

# Victory INCORE Investment Grade Convertible Fund Quarterly Commentary

As of September 30, 2018

## Executive Summary

- The Victory INCORE Investment Grade Convertible Fund (class A shares at net asset value) modestly underperformed the ICE BofAML Investment Grade Convertible Indices in the third quarter. Year-to-date, the Fund modestly underperformed both the ICE BofAML Investment Grade Convertible Index (VXA1) and the 5% Constrained Convertible Index (VX5C).
- Historically, convertibles have provided returns competitive with U.S. equity returns over the long term, with lower volatility.
- In the current environment, investment grade convertibles may be ideally suited to help investors continue to participate in a rising stock market, and may also provide a measure of stability during market volatility.



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## Market Review:

The stock market performed impressively in the third quarter with the S&P 500 Index rising 7.71% for its best quarterly return since the fourth quarter of 2013. Strong earnings stemming from economic growth and lowered tax rates continue to be the driving force behind higher stock prices. Stocks were up right out of the gate in the third quarter reacting to a robust earnings season and a better than expected 4.1% second quarter GDP release. As usual, stocks bounced around in the quarter, reacting to the ebb and flow of tariff and trade related news, as well as to a correction in FANG stocks (Facebook, Amazon, Netflix and Google) in late July. Facebook alone fell 20% after reporting disappointing earnings. On September 26, the Federal Reserve (the Fed) raised the Fed Funds rate a quarter point to a range of 2 to 2.25%, and indicated more hikes are on the way. The Fed cited strong economic growth and job gains with inflation remaining near its 2% target. Stocks seem to be shrugging off the higher rates for now, at least while inflation remains under control. Year-to-date, the S&P has returned 10.56%. Bonds were flat for the quarter, as measured by the Bloomberg Barclays Aggregate Index, finishing with a .02% gain in Q3, bringing the year-to-date total to negative 1.60%.

Having exceeded stock returns in the first half of the year, investment grade convertibles participated in only 32% of the S&P 500 in the third quarter. For the quarter, the ICE BofAML Investment Grade Convertible Index (VXA1) rose 2.47%, while the ICE BofAML Investment Grade Convertible 5% Constrained Index (VX5C) returned 2.43%. The Health Care, Financial Services and Utilities sectors led performance. Information Technology was the only negative sector in the quarter. Top individual performers included Illumina, Anthem Inc. and Citrix Systems, while bottom performers included Lam Research, Western Digital and Intel. Year-to-date the regular investment grade index (VXA1) is up 6.75%, while the 5% constrained index (VX5C) is up 5.22%.

## Portfolio Characteristics:

We strive to invest in high-quality convertibles with attractive underlying common stocks. We structure our portfolios by spreading our holdings across the three types of convertibles: 1) equity-sensitive, high- delta convertibles; 2) total return, middle-of-the-road convertibles; and 3) fixed income-oriented convertibles. This structure seeks to provide a balance of upside participation during good markets and a measure of downside protection during bad markets.

The Victory INCORE Investment Grade Convertible Fund has a delta (sensitivity to common stock) of 55%, compared to the ICE BofAML Investment Grade Convertible Index which has a delta of 47%.

The portfolio is overweight compared to the Index (VXA1) in the Health Care, Industrials, Materials, and Real Estate sectors. It is underweight in Financial Services, Consumer Discretionary and Utilities. It is approximately equal weight in Information Technology. The portfolio is broadly diversified among individual issues, sectors, credits and convertible types.

## Performance Attribution:

The Victory INCORE Investment Grade Convertible Fund (class A shares at net asset value) modestly underperformed the ICE BofAML Investment Grade Convertible Indices in the third quarter. Healthcare was by far the best performing sector followed by Financial Services, Utilities and Real Estate. The largest sector detractor was Information Technology, with Consumer Cyclical also finishing in the red for the quarter. Top performing individual convertibles included Anthem Inc., Illumina, Nvidia and Citrix Systems. Bottom Performers included Lam Research, Intel, Western Digital, and Booking Holdings. Relative to the Index, the top performing sectors were Information Technology and Healthcare, while the bottom performers were Financial Services and Consumer Cyclical. The top relative performer was Nvidia and the bottom relative performer was Illumina. Year-to-date, the Victory INCORE Investment Grade Convertible Fund (class A shares at net asset value) modestly underperformed both the ICE BofAML Investment Grade Convertible Index (VXA1) and the the 5% Constrained Convertible Index (VX5C).

## Buys & Sells:

During the third quarter, we initiated positions in Bank of America convertible preferreds, JP Morgan Exchangeable bonds, exchangeable into Voya Financial, and Palo Alto Networks. Due to a credit upgrade, Bank of America entered the investment grade convertible indices in July. The Bank of America preferred is high yielding (5.6%) and low delta (0%) and fits into the defensive portion of our portfolios. The JP Morgan bonds are exchangeable into Voya Financial which provides retirement planning, investment and insurance services. It acts like a typical convertible bond except that its credit profile (JP Morgan) is separate from its equity sensitivity (VOYA). Palo Alto Networks was purchased as a new issue and although unrated, is a high quality, large capitalization, network security provider. We swapped maturing NextEra Energy and VEREIT convertibles for newer convertibles from the same companies. We trimmed our holdings in Nvidia after a very successful run, replacing it with Western Digital, a much more defensive Tech convertible. We sold Starwood Property Trust after a run up in price. We also trimmed positions in some lower quality credits – Nabors Industries, Twitter, and Micron Technologies. Finally, we sold out Janus Group after it was called for redemption.

**Outlook:**

Investment grade convertibles appear well positioned in the current environment of moderate economic growth, strong earnings growth, and gently rising interest rates. The current economic expansion is now the second longest in U.S. history and appears to have plenty of gas left in the tank. GDP growth picked up from an upwardly revised 2.2% growth rate in Q1 to a 4.1 rate in the second quarter. Leading Economic indicators point to continued growth with no slow down on the horizon. The latest Bloomberg survey of leading economists shows a consensus of 3.0% real GDP growth for the remainder of this year and 2.5% growth in 2019. Corporate earnings have responded to the economy, and to recently lowered corporate tax rates. Strategists expect S&P 500 earnings to grow in excess of 20% this year to \$157 per share according to Bloomberg. With a S&P 500 P/E multiple at 18.5 times this year's estimate, market valuations appear reasonable.

To be sure, there are reasons to exercise some caution regarding the current outlook. Increased rhetoric on trade and tariffs has added to the level of market uncertainty. Rising interest rates may pressure stock valuations, and should gradually increase the competitive attractiveness of bond yields. A flattening yield curve could eventually invert, signaling a potential slowdown.

The low level of volatility experienced in 2017 is likely behind us and the bumpiness experienced in the first half of 2018 may well be with us for the foreseeable future.

We expect convertibles will continue to take their lead from the equity markets given the high correlation between the two asset classes. Convertibles have historically experienced a lower level of volatility than typically seen in the stock market, which could be to convertibles advantage if uncertainty picks up. Convertibles could also provide a hedge to rising interest rates, as they have performed quite well during past periods of rising rates. In the current environment, investment grade convertibles may be ideally suited to help investors continue to participate in a rising stock market and may also provide a measure of stability during market volatility.

Historically, convertibles have provided returns competitive with U.S. equity returns over the long term, with lower volatility. In general, convertibles have tended to underperform stocks in bull markets, outperform stocks in bear markets and provide competitive returns in normal markets. In addition, their lack of perfect correlation to either the stock or the bond market makes them an excellent addition to balanced portfolios.

Top 5 Contributors (%)	
Anthem, Inc. 2.75% 15-oct-2042	0.71
Illumina, Inc. 0.0% 15-jun-2019	0.29
Nvidia Corporation 1.0% 01-dec-2018	0.25
Citrix Systems, Inc. 0.5% 15-apr-2019	0.24
Alza Corp. 0.0% 28-jul-2020	0.20

Top 5 Detractors (%)	
AMG Cap Trust II 5.15 % Trust Preferred Secs 2007-15.10.37 Gtd Jr Subord Conv	-0.07
On Semiconductor Corporation 1.0% 01-dec-2020	-0.09
Western Digital Corporation 1.5% 01-feb-2024	-0.17
Intel Corporation 3.25% 01-aug-2039	-0.18
Novellus Systems, Inc. 2.625% 15-may-2041	-0.54

Source: StatPro.

Top Ten Holdings	% Portfolio
Anthem, Inc. 2.75% 15-oct-2042	5.04
Wells Fargo & Company 7.5 % Non Cum Perp Conv Pfd Registered Shs A Series L	4.95
Intel Corporation 3.25% 01-aug-2039	4.92
Red Hat, Inc. 0.25% 01-oct-2019	4.66
Booking Holdings Inc. 0.35% 15-jun-2020	4.37
Citrix Systems, Inc. 0.5% 15-apr-2019	4.24
Novellus Systems, Inc. 2.625% 15-may-2041	4.08
NextEra Energy Inc Corporate Units Cons of 1 PC + 1/20 Deb-I 1.9.21	3.99
Vereit, Inc. 3.75% 15-dec-2020	3.26
Rpm International Inc. 2.25% 15-dec-2020	3.14
<b>Total % of Portfolio</b>	<b>42.6%</b>

**Performance quoted represents past performance and does not guarantee future results. The performance data quoted represents past performance and current returns may be lower or higher. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. To obtain performance information current to the most recent month-end, visit [www.vcm.com](http://www.vcm.com).** Returns include reinvestment of dividends and capital gains.

**Risks Associated with Investing in the Fund:** There is no guarantee that the Fund will achieve its objective. The Fund may invest in below-investment-grade securities, sometimes known as "junk bonds." These securities generally offer higher yields than investment-grade securities but carry a higher risk of default and may be considered speculative. Investors should be able to assume the risks of investing in below-investment-grade securities. The Fund is subject to general stock market risk and convertible securities risk. The return of principal in bond funds is not guaranteed. The principal value of a bond falls when interest rates rise and rise when interest rates fall. During periods of rising interest rates, the value of a bond investment is at greater risk than during periods of stable or falling rates. Bond funds have the same interest rate, inflation, reinvestment, credit and prepayment risks associated with the underlying bonds in the portfolio. Political and economic risks, along with other factors, could adversely affect the Fund's investments in U.S.-traded foreign companies, ADRs and GDRs.

Convertible securities rank senior to the issuer's common stock, but may be subordinate to senior debt obligations. In part, the total return for a convertible security may depend upon the performance of the underlying stock into which it can be converted. Synthetic convertibles may respond differently to market fluctuations than traditional convertible securities. They are also subject to counterparty risk.

**Indexes Defined:** The ICE BofAML All Investment Grade US Convertibles (VXA1) Index is a market capitalization-weighted index of domestic corporate convertible securities. Bonds and preferred stocks must be convertible only to common stock, ADRs or cash equivalent and have a market value of at least \$50 million. Composed of Coupon, OID, or zero coupon convertible bonds rated by Moody's and/or S&P with an average rating of Baa3/BBB- or higher. This Index does not include the effect of expenses and is not representative of the Fund and cannot be invested in directly. The ICE BofAML Investment Grade US Convertible 5% Constrained Index (VX5C) Index is a market capitalization-weighted index of domestic corporate convertible securities. Bonds and preferred stocks must be convertible only to common stock, ADRs or cash equivalent and have a market value of at least \$50 million. Composed of Coupon, OID, or zero coupon convertible bonds rated by Moody's and/or S&P with an average rating of Baa3/BBB- or higher. This Index does not include the effect of expenses and is not representative of the Fund and cannot be invested in directly. All positions are capped at 5% of market value.

Holdings are subject to change. The information in this article is based on data obtained from recognized services and sources and is believed to be reliable. Any opinions, projections or recommendations in this report are subject to change without notice and are not intended as individual investment advice. The securities highlighted, if any, were not intended as individual investment advice. A complete list of all recommendations of security selection is available by request for the previous 12 months. Furthermore, Victory Capital Management Inc., and its affiliates, as agents for their clients, and any of its officers or employees, may have a beneficial interest or position in any of the securities mentioned, which may be contrary to any opinion or projection expressed in this report.

**Contributors and Detractors Source:** FactSet. The top contributors and detractors are presented to illustrate examples of the portfolio's investments and may not be representative of the portfolio's current or future investments. The percent displayed is contribution to return. Holdings are as of the quarter end and may change.

**Top Ten Holdings Source:** FactSet. The top ten holdings are presented to illustrate examples of the portfolio's investments and may not be representative of the portfolio's current or future investments. The percent displayed is percent of total portfolio weight. Holdings are as of the quarter end and may change.

**Investment value (or bond floor):** the level at which a straight bond with the same maturity and credit risk would trade. **Convexity:** Refers to the price sensitivity of the delta of a convertible to a change in the underlying stock price. Definitions source: BofAML

Lipper classification averages are calculated with all eligible share classes for each eligible classification. The calculation periods extend over 36, 60 and 120 months. The highest Lipper Leader for Consistent Return (Effective Return) value within each eligible classification determines the fund classification winner over three, five, or 10 years. Victory INCORE Investment Grade Convertible Fund Class I Shares was selected from among 14 funds and 63 share classes in the convertible securities category over five years for the period ending November 30, 2017. For a detailed explanation, please review the Lipper Leaders methodology document on <http://lipperalpha.financial.thomsonreuters.com/lipper/our-methodology/>.

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Class I shares are only available to select investors as described in the Fund's prospectus.

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