Quarterly Commentary

Raindrops on the windshield
There's a storm movin' in
He's headin' back from somewhere
That he never should have been
And the thunder rolls
And the thunder rolls
– Garth Brooks, "The Thunder Rolls"

The Federal Reserve is heading back from its zero interest rate policy (ZIRP). Rising rates in the United States are causing storms throughout the world. There seems to be significant stress in the fixed income markets. Volatility in the bond market is at levels historically associated with significant economic/financial events. In addition, foreign exchange markets and foreign banks are feeling the thunder of the Fed's rate increases' lightning. A number of financial stress indicators are at points last seen in the depths of COVID-19 lockdowns and the 2008 financial crisis. There is chatter about the solvency of Credit Suisse. Its credit default swaps are at prices last seen when Lehman Brothers failed. The Bank of England switched from reducing its balance sheet to quantitative easing in the course of about a week – temporarily, of course.

We believe ZIRP played a role in inflation, but it was a long-term role. Why after roughly 14 years of ZIRP did inflation rear its head now? Nassim Taleb recently tweeted, "Basically, experience in finance with a discount rate near zero is like having studied physics without gravity." We believe finance decisions were made in a way that allocated capital to companies currently losing money with no cash flow.

At one point, the percentage of money-losing companies in the Russell 2000® Growth Index was close to 40%. In our view, this starved the "old economy" of capital, and capital misallocation created a powder keg that was lit when COVID-19 hit. The federal government produced massive fiscal stimulus. People were at home with money and decided to spend it. A capital-starved supply chain, restructured for slow economic growth, was hit with a spike in demand. In addition, companies faced labor shortages from COVID-19. The result? Too much money chasing too few goods, the classic Milton Friedman definition of inflation.

The way inflation was stoked raises concerns for us about the virility of the Federal Reserve. If rates were a long-term factor in producing inflation, how will raising them quell inflation in the near term? There is a risk that rates keep rising until demand is extinguished. So far, rate increases have impacted housing, as we had expected. Mortgage rates have increased significantly, and we are seeing home prices roll over. However, most other parts of the economy remain strong. Demand for goods and services remains strong, too. If the Federal Reserve sticks to its 2% goal for inflation there could be a lot more work to be done and a lot more risk to the economy and markets.

Circling back to Europe and the rest of the world – there is growing pressure on the Federal Reserve from other countries, the United Nations, and the International Monetary Fund to end or slow its tightening cycle. We are not sure what the Fed's calculus is on this issue. We also are not sure of the tentacles of the problems in the European banking system. We hope the Federal Reserve has better insight into this issue. It does raise some concern though.

These recent developments reaffirm our belief in our current positioning. We continue, in most industries, to be leaning toward higher quality, more stable businesses. We have reduced beta in the portfolios. All of our strategies have a beta below one as of the end of the quarter. Moreover, should the Fed end its tightening cycle prematurely, we could be in for sustained inflation. We believe this benefits value stocks, particularly small value. However, if the Fed pivots away from tightening, we could see a rebound in the longer duration, non-earning companies which have significantly underperformed this year. With a higher level of interest rates and inflation running greater than the Fed's 2% target, we don't think that rally would be sustainable. We are digging through industries where we see extreme pessimism, such as retail and housing-related companies, looking for bargains.

Energy was the top performing sector in the benchmark. Real estate and communication services were the worst performing sectors in the benchmark. Small-mid cap growth outperformed small-mid cap value.

The Victory Integrity Small/Mid Cap Value Fund (A shares without sales charge) underperformed the Russell 2500™ Value Index benchmark for the period. Stock selection in technology and health care led to slight underperformance. Security selection within industrials was the largest positive source of contribution. Sector weights were a minor positive due to our underweight in real estate and overweight to industrials. Higher earnings growth was a positive style attribute.

Within technology, selection in semiconductors was the largest detractor. Reduced probe card demand from several major customers pressured FormFactor, Inc.'s (FORM) revenue and margin outlook. Not owning First Solar, Inc. (FSLR) and Wolfspeed Inc. (WOLF), up 94% and 63% respectively, detracted. Shares of MKS Instruments, Inc. (MKSI) lagged on the pushout of the accretion timeline for the recently closed Atotech acquisition as well as concerns of slowing semicap demand. Euronet Worldwide, Inc. (EEFT), Verint Systems Inc. (VRNT), and DXC Technology Co. (DXC) also hurt performance. Euronet Worldwide, Inc. (EEFT) issued disappointing guidance as unfavorable foreign exchange and EU travel bottlenecks are pressuring margins and growth. Foreign exchange headwinds resulted in disappointing top-line results and guidance at Verint Systems Inc. (VRNT). Shares of DXC Technology Co. (DXC) fell on softer than expected bookings as management prioritized deal profitability. There were a few positives. Flex Ltd. (FLEX) outperformed on solid earnings results, expectations for an easing supply chain, and investor enthusiasm around the monetization opportunities for their Nextracker (solar) segment. Belden Inc. (BDC) posted a beat-and-raise quarter driven by strong demand. Better than expected earnings and guidance driven by solid execution as well as expectations for an easing supply chain boosted Jabil Inc. (JBL) shares.

In health care, both stock selection and our overweight to pharmaceuticals hurt performance. Underperformance of the Nexplanon franchise during the quarter and pricing headwinds caused Organon & Co. (OGN) to decline.

Solid performance in industrials was led by Clean Harbors, Inc. (CLH) as the company posted its strongest quarter on record due to better than anticipated profits in both of their segments. There were a few other notable performers. Arcosa, Inc. (ACA) posted a beat-and-raise quarter and alluded to growth tailwinds in its utility and construction product segments. Carlisle Companies Inc. (CSL) benefited from a strong beat-and-raise quarterly result as gross margins in its construction materials business outperformed expectations once again. Regal Rexnord Corp. (RRX) outperformed following a tough second quarter as investors gravitated back toward North American focused industrial names. EMCOR Group, Inc. (EME) delivered strong quarterly results and continues to grow its backlog above trend despite concerns about interest rate impacts on construction. Shares of WESCO International, Inc. (WCC) outperformed as the company is domestically focused, posted upside quarterly results, and provided better than expected investor day targets. Curtiss-Wright Corp. (CW) benefited as investors sought out defense and nuclear-exposed names and it reported better than expected results. Greenbrier Companies, Inc. (GBX) hurt performance as the company announced underwhelming earnings as the drag from European operations will be larger and last longer than expected.

Selection in materials hurt performance. Berry Global Group Inc. (BERY) underperformed due to its higher than average debt load and exposure to the European consumer. Steel Dynamics, Inc. (STLD) and its peers gave mid-quarter updates which showed weaker gross margins due to higher input costs and weaker steel demand.

Energy was a minor negative as our average holding underperformed the benchmark (5.9% vs 7.7%). CONSOL Energy (CEIX) and Chord Energy Corp. (CHRD) were positive highlights. CONSOL Energy Inc. (CEIX) achieved strong quarterly results driven by higher realizations at their mining facility. The company also announced a special dividend and introduced a plan to return 35% of their free cash flow to shareholders. Chord Energy Corp. (CHRD) was up 29% as the company completed their previously announced acquisition of Whiting Petroleum (WLL) and announced a higher level of capital return to shareholders.

Overall security selection in financials was neutral. Banks lagged as our average holding underperformed the benchmark (0.2% vs. 2.1%). In capital markets, Artisan Partners Asset Management, Inc. Class A (APAM) detracted as the company was hurt by lower and volatile financial markets. Stock selection in insurance was a positive. Unum Group (UNM) raised guidance and revealed a plan to return more cash to shareholders via buybacks. Higher interest rates and stronger jobs helped top-line growth and reduced liabilities. Kinsale Capital Group (KNSL) achieved strong top- and bottom-line growth during the quarter. The company also provided additional commentary on strong submissions activity that portends stronger growth going forward.

Real estate was a positive, largely due to our underweight. Higher interest rates and inflation were headwinds for REITS, and this impacted our holdings such as Highwoods Properties, Inc. (HIW) and SITE Centers Corp. (SITC).

Consumer discretionary was a small positive. Casual diners such as Bloomin' Brands, Inc. (BLMN) outperformed as earnings were better than feared, off-premise sales remained resilient, and elevated grocery store inflation enhanced the value proposition of the group. Signet Jewelers Limited (SIG) was a relative outperformer as management provided an optimistic tone at recent investor conferences. Newell Brands Inc. (NWL) detracted after the company cut guidance as a larger than expected pullback in retailer orders and an elevated inflationary environment put pressure on the consumer.

BJ's Wholesale Club Holdings, Inc. (BJ) was the main highlight in consumer staples. BJ's Wholesale Club Holdings, Inc. (BJ) announced strong earnings and comp sales. The company also increased guidance as consumers flocked to retailers with perceived value. Coty Inc. Class A (COTY) detracted on concerns that a large licensor may internalize their beauty business.

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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 9/30/2022 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 9/30/2022 were SouthState Corp (1.3%), Synovus Financial Corp (1.2%), Curtiss-Wright Corp (1.2%), Prosperity Bancshares, Inc (1.2%), Apartment Income REIT Corp (1.2%), Western Alliance Bancorp (1.1%), Wintrust Financial Corp (1.1%), Perrigo Co Plc (1.1%), Nexstar Media Group, Inc (1.1%), and Bank of Hawaii Corp (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.

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