INTEGRITY ASSET MANAGEMENT

Victory Integrity Small/Mid-Cap Value Fund As of December 31, 2020

Quarterly Commentary

"Nobody expects the Spanish Inquisition!"
– Monty Python

Apologies to those who grew up after the 1970s, but this line from the popular Monty Python skit of the same name sums up 2020. A more serious-minded quote would be the one we referenced in our outlook from Q4 2019 by the late Peter L. Bernstein: "Investing is unlike many other fields of endeavor because uncertainty is lodged in its heart. When we think we know the future, we are setting ourselves up for trouble. Trends are not destiny. We are no more able to extend smooth lines into the future than a sailor can observe what lies ahead on a choppy sea."

Last year we were posing the question if 2020 would be the year of small value. There were, and continue to be, historic performance differences between small-cap value and small-cap growth. It certainly wasn't the year for small value. In fact, according to Fama/French year-to-date performance data through October, small growth had beaten small value by 35%. Since 1927, the only year worse than 2020 was 1999, with a 38% differential. However, it does look like the tide may be turning. While we entered the year optimistic about the economy and the general possibility of value reasserting itself, the COVID-19 crisis resulted in a market drawdown that exacerbated the discrepancies between growth vs. value and small vs. large. While the sell-off was sharp and severe, we believed it set the stage for significant snapback in beaten-down value names. We have worked diligently throughout the year to position the portfolios for this return-to-value trade. We continue to believe this positioning is correct. The Fama/French data, perhaps, supports SCV reemergence. After the 1999 year referenced above, small-cap value outperformed by over 49% the following year. Could this be setting the stage for 2021?

The following data points lend some credence to our positioning:

- According to Empirical Research Partners, the free cash flow yield of small value stocks is almost 5 percentage points higher than large value stocks, which is similar to the past three recessions.

- Value has led out of every recession, and when GDP is above 4% value outperforms, according to Jefferies & Co.

- Small-cap value stocks are trading in the fifth percentile of cheapness relative to small growth based on work done by Jefferies & Co. Small value has only been cheaper than this 5% of the time. Moreover, the same research shows small growth stocks trading at 40x earnings and 37% of the companies in the Russell 2000® Growth Index not earning money, an all-time high.

While all this has happened in the past, it doesn't mean it will happen again. However, we think the odds favor our current value tilt and focus on stocks most impacted by the market sell-off. The fourth quarter witnessed value outperformance for the first time this year, and our portfolios responded well, inspiring further confidence in our positioning. While the COVID-19 crisis was unexpected and hurt performance, we believe our forward positioning will add value.

Most sectors broadly performed well within the benchmark. Energy (+47%) and technology (+37%) were the top performing sectors. Utilities was the worst performing sector relative the benchmark (+17%). Small/mid cap value outperformed small/mid cap growth.

The Victory Integrity Small/Mid Cap Value Fund (A shares without sales charge) outperformed the Russell 2500™ Value Index benchmark for the period. Performance was broad based as nearly every sector delivered positive contribution, except for energy and consumer staples. Stock selection in consumer discretionary, financials, materials, and industrials led the way. Sector weights were a modest positive, as our underweight to health care (biotechnology) and real estate helped. From a style characteristic standpoint, higher beta was a positive.

Retailers were the top contributors within consumer discretionary as positive vaccine news and better than feared earnings results sparked a rally in retailers heavily impacted by COVID-19. Top performers included Kohl's Corporation (KSS), Tapestry, Inc. (TPR), and Kontoor Brands, Inc. (KTB). Visteon Corporation (VC) was also a top performer. Increased demand for autos along with higher content per vehicle because of greater connectivity desired by consumers aided the company. Homebuilding stocks such as PulteGroup, Inc. (PHM) and TRI Pointe Group, Inc. (TPH) lagged on investor concerns about peaking fundamentals and the demand impact of a rising 10-year Treasury yield.

Banks led the way within financials, and Western Alliance Bancorp (WAL) was the main highlight as solid execution led to top-tier profitability. CIT Group Inc. (CIT) was another standout as the company agreed to be acquired. Hancock Whitney Corporation (HWC), Sterling Bancorp (STL), and East West Bancorp, Inc. (EWBC) all benefited from the cyclical recovery play as credit was less of a concern and a yield curve steepened. Within consumer finance companies, Discover Financial Services (DFS) was the top performer as positive vaccine news, fiscal stimulus, and less credit impact from COVID-19 than expected helped the company. Insurance companies limited performance. Kinsale Capital Group, Inc. (KNSL) took on greater than expected catastrophe losses. Elimination from the S&P SmallCap 600® Index was also a factor. Assurant, Inc. (AIZ) underperformed as the company is viewed as defensive. First American Financial Corporation (FAF) received a Wells Notice and concerns around peak housing cycle weighed on the company. We exited the position.

Stock selection within metals & mining companies paved the way in materials. Alcoa Corporation (AA) outperformed, with aluminum prices rising to 2-year highs and the announcement of a non-core divestiture to help de-lever its balance sheet. Allegheny Technologies Inc. (ATI) is a cyclical play on aerospace recovery and benefited as the company announced it will exit its low-margin commodity product business. Performance in chemicals was also strong. Olin Corporation (OLN) was a stalwart as their new CEO announced a turnaround strategy that was well received by investors. The company also benefited from positive vaccine news. A recovery in end-markets has led to better earnings for Kraton Corporation (KRA). In addition, there is increased enthusiasm for a new adhesive product with disinfectant properties that may be approved shortly. Coeur Mining, Inc. (CDE) limited performance. We exited the position in the middle of the quarter and missed the upside after gold prices rose following stimulus talks.

Solid stock selection across most sub-industries led to outperformance within industrials. Our average holding outperformed the benchmark (+31.4% versus +27.2%). Atkore International Group Inc. (ATKR) was our top performer, as it is a cyclical recovery play that also benefited from positive vaccine news. Knight-Swift Transportation Holdings Inc. Class A (KNX) limited performance as investors are concerned with peak earnings.

Energy was a very minor detractor. EQT Corporation (EQT) underperformed as the company was hampered by declining natural gas prices due to rising crude oil prices and warmer than expected weather. Arch Resources Inc. Class A (ARCH) underperformed due to the Chinese government imposing a ban on metallurgical coal imports from Australia, thus flooding the international market with supply and dropping prices. We exited the position.

Grocery Store Outlet Holding Corp. (GO) and BJ's Wholesale Club Holdings, Inc. (BJ) led to slight underperformance within consumer staples. Both companies underperformed as the economy reopened and investors worried about the sustainability of results.

Technology outperformed and had some noticeable contributors. Solid earnings results and guidance as well as excitement around their solar business following the recent IPO of a competitor boosted shares of Flex Ltd. (FLEX). ON Semiconductor Corp. (ON) outperformed following news of activist involvement and the naming of a new CEO with turnaround experience. NCR Corp. (NCR) rallied following an upbeat analyst day and on expectations for strong self-checkout machine demand and reduced COVID-19 business disruption.

Outperformance in health care was largely due to the aforementioned underweight to biotechnology companies. Magellan Health, Inc. (MGLN) and Perrigo Co. Plc (PRGO) held back performance. Magellan Health, Inc. (MGLN) underperformed as investors awaited more clarity on management's capital allocation plan for the proceeds from the MCC divestiture. Management continues to have a more cautious tone on guidance and COVID-19 related headwinds. Several company-specific items continue to weigh on Perrigo Co. Plc (PRGO): Albuterol recall, U.S. tax assessment, Ireland tax assessment, and timing of the potential separation of its RX business.

Real estate was a minor positive. In addition to being underweight the sector, DiamondRock Hospitality Co. (DRH) also helped performance as the announcement of a vaccine led to a rebound. Mack-Cali Realty Corp. (CLI) underperformed as office and residential leasing continues to be challenged by uncertainty related to COVID-19. Companies with more stable fundamentals, such as cold-storage REITs and industrial REITs like Americold Realty Trust (COLD) and First Industrial Realty Trust, Inc. (FR) lagged as investors rotated away from more defensive stocks.

We would like to end with another quote from Mr. Bernstein in response to the question, “What are investors’ most common mistakes?” Bernstein explains, “Extrapolation. Leaving fund managers in a down year to go with whoever’s hot. The refusal to believe that shock lies in wait. Believe me, individual investors are not the only ones who mire themselves in this mistake. It is endemic throughout the investing community.”

Quarterly Commentary

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The Russell 2500™ Value Index is a market-capitalization-weighted index that measures the performance of those companies in the Russell 2500™ Index with higher composite value scores.

Fund holdings mentioned in the Quarterly Commentary are as of the date shown 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 the date shown were: ON Semiconductor Corp. (1.5%), Western Alliance Bancorp (1.2%), Ally Financial Inc (1.2%), Medical Properties Trust, Inc (1.1%), Hancock Whitney Corp (1.1%), Highwoods Properties, Inc (1.0%), East West Bancorp (1.0%), Discover Financial Services (1.0%), Ralph Lauren Corp Class A (1.0%), and EMCOR Group, 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.

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