DISTILLATE CAPITAL

# 2020 Q3 Letter to Investors: Why We Owned... and *Sold* Apple

***Strategy Summary***

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

**U.S. Performance:** Despite the headwind from extremely concentrated gains among a few of the largest stocks in the market, Distillate's U.S. FSV strategy's year-to-date return of 6.20% remains ahead of S&P 500 Index's return of 5.57% and is nearly 18 percentage points above the Russell 1000 Value ETF's return of -11.64% (**See Figure 1**). By stock, Regeneron and Citrix contributed roughly 40 basis points each to outperformance versus the S&P 500 Index so far this year while the largest detractors are unowned names that now look very expensive on a free-cash-flow basis (see summary section on p. 6) with Amazon's 70% year-to-date gain subtracting over 2% from relative performance and Nvidia, PayPal, Microsoft, Netflix, and Adobe combining to detract another 2%.

**International Performance:** Distillate's International FSV strategy has continued to outperform the iShares MSCI All Country World Ex US (ACWI-EX) ETF with a year-to-date return of 3.72%, considerably ahead of the -5.27% return for the benchmark (**See Figure 2**). Relative performance has been well diversified by stock with the largest contributor, Tencent, adding one percentage point of this total. Performance has also been well dispersed across sectors and geographies.

**Figure 1: Performance of Distillate's U.S. FSV Strategy (through 9/30/2020)**

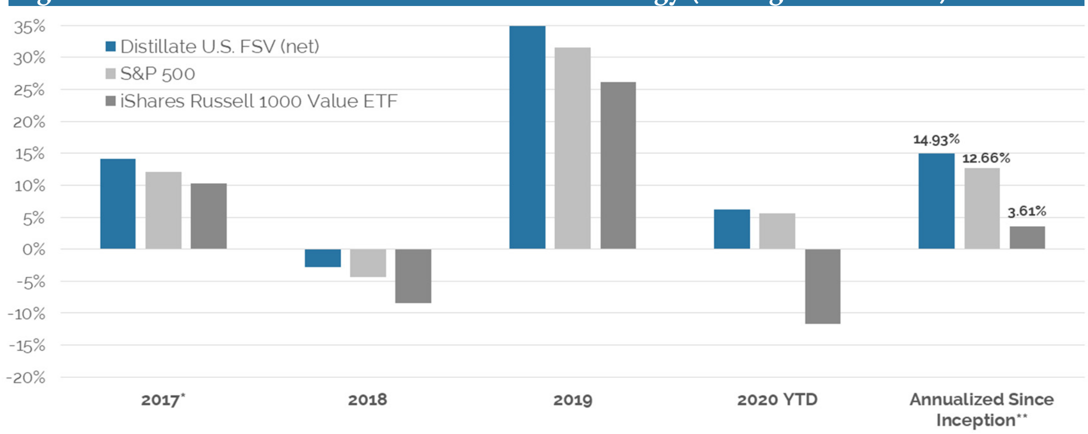
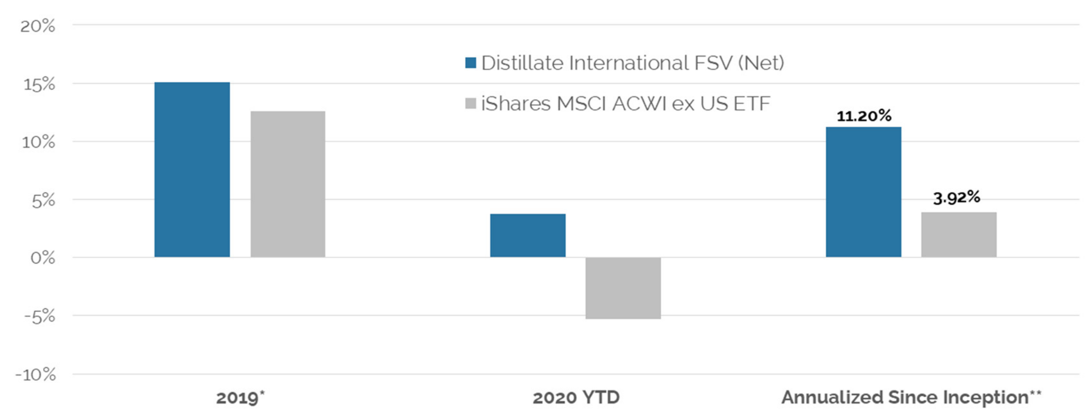



**Figure 2: Performance of Distillate's International FSV Strategy (through 9/30/2020)**




* Strategy inception of 5/31/2017 through 12/31/2017 for US FSV; 1/31/2019 through 12/31/2019 for INTL FSV

** Strategy inception of 5/31/2017 through 9/30/2020 for US FSV; 1/31/2019 through 9/30/2020 for INTL FSV

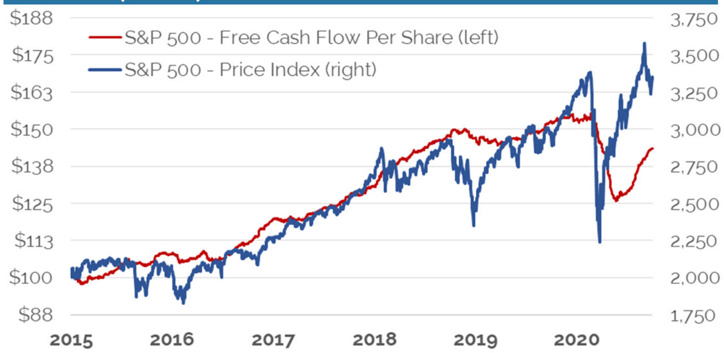
**Please see important performance disclosures at the end of this document.**

# Market Backdrop

After recovering sharply from the March lows, the S&P 500 Index sold off somewhat toward end of the quarter. In contrast to falling prices, fundamentals, as measured by estimates for next-twelve-month (NTM) free cash flows, have continued to move higher for the overall market despite the challenging environment and severe headwinds faced by a number of companies (**See Figure 3**).

*S&P 500 estimated free cash flows are recovering.*

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

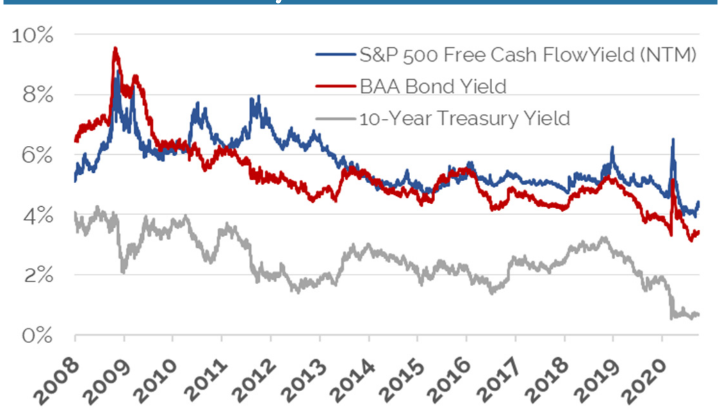



Source: FactSet

This combination of a declining headline price and ongoing recovery in free cash flow estimates has led to a recent improvement in equity valuations with the free cash flow yield on NTM estimates rising to 4.3% as of the end of the quarter. This uptick in the equity free cash flow yield occurred as the 10-year Treasury and BAA bond yields, which the equity yield has somewhat tracked recently, remained largely flat (**See Figure 4**).

*The free cash yield on the S&P 500 Index is higher than the BAA bond yield, which it has generally tracked in recent years.*

**Figure 4: S&P 500 Free Cash Flow Yield vs. BAA & 10-Year Treasury Bond Yields**




Source: FactSet

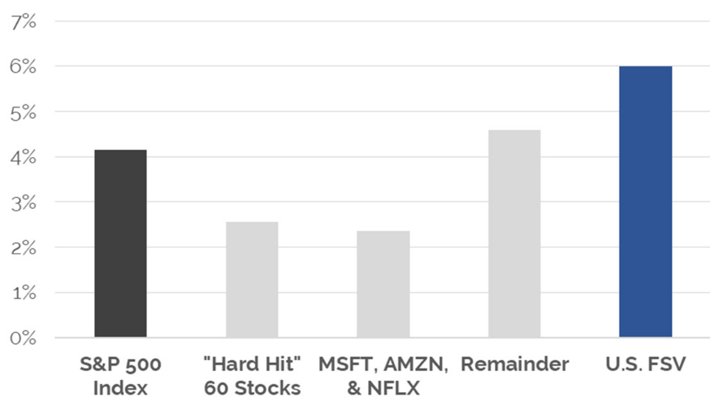
However, we believe looking at the overall market valuation at present misses two important issues that are masking a much more attractive set of opportunities beneath the surface. First, conditions for many companies are currently very depressed and this is downwardly biasing the overall yield. In order to better understand the very asymmetric impact of the pandemic, we previously dissected the S&P 500 and isolated a group of roughly 60 "hard-hit" companies that made up slightly over 10% of the value of the S&P 500 Index at year-end 2019, but that accounted for 80% of the reduction in NTM free cash estimates through Q2 (for more see our June paper *A Lopsided Crisis*). In terms of valuation, the free cash flow yield on NTM estimates for this hard-hit group of stocks has plummeted from around 5.2% at year-end 2019, to 2.5% as of September 30 due to the enormous near-term decline in profitability.

On the other side of the market, a number of very large stocks have become richly valued and this too is distorting the overall S&P 500 Index 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, their average NTM free cash yield of 2.3% is also significantly depressing the overall S&P 500 figure given their large size.

If both of these groups of stocks are excluded from the broader index, the yield on the remaining universe increases to 4.6% (**See Figure 5**). It is from this pool (in addition to a few of the hard-hit stocks where normalized valuations are more appealing) that our strategy draws its constituents to achieve its 6.0% FCF yield that is shown in blue in **Figure 5**.

*The overall market yield is being distorted by depressed fundamentals of hard-hit stocks on one end and several expensive stocks on the other.*

**Figure 5: S&P 500 Free Cash Yield on Next-Twelve-Month (NTM) Projected Free Cash Flows**




Source: FactSet, 10/7/2020

# Strategy Changes & Valuation

### U.S. Fundamental Stability & Value

After rebalancing, the weighted average free cash flow yield for the U.S. FSV strategy is 6.0% versus a comparable yield of 4.3% for the S&P 500.[1] This is the largest premium to the market since the launch of the strategy in '17 and we believe reflects the substantial dispersion in valuations across the market at present. 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 1**).

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

**Table 1: U.S. FSV Portfolio Characteristics***

| | U.S. FSV | S&P 500 |
|---|---|---|
| Free Cash Flow Yield (NTM)[1] | 6.0% | 4.3% |
| P/E[2] | 20.3 | 30.3 |
| Fundamental Stability[3] | 0.87 | 0.70 |
| Leverage[4] | 1.13 | 1.27 |

*as of 10/7/2020

**Sector Changes:** The largest change in the portfolio was the sale of Apple, which will be discussed at greater length on the following pages. As a result of this sale, the largest change in sector weight for the portfolio was a six percentage point decrease in technology. Offsetting this were increases of roughly 2 percentage points in each of the industrial, consumer discretionary, and healthcare sectors where valuations remain attractive. Industrials remain the largest sector overweight versus the S&P 500 Index.

**Sells:** After substantially outperforming the S&P 500 Index year-to-date and seeing their valuations become significantly less attractive, the largest sales in the quarter were Apple and Facebook.

**Trims**: The two largest reductions in position size, Expediters International of Washington and Cummins, each outperformed the S&P 500 by around 10 percentage points.

**Buys**: The largest new positions in the quarter were HCA Healthcare, the hospital operator, and Vistra, a utility. Both have underperformed the S&P 500 by around 20% year-to-date and each offers a very high normalized free cash to enterprise value yield.

**Additions**: The biggest additions to the portfolio in the rebalance were Alphabet, the parent of Google, and Intel, the chipmaker. Both companies underperformed the S&P 500 Index last quarter even though their free cash flow estimates increased. Because the portfolio's weighting methodology is linked to free cash flow, position sizes were increased to reflect improving fundamentals relative to prices and more attractive valuations.

**Exposure to Smaller Stocks**: As valuations among some of the largest stocks in the S&P 500 have become increasingly less appealing, the portfolio has generally shifted away from the mega-caps and more towards smaller stocks in the index where valuations look more attractive. This is evident in the decline in the weighted average market cap of the portfolio, which is now around $120 billion versus $250 billion previously and $450 billion for the S&P 500 Index. This shift has also caused the active share of the portfolio to rise to 79%, meaning only 21% of the portfolio is in common with the S&P 500 Index.

### International Fundamental Stability & Value

After being more expensive than the S&P 500 Index for much of the past decade on a free cash flow yield basis and after lagging it substantially in performance, the international All Country Ex-U.S. (ACWI Ex-US) index now offers a higher free cash flow yield than its U.S. counterpart. Somewhat offsetting this is that the index has a lower level of quality with constituent companies generally having less stable cash flows as well as higher leverage. Historic growth in free cash flow has also been more modest internationally. However, like with the U.S. strategy, the subset of companies held in Distillate's International FSV strategy offer a higher free cash flow yield, have substantially more stable fundamentals, and are less levered than the index (**See Table 2**).

*Like its domestic counterpart, Distillate Capital's International FSV Strategy is less expensive, more fundamentally stable, and less levered than the benchmark All Country World Ex U.S. (ACWI-EX US) Index.*

**Table 2: International FSV Portfolio Characteristics***

| | Intl. FSV | ACWI Ex-US |
|---|---|---|
| Free Cash Flow Yield (NTM)[1] | 6.2% | 4.8% |
| P/E[3] | 19.9 | 24.5 |
| Fundamental Stability[4] | 0.79 | 0.51 |
| Leverage[5] | 0.51 | 1.88 |

*as of 10/7/2020

[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] 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.
[3] Fundamental stability is Distillate Capital's proprietary measure of through-cycle cash flow stability with a higher value indicating greater stability.
[4] 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.)

# Apple's Price Increase, Valuation Change, and Why We Sold It

Over the past five years, Apple's stock is up nearly 5-fold with the majority of this gain coming in just the last twelve months (**See Figure 6**). With Apple now accounting for nearly 7% of the S&P 500 Index and having just been sold from Distillate's U.S. FSV strategy, we wanted to share a more detailed analysis of the drivers behind the stock's rise along with its positioning in our portfolio. The stock also serves as a useful example of our valuation process and why assessing valuation correctly is critical.

*Apple's stock is up nearly 5-fold since the end of 2014.*

**Figure 6: Apple Stock Price**

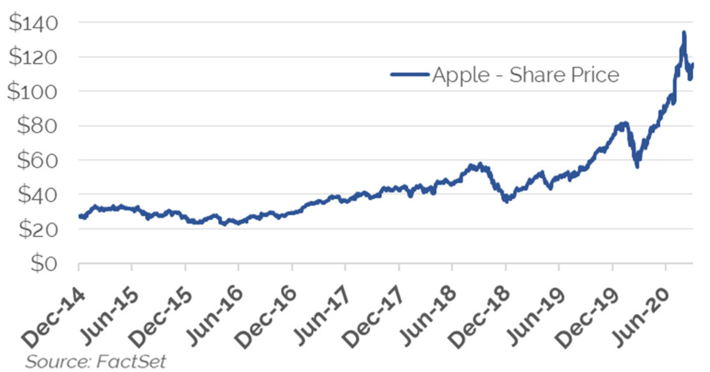



**Table 3** contrasts Apple's fundamentals and valuation at the start of 2015 versus Q3 2020 and highlights a number of key changes. **Figure 7** then shows how these fundamental changes are reflected in the stock price change over the same period. As we do in our process, we start with enterprise value (EV), which increased 280% over the period. Within that gain, the first and most basic driver was the change in underlying fundamentals which we measure using consensus estimates for next-twelve month (NTM) free cash flow. While the 50% growth in this figure was substantial, it falls far short of explaining the gain in EV. The much larger driver was the expansion in the valuation multiple paid for those cash flows with Apple's EV/FCF rising from 10x to 25x – a rather startling change. Then, to assess the value of Apple's equity, its balance sheet is included. In 2015, cash exceeded debt by $135 billion, but that figure fell to $81 billion most recently. The result is that Apple's equity value increased 212%, lagging the growth in EV.

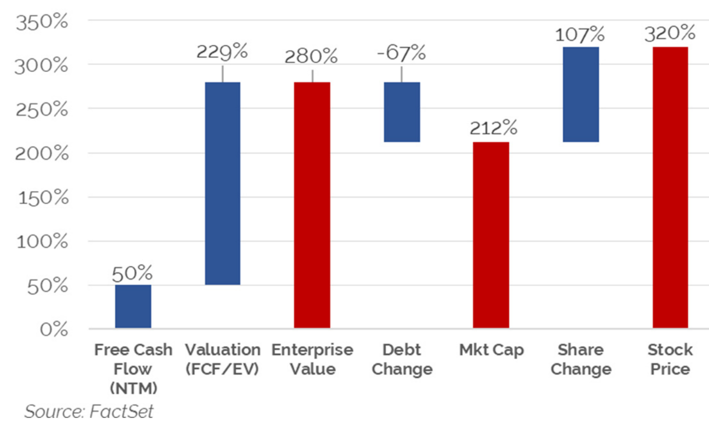
**Table 3: Apple Fundamentals & Stock Price (FactSet data)**

| | Jan 2015 | Sep 2020 | Change |
|---|---|---|---|
| Stock Price | $27.6 | $115.8 | 320% |
| Shares (mm) | 23,527 | 17,419 | -26% |
| Market Cap | $643,120 | $2,007,833 | 212% |
| Net Debt | $-135,439 | $-80,920 | -40% |
| Enterprise Value | $507,681 | $1,926,913 | 280% |
| FCF (NTM) | $50,898 | $76,599 | 50% |
| FCF/EV Valuation | 10.0% | 4.0% | -60% |

Finally, to get to the price of Apple's shares, the change in the share count must be considered. Apple repurchased a significant number of shares between the start of 2015 and Q3 2020. This near 25% reduction in outstanding shares magnified the increase in equity value on a per share basis. On top of the free cash flow and valuation changes, this repurchase activity accounted for about one-third of Apple's entire gain in the share price over the period examined – a significant impact.

*Apple's stock move can be broken into free cash flow, valuation, capital structure, and share count changes.*

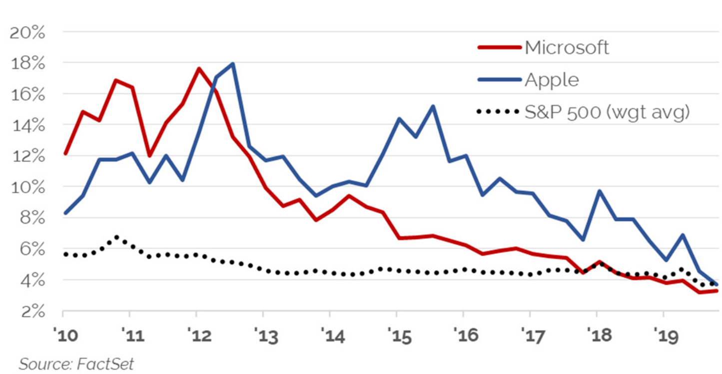
**Figure 7: Decomposition of Apple's Enterprise Value, Mkt Cap & Stock Price Increase ('15 to '20)**




As **Table 3** and **Figure 7** emphasize, the change in valuation was far and away the biggest driver of Apple's extraordinary recent stock price rise. Interestingly, this wasn't just true of Apple, but also of Microsoft, whose stock has increased nearly 10-fold since the end of 2012 and is now the second largest stock in the S&P 500 Index. As with Apple, Microsoft had been a significant holding in our strategy until its valuation became stretched more recently. With both stocks, an inexpensive starting valuation was the key driver of recent returns. Looking back to the end of the last decade and examining the next twelve month free cash to enterprise value yields of both stocks and the S&P 500 Index highlights how extraordinarily cheap each stock was (**See Figure 8**.)

*Apple and Microsoft were extraordinarily inexpensive.*

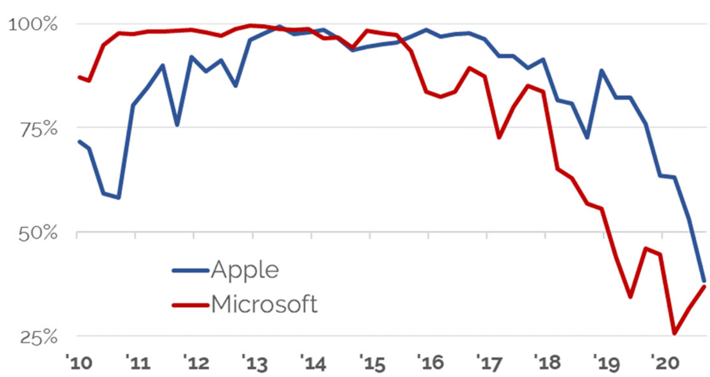
**Figure 8: Apple & Microsoft Free Cash to Enterprise Valuation vs. the S&P 500**



As **Figure 8** depicts, both Apple and Microsoft offered remarkably cheap valuations around 2012, with free cash to enterprise value yields around 18% compared to just under 6% for the market overall. Stated differently, with an enterprise value yield of nearly 20%, the implicit math suggests all of Apple and Microsoft's shares *and* debt could have been retired in just over 5 years. While Microsoft's valuation improvement began earlier and was more gradual, Apple still offered a free cash to enterprise value yield of around 15% as recently as 2015, and 10% at the end of 2018 before falling to about 4% currently. The percentile ranking of each company's valuation versus the market on Distillate's normalized free cash yield methodology is plotted in **Figure 9.** In both cases, the shares went from the 100th percentile, or absolute cheapest stocks in the S&P 500 Index, to being among the more expensive most recently. (It is worth acknowledging that since Apple and Microsoft are facing fewer fundamental headwinds in the current environment than many peers in the S&P 500 Index, their current rankings may be getting somewhat flattered.)

*On Distillate's normalized cash yield valuation methodology, Apple and Microsoft have gone from being the cheapest stocks in the market to among the more expensive on a percentile rank of valuation.*

**Figure 9: Percentile Rank of Apple and Microsoft's Valuations in the S&P 500 Index Over Time**




Source: FactSet

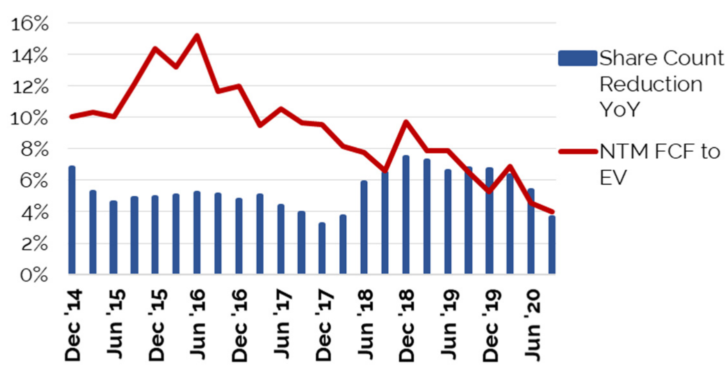
**Valuation Matters:** Just how inexpensive both Apple and Microsoft were and how changes in their valuation dove their extraordinary price moves over the past several years is something that we think is being sorely missed in discussions about "value" and "growth" today. First, that the gains of two of the largest stocks in the growth indexes were more driven by *valuation changes,* rather than growth in their underlying businesses, highlights the importance that should be placed on the price paid for any asset. It also supports the efficacy of paying less for assets as a wise investment strategy while many conversations seem to implicitly suggest the opposite.

Second, with free cash flow yields of nearly 20% of enterprise value, you might argue that both Apple and Microsoft should have been pillars of any value strategy. Yet this was most often not the case since value indexes (and therefore many of the strategies being managed against those benchmarks) tend to emphasize book value to define their constituents. We do not believe book value any longer accurately reflects the true value of assets in a market where many companies derive their profitability from research and development and other intangible investments that are not reflected as assets on corporate balance sheets. See our papers "*Value Investing in a Capital Light World*" & "*Value Failed Because it was Expensive*.")

Lastly, conversations about growth and value often miss that an inexpensive free cash flow valuation itself can counterintuitively be a driver of growth, as it was for Apple. While forecasts for rolling next twelve month free cash flows increased 50% for Apple from the start of 2015 through Q3 2020, the share count reduction amplified the per share impact of this growth by another 32%! And the magnitude of the share count reduction was driven by just how inexpensive the stock price was in relation to free cash flow. **Figure 10** shows Apple's free cash flow yield versus year-over-year changes in its share count and displays how the excess cash enabled share count reduction. With the shares now much more expensive, Apple will not be able to use its free cash flow to generate near the same level of share count reduction as it did in the past. This somewhat paradoxically illustrates that when a stock is cheap on a free cash flow basis and little future growth is implied in its valuation, a company can use the inexpensive value to generate growth through buybacks.

*Apple's inexpensive valuation in the past enabled strong growth on a per share basis through substantial share count reduction*

**Figure 10: Apple's Valuation vs. Share Count Reduction**




Source: FactSet

In relation to Distillate's U.S. FSV Strategy, Apple and Microsoft were among the strategy's largest holdings until valuations became more expensive and each stock was sold. Weights in our portfolio are set relative to normalized free cash flows rather than market capitalization, driving position sizes that generally follow valuations. For example, Apple's weight was increased at the end of '18 after its price fell but its normalized cash flows did not, and its relative valuation was much more attractive. Conversely, Apple's weight was reduced steadily in recent quarters as its price gains exceeded the gains in expected free cash flow generation until the valuation ultimately deteriorated to the point that the position was exited in total.

## Summary

Looking forward, there are clearly pockets of the market that are very expensive. **Table 4** shows the extreme valuations of a number of companies, ordered by size. The largest stock on the list, Amazon, trades at roughly double the overall market's multiple of free cash flow. Tesla is valued at $400 billion, yet it is expected to generate only $2.4 billion of free cash flow and less than $30 billion of revenue in the next twelve months. Companies like Netflix and Uber are worth substantial sums but remain loss-making on a free cash flow basis despite their scale. There are also a number of newly-listed stocks that trade at aggressive multiples: Zoom Video is worth $134 billion against forecast free cash flow of $1 billion and revenues of just over $3 billion for its fiscal year ending 2021; Shopify's $125 billion valuation is underpinned by negligible free cash flow and projected revenue of only $2 billion; Snowflake is worth nearly $70 billion versus annualized first half revenue of just $500 million.

Valuations such as these are clearly discounting extremely optimistic futures and offer very little margin of safety should the aggressive fundamental growth implied by current valuations not be achieved. A tempering of enthusiasm and an unwinding of elevated valuations in these stocks would pose a drag to overall market returns.

*Valuations on a number of stocks look very aggressive*

**Table 4: Select Expensively Valued Stocks ($ figures in billions)**

| Name | Market Cap | Sales (NTM) | FCF (NTM) | Price/ Sales | Price/ FCF |
|---|---|---|---|---|---|
| Amazon | $1,577 | $318.5 | $38.1 | 5.0 | 41 |
| Microsoft | $1,592 | $143.4 | $49.2 | 11.1 | 32 |
| Tesla | $399 | $28.9 | $2.4 | 13.8 | 168 |
| NVIDIA | $334 | $12.2 | $5.8 | 27.3 | 58 |
| Adobe | $235 | $12.8 | $5.7 | 18.4 | 41 |
| PayPal | $231 | $20.1 | $6.5 | 11.5 | 36 |
| Salesforce | $228 | $19.5 | $4.8 | 11.7 | 47 |
| Netflix | $221 | $23.8 | $-1.0 | 9.3 | -232 |
| Zoom* | $134 | $3.2 | $1.1 | 41.3 | 126 |
| Shopify | $123 | $1.9 | $.2 | 63.4 | 515 |
| ServiceNow | $93 | $4.2 | $1.6 | 22.2 | 59 |
| Snowflake** | $69 | $0.4 | $-0.1 | 143.5 | -667 |
| Uber | $64 | $17.3 | $-1.7 | 3.7 | -37 |
| Twilio | $35 | $1.4 | $0.0 | 25.4 | 5,182 |
| Zscaler | $19 | $0.4 | $0.1 | 44.3 | 239 |
| **S&P 500*** ** | **$3,336** | **$1,426** | **$144** | **2.3** | **23** |

FactSet Data as of 10/7/2020

*Uses fiscal year January 2022 due to data availability.

** Uses annualized first six months of 2020 due to data availability.

***Per share data

But while these richly-valued stocks garner substantial media and investor attention, there are numerous less-discussed stocks in the market that look very attractively valued at present and especially so in consideration of their quality. To capture this opportunity though, it is critical to employ a valuation discipline that can properly assess value and differentiate between companies that are more asset-light in nature, like those in Table 4 (as well as Apple and Microsoft), and companies that are more asset-intensive and that for accounting reasons tend to look more attractive on traditional valuation metrics like P/B or P/E.

It is this struggle to compare asset-light businesses and asset-intensive ones that we worry has led some investors to be willing to pay any price for some of the asset-light stocks, while other investors dig in their heels and insist that certain asset-intensive stocks are good values even when this is not supported by underlying free cash flow generation. We think this explains why many "value" investors missed out on the tremendous opportunity in the past to own Apple or Microsoft when they were among the absolute cheapest stocks in the market, but also why some "growth" investors may regret buying some of these richly-valued stocks at some point in the future.

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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.*

***Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs, which would reduce returns.***

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