INTEGRITY ASSET MANAGEMENT

Victory Integrity Small-Cap Value Fund

As of March 31, 2018

Quarterly Commentary

Should I stay or should I go now?
Should I stay or should I go now?
If I go, there will be trouble
And if I stay it will be double
So come on and let me know
— The Clash

Since we re-used a quote last quarter, why not make it two-in-a-row? The "should I stay or go" quote refers to a couple of things that could be the source of both the market's consternation and the direction of our decisions, depending on the outcome. We have tariff tantrum vs. rate shock. It's like the movie *Batman v Superman* – not very good. It's hard to pinpoint exactly what has caused the market turmoil, and like most things, it's likely a combination. To cut to the chase: If it's tariffs we are a buyer, if it's rates, we are a bit more cautious.

Looking at the concerns over tariffs and a trade war, to quote a line from *Batman v Superman*: "If I wanted it, you'd be dead already." (Good stuff, right? #Oscar snub?) If Trump really wanted a trade war and Smoot-Hawley type tariffs, we would have them already. Things could escalate from here. That is a risk, but we think cooler heads prevail, and that the threat of tariffs is a bargaining ploy. The myriad of exemptions (steel tariffs, for example) is evidence of that. The announced steel tariffs resulted in a sell-off in a number of steel-dependent industrials. We have used that sell-off to add some new companies to the portfolios and to add to some existing positions. Our assumptions are: no trade war and the ability to pass through at least some of the input price increases. Companies (both public and private) to which we have spoken have confidence that they can pass on some of the price increase. Given the significant sell-off in some of these names, we think we have unearthed some good risk/reward opportunities. The best performing sector of the market was health care. Telecommunication services, energy, and real estate were the worst performing sectors. Small growth outperformed small value.

The Victory Integrity Small-Cap Value Fund (A shares without sales charge) posted negative absolute returns, underperforming its benchmark, the Russell 2000® Value Index, for the quarter. Security selection in industrials, energy, and consumer discretionary were the main detractors to performance. Technology helped performance. Sector weights were a minor positive, as underweights to real estate and utilities helped. Higher market capitalization and higher exposure to stocks with more liquidity were style headwinds, while higher momentum helped offset this.

BMC Stock Holdings, Inc. (BMCH, 0.71%) and Meritor, Inc. (MTOR, 0.85%) were the largest detractors within industrials. An unexpected CEO departure prior to an earnings release prompted uncertainty within BMC Stock Holdings, Inc. (BMCH, 0.71%). Meritor, Inc. (MTOR, 0.85%) hurt performance as fears over material cost headwinds and the North American Class 8 market peaking in 2018 prompted weakness.

Weak stock selection in energy was led by Smart Sand (SND, 0.07%), RPC, Inc. (RES, 0.56%), and ProPetro Holding Corp. (PUMP, 0.78%). Weak quarterly results due to higher spending in order to increase capacity and the reality that in-basin Permian sand is going to work have pressured Smart Sand, Inc. (SND, 0.07%). We exited the position. RPC, Inc. (RES, 0.56%) reported disappointing results due to customer mix and weather, which was further compounded by cap-ex increases due to faster attrition of equipment. ProPetro Holding Corp. (PUMP, 0.78%) posted an earnings miss driven by lower than expected margins from the pressure pumping segment, stemming from holiday downtime, lower-quality mix, and weather issues. Callon Petroleum Company (CPE, 1.15%) was a bright spot, as the company had solid fourth quarter operations and is widely considered a consolidation candidate in the Permian region.

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Within consumer discretionary, Gray Television, Inc. (GTN, 0.70%), TEGNA, Inc. (TGNA, 0.90%), and Penn National Gaming, Inc. (PENN, 0.89%) hurt performance. Advertising spends that started the year weaker than expected impacted both Gray Television, Inc. (GTN, 0.70%) and TEGNA, Inc. (TGNA, 0.90%). In addition, investors were disappointed that Gray Television, Inc. (GTN, 0.70%) did not make any acquisitions following last quarter's equity raise. Penn National Gaming, Inc. (PENN) succumbed to profit taking following disappointing earnings resulting from several onetime items. ILG, Inc. (ILG, 0.88%) helped performance, as the company announced the board is examining strategic opportunities.

Technology was led by strong performance by Infinera Corp. (INFN, 0.60%), Oclaro, Inc. (OCLR, 0.00%), and CACI International Inc. Class A (CACI, 1.02%). Infinera Corp. (INFN, 0.60%) reported better than expected results and guidance. Oclaro, Inc. (OCLR, 0.00%) announced they would be acquired for a premium. CACI International Inc. Class A (CACI, 1.02%) beat earnings and raised guidance, buoyed by a book-to-bill greater than 1x with future revenue at the same or better margins.

KapStone Paper and Packaging Corporation (KS, 0.00%) was a positive highlight within materials, as the company was acquired by a competitor for a premium. U.S. Concrete, Inc. (USCR, 0.00%) and Venator Materials PLC (VNTR, 0.57%) hampered performance. U.S. Concrete, Inc. (USCR, 0.00%) was affected by worse than anticipated weather in its largest markets (NY and TX), which impacted quarterly results. Although Venator Materials PLC (VNTR, 0.57%) posted solid results, investors were focused on the higher-than-anticipated costs to rebuild its Finland facility and the impact on slowing its debt reduction process.

Health care had one significant contributor and detractor. Haemonetics Corp. (HAE, 1.01%) was the top performer. The company posted an earnings beat and raised guidance based largely on the tax reform benefit. Patterson Companies, Inc. (PDCO, 0.00%) was a notable detractor as the company badly missed earnings targets, reduced guidance, and announced a CFO transition.

An underweight to real estate helped offset underperformance by DDR Corp. (DDR, 0.81%) and Kite Realty Group Trust (KRG, 0.65%). Despite continued progress with asset sales and a pending spin-off that should allow it to grow again, the challenging retail environment weighed on DDR Corp. (DDR, 0.81%). Asset sales and a challenging retail environment led to slightly lower than expected guidance for Kite Realty Group Trust (KRG, 0.65%).

If the market believes the Federal Reserve is going to have to aggressively raise rates, that's a harder battle to fight. The rapid flattening of the yield curve is a sign that this is the case. The correlation to interest rates of our portfolios and the benchmarks has increased significantly in the last month or so. Opposing this perception is trickier than fighting market beliefs around rising input costs and pricing power. We will find out in a quarter or two whether we were right or wrong about pricing assumptions. Admittedly, interest rates will eventually become a problem. The question is when. If we fight rate perceptions too long, eventually we will be wrong. We are certainly not Fed forecasters. However, we do find it hard to believe that after a decade of trying to revive growth and inflation, the Fed is going to kill the first buds that they see. That said, we do have a large degree of interest-rate sensitivity in the portfolio. Our underweight to utilities and REITS in favor of banks and capital markets worked well last year, and the valuation discrepancies have mostly been reversed. To that end, we have modestly worked those relative exposures down.

We still think that economic growth in the U.S. and worldwide is solid and that there is a lot of cash earning subpar returns. As we wrote last quarter, we see this as a potential catalyst to move the market higher. Despite removing some of our interest rate bet in the face of a less steep yield curve, we continue to position the portfolio for a stronger growth environment.

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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. Further, 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 may be 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 2000® Value Index is a capitalization-weighted index that measures the performance of those Russell 2000® Index companies (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) with higher composite value scores. 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 3/31/2018 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 3/31/2018 were: IBERIABANK Corporation (1.6%), Synovus Financial Corp. (1.5%), Stifel Financial Corp. (1.4%), United Community Banks, Inc. (1.3%), First Horizon National Corporation (1.3%), BankUnited, Inc. (1.2%), MGIC Investment Corporation (1.2%), Caleres, Inc. (1.2%), Callon Petroleum Company (1.2%), and Banc of California 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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