INTEGRITY ASSET MANAGEMENT

Victory Integrity Mid-Cap Value Fund

As of December 31, 2018

Quarterly Commentary

To be, or not to be, that is the question:
Whether 'tis nobler in the mind to suffer
The slings and arrows of outrageous fortune,
Or to take arms against a sea of troubles,
And by opposing end them: to die, to sleep
No more; and by a sleep, to say we end
The heartache, and the thousand natural shocks
That flesh is heir to? – William Shakespeare's Hamlet

Hamlet's soliloquy pretty well sums up the swirling sentiments around the market as well as our portfolio positioning. The recession – to be or not to be? Rate increases – to be or not to be? Trade resolution – to be or not to be? You get the picture. Moreover, we have chosen recently to take arms against the sea of troubles plaguing the market. As valuations have come down dramatically in the last three months or so, we have chosen to lean against these forces and add some exposure to more cyclical groups being discounted in the market. Furthermore, we continue to re-evaluate current holdings in light of dramatic changes in prices and relative valuations.

We started 2018 optimistic on both the economy and the market. Caterpillar (CAT) and President Trump threw two big hand grenades into the mix. First, the new CEO at Caterpillar announced with Q1 earnings that he thought this was "as good as it gets" for the company. The market took this as a sign of peak earnings for the industrial economy (Caterpillar reported earnings of $2.82/share in Q1, $2.97/share in Q2 and $2.86/share in Q3). Next, Trump announced tariffs, sparking a trade war. Not too good for our industrials! Additionally, the Fed was raising rates - fostering concerns that they were out of touch with the slowing effects of the above-mentioned forces and which would/could result in a recession. We tactically reduced risk in the second quarter resulting in a better relative performance in the third quarter. However, in the fourth quarter we felt, and continue to feel, that the market has mispriced the odds of recession. Hence, we have increased our exposure in financials, namely banks, as that group has sold off significantly. Compared to utilities, the bank group has only been cheaper 2% of the time in market history. Banks have similar dividend yields, are buying back stock and have better growth potential. Unless we are going into recession, this is a good place to be. The best performing sector of the market was utilities (-1.4%). Most remaining sectors posted double digit return losses. Energy was the worst performing sector (down 35.3%). Mid value outperformed mid growth.

The Victory Integrity Mid-Cap Value Fund (A shares without sales charge) underperformed the Russell Midcap® Value Index for the quarter. Stock selection in materials, financials, health care, and consumer discretionary detracted from performance. Stock selection in consumer staples and technology were very minor positives. Sector weights were a minor negative, as we were underweight real estate and utilities, which outperformed. This offset the positive effect from being underweight energy, the worst performing sector. Larger exposure to stocks with higher volatility and a higher beta detracted.

Methanex Corporation (MEOH) and Carpenter Technology Corporation (CRS) were the main detractors in materials. Falling crude oil prices put downward pressure on prices for key output methanol at Methanex Corporation (MEOH). Carpenter Technology Corporation (CRS) reported weaker than expected volumes due to extended maintenance outages, and it also lowered guidance.

Stock selection in banks was the main cause of weakness in financials. Synovus Financial Corp. (SNV) was the biggest culprit, due to ongoing concerns with their FCB acquisition. Our average insurance holding underperformed slightly as well.

Perrigo Co. Plc (PRGO) and Laboratory Corporation of America Holdings (LH) were the pitfalls in health care. Perrigo Co. Plc (PRGO) lowered guidance on continued weakness in the generics business and lower margins. The company also announced a $1.9B tax assessment from the Irish tax authority. Weak results and lower guidance at Laboratory Corporation of America Holdings (LH) stemmed from Medicare pricing cuts, lower volumes, and the impact from Hurricane Florence.

Quarterly Commentary

Consumer discretionary was hurt by Aramark (ARMK) and Caesars Entertainment Corporation (CZR). Aramark (ARMK) issued disappointing long-term guidance at their analyst day. Investor concerns about softness in Las Vegas and high leverage weighed on Caesars Entertainment Corporation (CZR).

Stock selection in consumer staples was a minor positive thanks to Lamb Weston Holdings, Inc. (LW) and US Foods Holding Corp. (USFD). Lamb Weston Holdings, Inc. (LW) outperformed as strong earnings and reiterated guidance refuted a short seller report from the previous quarter. Strong earnings and reiterated guidance (versus the previous-quarter hiccup) helped US Foods Holding Corp. (USFD). Conversely, disappointment from the Pinnacle Foods acquisition integration and tepid core business growth hurt Conagra Brands, Inc. (CAG).

Performance in technology was a very minor positive, as our overall holdings outperformed slightly. There were no significant contributors or detractors for the quarter.

Utilities were a very minor negative due to the underweight, as the group materially outperformed as investors shifted toward defensive investments. Pinnacle West Capital Corporation (PNW) was our best performing utility.

Most of the market turmoil centers around recession fears which we think are overblown. Domestic non-cyclicals have dramatically outperformed domestic cyclicals. Barring a recession, this trade is wrong, and we believe that we are positioned correctly going forward. More recently, there are signs of the market coming our way - at least on rates - as the odds of a rate increase have dropped significantly from just a few months ago.
Admittedly, our view is contrarian and could be wrong. However, we strongly believe that it is the best risk/reward scenario for our clients. Short-term, we could “end the heart ache and the thousand natural shocks”, but the current price is too high. Buying utilities and non-cyclicals, at this point, is like buying insurance when your house is on fire. We will continue to monitor events as they unfold and adjust the portfolios appropriately.

As is our custom, we provide our sector outlooks for the year:

Communications Services
Within the new entertainment industry, the theaters remain appealing. With the 2018 box office coming in better than expected, 2019 looks to be another strong year. We have moderated our exposure to the broadcasters as we are more cautious on advertising spending. However, M&A activity and the upcoming 2020 political cycle remain catalysts for the group.

Consumer Discretionary
Selectivity remains the strategy, as we are underweight the sector. We are more cautious on retail names given tougher first half compares, lapping of last year’s tax benefit, tariff uncertainty, and margin risk from elevated shipping, labor, and investment costs. We are biased to either higher quality or company-specific catalysts. We are warming up to the homebuilders after exiting the space last year. Valuations are attractive (trading below book value), mortgage rates have pulled back with the potential for a more dovish fed, and supply/demand imbalances remain. We still like the hotels, restaurants, and leisure industry despite many of our holdings underperforming last year for various reasons. Valuations are more reasonable and many of the company specific catalysts have yet to play out.

We are limiting our exposure to the auto components group for now as we are concerned that demand, while stable, is likely to inflect negative as the year progresses. However, we are also cognizant that the valuations here may be overly pessimistic.

Consumer Staples
We are modestly overweight consumer staples as we used last year’s volatility to pick up beaten down names that were not overly expensive. While our thesis of increased M&A activity did not play out as robustly as hoped last year, we believe consolidation will be increasingly necessary to combat price deflation. We also believe that earnings will be stronger than expected as the year over year comparisons become more favorable and the headwinds of rising input costs become tailwinds by the end of the year. Also, tariffs and trade have created dislocations in the commodity markets that present interesting opportunities for mean reversion.

Energy
As we begin 2019 the group is rallying off its oversold level, but we are quite skeptical of its sustainability. After two years of trying to stabilize prices, we are essentially right back where we were in June of 2016. Coupling this volatility with the group underperforming the S&P 500 seven out of the last eight years, we are concerned that investors could just shrug off any positive news in the coming months. Given this backdrop we have tried to position the bulk of the portfolio in E&P names that have solid balance sheets (or a path to get there - near 2x Debt/EBITDA) and strong recycle ratios (a measure we use to gauge operational capabilities of management). We expect continued volatility and believe these names will hold up better over the course of the year. Additionally, we like the balance sheets and relative safety of the refiners and believe the international LNG market is attractive, but admit it is a longer term theme. Ultimately, we will look to add to quality names at attractive valuations.

Financials
Our outlook on banks is still constructive. We feel that the market has mispriced the odds of recession. Hence, we have increased our exposure in financials, namely banks, as that group has sold off significantly. Compared to utilities, the bank group has only been cheaper 2% of the time in market history. Banks have similar dividend yields, are buying back stock and have better growth potential. Capital is healthy as banks have repaired their balance sheets. Unless we are going into recession, this is a good place to be.

We have reduced some of our interest rate sensitivity within our holdings of insurers. With the prospects of more range bound interest rates we no longer see a viable catalyst for some names. As last year progressed we became more skewed to P&C names at the expense of life insurance names and we maintain that positioning currently. While valuations are more attractive than a year ago, few names are at levels consistent with a favorable risk/reward ratio considering moderating earnings estimates. Lastly, with the prospect of lower and/or slower increases in interest rates we are evaluating the title and mortgage insurers once again.

Health Care
We are roughly equal weight health care and broadly diversified, focusing on companies with stock-specific catalysts. We continue to like providers and services companies. Multiples are reasonable, and we continue to find opportunities in the group. We have repositioned somewhat in medical technology, selling winners and looking for cheaper names. Although expensive as a group, we view this industry as interesting and should continue to find relative value and good turnaround stories. Life science and tools could struggle if there is a global slowdown and valuations limit exposure to the group. We remain cautious on hospitals on weak fundamentals and political headline risks. An underweight to the biotechnology industry is present throughout the portfolios, as the group does not meet our valuation parameters.

Industrials
We are maintaining an overweight to industrials but decidedly less than last year. After the drubbing in performance last year, we are using the widening inter-sector valuations to selectively acquire higher quality companies that the market has traded indiscriminately. Valuations are more reasonable and, in some cases, very attractive but we believe earnings estimates need to be cut for the stocks to work as a group.

We have trimmed our exposure to transports as they must lap extremely tough comparisons in the first half of the year. While we believe the stocks reflect this reality, we are waiting to add back to positions opportunistically once earnings and guidance commentary are introduced and digested by the market.

We continue to overweight the aerospace & defense industry due to the general stability of the group and strong order books which support sales visibility. While defense stocks have come under pressure as fears about a peaking 2019 defense budget have risen, we still see a path to organic growth past 2019 and supportive free cash flow yields.

Materials
Entering 2019, we see an environment where the assumptions for demand and pricing are uncertain, which has led us to begin the year underweight the group. The Chinese economy and its future prospects have a significant impact on both of the aforementioned variables. Since we don’t presume to know more than the market in regards to the trade war and when it may end, we are choosing to pick our battles in pockets of the universe where demand is more certain. For example, specialty metals for aerospace alloys, carbon black where pricing power is more structural, and the ag cycle that has finally appeared to trough. While valuations in the metals and

commodity chemicals space are enticing, we would rather wait to see if the trade war is ended before getting back in too early. If the global economic picture worsens from here, we may look to add exposure to the packaging names which generally are less cyclical than metals or chemicals.

Real Estate
As interest rates rose in the first half of 2018 and valuations became much more palatable, we added exposure to industrial and residential REITs where underlying fundamentals were solid. We are underweight real estate but not as much as we were a year ago. Although, overall REIT fundamentals are steady, valuations continue to be relatively full. This group is likely to be a source of funds if we get more comfortable that the economy is okay and that better opportunities exist elsewhere. Acquisition activity in REITs increased noticeably from 2017 as companies continue to want added scale. We had some acquisitions, but they were for modest premiums.

Technology
While we are modestly overweight the sector, our positioning is less cyclical than in the past. Tariffs, China & EU weakness, an elongated mobile upgrade cycle, and pockets of elevated inventory have resulted in a more cautious stance on semiconductors. However, we still like the long-term secular demand drivers (auto, industrial, internet of things (IOT), 5G, and artificial intelligence) for the group. We are adding back exposure slowly as valuations have come in and fundamentals are not as bad as feared. Within semicap equipment, we prefer names that are less tied to capital expenditures. While software valuations, in general, remain elevated, opportunities lie in turn around stories. Hence, we are overweight the industry for the first time in a while. Companies with either improving margins or company specific catalysts remain appealing within the electronics equipment industry. We continue to be conservatively positioned within communications equipment on trade/tariff uncertainty and concerns of moderating carrier and data center spending.

Utilities
We are roughly equal-weight, as the groups stretched valuation is offset by the attractiveness of being resistant to a slowdown in the economy. Utilities are trading at a 20% premium to the market and near-peak P/E multiples vs the S&P 500. Macro uncertainty drove investors to seek safety in 2018, and utilities benefitted from this trade. Consequently, the group had strong absolute and relative performance as investor sentiment changed as the market turned defensive in 4Q18. We have concerns that sector multiples could quickly contract if generalists' interest in the group wanes. The group remains susceptible to additional underperformance if optimism returns regarding the economy and long rates rise. As we see catalysts unfold in non-cyclical groups, we may use utilities as a source of funds.

VictoryFunds®

Quarterly Commentary

Past performance does not guarantee future results.

Risks Associated with Investing in the Fund: The Fund invests in smaller and medium-sized company stocks, which are more volatile and less liquid than larger, more established company securities. Value-based investments are subject to the risk that the broad market may not recognize their intrinsic value. 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 Midcap® Value Index measures the performance of those Russell Midcap® companies (approximately 800 of the smallest securities in the Russell 1000® Index, which includes the 1,000 largest 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) with higher composite value scores. The S&P 500® Index is a widely recognized capitalization-weighted index that measures the performance of the large-capitalization sector of the U.S. stock market. 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 12/31/2018 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 12/31/2018 were: HCP, Inc (1.6%), PPL Corporation (1.6%), Zions Bancorporation (1.5%), Zimmer Biomet Holdings, Inc. (1.4%), Alexandria Real Estate Equities, Inc (1.4%), Huntington Ingalls Industries, Inc. (1.4%), Duke Realty Corp (1.3%), Stanley Black & Decker, Inc (1.3%), Hill-Rom Holdings, Inc (1.3%), and Host Hotels & Resorts, Inc (1.3%). 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.

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.

SHARES OF THE FUND MAY BE SUBJECT TO SALES CHARGES AND OTHER FEES. 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.VCM.COM. PLEASE READ THE PROSPECTUS CAREFULLY BEFORE INVESTING.

THE FUNDS ARE DISTRIBUTED BY VICTORY CAPITAL ADVISERS, INC. ("VCA"), MEMBER FINRA AND SIPC. VICTORY CAPITAL MANAGEMENT INC., AN AFFILIATE OF VCA, IS THE INVESTMENT ADVISOR TO THE FUNDS AND RECEIVES A FEE FROM THE FUNDS FOR ITS SERVICES.

V17.052 // 4Q 2018 INTGY Mid Cap Val Fund COM

VictoryFunds®