INTEGRITY ASSET MANAGEMENT



# Quarterly Commentary

*I was working in the lab late one night*
*When my eyes beheld an eerie sight*
*For my monster, from his slab, began to rise*
*And suddenly, to my surprise*
*He did the Mash,*
*He did the Monster Mash"*

– Bobby Pickett, "Monster Mash"

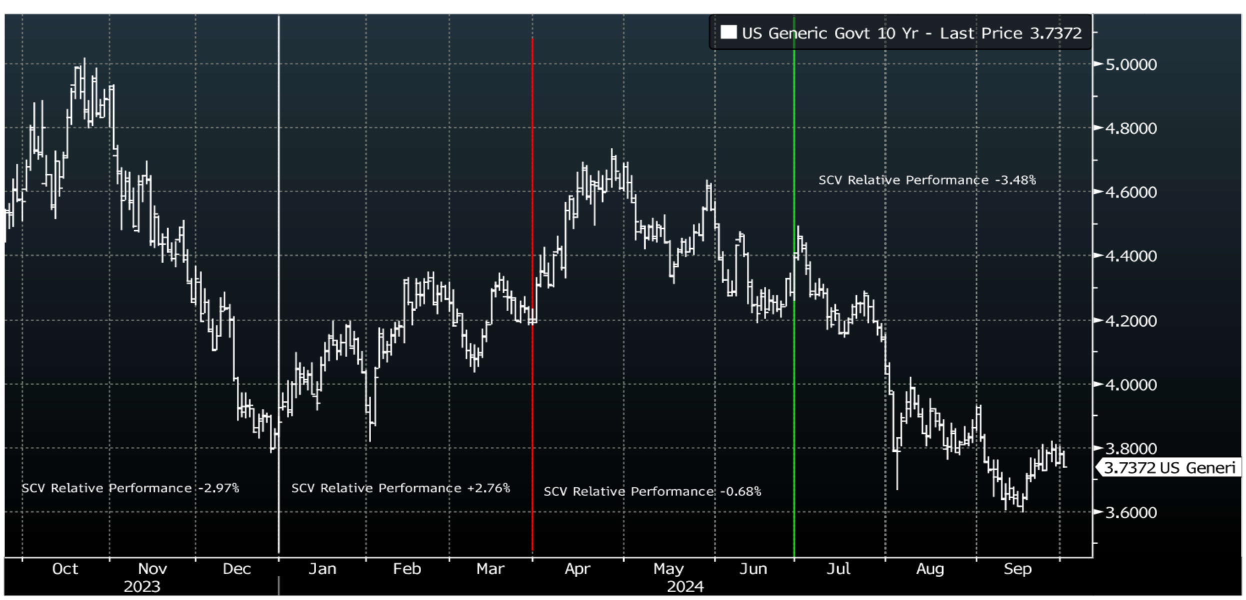
**Return of the Living Dead**

Just in time for Halloween, falling 10-year U.S. Treasury yields spurred a rally in the non-earning companies in our benchmarks. The largest impact was in the Russell 2000® Value Index, where about 16% of the companies don't make money. These "zombie" companies are sometimes the proverbial tail that wags the dog.

We have written volumes on this issue as well as our lack of exposure to these companies. Looking at the following chart of the 10-year U.S. Treasury yield, one can see the strong correlation with our relative performance (Integrity Small Cap Value Composite vs. the Russell 2000® Value Index). While this wasn't the sole determinant of our relative performance, the recent yield swings have had a significant impact.

Why don't we own these companies? That is a fair question. We strongly believe that cash flow is a prerequisite for long-term survival. It is the oxygen of company fundamentals.

**10-Year U.S. Treasury Yield and Small Cap Value Relative Performance**




*Source: Bloomberg*

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We dug a little deeper into these non-earners. Instead of just looking at companies losing money this fiscal year, we took a more conservative cut. We screened for companies that had no cash flow from operations last year and have never made money in their history (negative retained earnings). We see these as the true zombies in the graveyard.

Here's what we found: 292 companies that make up about 8% of the weight of the benchmark. Of those companies, 282 show some level of indebtedness. The average cost of that debt is 5.0%, with a median cost of 5.1% and a range of 0.7% to 10.5%. We don't know where rates are going, but we would argue it is safe to assume the refinancing rate on this debt is higher, not lower.

Our contention has been, and still is, that we are in a period of normalizing interest rates. The Federal Reserve has cut rates and will likely do so again. We don't know where rates will end up. However, the reaction among the zombie companies suggests that investors are expecting a return to near-zero rates. We strongly believe the rate environment post financial crisis was an anomaly, not normalcy.

When will companies need to refinance or require more cash? To get a sense of this, we compared cash on the balance sheet relative to last year's cash flow from operations. What we found is that over 67% of these companies have two years or less of cash on the books.

What will the new cost of capital be? How long will the market continue to fund these companies now that there is an opportunity cost to money with interest rates being higher than zero? We don't know the answer to these questions, but our guess is that the cost of new capital is higher. If we are right, we also believe there will be less of it available for money-losing speculative companies. Ultimately, companies need cash flow to survive. We see this as a long-term opportunity for relative performance, although the path will likely be a little bumpy.

Consumer staples and financials were the top performing sectors in the benchmark. Energy was the worst performing sectors in the benchmark. Micro cap growth outperformed micro cap value.

The Victory Integrity Discovery Fund (A shares without sales charge) underperformed its benchmark, the Russell Microcap® Value Index. Security selection in materials and energy were the main reasons for underperformance. Stock selection in financials and industrials aided performance. Sector allocations were a headwind as we were underweight financials, the best performing sector. A larger market cap was a negative style attribute.

Heritage Insurance Holdings, Inc. (HRTG) and our bank holdings led to the strong relative results in financials. Heritage Insurance Holdings, Inc. (HRTG) rose 73% thanks to solid earnings due to lower storm losses and improved pricing. A benign start to hurricane season and a resumption of growth due to better pricing were additional positives. Our average bank holding outperformed (20.28% versus 17.55%), led by Dime Community Bancshares, Inc. (DCOM) and ConnectOne Bancorp, Inc. (CNOB), which were up 43% and 34%, respectively. Banks fared well thanks to solid results along with expectations of lower interest rates after softer inflation data.

Willdan Group, Inc. (WLDN) was the most significant contributor within industrials. It posted a beat-and-raise quarter as growth in electricity usage at data centers for AI is driving increased demand for their services. Interface, Inc. (TILE) rallied 29% aided by steady results and raised guidance.

Consumer discretionary was a minor positive. Latham Group Inc. (SWIM) increased 124% and was the overall largest contributor. It reported better-than-expected second quarter results and announced an accretive acquisition that helps accelerate their pool liner penetration. Additional positives included Wolverine World Wide, Inc. (WWW), Portillo's, Inc. Class A (PTLO), and Chuy's Holdings, Inc. (CHUY). Optimism for improved second-half results as well as news of activist involvement lifted Portillo's, Inc. Class A (PTLO). A beat-and-raise quarter resulting from solid performance from their Merrell, Saucony, and Wolverine brands as well as an analyst upgrade boosted shares of Wolverine World Wide, Inc. (WWW). Chuy's Holdings, Inc. (CHUY) announced they would be acquired by Darden Restaurants. Some of this was offset by weakness elsewhere. Red Robin Gourmet Burgers, Inc. (RRGB) underperformed on a large downward EBITDA guidance revision. We exited the position. A softer-than-expected boat demand environment led to an earnings miss and lowered guidance at OneWater Marine Inc. Class A (ONEW). European Wax Center, Inc. Class A (EWCZ) announced an unexpected CEO change as well as a reduction in guidance and unit growth expectations.

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Clearwater Paper Corporation (CLW) and Metallus Inc. (MTUS) were weak performers in materials. Pricing pressure and higher maintenance/outage costs within paperboard hurt Clearwater Paper Corporation (CLW). A softer demand environment led to weaker volumes, pricing, and profitability at Metallus Inc. (MTUS). Conversely, Advansix, Inc. (ASIX) gained 31%. It reported better-than-expected results thanks to strong pricing in ammonium sulfate for the fertilizer market.

Energy was a modest detractor. Vital Energy, Inc. (VTLE) fell due to disappointing results and the announcement of a large acquisition. Additionally, concerns over near-term demand softness and potentially higher supply from OPEC+ production weighed on oil stocks. Berry Corporation (BRY) declined 18% due to higher-than-expected Capex which led to a miss on free cash flow. Solaris Energy Infrastructure, Inc. Class A (SEI) was a notable positive. It reacted favorably to an announced agreement to acquire privately held Mobile Energy Rentals, LLC.

Technology was a small negative. An unexpected product cancellation impacted results at Kimball Electronics, Inc. (KE). Conversely, Thoughtworks Holding Inc. (TWKS) was up 56%. It announced it would be acquired by Apax Partners for a premium.

Communication services was a very minor negative. Weakness in PubMatic, Inc. Class A (PUBM) offset gains from Marcus Corporation (MCS). PubMatic, Inc. Class A (PUBM) issued disappointing top-line results and guidance, pressured by softness in several ad verticals and a headwind from a change in bidding approach at a large DSP partner. The theater division at Marcus Corporation (MCS) was helped by a box office recovery, while the hotels division also produced solid results, benefitting from an occupancy recovery and the Republican National Convention.

**Past performance does not guarantee future results.** For standardized performance, please visit www.vcm.com.

**Carefully consider a fund's investment objectives, risks, charges and expenses before investing. To obtain a prospectus or summary prospectus containing this and other important information, visit www.vcm.com/prospectus. Read it carefully before investing.**

**All investing involves risk, including the potential loss of principal.** Micro-cap companies may have narrower markets and be difficult to buy and sell. Micro-cap companies may have limited products or resources and may experience higher failure rates than larger, more seasoned companies. Investments concentrated in an industry or group of industries may face more risks and exhibit higher volatility than investments that are more broadly diversified over industries or sectors. Companies in the financial services sector are subject to extensive governmental regulation that may affect the scope of their activities, the prices they can charge and capital maintenance. The industry is subject to severe competition and can be significantly affected by market conditions, including interest rate changes. Investments in companies in the industrials sector may be adversely affected by changes in supply and demand for products and services, governmental regulation and changes in spending policies, world events and economic conditions. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. The value of your investment is also subject to geopolitical risks such as wars, terrorism, environmental disasters, and public health crises; the risk of technology malfunctions or disruptions; and the responses to such events by governments and/or individual companies.

**The Russell Microcap® Value Index** is a market- capitalization-weighted index that measures the performance of Russell Microcap® Index companies (1,000 smallest stocks in the Russell 2000® Index plus 1,000 smaller U.S.-based listed stocks) with relatively lower price-to-book ratios and lower forecasted growth values. It represents the value-oriented micro-cap segment of the U.S. equity market.

Fund holdings mentioned in the Quarterly Commentary are as of 9/30/2024 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 9/30/2024 were Brookdale Senior Living Inc (1.4%), Artivion, Inc (1.2%), NETSTREIT Corp (1.2%), Plymouth Industrial REIT, Inc (1.1%), Dynex Capital Inc (1.1%), Great Lakes Dredge & Dock Corp. (1.1%), Advansix, Inc (1.1%), Columbus McKinnon Corp (1.1%), Wildan Group, Inc (1.1%), and Global Medical REIT, 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.

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