Redefining Indexing:
Alternatives to Market-Cap Weighting

Investors, and the advisors who serve them, are on the lookout for more efficient investment vehicles that have the potential to lower risk and provide better risk-adjusted returns. The proliferation of alternative indexing methodologies—also known as smart beta and strategic beta[1]—have attempted to meet this demand. Although investors have shown interest in strategic beta as demonstrated by net inflows of more than $360 billion between 2010 and 2016; many investors are confused about the different types of alternative indexes and the role they can play in their portfolios. Here, we explain different types of strategic beta approaches and define some commonly used terms.

CEMP®
Redefining Indexing

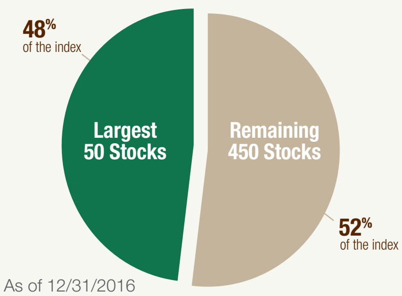
A VICTORY CAPITAL℠ INVESTMENT FRANCHISE

The Trouble with Traditional Indexing

Investors have long turned to traditional indexing strategies to achieve market-like returns. But traditional doesn't always equate to better. Traditional indexing strategies weight stocks based on the market capitalization of the underlying companies. As a result, the index is heavily concentrated in the largest names. As of 12.31.16, the largest 50 of stocks in the S&P 500 Index made up nearly 50% of the index. This can be a positive when those top few stocks are performing well, but it can also create a significant drag on performance and increase risk when one or more of those stocks is not in favor. Many investors don't realize that traditional indexing—and some alternative indexing strategies—can lead to concentration risk in certain stocks and/or sectors.

Alternative indexing uses a rules-based approach to weight stocks based on factors other than the market capitalization, such as volatility, dividend yield[2] or momentum. Alternative indexing seeks to capture excess returns above traditional benchmarks while retaining many of the benefits of passive strategies, such as diversification, transparency and low operating expenses.

S&P 500 by Market Cap Size



As of 12/31/2016
Source: FactSet Research Systems Inc.

Common Types of Alternative Indexing

Today, alternative indexing has grown to include a wide variety of methodologies, some may represent the broad market and some may not, but all strive to produce better risk adjusted returns.

Fundamentally-Weighted Indexes – Instead of weighting companies by size, fundamental indexing weights companies based on various combinations of fundamental factors. Depending on the index, factors can include revenue, dividends, debt-to-equity[3] ratio and earnings. Based on the fundamental criteria identified by the index, a company is assigned a score that drives its weighting in the index.

+	−
Uses fundamental characteristics that may naturally identify well-performing companies.	Introduces a value bias that could lead to sector and security concentration.

Equal-Weighted Indexes – Using a market-cap weighted index—such as the S&P 500—this methodology equally weights all stocks. Therefore, every underlying security has an identical weight in the index. This approach prevents the largest stocks from dominating the portfolio. More specifically, rather than having a small number of companies dominating the index, each stock is given the same weighting.

+	−
Reduces the impact of underperformance by a single stock or small group of stocks.	Could underperform when mega cap stocks are in favor. Generally increases risk by allocating more weight to smaller stocks in the index, which tend to be more volatile over time.

Common Types of Alternative Indexing (cont.)

Low Volatility Indexes – In this approach only stocks with the lowest volatility are included in the index. This approach attempts to remove the more volatile price swings that can be inherent in the broader market. Low volatility indexes tend to invest in slow-moving sectors, such as utilities and consumer staples, while avoiding potentially high-growth sectors, such as technology and telecom.

+ Low volatility indexes will tend to perform well when more volatile stocks are underperforming.

− Low volatility indexes are popular in recessionary environments but tend to underperform as markets recover. They also may be concentrated in only a few sectors.

Volatility-Weighted Indexes – Volatility-weighted indexes de-emphasize concentration risk and seek to equalize the risk contribution among all stocks in the index, volatility is measured by a specific risk factor, such as standard deviation. Therefore, the index is no longer concentrated in the largest names and risk is more evenly distributed. The goal is to provide an investor with a more balanced approach to achieving broad market exposure.

+ Volatility-weighted indexes have the potential to perform well in a variety of market environments. The risk parity achieved also works across asset classes and geographies.

− Volatility-weighted indexes may lag market-cap weighted indexes when a handful of mega cap stocks are leading the index (e.g., if four or five of the largest stocks are the primary source of positive performance).

? What Does Factor-Based Mean & What Are Commonly Used Factors?

Think of a factor like the DNA of a stock or bond; it's the characteristic that helps to explain its behavior over time. Strategic beta investing attempts to improve investment outcomes by targeting exposures to specific factors. There are a number of factors that have been identified in rigorous academic research and that are frequently cited in strategic beta investing, such as momentum, quality, value, size and volatility. Investors incorporate strategic beta factors into their portfolios in two ways: single factor methodologies or multi-factor methodologies. In both cases, the goal is to identify one or more factors that aren't correlated[4] and may further diversify investors' portfolios with the goal of maximizing returns and minimizing risk.

Depending on the investor's investment goals and risk tolerance, it might make sense to incorporate strategic beta indexes that rely on one or more factors to further diversify a portfolio. Volatility-weighted indexes naturally get exposure to different factors over time. This multi-factor exposure ebbs and flows as market condition change, resulting in broad factor diversification.

Why is Alternative Indexing Relevant?

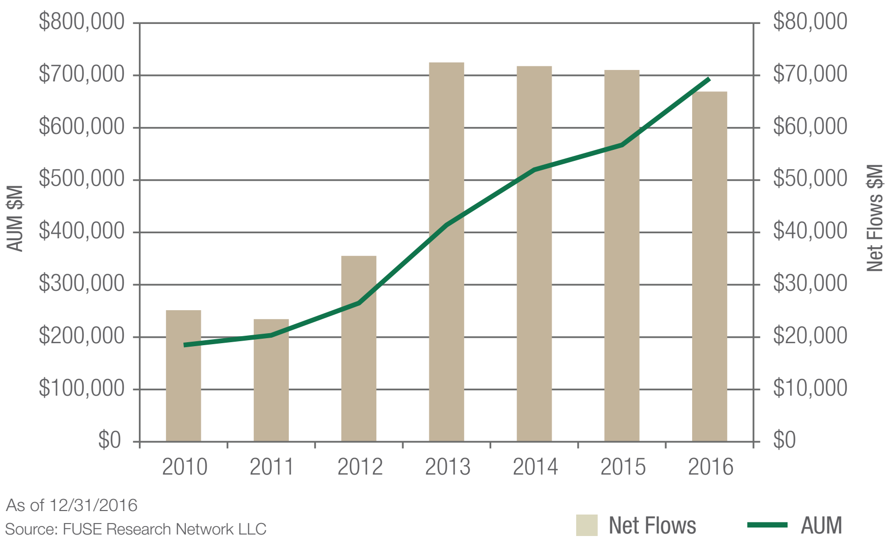
Index funds trace their origins back to the mid-70's. Fast forward roughly a decade and the first strategic beta indexing strategies were created. This new category of investments was designed to address investor concerns that traditional market-cap weighted indexing strategies can often hold large, concentrated positions in high-priced stocks, including what might be considered overpriced stocks, and have smaller positions in stocks that may be undervalued.

Although strategies that track cap-weighted indexes have been very popular with investors, their downside was evident during the tech bubble of the late 1990's, the related market collapse through 2002 and, again, during the global financial crisis, beginning in 2007. During these periods, when investor emotion and global events whip-sawed the markets and nearly all stocks—and their corresponding indexes—experienced prolonged steep declines.

Alternative indexing became popular when investors began searching for ways to diversify their portfolios by adding investments that have the potential to react differently and deliver a better risk-return tradeoff than traditional cap-weighted indexes, however like all other investment strategies smart beta methodologies may not always achieve their intended strategies or objectives.

Alternative indexing strategies may have the potential to deliver a better risk-return trade off than traditional cap-weighted indexes.

GROWTH OF STRATEGIC BETA PRODUCTS



As of 12/31/2016
Source: FUSE Research Network LLC

[1] Strategic beta — often called "smart beta"— refers to a growing group of indexes and the investment products that track them. The majority of these indexes aim to enhance returns or minimize risk relative to a traditional market-capitalization-weighted benchmark. Smart beta methodologies may not achieve their intended strategies or objectives.

[2] Dividend yield is a financial ratio that indicates how much a company pays out in dividends each year relative to its share price. Dividend yield is represented as a percentage and can be calculated by dividing the dollar value of dividends paid in a given year per share of stock held by the dollar value of one share of stock.

[3] Debt-to-equity ratio (D/E) is a financial ratio indicating the relative proportion of shareholders' equity and debt used to finance a company's assets.

[4] Correlation is a statistical measure of how two securities move in relation to each other.

CEMP's Indexing Methodology

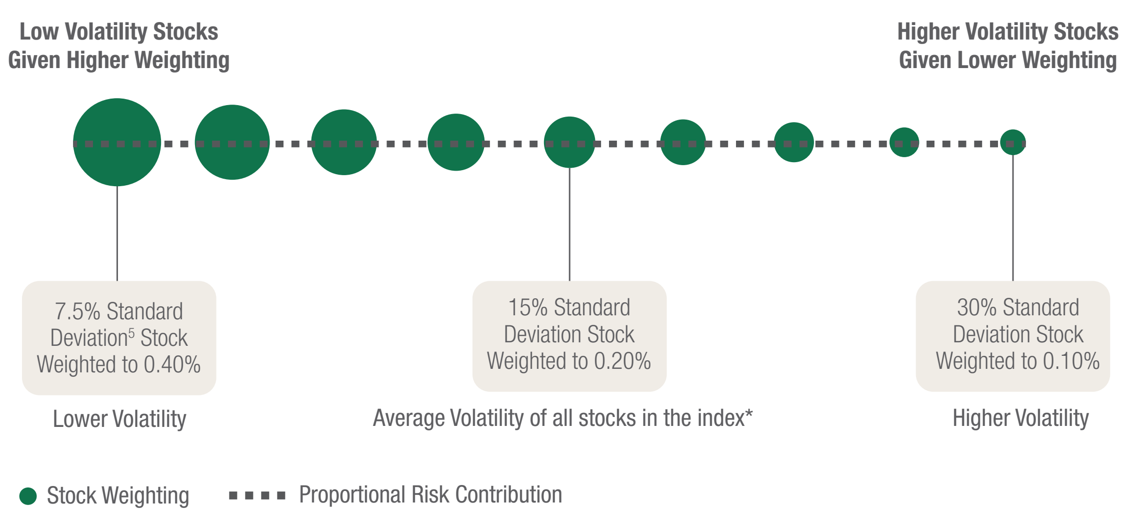
CEMP's strategic beta indexing methodologies combine fundamental criteria with volatility weighting to seek to improve an investor's ability to outperform traditional indexing strategies as well as active portfolios over time. The CEMP Methodologies are available in different types of investment vehicles, including ETFs, mutual funds and separate accounts for institutions.

What is CEMP?
CEMP, a Victory Capital investment franchise, has been weighting securities based on volatility since 2003. The CEMP investment team is led by Chief Investment Officer Stephen Hammers. The funds are designed to track the performance of the CEMP Volatility Weighted Indexes.

What makes CEMP different?
The CEMP Indexes are volatility weighted, meaning that the stocks in the index are on a level playing field from a risk volatility perspective. Other indexes weight stocks based on factors such as market cap size, potentially creating more risk and concentration. In order to remain in a CEMP Index, companies must report four consecutive quarters of net positive earnings.

Why volatility weighting?
A volatility weighted indexing approach, which is designed to even risk across all securities, can be a more balanced approach to achieving broad market exposure. Select CEMP strategies also offer a long/cash feature. The long/cash methodology seeks to limit drawdowns during extremely unfavorable market conditions. The strategies have the ability to allocate a maximum of 75% of the assets to cash or cash equivalents depending on the percentage decline of the corresponding index.

CEMP METHODOLOGY WEIGHTS STOCKS BASED ON VOLATILITY



* For purposes of illustration standard deviation is assumed at 15%
[5] Standard deviation is a quantity calculated to indicate the extent of deviation for a group as a whole.

Investment advisors are always looking for more efficient ways to invest on behalf of their clients. CEMP's volatility-weighted methodologies seek to provide investors and advisors with a more balanced approach to achieving broad market exposure.

For more information on CEMP's proprietary investment methodology and our family of mutual funds and ETFs, please call the Victory Capital sales desk at 800.991.8191.

VictoryShares ETFs and Victory Mutual Funds

ETFs	ETF Symbol
Equity	
VictoryShares US 500 Volatility Wtd ETF	CFA
VictoryShares US Small Cap Volatility Wtd ETF	CSA
VictoryShares International Volatility Wtd ETF	CIL
VictoryShares Emerging Market Volatility Wtd ETF	CEZ
Equity High Dividend	
VictoryShares US Large Cap High Div Volatility Wtd ETF	CDL
VictoryShares US Small Cap High Div Volatility Wtd ETF	CSB
VictoryShares International High Div Volatility Wtd ETF	CID
Equity Long/Cash	
VictoryShares US 500 Enhanced Volatility Wtd ETF	CFO
VictoryShares US EQ Income Enhanced Volatility Wtd ETF	CDC
VictoryShares US Discovery Enhanced Volatility Wtd ETF	CSF
VictoryShares Developed Enhanced Volatility Wtd ETF	CIZ

Mutual Funds	A Share	C Share	I Share
Equity Long/Cash			
Victory CEMP US 500 Enhanced Volatility Wtd Index Fund	CUHAX	CUHCX	CUHIX
Commodity			
Victory CEMP Commodity Volatility Wtd Index Strategy Fund	CCOAX	CCOCX	CCOIX
Equity Long/Short			
Victory CEMP Long/Short Strategy Fund	CHLAX	CHLCX	CHLIX
Market Neutral			
Victory CEMP Market Neutral Income Fund	CBHAX	CBHCX	CBHIX
Multi-Asset Class Funds			
Victory CEMP Global High Dividend Defensive Fund	LTGAX	LTGCX	—

Shares of the Funds may be subject to sales charges and other fees. An investor should consider the Funds' investment objectives, risks and charges and expenses carefully before investing or sending money. This and other important information about the investment company can be found in each Fund's prospectus. To obtain a mutual fund prospectus call 1-800-539-FUND or visit www.vcm.com. To obtain an ETF prospectus call 1-866-376-7890 or visit www.victorysharesliterature.com. Please read the prospectus carefully before investing.

Investing involves risk including the potential loss of principal. Strategies intended to hedge risk may be partly or wholly unsuccessful. ETFs have the same risks as the underlying securities traded on the exchange throughout the day. Redemptions are limited and often commissions are charged on each trade, and ETFs may trade at a premium or discount to their net asset value.

Diversification does not assure a profit nor protect against loss in a declining market.

The Funds are not actively managed and may be affected by a general decline in market segments related to benchmark indexes. The Funds invest in securities included in, or representative of securities included in, their benchmark index, regardless of their investment merits. The performance of a Fund may diverge from that of its benchmark index.

Indexes are unmanaged statistical composites and their returns do not include payment of any sales charges or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. It is not possible to invest directly in an index. The S&P 500 Index is a market-cap weighted index composed of the common stocks of 500 leading U.S. companies.

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