DISTILLATE CAPITAL

RATIONAL INDEX DESIGN

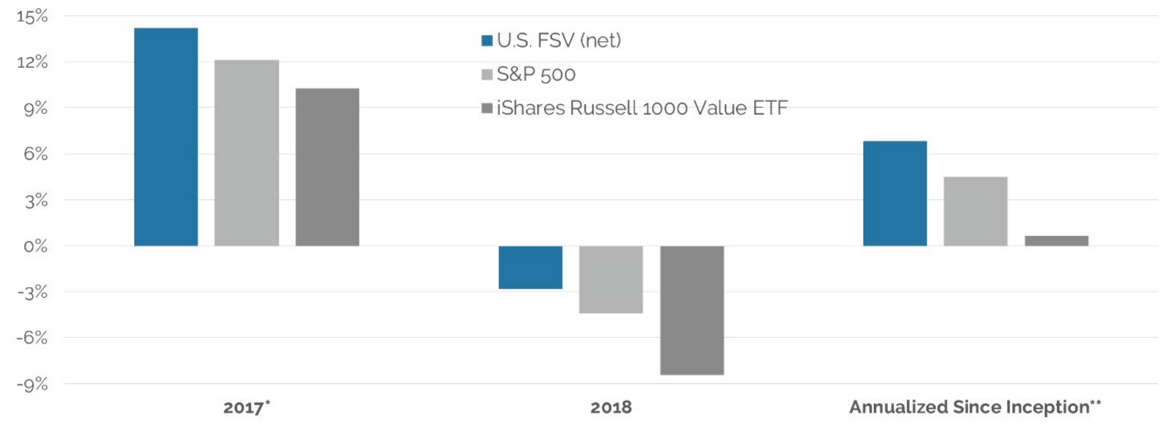
2018 Year-End Letter to Investors

Strategy Summary: Distillate Capital's U.S. Fundamental Stability & Value (U.S. FSV) fund seeks to distill a starting universe of large-cap U.S. stocks into a portfolio of the 100 most fundamentally stable and attractively valued securities. The portfolio excludes companies with excessive debt and is weighted according to each stock's normalized free cash flow. We use rationally defined measures of quality and value that draw on our experience as fundamental investors and are designed to avoid important accounting distortions in an increasingly capital-light economy.

Performance: Amid a turbulent market environment, Distillate's U.S. FSV strategy's total return of -2.8% after fees exceeded the S&P 500 total return of -4.4% in 2018. This follows on the heels of 2017's after-fee outperformance with the result that annualized performance since inception is ahead of the S&P 500 by 2.3% on an after-fee basis (See Figure 1). Performance compared to the Russell 1000 Value Index was even stronger with an excess return of 5.5% in 2018 after fees and annualized outperformance of over 6% net of fees since inception.

Breaking down the relative performance versus the S&P 500 for the U.S. FSV strategy in 2018, sector selection was roughly neutral with the overweight in retail and underweight in finance providing positives that were offset by the overweight in the producer manufacturing sector. In terms of stock selection, Fox, Kohl's, Procter & Gamble, Walmart, and F5 Networks provided the greatest positive contribution to relative performance, adding around 20 to 50 basis points each. On the negative side, Dentsply, Western Digital, Fortune Brands, Apple, and United Rentals each subtracted around 20 to 50 basis points of relative performance. Overall, more stocks were additive to relative performance than were detrimental and the portfolio benefitted from the aggregate underperformance of the names in the index it did not own.

Figure 1: Performance of Distillate Capital's U.S. FSV Strategy (through 12/31/2018)



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

** Strategy inception of 5/31/2017 through 12/31/2018

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

Portfolio Changes and Valuation

Stock price performance decoupled from underlying fundamental expectations for a large number of companies in the turbulence of 2018. This divergence created an attractive opportunity for our investment process to shed names that had outperformed and whose relative valuation thus became less appealing and to add stocks that became more attractively valued.

As a consequence of these changes, the weighted average free cash flow yield for the rebalanced portfolio in Q1 2019 is 7.7% versus a comparable yield of 5.9% for the S&P 500 Index. The rebalanced U.S. FSV portfolio also has significantly more stable long-term fundamentals and less leverage than the S&P 500 Index, as shown in **Table 1** along with the valuation figures.

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

Table 1: U.S. FSV Portfolio Characteristics

	U.S. FSV Strategy	S&P 500
Free Cash Flow Yield[1]	7.7%	5.8%
P/E[2]	14.9	19.4
Fundamental Stability[3]	0.87	0.66
Leverage[4]	1.0	1.5

*as of 1/8/2019

Sector Changes: Sector changes in the recent portfolio rebalancing are consistent with a re-allocation from outperforming sectors to underperforming ones where cash estimates have generally held up. The biggest increase was in the industrials sector, which rose from a weight of around 17% to 21% following its underperformance and improved valuation. The recently revised communications sector also increased from approximately 6% to 9% with the addition of Facebook and Alphabet. These increases were offset by a large reduction in the consumer staples sector from 8% to just over 1% following its significant outperformance in Q4 2018. The health care weight also came down, albeit more modestly, from around 20% to 17% in the wake of its relative outperformance in the year.

New Buys: The largest additions to portfolio were Alphabet, Facebook, AbbVie, Allergan, and PayPal. Broadly, these are stocks that suffered price underperformance despite stable or rising normalized free cash flow estimates.

Sells: The largest positions that exited the portfolio were Walmart, Proctor & Gamble, Cigna, Walgreens Boots Alliance, and Fox. In general, these stocks' relative valuations became less appealing as a result of strong price performance.

Adds: Because our weighting system is based in part on a company's forecast normalized free cash generation, we added to several holdings where relative price declines significantly exceeded changes in expected normalized free cash flows. The largest increased weight was Apple, which saw its stock price drop from around $230 to just above $140 in the first few days of 2019. As a result, Apple's market capitalization plummeted from a peak of just over $1.1 trillion to around $680 billion. Including the company's net cash of around $125 billion, the decline in enterprise value was even steeper at around 45%. During this same period, Apple's normalized free cash estimates have declined by less than 10% following the earnings preannouncement at the beginning of the year. Even if estimates continue to drift lower, this represents a substantial improvement in valuation. While Apple is certainly facing headwinds in its iPhone division with notable weakness in China, its high-margin services business has been growing rapidly and now represents a significant portion of overall profitability. From a long-term perspective, we believe this services business is much more attractive from both a profitability and stability standpoint in that it is tied to the installed base of products and not any individual product cycle. Thus, despite slower iPhone sales, the long-term potential for the services division makes the overall valuation very appealing, in our view.

The other largest additions to owned names included United Rentals, IBM, PVH, and Alexion. All but PVH also saw their expected normalized free cash flows increase in the face of price underperformance. Normalized free cash estimates for PVH were roughly stable, but the stock underperformance towards the end of 2018 was substantial enough to require an additional purchase to bring its weight back in line.

Trims: The largest reductions in the portfolio resulting from the Q1 2019 rebalance were Microsoft, Omnicom, AutoZone, Comcast, and Intel. Microsoft remains attractively valued and is still a large holding in the portfolio, but normalized cash flow estimates have receded slightly while the stock outperformed the broad S&P 500 over the course of the year. Consequently, Microsoft was reduced to a weight just over 3% at the beginning of 2019 from around 3.5% at the end of 2018. The other four stocks being trimmed all outperformed the S&P 500 in Q4 2018 and are being reduced as their relative valuations have become less compelling.

[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.)

Market Environment & Valuation

Following a period of atypical calm, volatility resurged in the stock market in 2018. The S&P 500 Index began the year by rallying nearly 8% in January only to drop by over 10% into February. The index then recovered almost 14% through September before plummeting nearly 20% by the end of December before it staged a roughly 7% rally in the final days of the year. Ultimately, the rollercoaster finished with a total return of -4.4% for the S&P 500 Index for the full year.

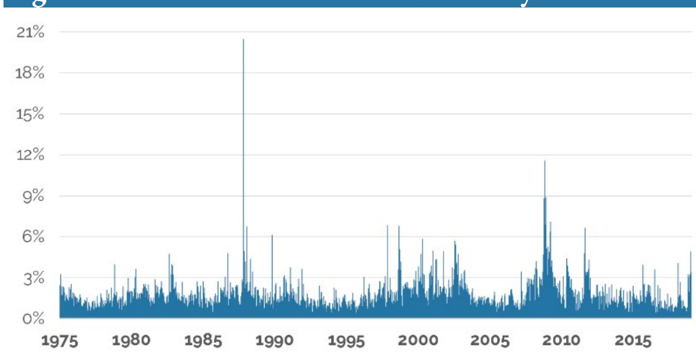
Despite much of the media hysteria surrounding the recent market moves, this type of short-term price volatility is not all that unusual for equities. There have been numerous periods where gyrations in daily percentage point moves were much greater. This is evident in a long-term chart of the absolute value of daily percentage moves going back to 1975 which shows that daily price moves were larger in the recent financial crisis, in the early 2000s and late 1990s, and in the late 1980s (**See Figure 2**).

While such price swings are not uncommon, they do frequently lead to suboptimal and fear-based decision-making that is often exacerbated by sensationalized media coverage. But at the same time that such short-term decision-making can undermine returns for some investors, they also create opportunities for less myopic ones.[5]

Beneath the surface of the volatile price moves of 2018, underlying fundamentals were much more stable. This is evident in a comparison of expected next-twelve month free cash flow and the index price (**See Figure 3**).

Recent price volatility is not unusual in a longer-term context as there were numerous periods with larger daily percentage point moves.

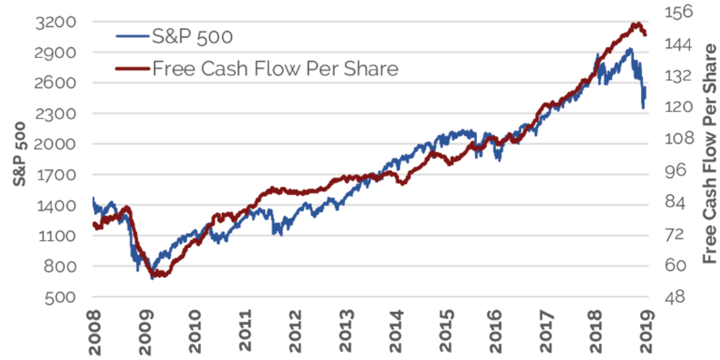
Figure 2: Absolute Value of S&P 500 Daily Price Moves



Source: FactSet

The S&P 500 price has moved much more than underlying fundamentals.

Figure 3: S&P 500 Price vs. Free Cash Flow Per Share



Source: FactSet

The disconnect between the 7% market price drop and 13% increase in consensus-estimated free cash flow per share over the course of 2018 resulted in a substantial improvement in valuation. The next-twelve-month forecast free-cash-yield on the S&P 500 increased from under 5% to roughly 6% by the end of the year. The current yield significantly exceeds the average of around 5% over the prior 5 years and represents a valuation that is less expensive than any time since the beginning of 2013 in the aftermath of the Great Financial Crisis (**See Figure 4**).

It follows that a significant amount of pessimism is now priced into the market. This is supported by surveys of sentiment, fund flows, and investor cash levels. All else equal, this causes us to be more optimistic.

The free cash yield for the S&P 500 improved substantially as the index price fell much more sharply than free cash estimates.

Figure 4: S&P 500 Free Cash Flow Yield[6]

Source: FactSet

[5] for more detail, see our white paper Long-Term Investing: The Cost of Myopic Thinking

[6] Based on next-twelve-month forecast free cash flow per share.

Looking more closely at the modest downward revision to expected free cash flow that did occur at the end of the year, most of the move was due to a decline in the energy sector. Outside of energy, the utilities and real estate sectors experienced slight drops and the technology sector started to exhibit some weakness, as well (**See Figure 5**). Within the technology sector, the story is somewhat more nuanced with disappointing guidance from Micron Technologies, Nvidia, and others in the semiconductor space causing estimates to roll over in that sub-industry after an extraordinary recent run. Apple's early 2019 preannouncement relating to iPhone sales in China also put downward pressure on estimates in the hardware segment. Tech estimates outside of these areas remain generally healthy.

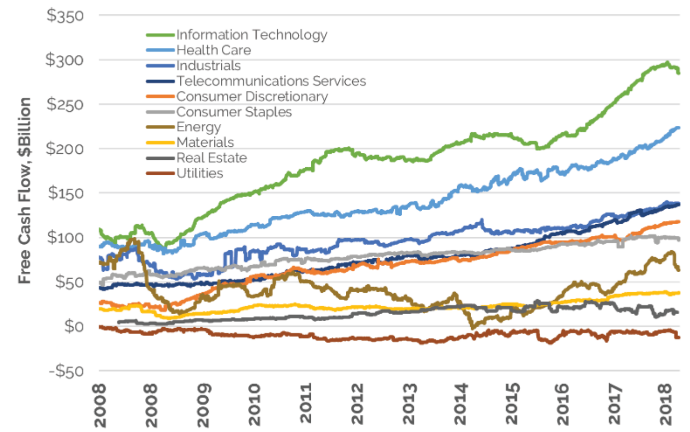
For the index overall, other than energy and a few small pockets of weakness, fundamentals remain significantly stronger than the steep price move would suggest. Market weakness thus occurred largely as a result of valuation compression rather than fundamental erosion.

Lastly, it is worth noting that there is some concern that quantitative or algorithmic trading, which now represents around 85% of total trading,[7] has exaggerated recent market volatility and explains some of the divergence between prices and fundamentals. While it is only speculative to attribute market swings to any particular factor, it is true that a large number of quantitative strategies now use market volatility as a risk measure and reduce equity exposures as volatility increases. Risk parity strategies, for example, target a certain level of overall portfolio volatility and so reduce the allocation to equities in declining markets when price volatility rises. Other strategies similarly use measures of market and individual stock volatility to attempt to control for risk and also reduce overall equity positions or sell out of certain stocks as a result of large price declines. It seems very possible that such trading behavior could create a situation in which falling prices beget falling prices.

While it is entirely possible that quantitative trading has contributed to the recent volatility, we think such exaggerated short-term moves create tremendous opportunities for long-term investors who are not bound by measures of price volatility. Since we measure risk by a combination of through-cycle fundamental stability, leverage, and valuation, price declines to us often make a stock look less risky with better downside protection. By ignoring short-term price swings and focusing on long-term fundamentals and valuation, our investment process thus seeks to capitalize on the long-term opportunities created by volatile markets regardless of what has created them.

By sector, free cash flow estimates remain generally strong outside of weakness the energy sector and semis and hardware within technology.

Figure 5: S&P 500 Estimated Next-Twelve-Month Free Cash Flow by Sector



Source: FactSet

[7] Zuckerman, Greg. "Behind the Market Swoon: The Herdlike Behavior of Computerized Trading" (Wall Street Journal) 12/25/2018

U.S. Economic Backdrop:

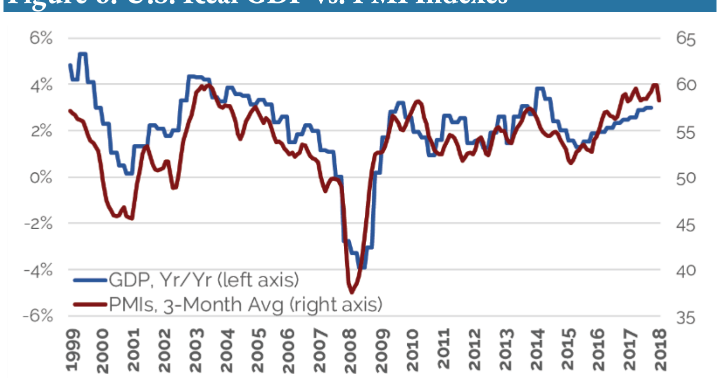
From an economic perspective, there are myriad near-term concerns ranging from trade tensions, political uncertainty domestically and abroad, moderating global growth, and less accommodative monetary policy in the United States. These are some of the key factors that weighed on sentiment and caused valuations to compress and the market to decline even though fundamentals remained generally healthy. Despite these near-term challenges, we think the longer-term trajectory of economic activity and corporate cash generation is still solidly positive even if economic growth does moderate to a degree from current levels.

The U.S. economy, in particular, looks healthy. Consumer incomes and spending have been strong and overall activity has been quite positive even amid some moderation in certain segments of the economy due to rising trade tensions and other concerns. This strength is evident in a comparison of the combined manufacturing and non-manufacturing purchasing managers surveys with year-over-year growth in real Gross Domestic Product (GDP) (**See Figure 6**).

Monetary policy has tightened, but inflation has remained fairly muted and this should give the Federal Reserve leeway to slow the pace of interest rate hikes, or even ease them altogether. Wages have picked up amid a tighter labor market, but so too has labor productivity with the result that unit labor costs remained well contained. From a longer-term view, wages do not seem out of line with unit labor costs even after their recent rise and unit labor costs thus do not appear at risk of rising sharply (**See Figure 7**). Given the tight relationship between core inflation and unit labor costs (**See figure 8**), this is of critical importance. Inflation is also likely to be moderated by the stronger dollar, the dampening impact on labor costs from an increasingly globalized workforce, and deflationary impulses from technological innovation and new goods and services. These factors should all help keep inflation in check and enable the Fed to shift to a more moderate policy stance.

Economic conditions in the United States are healthy.

Figure 6: U.S. Real GDP vs. PMI Indexes



Source: U.S. Bureau of Economic Analysis, Institute for Supply Management, FactSet

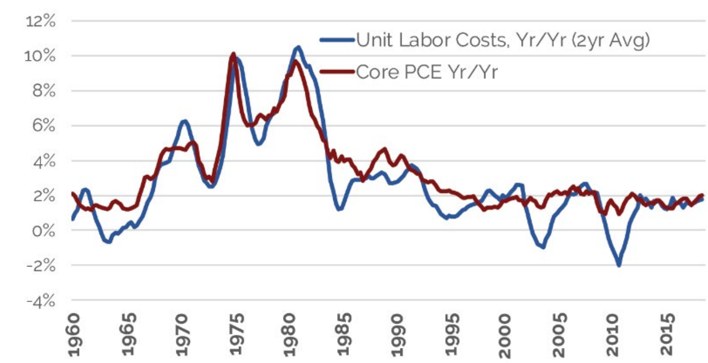
Unit labor costs remain relatively modest even with the uptick in wages.

Figure 7: U.S. Unit Labor Costs vs. Wages

Source: U.S. Department of Labor, FactSet

Inflation is closely tied to unit labor costs.

Figure 8: U.S. Inflation (Core PCE vs. Unit Labor Costs)

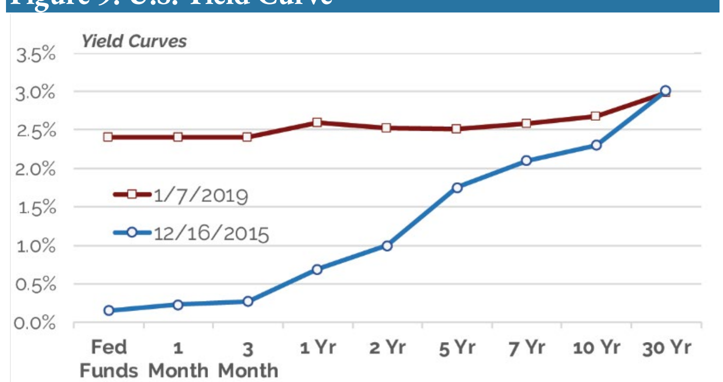


Source: U.S. Bureau of Economic Analysis, U.S. Department of Labor, FactSet

It is also important to note that much of the monetary policy tightening that has occurred has been dulled by a flattening yield curve. Longer-term rates matter much more for borrowers and the economy overall and have moved up much more modestly than the short-term rates that the Fed directly impacts. This is evident in a comparison of the current yield curve with the curve when the Fed began raising interest rates in in December of 2015 (**See Figure 9**).

Long-term borrowing costs have moved much less than short-term yields.

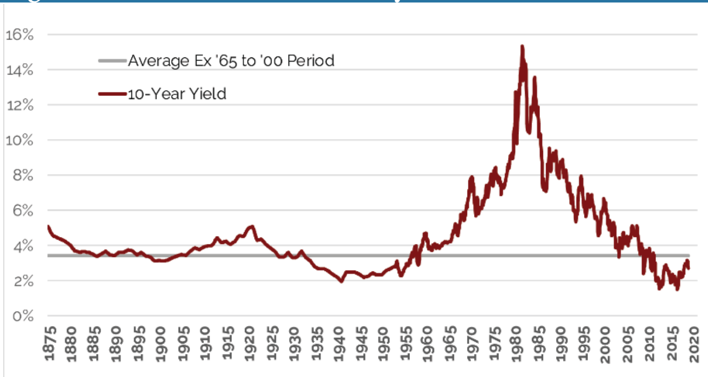
Figure 9: U.S. Yield Curve



Source: FactSet

Excluding the spike that peaked in the 1980s, current 10-year treasury yields are not far out of line with the long-term average.

Figure 10: U.S. 10-Year Treasury Yield



Source: Multpl

Junk bond yields were at record lows before rising modestly at the end of the year.

Figure 11: U.S. Junk Bond Yield, 1987-Present

Source: FactSet

Lastly, it is worth putting the current yield on the U.S. 10-year treasury into its longer-term context. From this perspective, the current yield does not look unusual. The more unusual period was the spike that occurred in the mid-1960s and 1970s and the period of normalization that took place over several decades thereafter. Excluding this more anomalous period, the current yield is not too far from the long-term average (**See Figure 10**).

Although long-term rates thus appear unlikely to move materially higher and severely dampen overall economic activity, rising short-term borrowing costs may pose a headwind to lower quality borrowers who have benefitted tremendously from a recent surge in credit risk appetite and a massive wave of lending. As credit investors moved up the risk curve in search of higher yields, the cost of issuing riskier debt plummeted and junk bond yields hit record lows since the index began (**See Figure 11**).

This low cost of credit encouraged an increase in borrowing among riskier issuers. Consequently, while overall corporate debt has risen over the past decade, a disproportionate share of the increase has occurred in the riskier segments of the credit market with massive growth in the lowest rated investment grade bonds (BBB), junk bonds, and leveraged loans (**See Figure 12**).

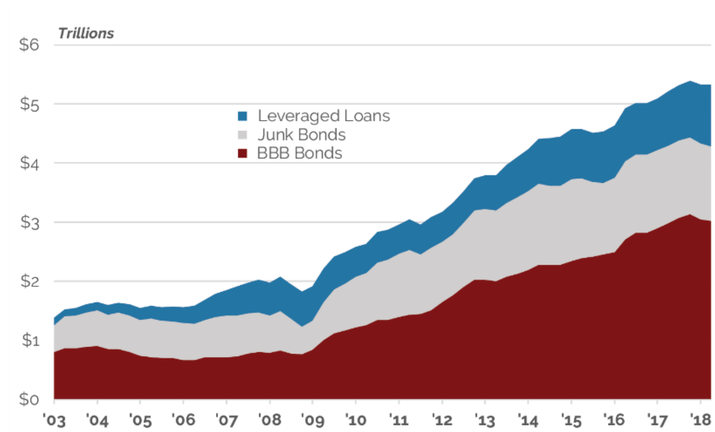
In addition to the rapid increase in risky debt, there are concerns about deteriorating quality. For example, only around 20% of leveraged loans now include buyer protections, called covenants, compared to around 70% a decade ago.[8] As well, an increasing share of credit is being supplied to firms with the highest debt burdens and debt ratios where customized measures of profitability are being utilized to create the appearance of better quality.[8] It is notable that Federal Reserve Chair Janet Yellen, current Federal Reserve Board Member Lael Brainard, the International Monetary Fund, and the Bank for International Settlements have all cautioned about these risks in the corporate credit space.

While the increase in rates may negatively impact the high yield market, as Yellen and Brainard have cautioned, the positive is that much of this debt was issued by private companies, smaller public companies, and companies in select sectors of the equity market. Most large publicly traded companies do not have overwhelming debt burdens and quite a number have very large net cash surpluses. Thus, even if the high yield or leveraged loan markets do suffer some stress, the fundamentals of most companies in the S&P 500 Index appear less at risk.

Overall, the U.S. economy remains quite healthy in our view. Activity is likely to moderate next year given less support from fiscal stimulus, some tightening in monetary conditions, trade tensions, and general political uncertainty. But despite the dampening effects of these issues, economic growth in general is strong and there is nothing so far to suggest the possibility of a more severe slowdown.

Low borrowing costs and a high level of risk appetite on the part of investors led to a surge in risky debt.

Figure 12: U.S. BBB, Junk & Leveraged Loans



Source: ICE, FactSet

[8] Brainard, Lael "Assessing Financial Stability Over the Cycle" December 7, 2018

International Economic Outlook:

Outside the United States, economic growth is also likely to moderate with headwinds in Europe and China but should likewise remain generally healthy. Ongoing challenges in Europe have contributed to a recent slowdown there, as is evident in the chart of real GDP growth and business sentiment (**See Figure 13**). Going forward, very weak demographic growth and continued issues of indebtedness and economic integration relating to the Euro-crisis will weigh on growth. And issues around Brexit in the United Kingdom are also likely to be a drag on activity.

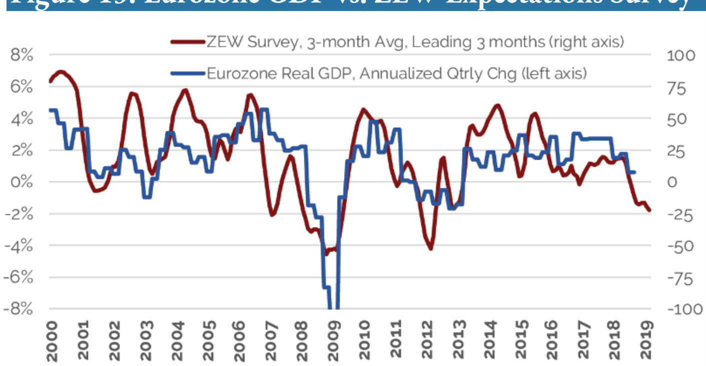
China has also experienced an economic slowdown. China is struggling with the interconnected issues of an explosion in credit and an investment surge that has led to uneconomic spending that does not look sustainable over the long-term. These imbalances are likely to continue to dampen Chinese economic activity and even threaten the possibility of a sharper slowdown. To get a sense of the enormity of the credit expansion in China, it is useful to look at credit growth relative to GDP and then to compare these figures with those in the United States for context.

In the United States, GDP has grown from around $13 trillion in 2005, to roughly $21 trillion now, while assets in the banking system rose from around $9 trillion to $17 trillion. In China, by contrast, nominal GDP surged from $2.5 trillion in 2005 to around $13 trillion. At the same time, however, bank assets grew even more rapidly from $5 trillion to $40 trillion. It is staggering that Chinese bank assets grew by $35 trillion compared to an increase in GDP of $10 trillion and that the increase in bank assets is multiples of the increase experienced in the much larger U.S. economy.

One mitigating factor in this credit accumulation, however, is that it was generally supported with domestic savings rather than a reliance on foreign capital as occurred in many other Asian countries in the late 1990s. This may thus help limit the risk of a sudden reversal of credit and more severe slowdown.

Economic activity is slowing in the Eurozone.

Figure 13: Eurozone GDP vs. ZEW Expectations Survey



Source: Eurostat, ZEW Center for European Economic Research, FactSet

China is struggling with the aftermath of a massive credit surge.

Figure 14: China & U.S. Bank Assets vs. GDP (in USD)

Source: People's Bank of China, U.S. Federal Reserve, U.S. B.E.A., FactSet

Even so, the overhang of credit and its associated challenges are likely to weigh on growth in China going forward. Any potential credit-related slowdown is likely be felt most strongly in construction or other areas of investment where excesses are particularly acute. Foreign companies that supply iron ore, coking coal, nickel, and other materials where China consumers over 50% of the world's total would likely struggle. Consumer-related spending, on the other hand, may hold up much better.

Overall, despite headwinds in Europe and China, reasonable activity elsewhere in the world and healthy, albeit more moderate, conditions in the United States, should support overall global economic growth. There may be near-term risks to navigate, but the longer-term structural underpinnings of economic growth remain strong. Demographic gains are moderating but still solidly positive, especially in the emerging world, and technological innovation is robust and should fuel ongoing productivity gains. While a moderation from the above-trend level in 2018 seems very likely, global economic growth should nevertheless remain strong. This outlook for a more modest but still solid trajectory of economic activity is evident in the International Monetary Fund's forecast for world real GDP growth (**See Figure 15**).

Even though global growth may moderate, it should remain healthy.

Figure 15: IMF Forecast World Real GDP Growth

Source: International Monetary Fund, FactSet

Investment Implications:

From an investor perspective, while there is always the possibility that some near-term hiccups or challenges will weigh on underlying equity fundamentals, economic growth over the longer-term should support continued strength. In addition, we think many equities around the world and in the United States, in particular, are benefiting from an ongoing shift from asset-intensive to more asset-light operations that is providing additional support to underlying free cash flow generation.

In combination with very attractive current valuations, we therefore see the current backdrop as being favorable for equities over the longer-term. There are some potential near-term risks, which we think make our focus on fundamental stability and low leverage particularly prudent in addition to the opportunity this creates to exploit behavioral biases.[9]

Most importantly, we think valuations are now very appealing and should provide investors with an attractive starting point for long-term equity returns even if there are uncomfortable price swings to weather in the short-term. This may prove to be especially true given valuations in other asset classes. For example, compared to a yield of under 3% on 10-year treasuries, the S&P 500 looks attractive at a nearly 6% free cash flow yield. Moreover, coupon payments on 10-year treasuries will not increase over the next decade while the free cash flow of the S&P 500 is likely to grow by at least several percentage points per year.

[9] for more detail, see our white paper Behavioral Biases: Exploiting Systematic Mispricings

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 .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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