INTEGRITY ASSET MANAGEMENT

Victory Integrity Discovery Fund | As of June 30, 2018

Quarterly Commentary

"Fasten your seatbelts; it's going to be a bumpy night."
All About Eve

We are entering a very interesting and complicated backdrop for the markets and the global economy with uncertainties from monetary policy, cracks in the synchronized global growth story, and escalating global trade tensions. Additionally, the yield curve continues to flatten, credit spreads are moving higher and the dollar has strengthened. Lastly, emerging markets stocks are correcting and commodity prices have become more volatile. Since our last communication, we have become more conservative in our outlook. Previously, we believed that cooler heads would prevail in the global trade disputes, however, tariffs have been enacted or threatened to be enacted globally and markets are adjusting to these uncertainties. Companies from General Motors, Campbell Soup and Harley Davidson, to name a few, are starting to feel the effects of the trade wars.

As we stated last quarter, we had begun to take some interest rate sensitivity out of the portfolios due to Federal Reserve interest rate increases and the resulting yield curve flattening. That said, we are not quite at the point of capitulation in the more interest rate sensitive groups. As the quarter progressed, we began to shift the portfolios to a more neutral position as the trade tensions increased more than we had predicted and the yield curve continued to flatten. We decreased weights in financials and industrials, while increasing weights in REITs and utilities. The portfolios are still tilted towards a growing economy, however, with this back drop we felt it prudent to position the portfolio in this manner. The best performing sector of the market was telecommunication services. Consumer staples lagged. Micro value outperformed micro growth.

The Victory Integrity Discovery Fund (A shares without sales charge) underperformed its benchmark, the Russell Microcap® Value Index. Stock selection in technology and energy were the largest detractors for performance. Stock selection in financials was a minor headwind. Stock selection in consumer discretionary was the most significant positive. Stock selection in real estate and materials were minor positives. Sector weights were a modest negative as we were overweight consumer discretionary which underperformed. A larger market cap was a positive style attribute.

Technology was the most significant negative, costing us about 60 basis points. Not owning any software and internet service companies was responsible for almost the entire deficit. The average stock in these two groups was up more than 37%. Of the stocks we did own, Nanometrics (NANO, 0.59%) contributed, while NeoPhotonics (NPTN, 0.77%) detracted. Nanometrics (NANO, 0.59%) was helped by earnings leverage from new customer wins and strong demand for both DRAM and NAND. NeoPhotonics (NPTN, 0.77%) suffered from a general pullback in the optical space around concerns related to customer demand trends, particularly ZTE. ZTE is not a large customer of NeoPhotonics (NPTN, 0.77%).

Although we had some standouts on the equipment and services side, this was more than offset by negative selection in energy and production (E&P). Within E&P, we owned a pair of laggards and missed owning some of the best performing stocks. The laggards included Earthstone Energy (ESTE, 0.81%) and Ring Energy (REI, 0.74%). Earthstone Energy (ESTE, 0.81%) underperformed on weak well production. Ring Energy (REI, 0.74%) reported weak production in the first quarter based on operational issues with one frack crew. Pioneer Energy Services (PES, 0.88%) and Newpark Resources (NR, 1.11%) led performance in energy equipment and services. Pioneer Energy Services (PES, 0.88%) was up 117% as it realized strong demand for their drilling services with the rally in oil prices. They had 100% utilization on their rigs. Newpark Resources (NR, 1.11%) announced solid quarterly results. It is seeing improved drilling fluids market share and has benefitted from unique technologies which allows full-cycle leverage to rising oil prices and activity.

Our average financial holding underperformed slightly. Notable laggards included Howard Bancorp (HBMD, 0.67%) and EZCORP (EZPW, 0.87%). Howard Bancorp (HBMD, 0.67%) had messy results as it closed a merger in the quarter. It posted lower than expected margins and non-interest income. Although EZCORP (EZPW, 0.87%) reported solid results, it sold off after issuing convertible notes to fund future acquisitions.

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Health care was a minor negative. We had some weak selection within the equipment and supplies, and the biotech industries as we missed owning some of the better performing stocks in these categories. Conversely, Addus HomeCare (ADUS, 1.65%) was a positive advancing 18% as fundamentals remain solid.

Performance in industrials was flat overall. The highlights were Team (TISI, 0.96%) and ArcBest (ARCB, 0.00%). Team (TISI, 0.96%) rallied 68% as solid results showed progress on cross-selling opportunities, expense initiatives, and debt reduction. ArcBest (ARCB, 0.00%) continued to show great operating leverage to a trucking industry that is exhibiting strong pricing and volume growth. Unfortunately, our machinery holdings outweighed much of this. NN (NNBR, 0.52%) and Spartan Motors (SPAR, 0.82%) were the largest detractors. NN (NNBR, 0.52%) was weak after the announcement of an acquisition that improves growth and margins, but at the cost of higher debt. Spartan Motors (SPAR, 0.82%) fell victim to some profit taking after reporting good results and announcing its CFO has taken a temporary medical leave of absence.

Carrols Restaurant Group (TAST, 1.42%) was the biggest contributor to positive performance in consumer discretionary as sales continued to outperform industry trends and expectations. The company reported comps of 7% in the first quarter while most restaurants were near flat. Malibu Boats (MBUU, 1.10%) was up 26% as it continues to outperform a strengthening boat market with industry leading growth in the ski boat category. Gray Television (GTN, 1.19%) rallied after announcing an accretive and transformational merger with Raycom Media. Some of this was offset with weak selection within homebuilders and auto components. M/I Homes (MHO, 0.78%) was hit by fears that the U.S. homebuilding market could see a pause as rising mortgage rates could temper affordability and higher input costs could pressure margins. Motorcar Parts of America (MPAA, 0.73%) was down 13% as it offered weaker guidance due to higher costs.

TIER REIT (TIER, 0.63%) was our best performing REIT. Strong results highlighted the improved quality and growth characteristics of its office assets. In materials, Ryerson Holding (RYI, 0.55%) rebounded almost 37% as demand and pricing improvements have persisted.

The contrarians in us would very much love to bet against the increasingly consensus view that we are heading for an all-out global trade war as corporate profits are solid, interest rates are still low, the consumer is strong, the regulatory environment is pro-business and valuations are palatable in some groups. Unfortunately, the eventual outcome of the trade tensions is binary, and the markets have not completely discounted the impacts of a full-blown trade war. Hence, we are very cognizant that we are always one tweet away from global tensions being alleviated or escalated. However, we fear some real damage has already been done from the rhetoric and the first round of tariffs. Bottom line, it's going to be a very volatile market this summer, but hopefully cooler heads can prevail and markets can refocus on fundamentals.

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Past performance does not guarantee future results.

Risks Associated with Investing in the Fund: The Fund invests in smaller company stocks, which are more volatile and less liquid than larger, more established company securities. A substantial portion of the Fund's assets is invested in the financial sector, whose performance can be significantly negatively impacted by economic downturns and changes in government regulation and interest rates. The Fund may invest up to 25% of its assets in foreign securities, which involve additional risks due to currency fluctuations, economic and political conditions, and differences in financial reporting standards. Performance and after-tax returns can be significantly impacted by the Fund's investments in Initial Public Offerings (IPOs), which may involve short-term trading. We cannot, however, ensure that the Fund will obtain IPOs.

Indexes Defined The Russell Microcap® Index is a capitalization-weighted index that measures the performance of the smallest 1,000 companies in the Russell 2000® Index (the 2,000 smallest stocks by market capitalization in the Russell 3000® Index, an index of the top 3,000 U.S. stocks by market capitalization covering 98% of the U.S. equity investable universe), plus the next smallest 1,000 U.S. listed stocks. You cannot invest directly in an index. Although reinvestment of dividend and interest payments is assumed, no expenses are netted against an index's returns.

Fund holdings mentioned in the Quarterly Commentary are as of 6/30/2018 and the percentages shown are based on net assets as of that date. Fund holdings are subject to change and should not be considered purchase recommendations. There is no assurance that the securities mentioned remain in the Fund's portfolio or that securities sold have not been repurchased. The Fund's top ten holdings as of 6/30/2018 were: Addus HomeCare Corporation (1.7%), Carrols Restaurant Group, Inc. (1.4%), NexPoint Residential Trust Inc. (1.2%), Covenant Transportation Group, Inc. Class A (1.2%), Gray Television Inc (1.2%), Ruth's Hospitality Group, Inc (1.1%), Newpark Resources, Inc (1.1%), Heritage Financial Corporation (1.1%), Malibu Boats Inc (1.1%), and United Financial Bancorp Inc (1.1%). Top holdings do not reflect cash, money market instruments, or options/futures contracts holdings. The most currently available data regarding portfolio holdings can be found on our website, www.vcm.com.

Contributors and Detractors Source: FactSet. The contributors and detractors mentioned are presented to illustrate examples of the Fund's investments and may not be representative of the Fund's current or future investments. Fund holdings are as of quarter-end and may change at any time.

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