DISTILLATE CAPITAL

2020 Q2 Letter to Investors & Introduction of the International Fundamental Stability & Value Strategy

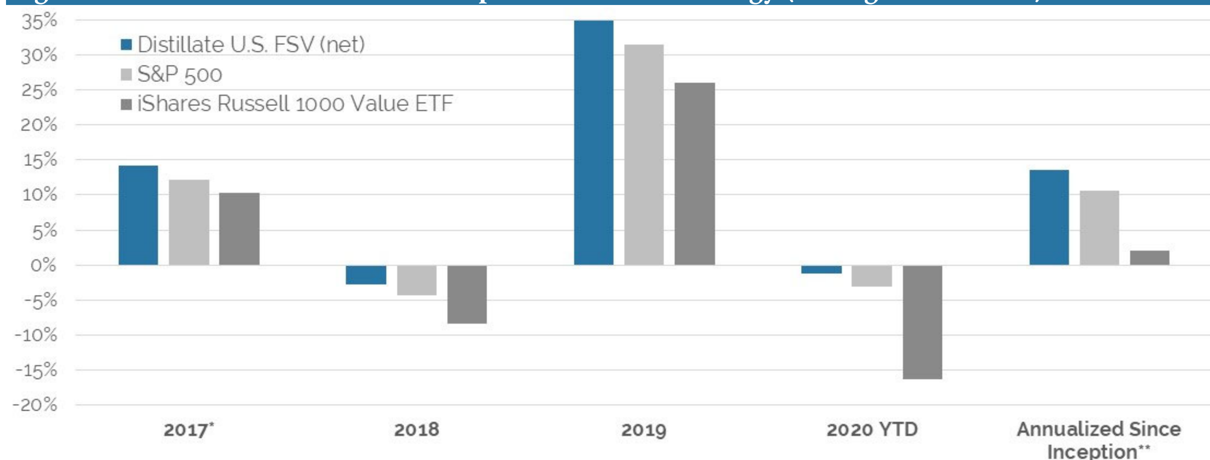
Strategy Summary

Distillate Capital's Fundamental Stability & Value strategies seek to outperform over the long-term by minimizing risk and investing in stocks that are more fundamentally stable, less levered, and more attractively valued.

U.S. Performance: Despite the challenging backdrop and extremely concentrated gains among a few of the largest stocks in the market, Distillate's U.S. FSV strategy has continued to outperform the overall S&P 500 Index. The U.S. FSV's year-to-date decline of 1.19% through Q2 2020, is ahead of the comparable drop of 3.08% for the S&P 500 and 15.1 percentage points above the -16.3% return for the iShares Russell 1000 Value ETF. This follows outperformance in each of the three prior years with the result that annualized performance since inception is 2.9 percentage points above the S&P 500 and 11.4 percentage points above the Russell 1000 Value ETF on an after-fee basis (**See Figure 1**).

After lagging in the earlier part of the year, outperformance occurred both in the sharp market decline as well as in the recovery. By stock, Regeneron and Citrix contributed roughly 50 basis points each to outperformance versus the S&P 500 Index and Fortinet, Align Technology, Proctor & Gamble, and AbbVie each added around 20 basis points. The largest detractors from relative performance were unowned names with Amazon's 49.3% gain as of the end of the quarter subtracting almost 1.7 percentage points from relative performance, and Netflix, PayPal, Nvidia, and Microsoft cumulatively subtracting another 1.6 percentage points.

Figure 1: Performance of Distillate Capital's U.S. FSV Strategy (through 6/30/2020)



* Strategy inception of 5/31/2017 through 12/31/2017

** Strategy inception of 5/31/2017 through 6/30/2020

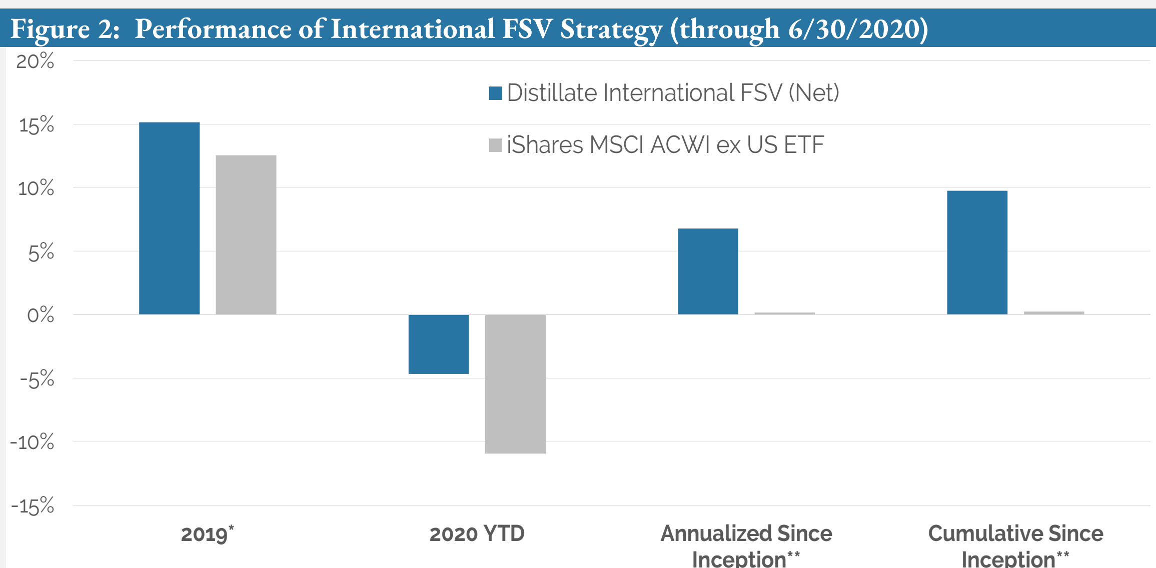
Please see important performance disclosures at the end of this document.

Introducing Distillate's International Fundamental Stability & Value Strategy (INTL FSV)

Modeled after the U.S. FSV strategy, Distillate Capital launched an international FSV strategy with a GIPS-compliant track record in January of 2019. The starting universe consists of non-U.S. stocks with daily liquidity of over $20 million, which corresponds to roughly 90% of the MSCI All Country World Index Ex-US (ACWI-EX). Similar to the U.S. version, the strategy seeks to invest in the 100 most attractively valued stocks with high levels of long-term fundamental stability and low leverage. The strategy is currently available in a separate account format, with additional vehicles considered based on client need.

Performance: The international FSV strategy performed well in the up-market of 2019* with performance of 15.1% versus the MSCI ACWI-EX U.S. ETF's 12.6%, and has outpaced the benchmark again in 2020 with a net of fee return through Q2 of -4.7% versus -10.9% for the benchmark. As a result of outperformance in both years, annualized performance since inception is ahead of the benchmark by 6.6 percentage points (**See Figure 2**).

Figure 2: Performance of International FSV Strategy (through 6/30/2020)



* Strategy inception of 1/31/2019 through 12/31/2019 ** Strategy inception of 1/31/2019 through 6/30/2020
Please see important performance disclosures at the end of this document.

Portfolio Changes & Valuation: The weighted average free cash flow yield on next-twelve-month consensus estimates for the International FSV strategy of 6.4% is substantially higher than the comparable yield of 4.9% for the iShares MSCI ACWI Ex-US ETF. In addition to being substantially better valued on a free-cash-basis, the strategy also has significantly more stable long-term fundamentals and less financial leverage than the broader international benchmark (**See Table 1**).

Distillate Capital's INTL FSV Strategy is less expensive, more fundamentally stable, and less levered than the ACWI Ex-U.S. benchmark.

Table 1: International FSV Portfolio Characteristics*

	Intl. FSV	ACWI Ex-US
Free Cash Flow Yield (NTM)	6.4%	4.9%
Free Cash Flow Yield (2021)	7.0%	5.3%
P/E	19.3	23.5
Fundamental Stability	0.80	0.50
Leverage	0.48	1.78

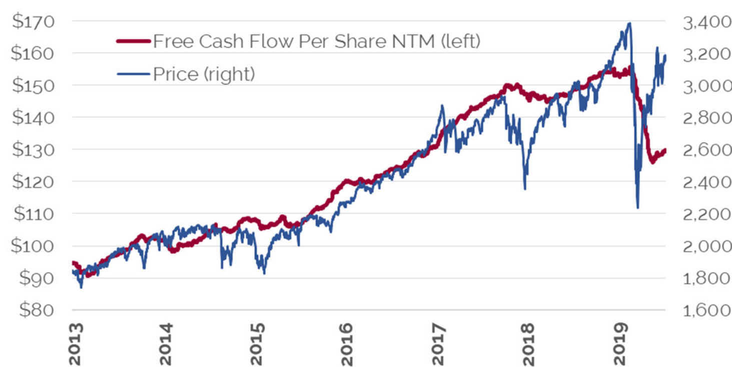
*as of 7/2/2020; See footnotes on page 4.

Market Backdrop

Amid the uncertainty and severe economic damage of the coronavirus crisis, the equity market fell sharply alongside rapidly declining estimates for next-twelve-month (NTM) free cash flows in February and March. The market then experienced a rapid but very uneven rebound and free cash flow estimates began to stabilize (**See Figure 3**).

S&P 500 estimated free cash flows have fallen more than the price in 2020.

Figure 3: S&P 500 Index Price vs. Next-Twelve-Month (NTM) Estimated Free Cash Flows Per Share



Source: FactSet

With the market down significantly less than NTM free cash flows, the free cash yield on the market fell to 4.1% from 4.8% at the end of last year. While the attractiveness of the market on that metric is obviously less, valuation of the market on a free cash flow basis is not expensive in an historical sense. More interesting, we see a complicated story underneath the surface, where the aggregate figure is being distorted by very depressed fundamentals on one side and very rich valuations from select large companies on the other. In combination, these two factors are masking a potentially attractive opportunity set within the market.

The first issue in looking at valuations is that near-term cash flow estimates are depressed by the current crisis. One simple solution is to look at the trend of free cash flows per share and estimate a normal level of around $155 for the S&P 500, which corresponds to a free cash yield of 5.2%. However, that approach ignores the risk that some businesses may suffer more structural impairments to their earning potential, as well as the fact that a number of companies have already diluted shareholders by issuing equity.

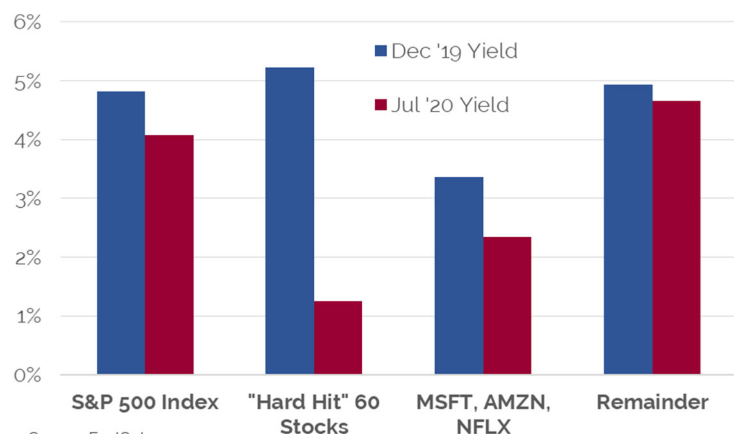
Alternatively, we can look at valuations by building on a recent analysis we did showing how the crisis is disproportionately hurting particular businesses. We split the S&P 500 into a group of roughly 60 "hard-hit" companies that includes stocks in the energy sector (plus Sempra Energy in Utilities); the airline industry (plus Boeing and General Electric from the industrial sector); the auto industry; hotels, restaurants and leisure (including Disney, Expedia, and Booking Holdings); and the textile and luxury retail industry. This group of 60 stocks made up slightly over 10% of the market cap of the S&P 500 Index at year-end 2019. But due to the collective almost 90% reduction in NTM free cash estimates for the group, they alone account for 80% of the decline in estimated free cash flow for the overall S&P 500. In terms of valuation, the free cash yield on NTM estimates for this hard-hit group of stocks has plummeted from around 5.2% at year-end 2019, to just over 1% as of July 8, 2020.

On the other side of the market, a number of very large stocks have become richly valued and this too is distorting the overall valuation. While there are a number of stocks where this is the case, if we look at just the combination of Amazon, Netflix, and Microsoft, the combined market capitalization of the three has increased by 49% from the end of 2019 to July 8. Against a 4% increase in estimated NTM free cash flows over the same period for the three companies, the combined free cash yield dropped from around 3.4% to 2.3%. If this group is excluded from the broader index along with the hard-hit stocks, the yield on the remaining universe increases to 4.7%, which is roughly in line with the year-end 2019 figure (**See Figure 4**).

While a lot of cautionary commentary takes issue with the market's stability and recovery from the lows, we see a potentially more attractive opportunity beneath the surface. And in general, we take as a positive the angst we read and hear as it would be more concerning if the commentators and pundits were universally bullish, and that seems not the case at present. It is between the two ends of the market that we are finding substantial opportunity, which we will discuss in the portfolio changes section on the following page. This is not to say that there are not opportunities within the hard hit groups, but a number of those companies are saddled with high levels of debt and many look to be at risk of longer-term impairment to their businesses or have issued equity that will dilute any rebound. Some healthier stocks in this group have also rallied substantially from the trough and look less attractive from a risk/reward perspective at present.

The overall 4.1% free cash yield on the market is being distorted by very depressed fundamentals among 60 "hard hit" stocks and several very expensive ones on the other end and would be 4.7% without these stocks.

Figure 4: S&P 500 Free Cash Yield on Next-Twelve-Month (NTM) Projected Free Cash Flows



Source: FactSet

Portfolio Changes and Valuation

After rebalancing, the weighted average free cash flow yield for the U.S. FSV strategy is 5.6% versus a comparable yield of 4.1% for the S&P 500.[1] If we look at valuations against 2021 estimates, which may offer a less distorted picture, the strategy's yield of 5.9% is also well above the S&P 500's comparable yield of 4.6%. The rebalanced U.S. FSV strategy also has significantly more stable long-term fundamentals and less financial leverage than the S&P 500 Index, which we believe will continue to be important attributes amid ongoing near-term economic pressures (**See Table 2**).

Distillate Capital's U.S. FSV Strategy is less expensive, more fundamentally stable, and less levered than the S&P 500.

Table 2: U.S. FSV Portfolio Characteristics*

	U.S. FSV	S&P 500
Free Cash Flow Yield (NTM)[1]	5.6%	4.1%
Free Cash Flow Yield (2021)[2]	5.9%	4.6%
P/E[3]	20.8	32.2
Fundamental Stability[4]	0.86	0.70
Leverage[5]	1.07	1.30

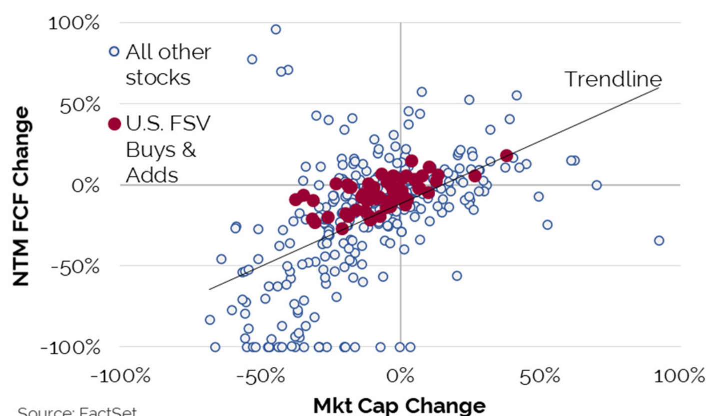
*as of 7/8/2020

Building on the commentary from the previous page, while the overall market has fallen much less than next-twelve-month free cash flow estimates, there are a number of stocks where the reverse occurred and valuations have improved. This generally characterizes the newly purchased stocks or positions that were increased with the recent rebalance. The scatter plot in **Figure 5** shows market cap changes on the X axis and the change in next-twelve-month free cash flows on the Y axis (companies where free cash flows fell below zero are shown at -100% on the Y axis for all stocks with available data). As the trendline highlights, market caps generally declined less than estimated free cash flows. This makes sense since stocks are supposed to discount the present value of long-term future free cash flows and so should not reflect weakened near-term fundamentals on a one for one basis.

For a number of stocks, including many of those that the FSV strategy added-to or purchased as new positions, however, the opposite occurred. For this group, market values fell by more than free cash flows such that valuations actually became more attractive. Others that were newly purchased or increased had their relative valuations improve and were above the trendline for the overall market. Purchases and additions are highlighted in red in **Figure 5**. The relationship is not perfect since our valuation framework looks at normalized free cash figures that make a series of systematic adjustments and incorporate leverage, but we believe the illustration it is still representative of portfolio changes.

Market caps have generally fallen less than estimate free cash flows, but the US FSV portfolio has bought and added when the reverse occurred.

Figure 5: Year-to-Date Change in Market Value vs. Estimated Free Cash Flows for S&P 500 Stocks



Source: FactSet

Sector Changes: After being the strongest performing sector in Q2 2020, the consumer discretionary sector saw the biggest decline in weight in the portfolio, down 3.7 percentage points. Smaller reductions occurred in the materials, industrials, and health care sectors. These declines were offset by a roughly 5.5 percentage point increase in the consumer staples sector, which lagged considerably in Q2. The staples sector has seen its market capitalization decline by more than its projected free cash flows from year-end 2019 to Q2 2020, with FCF yields on next-twelve month estimates increasing from 4.8% to 5.0%.

Sells: Generally, stock sales resulted from valuations becoming less attractive. However, AT&T and IBM exited the portfolio as they no longer met the quality criteria for inclusion with AT&T exceeding the debt limit and IBM falling out due to deteriorating long-term fundamental stability.

Trims: Apple and Facebook saw the largest reductions in weight with Apple declining a full percentage point to 5.5% and Facebook declining to a roughly 2% position. These adjustments resulted from the fact that the price gains for the stocks exceeded changes in normalized free cash flows in the quarter. Since weightings reflect the level of normalized free cash flows, the positions were trimmed.

[1] Free Cash Flow Yield is based on the next-twelve-month free cash flow estimate relative to market capitalization. Stocks without estimates in the index are excluded and the remaining names are reweighted based on those exclusions.
[2] Free Cash Flow Yield is based on 2021 free cash flow estimate relative to market capitalization. Stocks without estimates in the index are excluded and the remaining names are reweighted based on those exclusions.
[3] P/E is based on consensus estimates for next-twelve-months and excludes P/Es over 250 and under 0 to avoid the distortion from outliers.
[4] Fundamental stability is Distillate Capital's proprietary measure of through-cycle cash flow stability with a higher value indicating greater stability.
[5] Leverage is based on Distillate Capital's proprietary measure of indebtedness which looks at the ratio of adjusted net debt to an adjusted measure of forecast Earnings Before Interest, Taxation, Depreciation, and Amortization (EBITDA.)

These changes highlight how the weighting methodology reduces positions where valuations have become less attractive and vice versa.

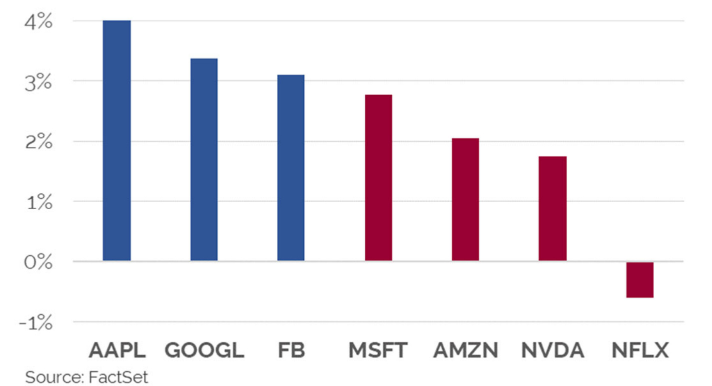
Buys: The largest new positions in the quarter are Alphabet and Proctor & Gamble. P&G is an example of a stock where the free cash yield has actually improved over the course of the year on both next-twelve-month estimates and our normalized methodology. With Alphabet, the stock is up year-to-date, but its valuation has become more attractive as its normalized free cash estimates have risen further.

Additions: The biggest additions to the portfolio in the rebalance were Biogen and Philip Morris, each increasing around 30 basis points as their relative valuations improved over the quarter.

Big Tech Exposure: With positions in Apple, Facebook, and Alphabet, we think it is worth briefly discussing the valuations for these stocks on our normalized cash yield methodology and how they look relative to the other major tech stocks. Facebook, Amazon, Apple, Netflix, and Google are often grouped together with the acronym FAANG with Microsoft and Nvidia sometimes included in various rearrangements of the acronym. This group of tech stocks consistently and homogeneously looks expensive on the basis of price-to-book (P/B) and price-to-earnings (P/E), largely due to accounting treatments of R&D spending. This makes comparisons among the group and against other stocks in the market largely meaningless using P/E or P/B and highlights why we employ a free cash flow based methodology that does not suffer from such distortions. On our normalized free cash yield methodology, a more nuanced picture of valuation for the group emerges with Apple, Alphabet, and Facebook looking the least expensive. Given each has little debt and high fundamental stability, they are holdings. Microsoft, which was held in the first quarter, has since become significantly more expensive with a yield under 3% and was previously sold. Amazon, Nvidia, and Netflix all appear even more expensive with the cheapest of them, Amazon, being twice as expensive on a FCF yield basis as Apple (**See Figure 6**.)

Despite being lumped together, big tech valuations on our normalized cash yield are more diverse than is often suggested.

Figure 6: Big Tech Normalized Cash Flow Yields



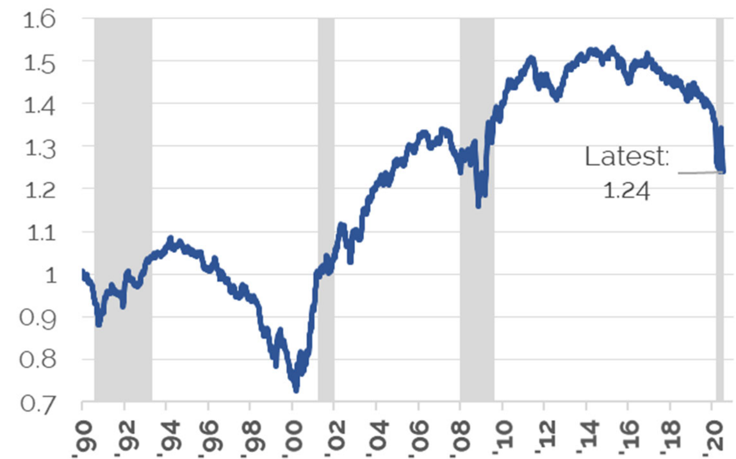
Index Overlap & Market Breadth

Despite holding several large companies -- Apple, Alphabet, Facebook, Johnson & Johnson, and Proctor & Gamble -- the overall FSV portfolio is skewed towards smaller stocks. The portfolio's weighted average market cap is around half that of the S&P 500 Index, and as a result, the total overlap of our strategy and the S&P 500 index is around 30%. Said differently, FSV has an active share of 70% despite some overlap among larger companies.

This smaller stock bias looks very appealing at present from a historical perspective. Typically in recessions (or in the bubble of the late 1990s), bigger stocks outperform and the equal-weighted index lags. Coming out of recessions, however, the equal weighted index tends to bounce back strongly and outperform the capitalization-weighted index (**See Figure 7**). In this sense, the current underperformance of the equal-weight index and outperformance of the largest stocks looks no different from history. Given where we are seeing better valuations, the set-up exists again for intra-market performance that will diversify beyond the largest names, and where the equal-weighted index could outperform the cap weighted S&P 500.

The equal weight index typically lags the standard capitalization weighted S&P 500 Index in downturns, but bounces back in recoveries.

Figure 7: S&P 500 Equal Weight Index Relative to the Capitalization-Weighted Index



Summary

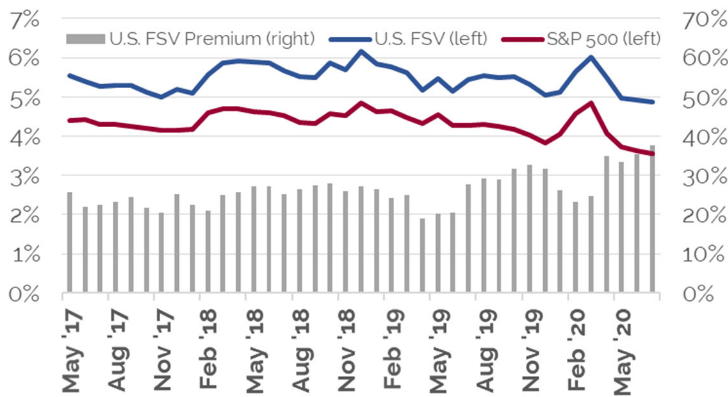
Overall, we are encouraged by the prospective opportunities being presented by the very uneven market environment.

Internationally, valuations have become more appealing. After consistently being more expensive than the S&P 500 Index on a free cash flow basis since the financial crisis, the ACWI-EX U.S. index now finally offers a somewhat better valuation than the U.S., and the International FSV's free cash yield is substantially higher than that of its benchmark.

Domestically, we are also optimistic about the combination of value and quality offered in the FSV strategy. While the absolute level of the strategy's normalized cash yield is being somewhat depressed by the current crisis, the relative attractiveness of FSV to the market is now at the highest premium to the index we have seen since the strategy's inception (**See Figure 8**).

The normalized cash yield on the U.S. FSV strategy appears attractive on an absolute level despite depressed conditions and is at record premium to the comparable yield on the S&P 500 Index.

Figure 8: Normalized Cash Flow Yield for U.S. FSV Strategy vs. the S&P500 Index



Source: FactSet

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Distillate claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Distillate has been independently verified for the periods June 1, 2017 through November 30, 2018. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

*To receive a GIPS compliance presentation and/or our firm's list of composite descriptions please email your request to **info@distillatecapital.com**.*

The U.S. Dollar is the currency used to express performance. Returns are presented net of management fees and include the reinvestment of all income. For non-fee-paying accounts, net of fee performance was calculated using a model management fee of 0.39%, which is the highest investment management fee that may be charged for this composite. For accounts calculated with a per share, net-of fee NAV, gross performance was calculated by adding back the unitary fee associated with that fund. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The investment management fee schedule for the composite is 0.39%; however, actual investment advisory fees incurred by clients may vary.

The U.S. Fundamental Stability & Value composite seeks to distill a starting universe of large cap U.S. equities into only the stocks where quality and value overlap using Distillate's proprietary definitions. Its goal is to achieve superior compounded long-term returns by limiting downside in periods of market stress, while still providing strong performance in up markets. This composite was created in May 2017.

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***Free Cash Flow** refers to a company's operating cash flow, less its capital expenditures.*

***Enterprise Value** refers to a company's market capitalization plus its net debt balance.*

***Free Cash Flow to Enterprise Value Yield** refers to a company's or group of companies' free cash flow divided by the company's (or companies') Enterprise Value, with a higher resulting ratio indicating a more attractive valuation.*

***Normalized Free Cash Yield (or Distilled Cash Yield)** refers to the firm's proprietary valuation measure that looks at estimated, adjusted free cash flow relative to a company's adjusted enterprise value. References to historical stocks that ranked well using this methodology refer only to these stocks' historical valuation and not their inclusion in any actual or hypothetical strategies/accounts managed by Distillate Capital Partners LLC.*

*The **S&P 500 Index** is an index of roughly the largest 500 U.S. listed stocks maintained by Standard & Poor's. The **iShares MSCI ACWI Ex-US ETF** is an investable benchmark used as a proxy for its underlying index, the **MSCI ACWI ex USA Index**, an index managed by MSCI representing large and mid cap stocks outside of the U.S.*

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