Integrity Asset Management

Victory Integrity Mid-Cap Value Fund | As of June 30, 2020

Quarterly Commentary

We back, we back, we back in the saddle
Back on the stage making the whole place rattle
Back with the A-Team, train on the track
Thought we were gone but you wrong, now it's on
We back.
– Jason Aldean

The once COVID-coma economy seems to be back on track, at least for the time being. After dramatic contractions in activity, the economy has been back in the saddle and exhibiting a V-shaped recovery path, not just in the US but around the world. PMIs in China, India and Australia have spiked. China's PMI is over 50, indicating expansion, and copper prices have risen, signaling stronger economic activity. In the US, employment, vehicle production, and existing home sales have recovered sharply. The reopening of economies, along with massive fiscal and monetary stimulus, has spurred this activity. Evercore ISI counts 519 stimulus initiatives around the world. The Federal Reserve's balance sheet is up 60% this year, while the balance sheet for the Bank of England has increased by 60%, and for the Bank of Canada by 350%.

Seemingly, this influx of cash has found its way into what have come to be perceived as defensive companies. The strong run in these large-cap growth stocks has brought out calls of "too far, too fast." The non-economically sensitive Nasdaq-100® Index is *up* over 16% this year, while the more cyclical Russell 2000® Value Index is *down* 23%. This whopping 39% differential appears indicative of investor pessimism regarding the virus and the economy. Certainly, the second wave of the virus is a risk to the recent economic good news. However, if death rates remain low and the economy continues to recover, we see the current valuation and performance disparity as a compelling investment opportunity. We talked last quarter about valuation spreads being as wide as they've been since 2008 and during the Great Depression. They have since receded some in the market rally. However, spreads are still greater than two standard deviations above the mean and historically attractive. We expect continued volatility around media reports on the virus and the economy.

The best performing sector of the market was energy (+55%). Consumer discretionary, technology, and materials also outperformed the broad market. Utilities was the worst performing sector (+3.5%). Mid cap growth outperformed mid cap value.

The Victory Integrity Mid-Cap Value Fund (A shares without sales charge) outperformed the Russell Midcap® Value Index for the quarter. Utilities, industrials and real estate led to outperformance, while stock selection in energy and financials detracted. Sector weights were a minor positive as we were underweight utilities, the worst performing sector, and overweight technology, the third best performing sector. A smaller market capitalization and higher beta were positive style attributes.

Beacon Roofing Supply, Inc. (BECN) and Owens Corning (OC) were the standouts in industrials. Beacon Roofing Supply, Inc. (BECN) outperformed as reroofing activity was better than expected due to easy comparisons, strong existing home sales, and better weather. Owens Corning (OC) recovered strongly as concerns about a housing downturn subsided with new/used home sales remaining buoyant and roofing activity accelerating with better weather. Curtiss-Wright Corp. (CW) was a detractor. Investor concerns about a downturn in defense spending and aerospace exposure caused Curtiss-Wright Corp. (CW) to lag more cyclical names.

Our average real estate holding outperformed (+14.8% versus +12.4%), led by STORE Capital Corporation (STOR). The company rebounded 33% as tenants reopened and rent collections were better than feared.

Technology was a positive, mostly due to the overweight allocation. It was the third best performing sector (+27.4%), and our overweight contributed. ON Semiconductor Corporation (ON) was our largest contributor. A cheap valuation and a large investment by Koch Industries sparked a rally in ON Semiconductor Corp. (ON) shares.

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Health care was a minor positive, with Hologic, Inc. (HOLX) the most significant overall contributor. Hologic, Inc. (HOLX) is well positioned to benefit from high demand for COVID-19 testing. The company's PANTHER system offers high-throughput testing to take advantage of demand and is a market leader in molecular diagnostics. Conversely, Encompass Health Corp. (EHC) hurt performance. Work-from-home orders and suspension of elective procedures due to the COVID-19 outbreak resulted in lower admissions and volumes.

Consumer discretionary was also a minor positive thanks to Brunswick Corporation (BC). It was up 81% as boat sales and boat usage remained resilient during the quarter, with families shifting to activities that provide social distancing.

Performance in materials was neutral. Freeport-McMoRan, Inc. (FCX) was a strong performer, but essentially offset by some minor laggards. Freeport-McMoRan, Inc. (FCX) advanced 71%. Fundamentals in the copper market improved greatly as competitive mines closed amid the COVID-19 outbreak, while China stimulus spurred increased demand and copper prices.

Energy was the largest detractor. It was the best performing sector (+55%), and being slightly underweight during the quarter was a very minor negative. Cabot Oil & Gas Corporation (COG) and not owning some of the best performing energy stocks hurt. After an April surge, natural gas pricing weakened due to fears that associated gas will come back with increased crude oil production. This led to underperformance at Cabot Oil & Gas Corporation (COG), a natural gas company.

Stock selection in financials was a modest negative. Within capital markets, Northern Trust Corporation (NTRS) lagged as management offered cautious guidance for the second quarter. American Financial Group, Inc. (AFG) was the largest overall detractor in financials. It provided reduced guidance due to pressure on its life insurance business. Assurant, Inc. (AIZ) underperformed as its business mix is viewed as defensive. LPL Financial Holdings Inc. (LPLA) was a bright spot as strong organic growth and share gains led to outperformance.

We have worked diligently to build a portfolio that should benefit from a reduction in anxiety over the virus and the economy. We have been adding small positions in companies where we see enticing relative valuations with above-average snap-back potential as the COVID-19 and economic clouds begin to clear. The number of securities held in the portfolios has expanded to try to capture this return while taking less company-specific risk. We believe our strategy of buying names with solid free cash flow characteristics, coupled with deeper discounts and some controversy surrounding them, is the right one that will add alpha for our clients going forward. Our largest risk lies in second-wave fears and the resulting economic worries and implications. Our performance was very strong during the first two months of the quarter; however, in the last few weeks of the quarter, second-wave COVID-19 cases increased, and we did lose some relative outperformance. This is certainly a concern, but we see it as performance delayed, not lost.

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 6/30/2020 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 6/30/2020 were: Zimmer Biomet Holdings, Inc (1.5%), Laboratory Corporation of America Holdings (1.5%), Northern Trust Corp (1.3%), Perrigo Co. Plc (1.3%), Arthur J. Gallagher & Co (1.3%), Voya Financial, Inc. (1.2%), DTE Energy Co. (1.2%), Regions Financial Corp (1.2%), Nuance Communications, Inc. (1.2%), and Microchip Technology Inc. (1.0%). 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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