

Victory Trivalent Emerging Markets Small-Cap Fund Quarterly Commentary



As of September 30, 2018

Market Environment

Emerging small-cap equities declined in the third quarter as U.S. Dollar strength, Federal Reserve tightening, and trade disputes diminished investor sentiment for the asset class. Higher interest rates in the U.S. and a strong U.S. Dollar are viewed as headwinds for emerging markets as their dollar-denominated debt becomes more expensive and capital outflows from those countries may accelerate. For the quarter, the MSCI Emerging Markets Small Cap Index declined 4.2%. The Victory Trivalent Emerging Markets Small-Cap Fund (Class A, without load) trailed the index. There was wide dispersion among country returns. Thailand rose 21.0% and was the best performing country. Manufacturing growth in Thailand was strong, and improving consumer confidence had a positive effect on private consumption. Mexican small-cap equities also had a strong quarter, rising 11.9% after the Mexican government reached a new trade agreement with the United States and Canada. South Korea rose 1.4% as exports remained stable. Turkey declined 22.6% and was the worst performing market. The Turkish Lira depreciated by over 30% relative to the U.S. Dollar during the quarter, and economic confidence hit a nine-year low. Despite GDP growth which exceeded expectations, India fell 13.4% as inflation rose, leading the Reserve Bank of India to raise interest rates twice in three months. China also underperformed the overall market as Chinese small-caps dropped 9.7%. Rising concerns of a trade war with the United States and slowing economic growth have been a headwind for Chinese equities.

Most sectors were down, with nine of the eleven economic sectors finishing the quarter in negative territory. Health Care (+1.5%) and Materials (+0.4%) were the lone exceptions. Information Technology was the worst performing sector, as it declined 8.9%. The consumer-oriented names were also weak, as Consumer Staples fell 5.3% while Consumer Discretionary stocks dropped 5.0%.

Portfolio Review

Overall security selection was a drag on relative performance. Excess returns were generated in one of three regions and five of the eleven economic sectors. Despite the underperformance of the overall portfolio, there were a few spots of notable outperformance within Consumer Discretionary, Telecommunication Services, and Utilities. Within Consumer Discretionary, Fila Korea rose 34.1% as second quarter earnings were supported by strength in their Acushnet golf business as well Fila brand market share gains in key U.S., Korean, and Chinese sporting goods markets. Also within the Consumer Discretionary sector, Korean auto parts manufacturer SL Corp. gained 16.5% as new order trends for their LED auto lamps improved. Performance in Telecommunication Services got a boost from the portfolio's holding of China Communication Services which rose 50.8% as the demand for telecom infrastructure and equipment is expected to remain strong as the country rolls out a 5G network. Performance in Utilities benefited from two names. AES Gener, a Chilean energy generator, rose 17.2% as the company benefits from rising power prices caused by poor hydrology conditions in Chile. The company generates approximately 70% of its electricity from thermal power plants. Terna Energy, a Greek renewable energy producer, rose 16.2% as power prices rose over the period. European power prices have been supported by higher natural gas prices and higher carbon costs.

On the downside, Financials and Information Technology were a drag on relative performance. Financials holding Dewan Housing was the top detractor for the quarter. The India-based non-bank financial company focused on mortgage lending declined 59.3% on concerns that a loan default by a smaller in-country competitor could spill over to other mortgage finance companies. Within Information Technology, Hua Hong Semiconductor reversed strong gains from the prior quarter (+76%) and fell 37.3% as sentiment turned negative on the semiconductor industry. The U.S.-China trade dispute and slower industry spending have led to a sharp sentiment shift. Chilis Electronics, the Taiwanese passive components company, also experienced a reversal, +60% in the prior quarter, only to fall 47.1% this quarter. Expectations changed quickly on whether average selling prices would continue to rapidly appreciate.

Market Outlook

Emerging markets equities have underperformed developed markets in 2018 as currency weakness in several markets has coupled with rate hikes in the U.S. and protectionist economic policies to dampen sentiment for the asset class. Further tightening by the Federal Reserve and geopolitical risks are likely to continue to impact emerging market equity valuations near-term. A resolution to the trade tensions between China and the U.S. would be a positive catalyst for emerging market equities. The new trade agreement between the U.S. and Mexico eased uncertainty in North America and leaves hope for an agreement with China. If China and the U.S. fail to reach a trade agreement, protectionist policies, if implemented, would have the beneficial impact of likely increasing domestic demand, an area where emerging small-cap equities have more exposure than emerging large-caps. Several other emerging countries have reported improving economic performance that could become a catalyst for stock returns. India has seen an expansion in manufacturing and construction that boosted GDP growth above market expectations. In Thailand, the military government appears to be moving closer to holding a general election early next year, thus soothing heightened geopolitical concerns. Taiwan continues to have a tight labor market and generous fiscal policy, which bodes well for a continuation of above-average growth and improving domestic demand. In China, The People's Bank of China has introduced policies this year that provide access to capital for smaller, domestic-oriented companies which historically have struggled to gain access to credit. The Brazilian economy has returned to growth, and while the recovery remains fragile and the results of the upcoming election uncertain, a new, more market-friendly government would be viewed positively by investors. We are confident that opportunities for relative outperformance remain robust, particularly in the broad small-cap space. We will maintain our portfolio construction guidelines and expect that higher quality companies that exhibit attractive relative valuations combined with improving business momentum will outperform.

Top 5 Contributors* (%)	Return	Contribution to Relative Return
POSCO Chemtech Co., Ltd	66.5	0.4
Fila Korea Ltd	34.1	0.3
China Communications Services Corp. Ltd. Class H	50.2	0.3
Samjin Pharmaceutical Co., Ltd.	29.5	0.2
Sinotruk Hong Kong Ltd.	40.6	0.2

Top 5 Detractors* (%)	Return	Contribution to Relative Return
Dewan Housing Finance Corporation Limited	-59.2	-0.6
Chilisin Electronics Corp	-47.2	-0.4
Hua Hong Semiconductor Ltd.	-37.3	-0.4
Tianneng Power International Limited	-43.3	-0.3
IRB Infrastructure Developers Limited	-37.7	-0.3

Source: FactSet.

Top 10 Holdings	Country	Sector
F & F Co., Ltd.	Korea	Consumer Discretionary
Dentium Co., Ltd.	Korea	Health Care
China General Plastics Corporation	Taiwan	Materials
Construtora Tenda SA	Brazil	Consumer Discretionary
Maeil Dairies Co., Ltd.	Korea	Consumer Staples
Samjin Pharmaceutical Co., Ltd.	Korea	Health Care
Fila Korea Ltd	Korea	Consumer Discretionary
Ternium S.A. Sponsored ADR	Mexico	Materials
Mahindra CIE Automotive Limited	India	Consumer Discretionary
Kiwoom Securities Co., Ltd	Korea	Financials
Total % of Portfolio		12.56%

ANNUALIZED RETURNS EXPENSE RATIO

Investment Performance (%)	QTR	YTD	1-YR	3-YR	5-YR	10-YR	Since Inception	Gross	Net
							7.2.13		
Class A, without load	-5.29	-10.17	-2.57	11.05	5.92	—	5.95	4.49	1.76
Class A, with load	-10.73	-15.35	-8.19	8.87	4.68	—	4.77	4.49	1.76
Class Y	-5.21	-10.03	-2.32	11.34	6.18	—	6.22	3.49	1.51
MSCI Emerging Markets Small Cap Index (net)	-4.21	-12.3	-4.2	7.43	2.72	—	—		
S&P® Emerging Plus SmallCap Index (net)	-5.73	-12.46	-4.66	8.29	2.93	—	—		

Source: Zephyr StyleADVISOR.

Past performance does not guarantee future results. The performance data quoted represents past performance, and current returns may be lower or higher. The investment return and principal will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. To obtain performance information current to the most recent month end, please visit www.vcm.com.

Net expense ratios reflect the waiver, reimbursement or recoupment, as applicable, contractually agreed to through October 31, 2018.

Returns include reinvestment of dividends and capital gains.

Risks Associated with Investing in the Fund: There is no guarantee that the Fund will achieve its objective. All investing involves risk, including potential loss of principal. Investors should note that investments in foreign securities involve additional risks due to currency fluctuations, economic and political conditions, and differences in financial reporting standards. There are greater risks involved in investing in emerging market countries than those associated with investment in developed foreign markets. Smaller company stocks are more volatile and less liquid than larger, more established company securities. A substantial portion of the Fund's assets may be invested in securities issued in a small number of countries; therefore, adverse market conditions impacting those countries may have a more pronounced effect on the Fund.

Indexes Defined: The S&P® Emerging SmallCap Plus Korea Index measures the equity performance of the bottom 15% (based on market capitalization) of companies from each country represented in the S&P® Emerging BMI plus Korea. The MSCI Emerging Markets Small Cap Index is a free float-adjusted, market-capitalization-weighted index that measures the performance of small-cap stocks in 24 emerging markets.

Fund holdings mentioned in the Quarterly Commentary are as of 09/30/18 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. 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. Percentages shown are for the most recent quarter.

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