

Quality in Small Caps

The Virtus Quality Small-Cap Fund seeks long-term capital appreciation by investing in small-cap value companies believed to be undervalued relative to their future growth potential. The Fund managers look for high-quality companies with a sustainable competitive advantage, disciplined shareholder value oriented management, and solid financial strength that have the opportunity to outgrow their markets.

What is your investment philosophy?

We describe ourselves as investors in the highest quality companies in America. We're looking for businesses that can protect markets they serve to create exceptional returns on capital and strong free cash flow from underleveraged balance sheets, and along the way, generate industry-leading profitability—not just in good times but challenging times as well. The key to our investment philosophy is building diversified portfolios of the highest quality businesses with a long-term investment horizon. We believe these companies will consistently outperform industry peers providing strong long-term returns to shareholders.

The ultimate objective of the portfolio is to produce superior risk-adjusted returns compared to our benchmark Russell 2000 Value Index by achieving the returns of the asset class (and we've done better than that over time) but with no greater volatility than that of the S&P 500. We have delivered on this objective over time.

What kind of small cap companies do you invest in?

Our focus is on the highest quality companies. These businesses have high

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returns on capital which allows them to self-fund their growth, making them less dependent on capital markets. It is also important to understand that we have a very different approach to value investing because of our focus on high-quality businesses. The classic approach to value investing is to buy a stock that is down due to a number of issues, and hope that the business recovers and the stock moves up. Our approach is quite the opposite. We own exceptionally profitable businesses, but these businesses operate in mature markets and sell at discount values because these markets aren't exciting enough for the majority of small cap investors. Our companies remain solid free-cash-flow generators but, with reinvestment opportunities in their markets limited, they choose to return excess capital to shareholders in the form of cash dividends and regular share repurchases.

As far as capitalization levels are concerned, we use the Russell 2000 Value benchmark as a guide in terms of the dollar-weighted average market cap, the largest market cap, and the smallest market cap. At December 31, 2008, the dollar-weighted average market cap of the Russell 2000 Value Index was \$1 billion, and our portfolio was in line at \$1.2 billion. Importantly, as high-quality investors in the small cap space, we are operating in an inherently inefficient market. Typically, higher quality-oriented investors tend to lean towards larger capitalization, traditional blue chip names. In fact, we often call ourselves investors in the “next generation of blue chips”. Lacking a natural investor base, these companies



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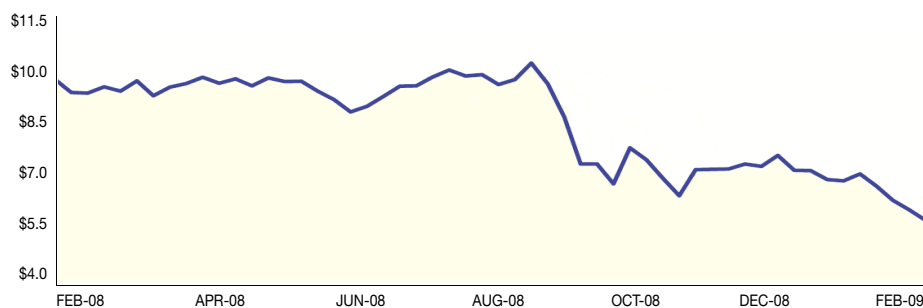
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Performance - Price History N.A.V.

Virtus Quality Small Cap Fund (PXQSX)



	2006	2007	2008
Russell 2000 Value Index	23.48%	7.05%	-28.92%
Virtus Quality Small Cap Fund	N/A	N/A	-12.60%

tend to be overlooked by the majority of both large cap and small cap investors. It is this inherently inefficient nature of the high-quality small cap marketplace that allows us to achieve strong risk-adjusted returns.

What is your research process?

As we discussed earlier, we're looking for businesses that can protect markets they serve to create exceptional returns on capital and strong free cash flows from underleveraged balance sheets, and achieve industry-leading profitability both in good and bad economic times. We believe that these businesses have certain characteristics: A brand name or dominance of a small niche within a big market, for example. There are thousands of small cap companies listed in the U.S. but only several hundred of these would meet our quality criteria. We select and find these high-quality companies using a number of quantitative and qualitative metrics. We have built a library of proprietary quantitative screens and continue to build screening tools searching for new ways of translating "quality" into the language of financial metrics.

Once we identify a potential opportunity based on both financial performance and valuation, we conduct our in-depth fundamental analysis of the company.

Among other things, that includes a detailed financial analysis and line-by-line review of the company's SEC filings and other documents. It also includes looking at the qualitative factors that determine the competitive differentiation of the company and its market control. We also like to talk to company's customers, suppliers, and visit trade shows to get the feel of the competitive and market dynamics. All of this work culminates in an extensive discussion with the company's management team with our questions being focused on the longer term market positioning of the business and, more importantly, its ability to protect this defensive positioning. After all this work is completed, if we are comfortable with the company and the valuation is attractive, the company becomes a candidate for purchase.

Can you give us an example of companies that you have selected through your research process?

We'd like to discuss Landauer Inc. (TK: LDR) which has been a long-term holding for us. Landauer is the leader in the radiation dosimetry market holding a roughly 60% market share in the U.S. Landauer's customers include hospitals, doctors offices, university labs, and nuclear generating plants. If you had your teeth X-rayed at a dental office, for example, the X-ray technician would be

wearing a monitoring badge - a device that measures his or her radiation exposure. Landauer collects this exposure data monthly and maintains it as long as that employee is alive.

Landauer's business is inherently "sticky" as customers value this data highly for several reasons (including that of a potential litigation) while the cost of Landauer's services represents a very insignificant piece of that hospital's or nuclear plant's overall budget. This provides Landauer with solid pricing power that translates into an impressive nearly 40% operating margin. In addition, the service is sold on a subscription basis with the company collecting a year's revenue in advance, thus, operating on customers' (and not shareholders') capital allowing Landauer to earn a 36% return on equity from a debt-free balance sheet while generating an excellent free cash flow stream that the company returns to shareholders in the form of share repurchases and cash dividend payments. Longer term, while the company's U.S. operating market is mature, international growth opportunities remain solid.

How do you construct your portfolio and what is your buy and sell discipline?

We run focused portfolios of 20 to 35 positions at any given time. We believe that our high-quality companies have less business risk. We have shown over time that our companies can protect from competition and generate strong returns in the industries in which they operate.

We want to own the best quality businesses that can consistently outgrow the market, which we can purchase at discount valuations. We are long-term investors with holdings in the portfolio averaging three to four years, meaning that our turnover is about 25% to 35%. We regularly monitor the valuations of the companies in the portfolio on a near-term and long-term basis. Near term, if a stock's risk-to-reward profile is attractive,

we may add to our position. Conversely, if the risk-to-reward gets low, we may trim our position. However, if a stock's five-year expected return becomes expensive relative to the ten-year Treasury bond, we will sell our entire holding in the company. Additionally, while we do not have a hard and fast rule of a stop loss, we'll review a position if a holding drops 20% in a short period of time in the absence of a market decline. During this review, we will reexamine the original reasons why we purchased the stock, reassessing their validity. This process will result in an action of either holding the existing position, selling the entire holding, or potentially adding to the position provided that the original investment thesis remains intact.

What are your risk controls?


We control risks in the portfolio at three levels. The most important control for us is at the company level. The second one is at the sector level, and the third one is at the portfolio level.

We believe that investing in low-risk businesses is the most important piece of our risk control, and that is why we look for protectable businesses. Along with the strength of the balance sheet, these businesses have less financial risk than the typical stock in the benchmark.

At the sector level, we control risk by not taking any large, significant, or specific bets. We generally strive to be within 10 percentage points above or below the economic sector weight of the Russell 2000 Value benchmark.

At the portfolio level, we are looking to build a portfolio of companies of higher quality, stronger and more consistent growth, and better value than that of the benchmark. We believe that the quality characteristics create a low-risk profile from an economic standpoint while the combination of superior growth and better value creates lower risk from a stock market perspective.

Let us share some portfolio statistics as of December 31, 2008. In terms of higher quality, the average return on equity for the companies in our portfolio for the past five years equaled a strong 22.7% versus 10.8% for the Russell 2000 Value benchmark. It shows that in a market of commodity businesses we own proprietary businesses. Our companies have strong balance sheets and are either debt free or have little leverage. The portfolio's interest expense coverage stood at 8.1 times versus 4.3 times for the benchmark. In terms of growth, over the past five and ten years, our portfolio companies' earnings have grown 15.1% and 14.3%, respectively, versus only 9.2% and 6.8%, respectively, for the index. Capital generation, which is the source of future earnings growth, stood at 15.6% for the portfolio versus 8.2% for the benchmark. All of this shows that we own the highest quality businesses that are growing their earnings stronger, more consistently through difficult economies, and more sustainably into the future. And we are able to acquire these businesses at a discount—despite the portfolio's strong outperformance in the fourth quarter, its 12-month trailing price-to-earnings ratio stood at 14 times at December 31, 2008—well below the 16.2 times for the index. Most importantly, the portfolio's free cash flow yield was a solid 6.5% at the end of the year while the benchmark's free cash flow yield had turned negative.

We see a structural shift in the credit markets, with debt capital to remain both more expensive and less available for an extended period of time following this credit crunch. We expect that our companies, with their limited dependence on capital markets and solid defensive market positioning, will benefit taking market share from competitors. Thus, we believe that our high-quality investment philosophy and portfolio risk management is of particular relevance in the current environment. 

Virtus Quality Small Cap Fund

Symbol	PXQSX
Website	www.virtus.com
Address	Virtus Investment Partners, Inc. 100 Pearl Street 9th Floor Hartford, CT 06103
Telephone	800-243-1574
Inception	06/28/2006

PORTFOLIO	
Total Net Assets*	\$36.2
Avg Mkt Cap (\$ Weighted) *	\$1,200
Average Price/Earnings Ratio	18.76x
Average Price/Book Ratio	4.02x
Turnover Ratio	N/A

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$100,000
Min Subsequent Investment	\$0.00
Min Initial IRA Investment	N/A

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)	
Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann Std Deviation	N/A
Sharpe Ratio	N/A

RETURNS VS. S&P 500 DAILY REINV INDEX		
	PXQSX	Index
1 Year (Cum.)	-39.05%	-43.32%
3 Year (Ann.)	N/A	-15.11%
5 Year (Ann.)	N/A	-6.63%

RETURNS VS. RUSSELL 2000 VALUE INDEX		
	PXQSX	Index
1 Year (Cum.)	-39.05%	-43.03%
3 Year (Ann.)	N/A	-18.58%
5 Year (Ann.)	N/A	-6.64%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	0.00%
Total Expense Ratio	1.25%

PORTFOLIO MANAGER	
Robert Schwarzkopf	2006
Julie Kutsov	2008
Craig Stone	2009

*millions
02/28/2009; Source: Company Documents; Lipper

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