DISTILLATE CAPITAL

2021 Q1 Letter to Investors: What the Growth vs. Value Debate is Missing

Strategy Description

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.

Distillate Capital's U.S. FSV strategy outperformed the S&P 500 Index by just over 3 percentage points in the first quarter of 2021 and lagged the Russell 1000 Value ETF benchmark by around 2%. Our International strategy trailed its MSCI ACWI ex-US benchmark by just under 2% in the quarter following substantial outperformance in 2020 (**see Figures 1&2**).

Figure 1: Performance of Distillate's U.S. FSV Strategy (through 3/31/2021)

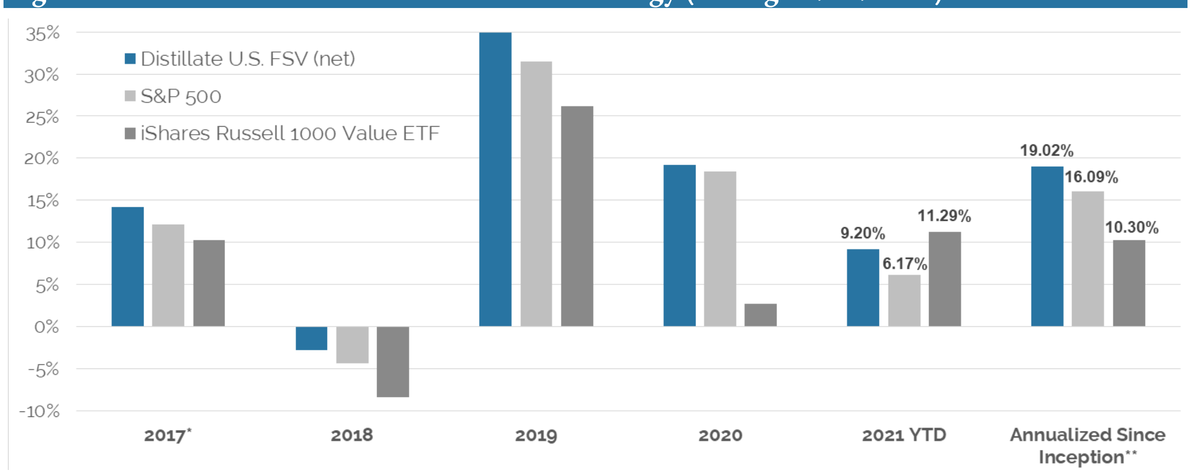
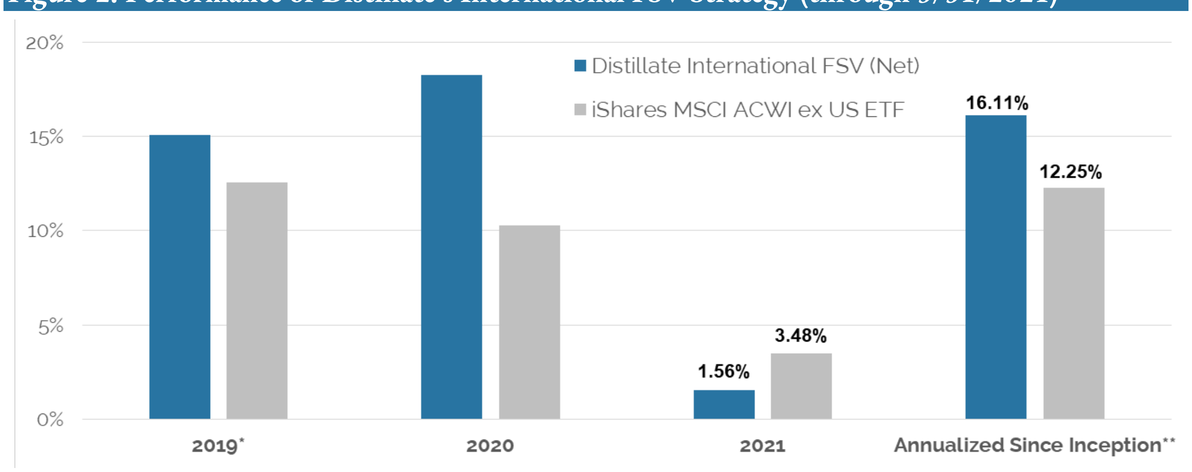


Figure 2: Performance of Distillate's International FSV Strategy (through 3/31/2021)



* 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 3/31/2021 for US FSV; 1/31/2019 through 3/31/2021 for INTL FSV
Sources: U.S. Bank, iShares.com. Please see important performance disclosures at the end of this document.

Performance

U.S. Fundamental Stability & Value (U.S. FSV)

Things changed in the first quarter of 2021. While last year's market returns were characterized by concentrated gains among the top few stocks, the first three months this year were the opposite. This is consistent with past recoveries when equal-weighted benchmarks similarly outperformed cap-weighted ones as recoveries lengthened in duration. The first quarter was also marked by a shift in outperformance from "growth" stocks to stocks more commonly thought of as "value". Within this environment, Distillate's U.S. FSV strategy generated a first quarter total return of 9.20% that exceeded the comparable S&P 500 Index return of 6.18%, while lagging the Russell 1000 Value benchmark's return of 11.29% by around 2%. Annualized performance net of fees for the U.S. FSV strategy is nearly 3% ahead of the S&P 500 since inception with positive relative performance in each year, and versus the Russell 1000 Value benchmark, FSV is ahead by nearly 9% per year over the same timeframe (**See Figure 1**).

The strong performance of the energy and bank stocks in the first quarter and Distillate's underweight position in those sectors relative to the benchmark resulted in about a 1.5% drag in relative performance versus the S&P 500. This was offset by a similar gain versus the benchmark from not owning Apple and Amazon, which both underperformed the market during the quarter. In terms of holdings, Intel, United Rentals, and Applied Materials each contributed around 30 basis points of relative performance, but there were smaller and broad-based gains across the strategy beyond those three holdings. The largest detractor from relative performance among owned stocks was Viatris, the generic pharmaceutical company, which subtracted approximately 25 basis points from performance versus the S&P 500 benchmark.

International Fundamental Stability & Value (Intl. FSV)

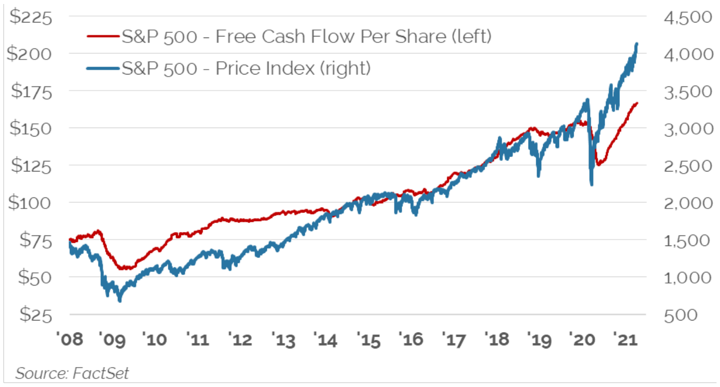
After doing significantly better than the benchmark last year, the International FSV strategy's total return of 1.56% lagged the All Country World Ex-U.S. (ACWI Ex-US) benchmark by just under 2% in the first quarter **(See Figure 2)**. Like in the U.S., the strategy's focus on low leverage contributed to an underweight in the financial sector that generated a headwind of approximately 1.25% in the quarter. By region, the largest detractor from performance was Europe, where the majority of the financial drag was felt, and Australia, where there was a headwind from several resource related companies. Performance in China and Hong Kong, where the portfolio began the quarter with a weight of ~20% vs. 15% for the benchmark, was even with the index. The same was true in Japan, where the strategy began the quarter slightly underweight at 12% vs. 16% for the benchmark. By stock, Alibaba, Roche, and SSR Mining each subtracted around 20 basis points from performance, while Tourmaline energy and Dialogue Semiconductor each added about the same.

Market Backdrop

The U.S. stock market continued its upward trend in the first quarter. **Figure 3** highlights that the gains in the S&P 500 have a strong underpinning from similar strong gains in projected free cash flows (shown in red).

The S&P 500 Index and estimated free cash flows have recovered solidly.

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

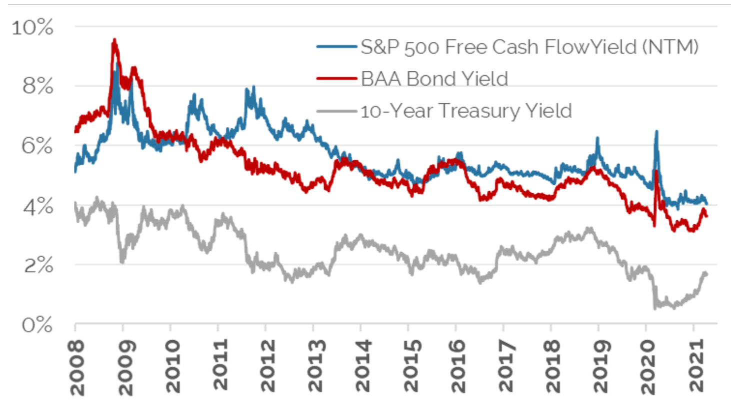


Source: FactSet

Because of the sharp rebound in projected free cash flows, the market valuation has largely held steady at a free cash flow yield of just over 4% (**See Figure 4**). This yield is below the 5% level that prevailed for much of the past decade, but still well above the BAA bond yield, which it has recently tracked in spite of the fact that the free cash flows grow over time and the coupons comprising the BAA yield do not. This suggests that while equities do not look especially cheap, they do not appear particularly expensive in the context of alternatives. Critically, the equity free cash flow yield reflects the value for the market in its entirety, which includes a number of very expensive stocks (in our estimation) and masks a broader set of very attractive opportunities within the market.

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



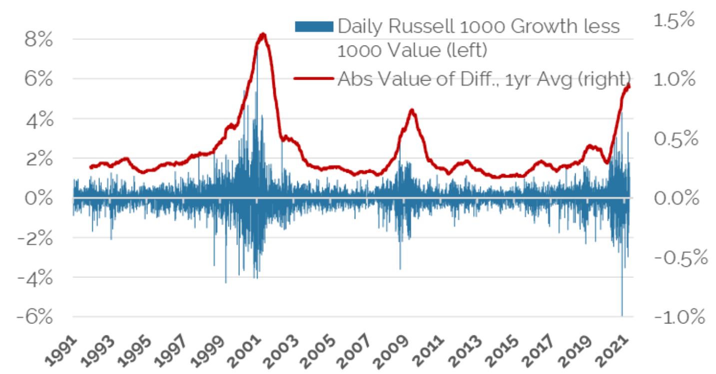
Source: FactSet

A Different Growth/Value Debate

Investors are forever focused on market performance split by "growth" stocks, which have faster historical and projected revenue and earnings gains, and "value" stocks, which are typically defined as those that are the least expensive on a price-to-book (P/B) basis. In recent months, the growth/value split has intensified and the daily performance difference between the Russell 1000 Growth and Value indexes has expanded to a point not seen since the technology, media, and telecom bubble in the late 1990s. **Figure 5** shows the widening daily return differential between the two indexes, as well as the sharp rise in the absolute value of this figure averaged over the prior year (the red line on the right axis).

Return spreads between growth and value are widening sharply.

Figure 5: Russell 1000 Growth vs. Value Performance



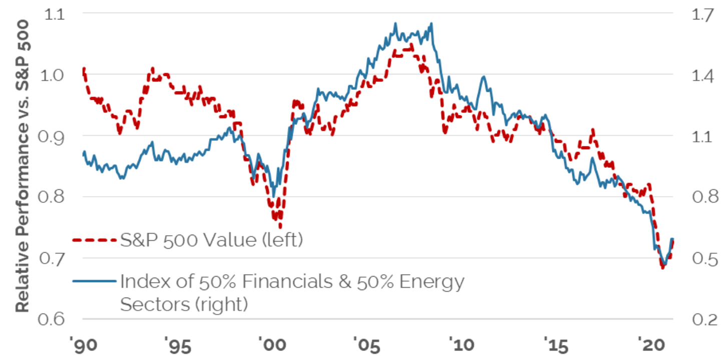
Source: FactSet

While figure 5, which resembles the graph of a sound wave, shows that the noise around the growth/value schism is getting louder, we think the debate and whipsawing performance are missing a much bigger picture. As we have discussed previously and detailed in greater depth in our paper on Valuation & Accounting (updated Sep 2019), economic and accounting changes have rendered P/B a much less useful measure of value than it once was. Instead of measuring relative value, as is intended, accounting rules mean that book value largely ignores the value of intangible assets that increasingly drive our modern economy and instead emphasizes physical or financial assets. Consequently, P/B ends up less a measure of price-to-worth and more an indicator of asset intensity as determined by accounting rules.

A crucial corollary is that P/B-based valuation strategies tend to look a lot more like collections of energy and financial stocks than portfolios of truly undervalued securities. **Figure 6** highlights this by comparing the relative performance of the S&P 500 Value index with the relative performance of an index comprised of a 50/50 mix of the financials and energy sectors. The two lines match up almost perfectly and especially so more recently when increased intangible investment has made the accounting distortion more pronounced. In this context, the much-discussed bounce in P/B-defined "value" in the first quarter of 2021 looks like little more than an uptick in the financial and energy sectors.

Due to accounting distortions, traditional P/B-defined value strategies look a lot like collections of energy and financial stocks.

Figure 6: Relative Performance of S&P 500 Value Index & an Index of 50/50 Financial & Energy Sectors



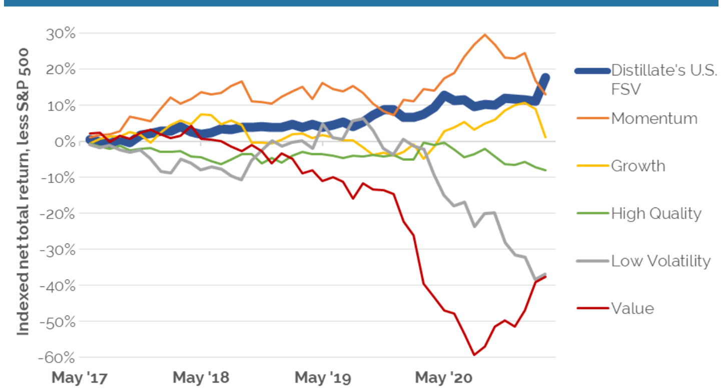
Source: FactSet

This is not to say that concerns about the price of faster growing stocks and the growth/value debate is misplaced. Far from it. We simply believe that the value side of the conversation should be properly measured so the debate does not mistakenly end up being about growth vs. financials and energy stocks.

If value is measured more accurately and avoids accounting biases, as we seek to do at Distillate Capital, a very different result emerges. Instead of suffering from deep underperformance, as traditionally defined P/B strategies have, value investing as a strategy has not lagged at all. This is true not just in the most recent quarter when growth trailed significantly, but also over the duration of the period since we launched our strategy in early 2017. This is evident in **Figure 7** which contrasts the more consistent relative outperformance of Distillate's U.S. FSV strategy with the much more volatile relative performance of a number of common factor strategies including both growth and value. Instead of finally waging a comeback in the first quarter of 2021, we think paying less for stocks has been performing well all along.

The relative performance of Distillate's U.S. FSV strategy looks very different and much more stable than that of traditionally defined factors.

Figure 7: Distillate U.S. FSV Strategy Relative to the S&P 500 Index vs. Traditional Factors



*Monthly performance relative to the S&P 500 Total Return Index. U.S. FSV is net of fees. Invesco ETFs used are SPMO, SPLV, RPG, RPV, & SPHQ. FactSet data, from 5/31/2017 through 3/31/2020

Strategy Changes & Valuation

U.S. Fundamental Stability & Value (U.S. FSV)

After rebalancing, the weighted average free cash flow yield for the U.S. FSV strategy is 5.5% versus a comparable yield of 4.0% for the S&P 500.[1] This significant spread reflects our view of the substantial dispersion in valuations across the market at present. In addition to a more attractive valuation, the U.S. FSV strategy also enjoys significantly more stable long-term fundamentals and less leverage (**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]	5.5%	4.0%
P/E[2]	20.6	31.1
Fundamental Stability[3]	0.87	0.68
Leverage[4]	1.07	1.14

*as of 4/9/2021

Sector Changes: the largest sector change in the rebalance was a 4% reduction in industrials, which outperformed in the first quarter. Mirroring this reduction was a 4% increase in the communications sector driven by the purchases of Comcast and Facebook. The technology weight came down modestly despite the initiation of a 2% position in Apple, which is discussed further on the following page. The heath care weight also increased after the sector lagged in the quarter and as a result of the addition of AbbVie.

Overall, sector weights favor the industrials and health care sectors where valuations look attractive, and lean away from financials and communications, as well as the much smaller energy, real estate, and utilities sectors due to combinations of leverage, stability, and valuation (**See Table 2**). Sector weights in the U.S. FSV strategy reflect the opportunity set at a stock level and are not driven by any top-down decisions. Sector classifications are prone to changing over time and at times seem arbitrary—the lines between a number of industrial and tech companies look increasingly blurry as does the classification of some financial companies like Visa in the tech sector. Certain sectors, like consumer discretionary, also include a wide range of businesses ranging from Amazon and Tesla (which are excluded in a fourth line in Table 2) to homebuilders, cruise ship operators, and auto parts suppliers.

Sector weights are driven by bottom-up stock selection which currently favors the Industrials and health care sectors versus the S&P 500 Index.

Table 2: U.S. FSV Portfolio Characteristics*

	U.S. FSV	S&P 500
Communication Services	6.7%	11.1%
Consumer Staples	9.4%	6.0%
Consumer Discretionary	8.5%	12.6%
Ex Amazon & Tesla	*8.5%*	*6.3%*
Energy	0.8%	2.7%
Financials	8.0%	11.2%
Health Care	17.9%	12.6%
Industrials	18.3%	8.7%
Information Technology	25.6%	27.4%
Materials	3.9%	2.6%
Real Estate	0.8%	2.4%
Utilities	0.0%	2.6%

*as of 4/9/2021

Sells: Walmart, Applied Materials, Anthem, Target, and Norfolk Southern were the largest sales in the quarter. With the exception of Walmart, which saw its normalized free cash flow estimate decline, and Anthem, where fundamental stability fell below the threshold for inclusion, sales generally resulted from outperformance.

Trims: The two largest reductions were in Intel and Cisco, where each outperformed the S&P substantially in the first quarter. Intel was trimmed by ~80 basis points to a 1.6% position and Cisco was cut by 40 basis points to a similar weight.

Additions: The largest additions in the rebalance, GoDaddy and Colgate-Palmolive, were fairly small in size at just around 10 basis points apiece. Each stock underperformed in the quarter and was added to as relative valuations became more attractive.

Buys: The most notable change in the portfolio in the rebalance was the purchase of AbbVie at a 2.2% position in addition to the repurchase of Apple and Facebook at 2.0% weights. Facebook has come in and out of the portfolio before and did so this quarter on the back of substantial improvement in projected free cash flows such that its valuation now meets the criteria for inclusion.

Apple is an even more notable situation and one that highlights our free cash valuation methodology and bears further discussion given its Q3 '20 sale from our strategy. For an extended period, Apple

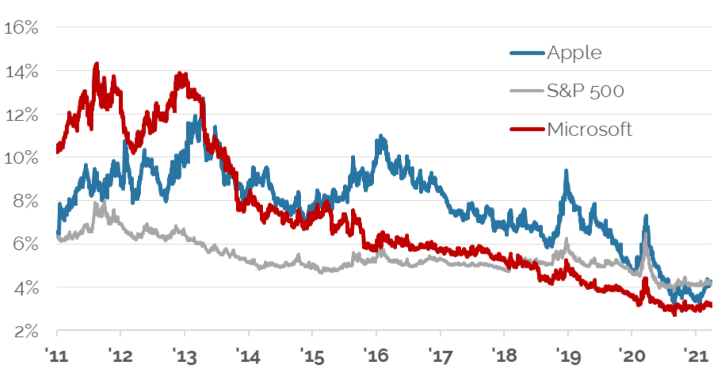
[1] Free Cash Flow Yield is based on the next-twelve-month free cash flow estimate relative to market capitalization. Stocks without estimates in the index are excluded and the remaining names are reweighted based on those exclusions.
[2] P/E is based on consensus estimates for next-twelve-months and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

was extraordinarily inexpensive on a free cash flow basis and was the largest position in our strategy, exceeding 5% of the portfolio. Microsoft, which is a useful comparison in explaining the Apple repurchase, was similarly cheap on a free cash flow basis and was also formerly a substantial weight in our strategy. But when Microsoft and Apple inflected from being among the cheapest in the market to being more expensive than the broader index on a free cash flow basis, each was sold. This happened earlier for Microsoft than Apple. These valuation inflections can be seen in **Figure 8** which shows the free cash yield for Apple and Microsoft versus the overall S&P 500 based on next-twelve-month estimated free cash flows.[5] The extent of how extraordinarily inexpensive each stock was before their respective price surges is also worth noting.

Most recently, while Microsoft has remained very expensive versus the overall market with a free cash yield around 3%, Apple's underperformance combined with rising free cash flow estimates has led to its valuation once again becoming more attractive than the overall market. Apple was repurchased as a result while Microsoft remains unowned. Apple's valuation is only modestly more attractive than the overall market, subjecting it to an existing limitation where new positions in U.S. FSV ranking in the lowest valuation quintile (of owned stocks) are limited to a 2% position at the time of re-initiation. Our weighting strategy is based on fundamentals instead of prices to take advantage of valuation opportunities when the two diverge, but also prevents names with large normalized free cash flows, which factor into position sizing, from crowding out more attractive opportunities elsewhere in the portfolio. The same limit applied to Facebook, which was also initiated at a 2% weight.

After being our largest positions when their free cash yields substantially exceeded the overall market, Apple and Microsoft were sold as their valuations became more expensive. Most recently, Apple was repurchased at a 2% weight as its valuation improved versus the market while Microsoft remains more expensive and unowned.

Figure 8: Next-Twelve-Month Estimated Free Cash Yield of Apple & Microsoft vs. the S&P 500



Source: FactSet

International Fundamental Stability & Value (Intl. FSV)

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 World Index Ex-U.S. (ACWI Ex-US) now offers a higher free cash flow yield than its U.S. counterpart. Somewhat offsetting this is the level of underlying risk. ACWI Ex-US constituent companies in aggregate have less stable cash flows than those in the S&P 500. 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 and have substantially more stable fundamentals and are less levered than the index (**See Table 3**).

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 3: International FSV Portfolio Characteristics*

	Intl. FSV	ACWI Ex-US
Free Cash Flow Yield (NTM)[1]	6.5%	4.7%
P/E[3]	17.1	22.5
Fundamental Stability[4]	0.83	0.50
Leverage[5]	0.48	1.07

*as of 4/15/2021

Changes & Regional Weights: The largest sales in the quarter were Nestle and Infosys due to valuation, while the biggest purchases were SK Hynix, the South Korean semiconductor supplier and PTT, the Thai oil and gas company, which rank highly on their normalized free cash yields. Weightings regionally are limited to 150% of the benchmark weight and the largest relative overweight remains China at 20% vs. 13% for the benchmark as a result of very attractive valuations among many of the less leveraged non-state-owned enterprise companies. Europe and Japan remain modest underweights due to valuation (**See Table 4**).

Regional weights reflect bottom-up stock selection but are limited to 150% of the benchmark to limit geographic concentration risk.

Table 4: International FSV Portfolio Region Weights*

	Intl. FSV	ACWI Ex-US
Europe	34.9%	41.0%
Asia ex China & Japan	20.5%	18.1%
China (incl. Hong Kong)	20.2%	13.3%
Japan	11.0%	15.4%
Americas	13.4%	9.1%
Middle East & Africa	0.0%	3.1%

*as of 4/15/2021 and based on headquarter location using FactSet data.

[5] This free cash yield using NTM estimates in the numerator and market cap in the denominator differs from our normalized yield methodology but is directionally similar and helpful for simplicity's sake in this example.

Final Word: Always Something and Probably an Acronym

In our collective experience as investors dating back to the 1980s, there always seems to be a litany of anomalous events, sometimes but not always with an acronym in the making. These range from very large and deleterious events like the 1987 crash, the Long-Term Capital Management (LTCM) crisis, the technology, media, and telecom (TMT) bubble, the great financial crisis (GFC), and the pandemic. Less severe developments include some from the most recent quarter—wild swings in the prices of stocks (or "stonks") promoted by online chat groups, the collapse of the extraordinarily levered Archegos family office, the plethora of celebrity-promoted special purpose acquisition companies (SPACs), and the rise of wildly priced non-fungible tokens (NFTs). While the alphabet soup of acronyms may change, there seems to be a remarkable consistency with which such events or developments both large and small tend to occur.

Not in our wildest dreams could we have accurately predicted any of these things, let alone the market reaction to them. Instead of trying to foresee such unforeseeable proceedings, their outcomes, and the corresponding market moves, we have instead designed a long-term investment strategy that will be durable to the potential challenges associated with such events when they do strike.

The design is exceedingly simple—invest in attractively valued companies with stable fundamentals and low leverage. Instead of getting caught up in a debate about factor performance or moves in the 10-year yield, the aim of the strategy is to gradually outperform over time with a particular emphasis on avoiding or mitigating the declines that such unknowable events can trigger. This can be a company's fundamentals suddenly eroding, its price correcting from an elevated valuation, or the magnifying impact of leverage on either one of these outcomes.

Since launching Distillate Capital what seems like a remarkably distant four years ago, a barrage of such events has significantly buffeted prices in both directions. Throughout, we have been pleased by the performance of our strategies and their very simple design. But just as assuredly as there will be future market-impacting anomalous events and novel combinations of letters by which to define them, our strategies will suffer stretches of underperformance. Rising valuations and concentrated leadership posed a headwind domestically in the second half of last year and the underweight in the banking sector was a drag internationally in the first quarter of this year. Over time, however, we believe that the straight-forward goal of trying to minimize downside risk by focusing on fundamental stability, valuation, and leverage, will continue to make sense not in spite of the seemingly constant bombardment of unexpected events, but largely because of them. To us, a simple strategy makes sense in an investing world where we have yet to see "normal" in over 40 years of experience.

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.*

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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