INTEGRITY ASSET MANAGEMENT

Victory Integrity Small/Mid-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. Energy, real estate, and materials were the worst performing sectors. Small-mid growth outperformed small-mid value.

The Victory Integrity Small/Mid Cap Value Fund (A shares without sales charge) underperformed the Russell 2500™ Value Index benchmark for the period. Security selection in health care and energy were modest negatives for the quarter. Stock selection in consumer discretionary, industrials, and technology were the top contributors to performance. Sector weights were positive, as an underweight to real estate and an overweight to financials helped. Higher momentum and higher earnings growth were style tailwinds, while higher exposure to stocks with more liquidity was a headwind.

Patterson Companies, Inc. (PDCO, 0.00%) and not owning biotechnology companies hurt performance within health care. Patterson Companies, Inc. (PDCO, 0.00%) was the most significant detractor within health care, as the company missed earnings targets, reduced guidance, and announced a CFO transition. The average biotechnology company within the Russell 2500™ Value Index was up 6%, and we did not have exposure to this group. Alternately, an earnings beat driven by home health and hospice performance aided Encompass Health Corporation (EHC, 1.12%).

Within energy, Ultra Petroleum Corp. (UPL, 0.41%), RPC, Inc. (RES, 0.69%), and ProPetro Holding Corp. (PUMP, 0.95%) hurt performance. Ultra Petroleum Corp. (UPL, 0.41%) has been battered by western gas differentials blowing out, as weather in its largest demand market was better than expected and supply to the basin has increased drastically due to association with Permian gas. RPC, Inc. (RES, 0.69%) reported weak results due to customer mix and weather, which was further compounded by capex increases due to faster attrition of equipment. ProPetro Holding Corp. (PUMP, 0.69%) 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. RSP Permian, Inc. (RSPP, 1.11%) was a bright spot, as the company agreed to be acquired.

Macy's Inc. (M, 0.83%) led the way within consumer discretionary. The company posted better than expected results as they benefited from favorable weather, lean inventories, and disciplined promotional activity. TEGNA, Inc. (TGNA, 0.93%) and Dana Incorporated (DAN, 0.64%) held performance back. Advertising spend that started the year weaker than expected hurt TEGNA, Inc. (TGNA, 0.93%). Investors skeptical of sales and margin improvements (with the Class 8 market nearing a record high) hurt Dana Incorporated (DAN, 0.64%).

XPO Logistics, Inc. (XPO, 0.85%) and Chart Industries, Inc. (GTLS, 0.58%) were top contributors within industrials. Strong freight markets with higher free cash flow guidance aided XPO Logistics, Inc. (XPO, 0.85%). A strong quarter and enthusiasm for accelerating order growth for the company's LNG equipment propelled Chart Industries, Inc. (GTLS, 0.58%). Meritor (MTOR, 0.85%) detracted as fears over material cost headwinds and the North American Class 8 market peaking in 2018 prompted weakness.

Technology was led by strong performance by ON Semiconductor Corporation (ON, 0.75%), Oclaro, Inc. (OCLR, 0.00%), and CACI International Inc. Class A (CACI. 0.75%). ON Semiconductor Corporation (ON, 0.75%) delivered solid results driven by end-market demand in auto, industrial, and cloud markets. Oclaro, Inc. (OCLR, 0.00%) announced they would be acquired for a premium. CACI International Inc. Class A (CACI, 0.75%) beat earnings and raised guidance, buoyed by a book-to-bill greater than 1x with future revenue at the same or better margins.

Our above-mentioned overweight to financials helped offset security selection within insurance. We missed owning some of the better performing insurance companies (the average insurance company within the Russell 2500™ Value Index generated a 6% return versus our return of -2%). E*TRADE Financial Corporation (ETFC, 1.27%) and our bank holding companies outperformed. A small accretive acquisition of retail brokerage accounts (from Capital One), along with improved asset gathering and retail trading activity, were key highlights for E*TRADE Financial Corporation (ETFC, 1.27%). Earnings levers from continued expense initiatives and expanding margins, along with a favorable capital return profile, led to outperformance for Comerica Incorporated (CMA, 1.10%). Continued progress on improving returns and a favorable capital return profile helped Synovus Financial Corp. (SNV, 1.98%). Huntington Bancshares Incorporated (HBAN, 0.00%) achieved solid results, highlighted by progress the company has made since acquiring First Merit. Ally Financial Inc. (ALLY, 2.00%) underperformed, as it was a victim of profit taking after a strong run and higher than expected expenses in the most recent quarter.

Performance in materials was muted. KapStone Paper and Packaging Corporation (KS, 0.00%) was a positive highlight, as the company was acquired by a competitor for a premium. U.S. Concrete, Inc. (USCR, 0.00%) and Venator Materials PLC (VNTR, 0.70%) limited 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, 0.70%) 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.

An underweight to real estate helped offset underperformance by DDR Corp. (DDR, 1.47%) and Kimco Realty Corporation (KIM, 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, 1.47%). Asset sales and a challenging retail environment led to disappointing guidance for Kimco Realty Corporation (KIM, 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.

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 2500™ Value Index measures the performance of those Russell 2500™ Index companies (approximately 2,500 of the smallest securities 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: Ally Financial Inc. (2.0%), Synovus Financial Corp. (2.0%), PacWest Bancorp (1.9%), American Financial Group, Inc. (1.8%), DDR Corp. (1.5%), Zions Bancorporation (1.3%), E*TRADE Financial Corporation (1.3%), ManpowerGroup, Inc. (1.2%), IBERIABANK Corp (1.2%) and Voya Financial, Inc. (1.2%). 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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