

Victory INCORE Investment Grade Convertible Fund Quarterly Commentary

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As of September 30, 2019

Executive Summary

- Investment grade convertible performance was strong in the third quarter, as falling rates helped push interest-rate-sensitive convertibles higher.
- The ICE BofAML Investment Grade U.S. Convertible 5% Constrained Index (VX5C) (the “Convertible Index”) advanced 3.45% in the third quarter, exceeding the 1.70% return of the S&P 500® Index. Year-to-date, the Convertible Index returned 16.06%, participating in 78% of the 20.55% S&P 500 return.
- The Victory INCORE Investment Grade Convertible Fund’s third quarter and YTD returns trailed the Convertible Index (VX5C). Underweights in interest-rate-sensitive Financials and Utilities, which together make up 50% of the benchmark, were the primary cause of the underperformance.
- Historically, convertible returns have closely matched or even exceeded equity returns over the long term, with lower volatility.
- Investment grade convertibles appear well positioned in the current environment, in that they should participate in a rising market, while providing a measure of stability during market volatility.

Market Review:

The stock market advanced modestly in the third quarter, but its gains were easily outpaced by both bonds and investment grade convertibles. The quarter began with stocks rising in July as investors anticipated a rate cut at the Federal Reserve’s July 31 meeting. Citing weak global growth, trade tensions, and persistent low inflation, the Fed did in fact cut rates, but during Chairman Powell’s post-cut press conference left doubt as to the pace of future cuts. Stocks immediately pulled back, and continued to fall for the rest of the month and into August. The emerging trade war with China and weak global economies pressured stocks throughout most of August, driving the S&P 500 down 4.6% midway through the month. Volatility reigned supreme in August as the S&P 500 posted 11 daily moves of at least 1%, and the Dow Jones Industrial Average fell over 600 points on three separate occasions (including an 800-point drop on August 14). Markets improved the following month, with stocks gaining back in September what they lost in August, as positive economic news and word that the U.S. and China agreed to restart trade talks spurred an equity rally. The Federal Reserve cut rates for the second time in the quarter (and year) in mid-September. As with the July cut, investors welcomed the September reduction, but were disappointed that Chairman Powell did not signal the need for future cuts. After the Fed meeting, stocks slowly drifted lower for the remainder of the month, finishing with an S&P 500 gain of 1.70% in the quarter. This brought the S&P 500 YTD total return to a stellar 20.55%. Bonds reacted positively to the third quarter’s economic concerns and market volatility, driving rates down, resulting in a 2.27% gain in the Bloomberg Barclays U.S. Aggregate Bond Index in Q3. Year-to-date, the bond index has returned a respectable 8.52%.

The rise in stocks, and the even bigger rise in bonds in the quarter, combined to push investment grade convertible returns above those of both stocks and straight bonds. For the third quarter, investment grade convertibles, as measured by the Convertible Index (VX5C), returned 3.45%. The more interest-rate-sensitive Unconstrained Investment Grade Convertible Index (VXA1) performed even better, returning an incredible 5.42%. Clearly the drop in rates had a strong influence on returns, as the interest-rate-sensitive Financial Services and Utilities sectors rivaled the Information Technology sector as the top performing sectors. While technology convertible Lam Research was the number one performing individual security, interest-rate-sensitive convertible preferreds Wells Fargo and Bank of America were numbers two and three. Health Care was easily the worst performing sector in the quarter, and contained the two worst performing securities: Anthem Inc. and Illumina. Industrial holding Fortive Inc. was the third worst index performer in the quarter. Year-to-

date, the Convertible Index (VX5C) returned 16.06%, participating in 78% of the S&P 500 return.

New convertible issuance has been strong through the first three quarters of the year. To date 97 new convertibles have been issued in 2019, amounting to \$48.6 billion. While most of the new issues are unrated or below investment grade, there have been eight new investment grade convertibles issued so far this year, compared to only two in 2018.

Fund Performance:

The Victory INCORE Investment Grade Convertible Fund underperformed the ICE BofAML Investment Grade U.S. Convertible 5% Constrained Index (VX5C) in the third quarter. Underweights in interest-rate-sensitive Financials and Utilities, which together make up 50% of the benchmark, were the primary cause of the underperformance. An overweight in the third best performing sector, Information Technology, helped mitigate some of the shortfall in Financials and Utilities. An overweight in the worst performing sector in the quarter, Health Care, was a minor drag on relative performance. Top-performing individual convertibles included Lam Research (Novellus), Wells Fargo, Intel, and NextEra Energy. Bottom performers included Anthem Inc., Illumina, Fortive, and Johnson & Johnson. The Victory INCORE Investment Grade Convertible Fund also trails the Convertible Index on a YTD basis, primarily because of underweights in Financials and Utilities.

Fund 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 provides a balance between upside participation during good markets and downside protection during bad markets.

The Victory INCORE Investment Grade Convertible Fund has a delta (sensitivity to common stock) of 49% and an average credit rating of BBB. The Convertible Index (VX5C) has a delta of 47% and an average credit rating of BBB, so the portfolio has a higher delta and similar credit quality. The portfolio is overweight compared to the Convertible Index in the Health Care, Information Technology, and Real Estate sectors. It is underweight Financials and Utilities. It is approximately equal weight Industrials and Consumer Discretionary. The portfolio is broadly diversified among individual issues, sectors, credits and convertible types.

Buys & Sells:

During the quarter, we initiated a position in a new mandatory convertible preferred from Southern Company. Southern is an electric and natural gas utility based in Atlanta with service concentration in Georgia, Alabama, and Mississippi. "Mandatories" are high-yielding, short-term preferreds that automatically convert to common stock at maturity, usually in three years. Rated BBB, this new holding yields 6.75%. We also initiated a position in a new issue convertible bond from Snap Inc. Snap is a social media company whose primary product is "Snapchat," which allows users to communicate by sending photos and videos. Larger add-on purchases in the quarter include Dominion Energy, a new issue in the second quarter; JPMorgan Chase, which is convertible into Voya Financial; Illumina Inc.; VEREIT; Western Digital; and On Semiconductor. Two conversions and a maturity occurred during the quarter. NextEra Energy converted to stock, which was promptly sold. Red Hat was converted to cash value based on the IBM takeover of Red Hat. Finally, one of the two Macquarie Infrastructure convertibles matured at par.

Outlook:

Investment grade convertibles appear well positioned in the current environment in that they should participate in a rising market, while providing a measure of stability during market volatility.

Economic growth is slowing but remains positive. Second quarter domestic GDP grew at a 2.0% pace, down from the 3.1% growth experienced in the first quarter. Robust consumer spending remains the key driver of the economy, but weak global manufacturing demand and tight monetary policy are working to slow the economic engine. The strength in consumer spending, which makes up close to 70% of the economy, was countered by weaker second quarter readings across most other categories, including exports, inventories,

residential investment, and government spending. Bloomberg consensus calls for GDP growth to ease modestly in the second half of 2019 to 1.8%, and hold at that rate into 2020. The Federal Reserve reacted to the slowing growth by cutting rates by 25 basis points in both July and September. Further rate cuts are likely later this year, or early next. Inflation remains under control, but has crept closer to the Fed's 2.0% preference.

Last year's economic growth and lower corporate tax rates led to strong earnings growth during 2018. Earnings should continue to rise this year; however, difficult comparisons and moderating economic growth are expected to dampen this growth. Bloomberg consensus calls for mid-single-digit EPS growth this year to \$166, following 20%-plus growth in 2018. With the S&P 500 trading at 18.0 times this year's estimate, market valuation appears reasonable given low interest rates and controlled inflation.

We expect that 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 as 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.

Historically, convertible returns have closely matched or even exceeded equity returns over long periods, 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 (%)		Top Ten Holdings		% Fund
Novellus Systems, Inc. 2.625% 15-may-2041	1.1	Novellus Systems, Inc. 2.625% 15-may-2041		5.3
Wells Fargo & Company 7.5 % Non Cum Perp Conv Pfd Registered Shs A Series L	0.6	Intel Corporation 3.25% 01-aug-2039		5.2
Intel Corporation 3.25% 01-aug-2039	0.5	Wells Fargo & Company 7.5 % Non Cum Perp Conv Pfd Registered Shs A Series L		5.1
Western Digital Corporation 1.5% 01-feb-2024	0.2	Anthem, Inc. 2.75% 15-oct-2042		4.9
Bank of America Corp 7.25 % Non Cum Perp Conv Pfd Registered Shs Series L	0.2	Fortive Corporation 0.875% 15-feb-2022		4.4
Top 5 Detractors (%)		Booking Holdings Inc. 0.35% 15-jun-2020		4.2
AMG Cap Trust II 5.15 % Trust Preferred Secs 2007-15.10.37 Gtd Jr Subord Conv	-0.1	Dominion Energy Inc Corporate Units Cons of 1/10 CCRP Pfd Rg-A + 1 PC Series A		4.1
Alza Corp. 0.0% 28-jul-2020	-0.1	Illumina, Inc. 0.5% 15-jun-2021		3.9
Fortive Corporation 0.875% 15-feb-2022	-0.2	Jpmorgan Chase Financial Co. Llc 0.25% 01-may-2023		3.7
Illumina, Inc. 0.5% 15-jun-2021	-0.6	Vereit, Inc. 3.75% 15-dec-2020		3.7
Anthem, Inc. 2.75% 15-oct-2042	-0.7	Total		44.6

Source: FactSet

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. 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.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

High-yield/high-risk bonds, also known as "junk" bonds, involve a greater risk of default and price volatility than U.S. Government and other high quality bonds. High-yield/high-risk bonds can experience sudden and sharp price swings which will affect net asset value. 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

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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 oldings 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

Upside/Downside Capture: shows what percentage of the market's performance (as evidenced by an appropriate market index) the manager "captured." Up market capture is the extent to which the strategy gained value relative to the index over months when the index achieved gains. Down market capture is the extent to which the strategy lost value over months when the index declined. A measure of 100% means the strategy results went up (or down) exactly the same amount as the broader market index.

Credit Quality Ratings are obtained using Bloomberg Barclays methodology using ratings derived from Moody's Investors Service (Moody's), Standard & Poor's (S&P) and Fitch Ratings (Fitch). When ratings from all three agencies are available, the median rating is used. When ratings are available from two of the agencies, the lower rating is used. When one rating is available, that rating is used. Victory Capital Management does not evaluate these ratings, but simply assigns them to the appropriate credit quality category as determined by the rating agency.

AN INVESTOR SHOULD CONSIDER THE FUND'S 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 THE FUND'S PROSPECTUS. TO OBTAIN A PROSPECTUS, PLEASE CALL 1-800-539-FUND OR VISIT WWW.VICTORYFUNDS.COM. PLEASE READ THE PROSPECTUS CAREFULLY BEFORE INVESTING.

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