

ticker

Short in Duration, Long in Quality

Although Benjamin Caron, portfolio manager of Virtus Low Duration Income Fund, has the liberty to invest in all 14 sectors of the fixed-income market, he manages a conservative fund with a focus on segments with higher quality and liquidity. The long track record of the strategy and the team is among the key assets of the fund, combined with a rigorous sector and issue selection process.

Could you give us some background information on the fund?

The fund was established in 1999 and is currently managed using our multi-sector fixed-income style of investing. Our multi-sector strategy has a long track record and has been used for over two decades in all of our multi-sector portfolios.

It is important to note that we select securities from all 14 sectors of the fixed-income market. Newfleet's team of investment professionals has expertise in all sectors, including evolving, specialized, and out-of-favor sectors.

Our investment strategy and processes have been very consistent through the years. The core tenets haven't changed – we always look at relative value across sectors, industries, issues, and capital structure in a risk-controlled manner.

There is long tenure and a high degree of continuity within the team, especially with the senior members, which adds value for investors. The core group of 15 investment professionals has worked together for an average of 20 years.

Nevertheless, we continue to incorporate new ideas to make the process more efficient and repeatable over time. With the growth of assets, we have enhanced our research team and included more specialization of sectors.

How would you define your investment philosophy?

Virtus Low Duration Income (A: HIMZX; I: HIBIX) is a conservative fund with an emphasis on low volatility and overall short duration, focusing on investment grade and liquidity within the bond market.

We work in the short-duration space and in the middle of the credit-risk spectrum. Although we can invest in all 14 sectors of the bond market, including high yield, it's a conservative fund that concentrates in investment grade credit.

The fund has limited exposure to below investment grade and is focused on quality. We buy only the highest quality tier within the high yield segment. Foreign exposure is also limited.

What differentiates you from your competitors?

A key differentiator is that structured credit has a meaningful allocation, currently at about 65% of the fund. Structured credit includes asset backed securities, non-agency commercial and residential mortgage backed securities, and agency mortgage backed securities.

Our team and process are also differentiating factors. The fund is managed on a team basis and this approach encourages independent thinking by our analysts and makes the decision-making process relatively flat. However, the final authority rests with the portfolio management team.



Benjamin Caron, CFA

Senior Managing Director and Portfolio Manager
Newfleet Asset Management, LLC

Ben Caron is a senior managing director and portfolio manager at Newfleet Asset Management, an investment management affiliate of Virtus Investment Partners.

Mr. Caron is co-portfolio manager of the Virtus Low Duration Income Fund and the closed-end Virtus Global Multi-Sector Income Fund (NYSE: VGI). He also assists in the management of the Virtus Multi-Sector Short Term Bond Fund, Virtus Multi-Sector Intermediate Bond Fund, Virtus Senior Floating Rate Fund, Virtus Tactical Allocation Fund, Virtus High Yield Fund, two variable insurance trust Series, and the closed-end Virtus Total Return Fund (NYSE: DCA).

Prior to joining Newfleet in 2011, Mr. Caron was on the fixed income team at Goodwin Capital Advisers, an investment management company that was previously a subsidiary of Virtus. He joined Goodwin Capital in 2002 as a client service associate for the institutional markets group focusing on institutional fixed income clients. Earlier in his career, he was with Fidelity Investments, where he was responsible for client management and sales in the managed account group.

Mr. Caron earned a B.A. from Syracuse University and an M.B.A. from Suffolk University. He is a CFA charterholder. Mr. Caron has been working in the investment industry since 1996.

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The size of the fund works to our advantage, as well. The assets are large enough to maintain strong relationships with Wall Street. Yet, at the same time, we are small enough to be nimble and to participate in a wide range of opportunities, including the smaller segments of the structured finance market that wouldn't be in the portfolio of a \$100-billion manager.

What is your investment strategy and process?

Our approach combines top-down sector allocation with bottom-up security selection, driven by relative value. Strategically, we overweight undervalued sectors.

We purchase securities that meet the criteria for the portfolio, including the credit risk spectrum, management quality, issue structure, and the market conditions for each issue and sector. Our process relies on intensive fundamental analysis with 70% to 80% of the research generated internally.

We tend to overweight seasoned originators that are well capitalized and have a history of strong underwriting.

What are the major characteristics of the sectors you choose?

Structured sectors can look attractive when compared to short-duration corporate bonds. We like asset backed securities, such as the subprime auto area. We look for high levels of credit support and significant excess spread. Both of these factors allow the security to absorb any high losses from the underlying loans, before the bonds in which we're invested would experience any losses.

Based on relative value management, there is value in the student loan market to top undergraduate and graduate schools, such as NYU, Harvard, and Columbia. The company that dominates this market is SOFI, or Social Finance. Essentially, it refinances students out of higher-cost government and private debt into lower-cost loans. Unlike government student loan pools, all the borrowers in these pools have graduated and are gainfully employed.

In the investment grade corporate area, we choose securities based on relative value, spread, and financials. Corporate investment grade is trading close to a four-year wide spread and is cheaper compared to other quality asset classes.

Within the sector, we overweight financial industries due to improving fundamentals and lower M&A risk in the area. That segment tends to have the best liquidity, which is important because we want to be able to rotate between issues and sectors. For higher-quality names, we are willing to go lower in the capital structure. Examples of such names are Bank of New York Mellon hybrid, or Wells Fargo hybrid.

Bank of New York and its hybrids, for example, represent a fundamentally different business than most of the Wall Street banks. It focuses on investment and clearing services as opposed to trading, investment banking, and lending. We like the stability of that bank's model. Its investment grade hybrid debt pays almost 5% premium over some of its other bonds. Similarly, the investment grade hybrid debt of Wells Fargo pays out 3% more than some of the other bonds.

How would you describe your research process? Where do you find opportunities?

The process begins with sector analysis and allocation. We analyze the 14 sectors to establish relative value. Then, we identify areas with the greatest opportunity. We measure relative value on a sector basis by analyzing a projected yield spread and tying it into our total return implications.

Supply and demand is also considered, as is the investment environment, including current economic indicators, the regulatory environment, and the potential impact of these factors on the different sectors.

Based on relative value, we establish target portfolio allocations for each of the sectors, emphasizing those that are most undervalued.

This allocation is formally reviewed at least once a month with all the investment team members participating in the discussion. Informally, however, there is constant discussion throughout the month on the relative value within our sectors.

Fundamental research is crucial because it is the underlying basis for issue selection. The credit analysts on the corporate side, the credit analysts on the structured side, and our traders work together, collaborating on different ideas. The analysts are industry specialists, divided by different industries of the bond market.

For each investment idea, they research credit risk, financial reviews, industry analysis, ratings, developments within an industry, price action, and recent and historic trading. They also assess management quality, issue structure, capital structure, and the size of the issue. Market conditions, such as supply and demand, are also considered.

Any specific issue that's recommended is always reviewed in the context of its industry and its sector to gain a true and comprehensive assessment of relative value.

What is your portfolio construction process?

After our analysts judge an opportunity on an issue-specific basis, the credit information is presented to the investment team, often in a formal credit meeting when a higher-risk credit, or one with a story behind it, is under consideration. If the credit is recommended, then the issue can be included in the portfolio.

We seek to maintain a diversified portfolio, and allocate the best finds across the 14 sectors with certain limits. Exposure to below investment grade is capped at 20%, while foreign exposure is limited to a maximum of 35% of the portfolio.

Our position limit on a single issue is 5%, but the average position size is much smaller. The average position size is 0.14%, while the top 10 positions average about 0.65%. In total, we have about 550 positions and about 300 to 350 issuers.

The duration is typically under three years. We do not make duration bets, so duration of the portfolio does not shift based on where we think rates are going. While we do not initially match the duration to the benchmark, the short duration is mainly a function of the various sectors that we favor at the time. Our benchmark is Barclays Capital U.S. Intermediate Government/Credit Bond Index. While we are aware of the macro and interest rate environment, duration is not a primary criterion and we don't use it to add value. Instead, we add value through sector selection and issue selection.

And while we are conservative, the fund has a lot of flexibility to invest in different sectors. We can invest in corporate investment grade, corporate high yield, bank loans, U.S. Treasury, mortgage backed securities, agency mortgage backed and non-agency mortgage backed securities, both commercial and residential, as well different foreign sectors. The fund can also include municipal bonds, tax free and taxable.

A favorable outlook on a particular company would lead to larger weight in the portfolio. If we see a company as undervalued, we would potentially add to that exposure to make it an overweight. Of course, the overweight would be in the context of the risk and volatility of a particular security. Generally, we allocate smaller positions to higher-risk securities.

How do you define and manage risk?

The two primary risks in this fund, and in most bond funds, are credit and interest rate risk. The credit risk in the portfolio is managed primarily by shifting the portfolio's overall credit quality and by adjusting the mix of the fund's assets among the ratings tiers. As we talked about earlier, this fund focuses on higher-quality investments. The interest rate risk in the fund is managed primarily by keeping the duration (the best gauge of interest rate risk) at a maximum of three years. With duration of three years or lower, this fund has a low level of interest rate risk.

To expand on how we manage these two risks, and other risks in the fund, it revolves around three key components: people, process, and technology. I've covered our people and the expertise they bring to each sector of the fixed-income market, and our process, which involves several formal meetings as well as daily discussions of the markets and the sectors and individual issues in which we invest. This is on top of the daily monitoring of the fund by the portfolio management team. Technology pulls it all together.

We've built proprietary systems, CFAR and SAMARI, which give us access to real-time data and information on our credits, as well as the ability to monitor all positions firm wide daily. Additionally, we use outside vendors for other applications like portfolio stress testing, whereby we test the portfolios under different interest rate and credit spread widening scenarios.

Our in-house compliance team maintains oversight of our portfolio management, trading, and operations teams, along with managing regulatory compliance.

I believe our risk management process is robust, covering the risks that need to be monitored and managed in an ever-changing and evolving investment environment. **T**

Virtus Low Duration Income Fund

Company	Virtus Investment Partners, Inc.
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Source: Company Documents

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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. **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. **Foreign Investing:** Investing internationally involves additional risks such as currency, political, accounting, economic, and market risk. **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. **Prospectus:** For additional information on risks, please see the fund's prospectus.

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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