DISTILLATE CAPITAL

RATIONAL INDEX DESIGN

2019 Q3 Letter to Investors:

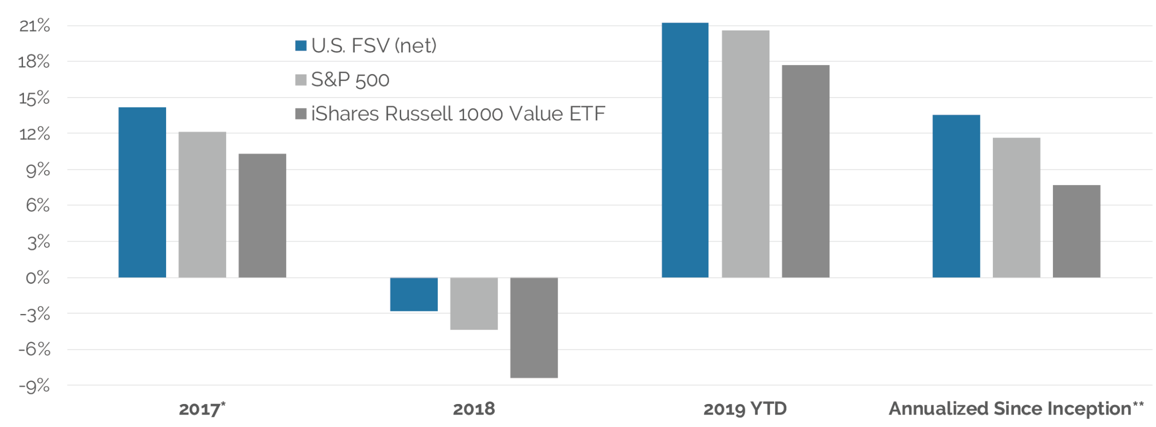
Long-Term Equity Valuations & Looking Past "Factor" Noise

Strategy Summary: *Distillate Capital's U.S. Fundamental Stability & Value (U.S. FSV) strategy seeks to outperform the equity market over the long-term by investing in high-quality stocks with attractive valuations. Our strategy uses cash-flow-based measures of value and quality that are designed to avoid accounting distortions that we believe have rendered many traditional valuation and risk metrics less relevant in an increasingly asset-light world. Our methodology seeks to systematically exploit pricing opportunities while at the same time protecting capital in down markets by being disciplined on valuation, emphasizing fundamental stability, and limiting the indebtedness of the companies held in the strategy.*

Performance: Distillate's U.S. FSV strategy's year-to-date and net-of-fee performance of 21.22% is ahead of the S&P 500 Index return of 20.55%. This follows outperformance in 2017 and 2018, and annualized performance since inception is around 2% above the index on an after-fee basis (**See Figure 1**). Performance compared to the iShares Russell 1000 Value ETF continues to be well ahead of the benchmark this year and annualized performance after fees is nearly 6% above of this benchmark since inception.

Relative to the S&P 500 Index, performance for the U.S. FSV strategy was aided somewhat by sector weightings with an overweight position in technology and underweight position in energy as a result of underlying free cash flow generation in each. This positive was somewhat offset by the negative impact of high relative weights in health services and transportation and an underweight in the finance sector. Stock selection drives performance and was favorable with the largest contributions coming from KLA Corporation, Apple, and Target, which each adding around 25 to 35 basis points to relative performance. CVS, Biogen, and Regeneron were the largest detractors from year-to-date performance with each subtracting around 30 basis points from relative performance.

Figure 1: Performance of Distillate Capital's U.S. FSV Strategy (through 9/30/2019)



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

** Strategy inception of 5/31/2017 through 9/30/2019

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

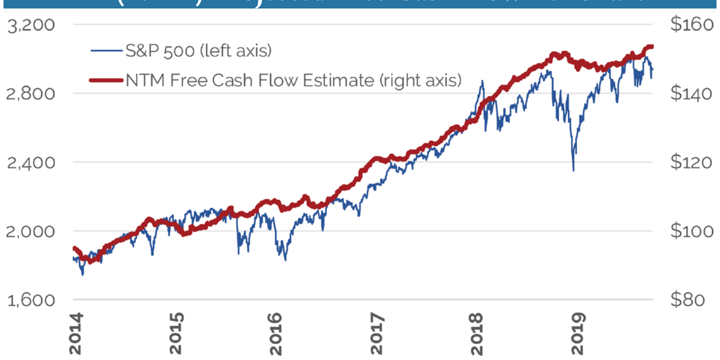
Market Backdrop

The equity market backdrop over the past year has been noisy. The S&P 500 Index fell sharply at the end of last year and has since rallied back strongly. Within this recovery, the market has experienced several downward moves relating to concerns about trade negotiations with China, worries about slower economic growth more broadly, and geopolitical uncertainties. Among the latter, the attack on Saudi Arabia's oil processing facilities induced a sharp spike in oil prices that quickly moderated as production came back online.

Amidst this backdrop of volatile equity prices, underlying fundamentals have been significantly more stable. While forecasted 12-month forward free cash flow estimates did moderate earlier this year due to weakness in the energy sector and reduced expectations in the technology hardware space, they fell by significantly less than the overall market price and have resumed their upward trajectory more recently (**See Figure 2**). This disconnect between the stability of fundamentals and prices is something that we discuss more extensively in our paper "Risk: Fundamentals Over Price Volatility." It also demonstrates the logic of why we focus on fundamentals over prices and seek to exploit opportunities created by discord between the two.

S&P 500 free cash flow estimates have been more stable than prices.

Figure 2: S&P 500 Index Price vs. Next-Twelve-Month (NTM) Projected Free Cash Flow Per Share



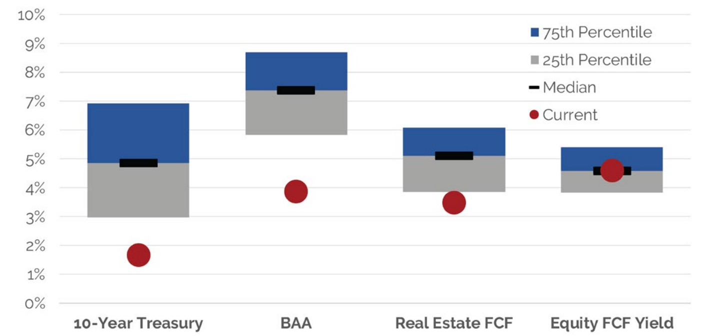
Source: FactSet

In addition to highlighting the disconnect between the volatilities of fundamentals and prices, **Figure 2** shows that prices and free cash flows have both increased by roughly the same amount over the last five years. The market's strength, contrary to a lot of commentary, has been underpinned by fundamentals and was not due to valuation gains. In fact, after some recent price weakness, the current free cash flow yield of 5.2% is slightly more attractive than the 5.1% yield at the beginning of this period.

Looking at a longer stretch of time and using trailing free cash flows instead of forward estimates due to data availability, we can examine how equity valuations currently compare to their historical levels as well as other asset classes. Doing so reveals that the current equity yield on trailing twelve-month free cash flows is virtually equal to the median since 1985 when our data series begins. Current yields on other asset classes, by contrast, are near the bottom of their historical ranges (**See Figure 3**). This suggests that equity valuations are not stretched versus history and look fairly appealing compared to other asset classes.

Current yields for 10-year treasuries, BAA bonds, and real estate free cash flows are near the bottom of their historic ranges, while the equity free cash flow yield stands out as looking more attractively valued.

Figure 3: Current Yields vs. Historical Ranges for Various Asset Classes

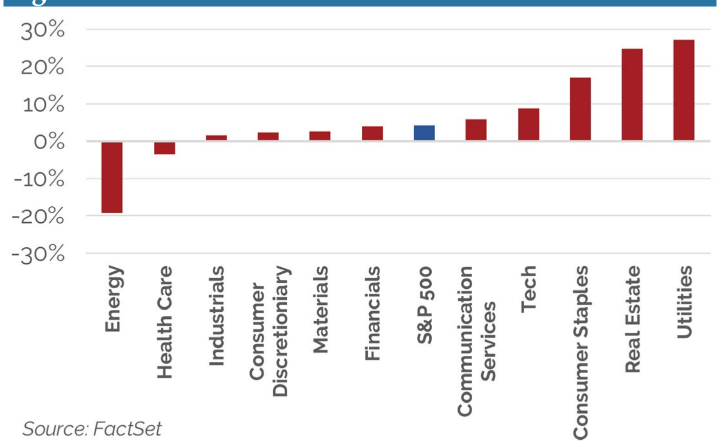


Source: See end notes for a description of methodology

While equity valuations look reasonably attractive in this context, we do not intend to suggest that the current environment is without risk. There are areas of the market that look quite expensive and debt levels in certain segments of the market are very elevated. There has also been a fair amount of dispersion in performance and valuations over the past year that has created a number of opportunities and risks. For example, even though the overall market is roughly flat over the past 12 months, returns have been extremely strong in staples, real estate, and utilities, all sectors that have benefitted from strong investor appetite for low-beta or low-volatility funds (**See Figure 4**). Investors have sought out the perceived safety of such funds, but we believe they may be missing the risk of increasingly stretched valuations and high debt levels. We consider both issues critical when focusing on downside protection.

Despite a flat overall market, low-beta sectors have risen sharply.

Figure 4: S&P 500 Sector Performance Since 9/30/2018



Source: FactSet

Portfolio Changes and Valuation

After rebalancing, the weighted average free cash flow yield for the U.S. FSV strategy at the beginning of Q4 2019 is 7.0% versus a comparable yield of 5.2% for the S&P 500.[1] The rebalanced U.S. FSV strategy also has significantly more stable long-term fundamentals and less financial leverage than the S&P 500 Index, as shown in **Table 1**. Given rising debt levels generally and particularly elevated indebtedness in certain areas of the market, we think our focus on low leverage is especially relevant at present.

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 Strategy	S&P 500
Free Cash Flow Yield[1]	7.0%	5.2%
P/E[2]	16.4	21.3
Fundamental Stability[3]	0.87	0.68
Leverage[4]	1.3	1.7

*as of 10/07/2019

Sector Changes: After rebalancing, the consumer staples weight came down following strong performance while the communication services and health care weights increased. The industrial and technology sectors remain the largest relative overweights due to several rich valuation opportunities that exhibit high fundamental stability and generally low levels of debt.

In the case of the technology sector, the high level of cash flow stability is a marked change from the technology, media, and telecom bubble. Then, the sector was dominated by more fundamentally volatile companies in the tech hardware space and many generated little if any free cash flow. But at present, much of the sector (and many of our holdings) is comprised of companies like Microsoft that derive their cash flow predominantly from recurring revenue businesses. Other technology holdings like Accenture, the consulting firm, or Visa, the credit card company, also look more stable and very different from companies that dominated the sector 20 years ago.

The industrial sector has also evolved and now includes many companies that have shifted their underlying businesses up the value chain to sell products and services that are backed by substantial research and development and patents. These companies are thus somewhat more insulated from competition than was the case in the past. Many are also very dynamic and have attractive long-term value propositions but have become temporarily less expensive amid trade concerns. We think this has presented some attractive opportunities from a longer-term risk versus reward perspective.

New Buys: The largest new positions are AT&T and Facebook. AT&T was attractively valued previously, but was filtered out of our investment process due to its high leverage. In the most recent rebalance, however, this leverage ratio improved by enough to warrant inclusion. Facebook was repurchased following its underperformance in the prior quarter and improved relative valuation. Facebook is an example of a company that is traditionally thought of as a growth stock given strong gains in sales and profits, but one that stands out now as being inexpensive on a free cash flow basis and is appealing to us given this combination of value and growth.

Sells: The largest positions that came out of the strategy after the rebalance were Alphabet, the parent company of Google, and Proctor & Gamble. Both stocks outperformed the overall market solidly last quarter and were sold as their valuations became less attractive. In the case of Alphabet, free cash flow gains have started to slow despite solid topline growth as spending on research and development and capital expenditures has surged from $21 billion in FY'16 to an estimated nearly $60B in FY'20. Alongside strong price gains, the stock has become less attractive on our methodology as a result.

Adds: The biggest additions by weight in the rebalance were Alexion and UnitedHealth Group. Both stocks are in the health care sector and underperformed the overall market considerably in the third quarter.

Trims: The largest reductions in the quarter were Apple and KLA Corporation, the semiconductor equipment company. Both stocks outperformed the market considerably in the quarter and saw their valuations become somewhat less attractive as price gains generally exceeded changes in projected normalized free cash flows. Both companies remain attractive from a valuation standpoint, but are now smaller positions. Apple remains the largest position in the strategy at approximately 4.5%, driven by its enormous free cash generation. Despite a somewhat volatile stock price, Apple's underlying fundamentals are more stable and the company is increasingly deriving its free cash flow from the more stable services business, which is estimated to make up around a third of gross income in FY'20. In terms of valuation, even after its strong performance relative to the market so far this year, Apple still looks attractively valued at a free cash flow to enterprise value yield of nearly 7% on FY'19 estimates.

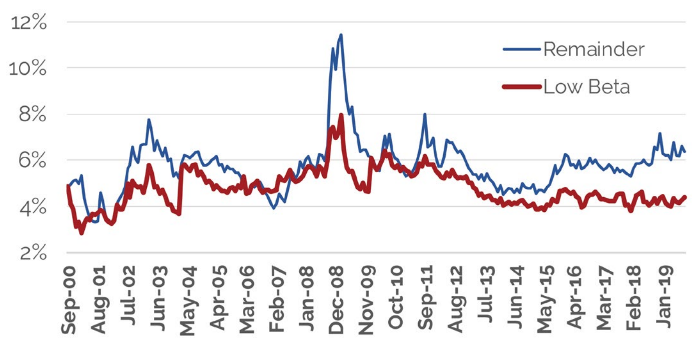
[1] Free Cash Flow Yield is based on the next-twelve-month free cash flow estimate relative to market capitalization. Stocks without estimates in the index are excluded and the remaining names are reweighted based on those exclusions.
[2] P/E is based on consensus estimates for next-twelve-months and 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.)

Factor Fluctuations & Valuations

Many investors have begun to think about and invest in equities on the basis of "factors," or groups of stocks that share common characteristics, often defined by price movements or traditional accounting-based metrics. One of the most popular factors that has garnered significant inflows is "low volatility" or "low beta." Stocks with this factor exhibit less volatile share prices, typically measured over the prior year or two, and are thus thought to be less risky. Historically, low beta stocks have done very well due to the "low beta anomaly," in which these stocks produce superior compounded returns because they tend to preserve capital in down markets. While we wholeheartedly agree with the importance of preserving capital in down markets and have specifically designed the U.S. FSV strategy with this goal, we worry that price volatility is an indirect measure of quality and such stocks may not always demonstrate the kind of fundamental stability that can help cushion negative economic circumstances. Even more importantly, low beta stocks can become expensive or highly leveraged, as is the case currently, and this could cause them to lag the overall market in a downturn or through an economic cycle. The current gap in valuation of such stocks is evident in the growing divergence in their free cash flow yields with the rest of the market (**See Figure 5**).

Low beta stocks are trading at a much lower free cash flow yield than the rest of the market.

Figure 5: Free Cash Flow Yield for Low Beta Stocks[5] vs. the Rest of the Market



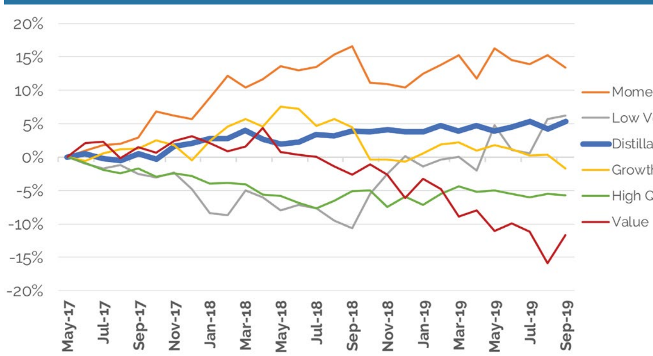
Source: FactSet.

Rather than using short-term price volatility as an indicator for risk to try to preserve capital in a downturn, we focus instead on fundamental stability, leverage, *and* valuation. We do so to more directly focus on the characteristics that can help limit losses in an economic slowdown as well as to avoid the very important risk of overvaluation. This approach has resulted in positive relative performance of the U.S. FSV strategy versus the S&P 500 since inception, and performance roughly equal to that of the Invesco S&P 500 Low Volatility fund (SPLV), without the valuation issue highlighted in **Figure 5**. The relative performance of the U.S. FSV Strategy has also been significantly more consistent. This is not surprising considering the sector concentration of SPLV, where nearly 50% of the portfolio is currently invested in utilities and real estate compared to less than 7% of the overall S&P 500 Index. **Figure 6** highlights this performance contrast by showing the indexed relative performance of our U.S. FSV strategy versus the S&P 500 Index with that of SPLV and then several other factor-based exchange traded funds (ETFs).

Broadly, the relative performance of the U.S. FSV strategy looks quite different than the factor-driven funds which use more typical definitions of value, high quality, growth, low volatility, and momentum. We are encouraged by this result given that our strategy employs a very different methodology than these funds, even though it draws on the same concepts of value and quality.

The relative performance of traditional "factors" has been quite volatile and the value and quality factors that would be considered most similar to our U.S. FSV strategy have markedly underperformed it.

Figure 6: Indexed Relative Performance of Various Factor Funds vs. Distillate's U.S. FSV Strategy



Source: FactSet. *Monthly performance relative to the S&P 500 Total Return Index. U.S. FSV is net of fees. Invesco ETFs used for factor return series include SPMO, SPLV, RPG, RPV & SPHQ.

In comparing our strategy's performance with that of the value factor ETF, we have written extensively about how the economic evolution toward a capital-light economy has led to accounting distortions that have made traditional measures of value like price-to-book (P/B), price-to-earnings (P/E) less meaningful (See our paper on valuation). Most recently, much was made of the uptick in the performance of traditionally defined "value," which is visible in the red line in **Figure 6**. While we would note that our strategy performed well in the same period, we would caution against reading too much into revived hopes for a "value recovery." We believe the way value is measured in many funds is flawed and does not truly identify underpriced stocks. Instead, we would contend that there has been no issue with the performance of value as a concept and thus no need for a recovery when it is measured in a rational way that still holds meaning in an asset-light world. We discuss this at greater length in our valuation paper, as well.

[5] Beta is calculated over 3 years vs. the S&P 500 Index; groups rebalanced monthly. Trailing data is used prior to '09 and next-twelve-month estimates thereafter.

The performance of our U.S. FSV strategy has also looked very different from that of the Invesco S&P 500 High Quality ETF (the orange line in **Figure 6**). This factor is less consistently measured, but often relies on metrics like return on equity (ROE), return on assets (ROA), or return on invested capital (ROIC) that suffer from the same accounting distortions that have eroded meaning and reduced comparability for book value and net income.

Momentum and growth are the other two main factors that have been increasingly grabbing investors' attention and assets. Growth is often discussed in relation to "value," even though the two are not necessarily opposed. Growth stocks are typically those that have exhibited strong prior gains in earnings or sales. A stock fitting this description could be inexpensive on a traditional measure of "value" and might be included in both a growth and a value index or ETF, although this is not often the case. For us, we incorporate a company's growth prospects into our methodology, but do so only in conjunction with value as we think investors are prone to overpaying for exciting growth stories and such stocks are often systematically over-priced. We think the behavioral biases behind this phenomenon help explain the opportunity to invest in less exciting companies at attractive valuations and why the companies we tend to own have more modest growth expectations (for more, see our paper on behavioral biases).

Momentum stocks are those that have experienced strong recent price gains. The performance of such stocks can be quite volatile and there is much discussion about the risk of "momentum reversals" when stocks that were doing well suddenly underperform sharply, as happened following the financial crisis. As fundamental and value-oriented investors, we do not understand any rationale for why such stocks should be able to sustainably outpace the overall market, especially when measured on a geometric rather than arithmetic basis such that the negative impact of reversals are considered in a way that is consistent with how investors actually experience returns. Most recently, stocks fitting this characteristic have done quite well, although their relative performance has begun to level off.

Overall, we tend not to think about stocks as factors and the performance of our strategy versus common factor funds demonstrates this. Instead of thinking about stocks along the lines of these common factors, our strategy is to invest in companies with stable fundamentals and low leverage at attractive prices. By doing this, we try to systematically capture favorable risk versus reward opportunities while avoiding the highly risky, lottery-like investments that people are often attracted to for behavioral reasons and that can end up being so damaging to long-term returns.

Investment Implications:

Overall, we believe that market valuations are reasonably attractive relative to history and especially so compared to alternatives. This may come as a surprise to many investors given strong market gains and frequent commentary to the contrary. The market recovery has been supported by strong cash generation and unlike many other asset classes, equities have risen without help from any valuation expansion over the past five years. In addition, we tend to think that negative commentary and dampened investor enthusiasm for equities, as indicated by flows, are usually a positive signal that suggest the market is climbing the proverbial wall of worry rather than riding a dangerous wave of exuberance.

But even as the overall market looks reasonably attractive, there are certain pockets that look risky from a long-term perspective given stretched valuations and historically elevated debt levels. In particular, we are worried about the popularity of low-volatility stocks that are thought to be less risky than the overall market. This ties in with the recent shift to thinking about stocks as factors, where we also worry that investors who are purchasing value or quality funds may not ultimately receive the benefits of the attributes they are seeking because of portfolio construction methods that rely on outdated accounting metrics that no longer accurately measure the intended attribute. We would encourage investors to think critically about what a metric is actually measuring and whether there are accounting issues that could cause that metric to be less relevant than it was in the past. We would also caution that merely looking at the performance of such a metric in the past, especially the distant past, should be of little comfort.

Distillate Capital Partners LLC *("Distillate"), is a registered investment adviser with United States Securities and Exchange Commission in accordance with the Investment Advisers Act of 1940. The firm's list of composite descriptions is available upon request.*

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.*

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 (such as Figure 3 above) refer only to these stocks' historical valuation and not their inclusion in any actual or hypothetical strategies/accounts managed by Distillate Capital Partners LLC.*

Figure 3 Methodology: Equity yield *is based on trailing free cash flow data from FactSet and the index is reweighted each quarter to exclude companies without data.* Real estate FCF *data is based on capitalization rate yields for apartment buildings from RERC and adjusted by the historic ~30% free cash flow discount to net operating income per the NCREIF Q2 2018 Indices Review as well as Joseph Paglia's 2017 "Some Thoughts on Real Estate Pricing". Lastly, it should be noted that the RERC data is based on surveyed estimates of forward year net operating income and is thus more akin to forward estimated equity free cash flow. Yield data for* 10-Year Treasury and BAA Bonds *are sourced from FactSet.* BAA Bonds *are U.S. corporate bonds rated "Baa" by Moody's Investors Service.*

The S&P 500 Index *is an index of roughly the largest 500 U.S. listed stocks maintained by Standard & Poor'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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