER GROUP	9.74	2.66	4.68	7.45
PERCENTILE ▶	2%	1%	2%	1%

Peer Group: Morningstar Small Growth; Small Blend; Small Value Categories. Number of Funds: 2,014 (2,004 for ROIC). As of 3/31/17, Class I. Source: Morningstar Direct. **Past performance is not indicative of future results.**

**ROE (Return on Equity):** The amount of net income returned as a percentage of shareholders’ equity. Return on equity measures a corporation’s profitability by revealing how much profit a company generates with the money shareholders have invested. **ROA (Return on Assets):** An indicator of how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings. **ROIC (Return on Invested Capital):** A calculation used to assess a company’s efficiency at allocating the capital under its control to profitable investments. The return on invested capital measure gives a sense of how well a company is using its money to generate returns. **Net Margin:** The ratio of net profits to revenues for a company or business segment that shows how much of each dollar earned by the company is translated into profits.

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.

## Sound Execution: Attractive Gains, Lower Risk

	5-Year Average Annual Return (%)	Standard Deviation (%)	Sharpe Ratio	Max Drawdown (%)
<b>VIRTUS KAR SMALL-CAP CORE FUND (PKSFX)</b>	11.35	11.20	1.01	-9.56
RUSSELL 2000® INDEX	12.35	14.36	0.88	-16.78
PEER GROUP	11.50	13.95	0.85	-16.78
PERCENTILE ▶	53%	2%	14%	2%

	5-Year Average Annual Return (%)	Standard Deviation (%)	Sharpe Ratio	Max Drawdown (%)
<b>VIRTUS KAR SMALL-CAP VALUE FUND (PXQSX)</b>	12.22	13.28	0.93	-9.71
RUSSELL 2000® VALUE INDEX	12.54	14.03	0.90	-15.36
PEER GROUP	11.50	13.95	0.85	-16.78
PERCENTILE ▶	36%	31%	30%	2%

	5-Year Average Annual Return (%)	Standard Deviation (%)	Sharpe Ratio	Max Drawdown (%)
<b>VIRTUS KAR SMALL-CAP GROWTH FUND (PXSGX)</b>	14.91	13.17	1.12	-13.41
RUSSELL 2000® GROWTH INDEX	12.10	15.24	0.82	-20.03
PEER GROUP	11.50	13.95	0.85	-16.78
PERCENTILE ▶	2%	28%	3%	19%

Peer Group: Morningstar Small Growth; Small Blend; Small Value Categories. Number of Funds: 1,679. As of 3/31/17, Class I. Source: Morningstar Direct. **Past performance is not indicative of future results.**

## A Concentrated Commitment to Quality

Distinction only comes from deviating from the crowd. KAR's exacting research generates concentrated portfolios, which feature very high "Active Share." That's a measure of the percentage of assets in a portfolio that differ from the names in the fund's benchmark index. KAR tends to own their picks for years, which has resulted in lower turnover and higher tax efficiency.

	Active Share	Holdings	5-Year Average Turnover Range
<b>VIRTUS KAR SMALL-CAP CORE FUND</b>	0.99	28	20-30%
<b>VIRTUS KAR SMALL-CAP VALUE FUND</b>	1.00	31	20-30%
<b>VIRTUS KAR SMALL-CAP GROWTH FUND</b>	0.98	24	20-30%

As of 12/30/16. Holdings as of 3/31/17. Source: Morningstar Direct. Number of holdings is subject to change. **Past performance is not indicative of future results.**

KAR has achieved attractive risk-adjusted returns in a number of its offerings.

KAR's focus on quality is not limited to small-cap funds. The firm also offers a range of mid-cap, large-cap, and international funds. To learn more, please contact us at 1-800-243-4361 or visit [Virtus.com](http://Virtus.com)

**Standard Deviation:** Measures variability of returns around the average return for an investment portfolio. Higher standard deviation suggests greater risk. **Sharpe Ratio:** A statistic that measures the efficiency, or excess return per unit of risk, of a manager's returns. The greater the Sharpe Ratio, the better the portfolio's risk adjusted return. **Maximum Drawdown:** The peak-to-trough decline during a specific record period of an investment, fund, or commodity. A drawdown is usually quoted as the percentage between the peak and the trough. **Active Share:** A measure of the percentage of stock holdings in a manager's portfolio that differ from the benchmark index.

## Average Annual Total Returns Class I as of 3/31/17 in percent

### Virtus KAR Small-Cap Core Fund (PKSFX)

	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	SINCE INCEP 10/18/1996
NAV	5.66	5.66	20.57	11.15	11.35	8.24	9.28
Index <sup>1</sup>	2.47	2.47	26.22	7.22	12.35	7.12	8.42

Morningstar		OVERALL	3 YEAR	5 YEAR	10 YEAR
Ratings		★★★★★	★★★★★	★★★★	★★★★★
Funds	Small Growth Category	599	599	527	386

The fund class gross expense ratio is 1.12%.

Effective May 8, 2017 this Fund changed its name from the Virtus Small-Cap Core Fund.

### Virtus KAR Small-Cap Value Fund (PXQXSX)

	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	SINCE INCEP 6/28/2006
NAV	4.57	4.57	23.20	10.96	12.22	8.17	9.11
Index <sup>2</sup>	-0.13	-0.13	29.37	7.62	12.54	6.09	7.38

Morningstar		OVERALL	3 YEAR	5 YEAR	10 YEAR
Ratings		★★★★	★★★★★	★★★★	★★★★
Funds	Small Growth Category	599	599	527	386

The fund class gross expense ratio is 1.05%.

Effective May 8, 2017 this Fund changed its name from the Virtus Quality Small-Cap Fund.

### Virtus KAR Small-Cap Growth Fund (PXSGX)

	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	SINCE INCEP 6/28/2006
NAV	5.93	5.93	23.59	13.86	14.91	9.74	9.35
Index <sup>3</sup>	5.35	5.35	23.03	6.72	12.10	8.06	8.93

Morningstar		OVERALL	3 YEAR	5 YEAR	10 YEAR
Ratings		★★★★★	★★★★★	★★★★★	★★★★★
Funds	Small Growth Category	599	599	527	386

The fund class gross expense ratio is 1.29%. The net expense ratio is 1.26%, which reflects a contractual expense reimbursement in effect through 4/30/2018. This ratio reflects the direct and indirect expenses paid by the Fund.

The net expense ratio minus the indirect expenses incurred by the underlying funds in which the fund invests is 1.25%.

Effective May 8, 2017 this Fund changed its name from the Virtus Small-Cap Sustainable Growth Fund.

The Morningstar Rating™ for funds, or “star rating,” is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product’s monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product 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 managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

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Strong ratings are not indicative of positive fund performance.

### 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. **Prospectus:** For additional information on risks, please see the fund’s prospectus.

*Please carefully consider a Fund’s investment objectives, risks, charges, and expenses before investing. For this and other information about any Virtus mutual fund, contact your financial representative, call 1-800-243-4361, or visit Virtus.com for a prospectus or summary prospectus. Read it carefully before investing.*

Not all products or marketing materials are available at all firms. Please check with your firm’s compliance department for availability.

Not insured by FDIC/NCUSIF or any federal government agency. No bank guarantee. Not a deposit. May lose value.

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Average annual total returns reflect the change in share price and the reinvestment of all dividends and capital gains. Class I shares have no sales charge and therefore their returns do not reflect the deduction of a sales charge, which if applied, would reduce the performance quoted. Fees and expenses vary among share classes and other share classes do carry sales charges. Class I shares are offered primarily to eligible institutional investors who purchase the minimum amounts required and may not be available to all investors. For Fund Performance on other share classes, please visit [www.virtus.com](http://www.virtus.com).

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.

<sup>1</sup>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.

<sup>2</sup>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.

<sup>3</sup>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 indexes are 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 are not available for direct investment.