



DISTILLATE CAPITAL

2022 Q1 Letter to Investors: Very Different Drivers of Returns

Strategy Description

Distillate Capital's U.S. and International Fundamental Stability & Value (U.S. FSV & Intl 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's Small Cap U.S. Quality and Value (U.S. SQV) seeks to do the same by focusing valuation and indebtedness.

Performance Summary

U.S. Fundamental Stability & Value (U.S. FSV): Distillate's U.S. FSV outperformed S&P 500 in the first quarter of 2022 with a return of -3.60% net of fees versus -4.60% for the benchmark. Since its inception in 2017, annualized performance is now 1.93% ahead of the S&P 500 after fees (See [Figure 1](#) on the following page). The U.S. FSV strategy lagged against the Russell 1000 Value ETF benchmark in the first quarter of 2022, but remains 7.41% ahead annualized since inception. The strategy performed consistent with its objective in the quarter, holding up better than the overall market during the drawdown through February. Performance then lagged in the recovery in March when some of the large and more expensive stocks led the market upturn.

International Fundamental Stability & Value (Intl. FSV): Distillate's Intl. FSV strategy slightly outperformed its benchmark, the iShares MSCI ACWI ex-US ETF, with a return of -6.19% net of fees versus -6.26% for the benchmark during the first quarter of 2022 (See [Figure 2](#) on the following page). Annualized returns net of fees since inception for the international strategy remain 1.17% ahead of its benchmark.

U.S. Small Quality & Value (U.S. SQV): Distillate's U.S. SQV's 2022 Q1 total return after fees of -4.49% exceeded the total return for the iShares Russell 2000 ETF of -7.54%, but lagged the iShares Russell 2000 Value ETF's total return of -2.46%. Following significant previous gains over the benchmarks, the strategy is substantially ahead of the Russell 2000 and Russell 2000 Value ETFs, by 7.69% and 6.83% on an annualized net-of-fee basis since inception (See [Figure 3](#) on the following page).

Differing Drivers of Returns

While Distillate's U.S. FSV strategy has outpaced the gains of the S&P 500, it has done so largely due to fundamental performance rather than valuation expansion. This is discussed further in the letter, but is highlighted in the below tables that draw on FactSet estimated 2022 free cash flows per share for the U.S. FSV portfolio and the S&P 500 Index. Since 2020, when these estimates first became available, all of the S&P 500's 43% price gain is attributable to a 44% rise in the valuation multiple. Nearly the opposite is true of the U.S. FSV strategy, where very little of the even greater 49% price increase benefited from the 7% expansion in the valuation on 2022 estimated cash flows per share.

Table 1: Change in Price, Estimated Cash Flows, and Valuation From 2000 to March 2022 for Distillate's U.S. FSV Strategy vs. the S&P 500

S&P 500 ETF				Distillate's U.S. FSV Strategy			
	Price	Cash Flow Per Share Estimate for CY '22	Multiple		Price	Cash Flow Per Share Estimate for CY '22	Multiple
Jan '20	\$ 321.7	\$ 19.62	16.4	Jan '20	\$ 30.3	\$ 2.07	14.6
Mar '22	\$ 458.7	\$ 19.46	23.6	Mar '22	\$ 45.1	\$ 2.88	15.7
Change	43%	-1%	44%	Change	49%	39%	7%

Source: FactSet methodology of calculating cash flow per share for ETFs corresponding to the respective index/strategies listed. Data as of 3/31/22.

Performance Charts: Figures 1 through 3 depict annual performance for Distillate's U.S. and Intl. FSV strategies and its U.S. Small Quality Value (U.S. SQV) strategy versus their respective benchmarks since inception.

Figure 1: Performance of Distillate's U.S. FSV Strategy (through 3/31/2022)

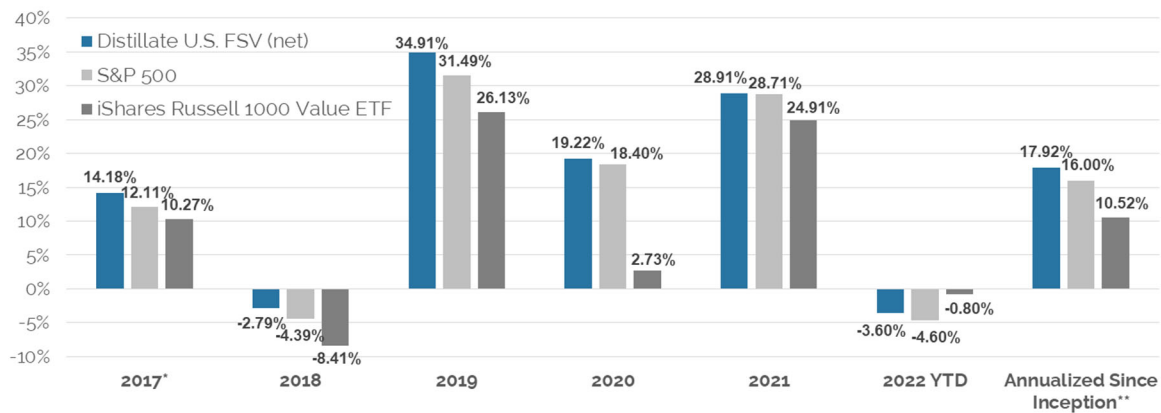


Figure 2: Performance of Distillate's International FSV Strategy (through 3/31/2022)

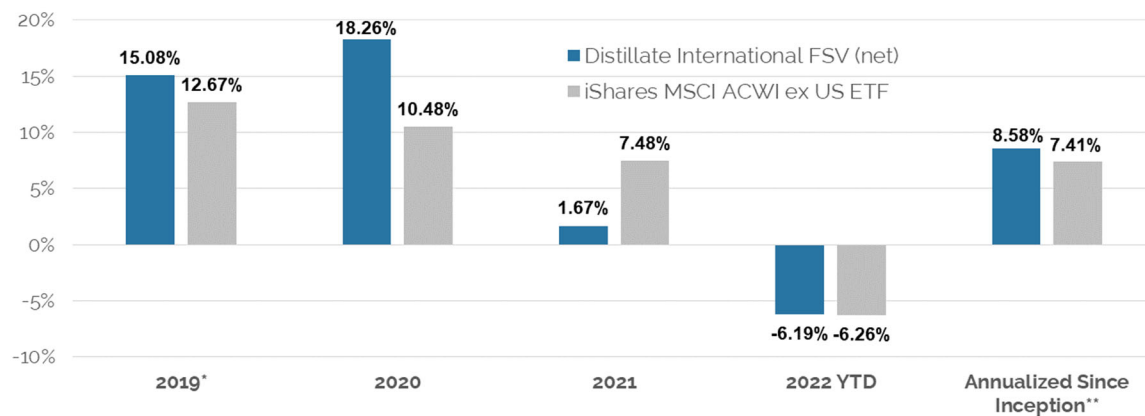
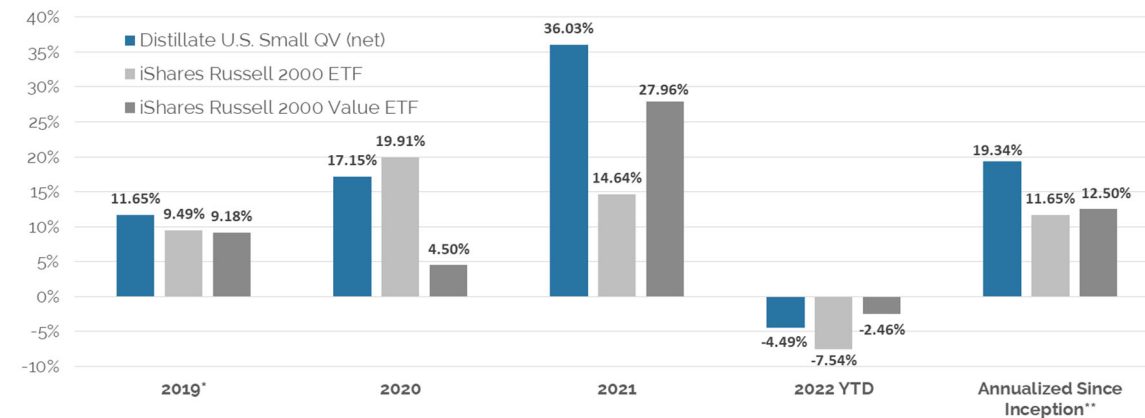


Figure 3: Performance of Distillate's U.S. Small QV Strategy (through 3/31/2022)



* Strategy inception of 5/31/2017 to 12/31/2017 for US FSV; 1/31/2019 to 12/31/2019 for INTL FSV; and 3/31/2019 to 12/31/2019 for US SQV.

** Strategy inception of 5/31/2017 for US FSV; 1/31/2019 for INTL FSV; and 3/31/2019 for US SQV.

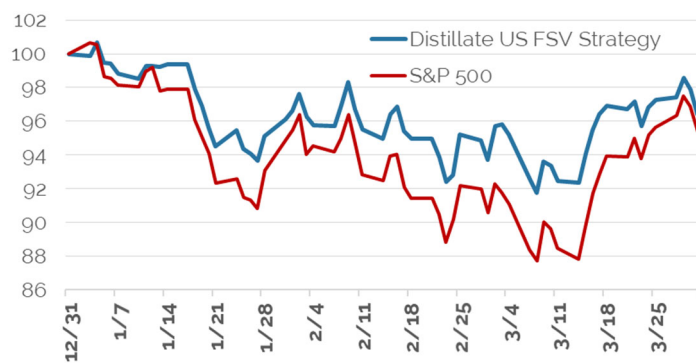
Sources: U.S. Bank, Morningstar Data. Please see important performance disclosures at the end of this document.

Market Commentary:

Equity markets declined in the first quarter of 2022 amid the economic and geopolitical uncertainty stemming from Russia's revanchist invasion of Ukraine. During this decline, Distillate's U.S. FSV portfolio performed well and experienced a more modest drawdown than the S&P 500 Index before giving up some of those relative gains when equities later recovered (See [Figure 4](#)).

Distillate's U.S. FSV outperformed the broad market in the sell-off.

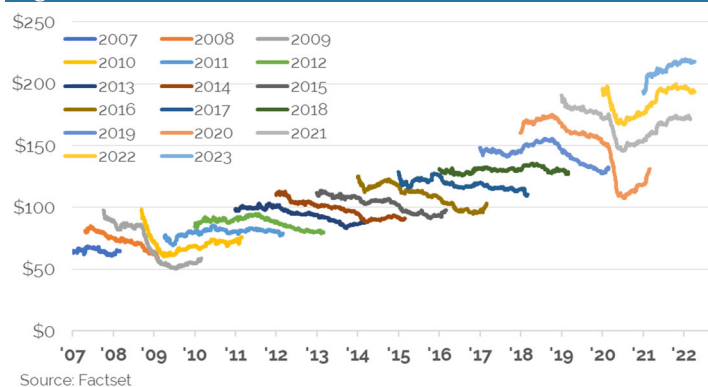
Figure 4: Indexed Price Performance of Distillate's U.S. FSV Strategy and the S&P 500 (YTD)



Despite the geopolitical backdrop, fundamentals remain relatively healthy with free cash flow estimates continuing their upward climb. This is evident in [Figure 5](#) which shows the steady upward trajectory of annual free cash flow estimates for the S&P 500 Index. This chart also highlights how the longer-term trend in estimates is rising, despite the annual pattern where estimates more typically erode as initial forecasts tend to be optimistic and then are revised somewhat lower. In terms of valuation, the current S&P 500 free cash flow yield on the 2022 estimate is 4.3%, which while being somewhat expensive is not dramatically expensive especially given the underlying growth in free cash flows and the ability of companies to raise prices amid inflation pressures. Even more importantly, this headline figure for the S&P 500 masks much greater opportunities below the surface.

Free cash estimates for the market continue to trend higher over time even as estimates for individual years tend to moderate over the shorter-term.

Figure 5: Free Cash Flow Estimates for the S&P 500



Different Drivers of Returns:

Both Distillate's U.S. Fundamental Stability & Value (U.S. FSV) strategy and the overall U.S. market (proxied with the S&P 500 ETF) have increased in price relative to their pre-pandemic levels. The paths of those price moves, however, are very different.

Based on the underlying securities held, the data platform FactSet provides weighted average free cash flow per share data for both the U.S. FSV strategy and the S&P 500 ETF. Using this data, [Table 2](#) shows the consensus estimated 2022 free cash flows per share for both portfolios, their prices, and their free cash flow valuations on those estimates in the beginning of 2020 and now. While estimated 2022 free cash flows per share for the S&P 500 ETF are slightly lower now than in the start of 2020, its price is up 43% due to the multiple paid for those cash flows expanding by 44%. By contrast, Distillate's U.S. FSV strategy has seen even greater price gains and has outperformed the S&P 500, but did so with very little in the way of multiple expansion with the dominant factor being rising free cash flow estimates.

Distillate's returns since the end of 2019 have been primarily driven by fundamental improvements rather than valuation expansion.

Table 2: U.S. FSV & S&P 500 Free Cash Flow Per Share Estimates for 2022, Price, & Valuation

S&P 500 ETF			
	Price	Cash Flow Per Share Estimate for CY '22	Multiple
Jan '20	\$ 321.7	\$ 19.62	16.4
Mar '22	\$ 458.7	\$ 19.46	23.6
Change	43%	-1%	44%

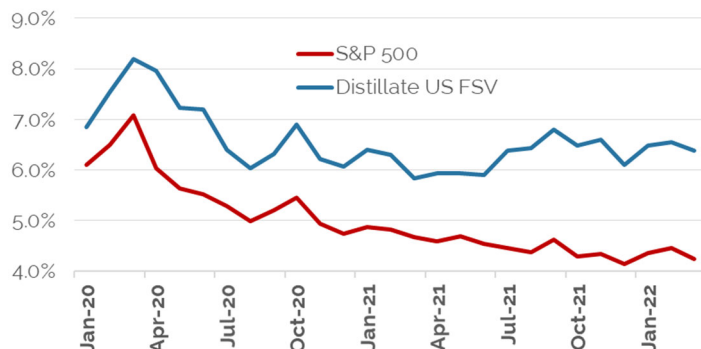
Distillate's U.S. FSV Strategy			
	Price	Cash Flow Per Share Estimate for CY '22	Multiple
Jan '20	\$ 30.3	\$ 2.07	14.6
Mar '22	\$ 45.1	\$ 2.88	15.7
Change	49%	39%	7%

Source: FactSet methodology of calculating cash flow per share for ETFs corresponding to the respective index/strategies listed. Data as of 3/31/22.

[Figure 6](#) plots the free cash flow yield on 2022 estimated free cash flows for U.S. FSV and the S&P 500 ETF since January, 2020. The free cash yield for the S&P 500 ETF has fallen from around 6% to 4.3% currently, after reaching a high of 7% during the pandemic. The free cash flow yield on our U.S. FSV strategy on 2022 estimates, on the other hand, fell very modestly over the period and the positive gap between it and the S&P 500 widened considerably. Instead of benefiting from a valuation expansion on 2022 estimated free cash flow per share as the S&P 500 ETF did, Distillate's price gains since the start of 2020 resulted from rising estimated free cash flows.

Distillate's U.S. FSV's free cash flow yield has remained fairly flat at around 6.5% while the S&P 500 ETFs has fallen significantly.

Figure 6: Free Cash Yield on 2022E Free Cash Flows

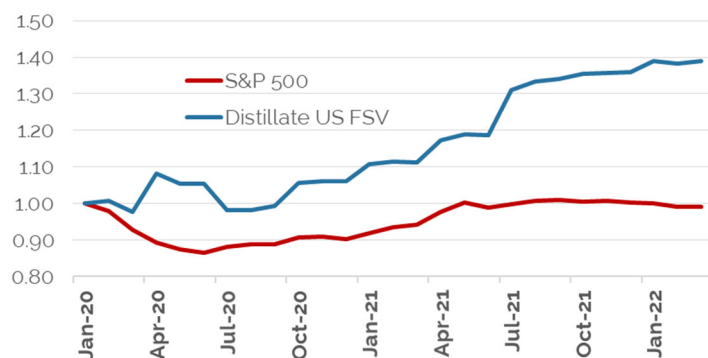


Source: Factset

This difference in free cash estimates is shown in **Figure 7** which indexes the estimated 2022 free cash flow per share for each strategy at the start of 2020 (the pattern for the S&P 500 ETF in this figure is the same as the green line for 2022 in Figure 5). Distillate's better free cash flow per share revisions likely result from two key factors. First, the weighted average free cash flow per share of the stocks in the Distillate portfolio held up much better in the crisis, which is consistent with the approach of emphasizing companies with stable long-term cash flow profiles. Second, there was also a benefit of rebalancing into names that were inexpensive and may have had overly pessimistic expectations. A similar benefit likely occurred from avoiding some of the more expensive stocks that might have had overly ambitious expectations.

Estimated 2022 free cash flows per share rose much more for Distillate's U.S. FSV strategy than for the S&P 500 ETF.

Figure 7: Consensus Estimated Weighted Average 2022 Free Cash Flows Per Share Indexed to 2020



Source: Factset

Overall, the path of estimated 2022 free cash flows per share for our strategy is consistent with the objective of limiting declines by focusing on fundamental stability and exploiting pessimistic expectations through a valuation discipline. That the strategy has benefitted more from fundamental improvement, rather than valuation expansion, leaves us constructive about the opportunity set.

Valuation & Quality vs. Indexes

The disparity between our strategies and the markets is emphasized in the valuation and quality charts on the following page which depict what we believe are the most relevant metrics for evaluating and understanding how they differ from comparable indexes.

Starting with valuation, **Figure 8** compares next-twelve-month's estimated free cash flow to enterprise value, and highlights substantial valuation advantages for each of Distillate's strategies compared to their relevant benchmarks. The yield differential of the U.S. FSV strategy over the S&P 500 Index is at an all-time peak and the international and small cap strategies also enjoy significantly more attractive valuations than their benchmarks.

Figure 9 looks at fundamental stability by assessing the through-cycle variability of cash flows, with a higher score equating to greater stability. It is the same metric used for stock selection in the FSV strategies. The greater stability available through stock selection versus benchmark in our estimation is meaningful and particularly important to our goal of preserving capital in adverse scenarios. The small cap strategy does not employ a stability overlay in the stock selection process since we have found this metric to be less useful in the small cap space where companies tend to have shorter histories and much less stability in general. Nonetheless, the figure is calculated and the portfolio does show more stability than the comparable benchmarks.

Figure 10 measures leverage in the form of total debt relative to normalized lease-adjusted consensus estimates for earnings before interest, taxation, depreciation, and amortization (EBITDA). Leverage for the U.S. FSV strategy is slightly below that of the S&P 500 benchmark where many mega-cap companies with little debt have significantly reduced the overall benchmark figure in recent years. The goal of employing a leverage limit is not necessarily to have less leverage than the overall index, but to avoid stocks with excess leverage that will be challenged in certain economic environments. Internationally, leverage is higher in the benchmark than it is domestically and the international FSV strategy is much more differentiated in this regard. Lastly, leverage is very high among small cap companies despite the fact that the fundamentals for these companies are more volatile and they are thus less able to support higher debt burdens on average. We believe this is a key risk among smaller companies and an attribute that is crucially differentiated in our small cap strategy versus benchmarks.

Given the backdrop of richer valuations in the U.S., lower quality and higher leverage internationally, and low valuations and high debt levels among smaller U.S. stocks, we continue to see significant potential benefits to stock selection, and a benefit in avoiding the risks noted in each of the U.S. large cap, International, and U.S. small cap spaces.

Positioning: **Figure 8** shows the current valuations for Distillate’s U.S. and International Fundamental Stability and Value (FSV) strategies and its U.S. Small Quality and Value strategy versus various benchmarks. **Figure 9** compares the same Distillate strategies and corresponding benchmarks on our cash flow stability scores, and **Figure 10** examines the degree of financial leverage across the same strategies and benchmarks.

Figure 8: Next 12-Month Free Cash Flow to Enterprise Value

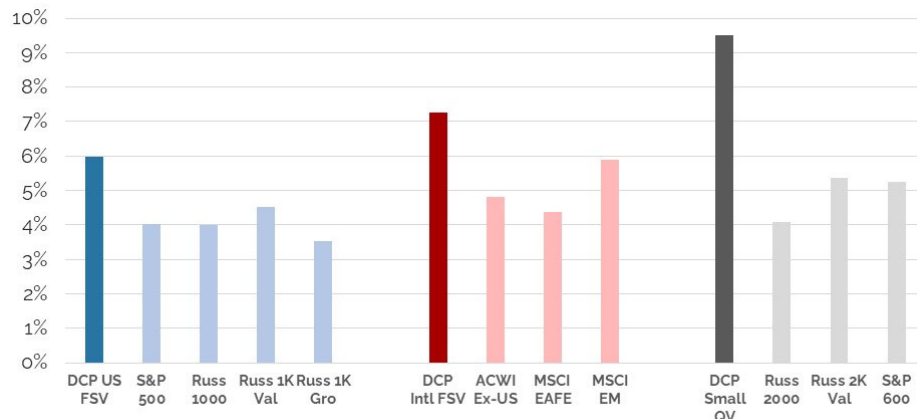


Figure 9 (Quality): Distillate’s Cash Flow Stability Score

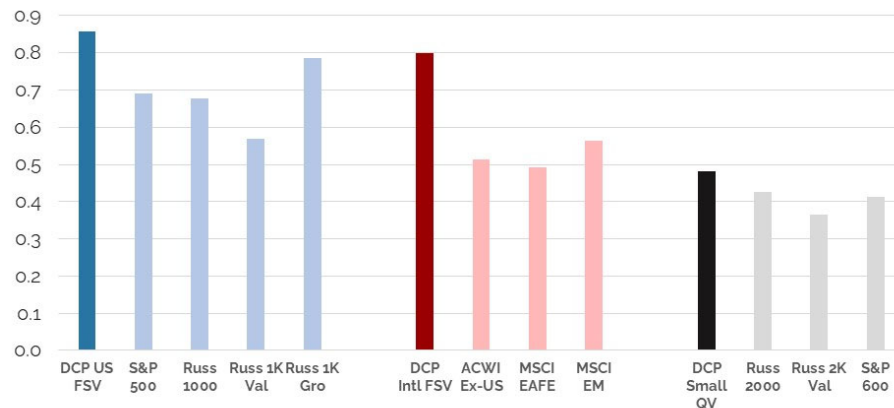
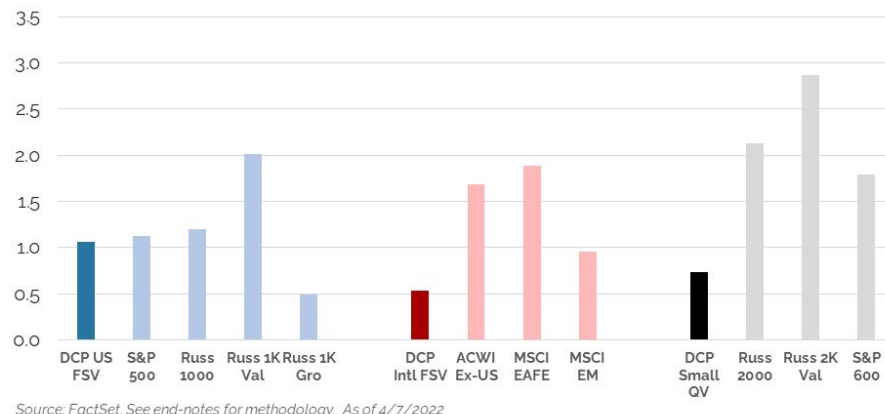


Figure 10 (Quality): Net Debt to Adjusted EBITDA



Performance

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

Distillate's U.S. FSV strategy outpaced the S&P 500 benchmark by around 1% in the first quarter of 2022. As noted earlier, relative performance was very strong in the downturn and then lagged somewhat in the price recovery that took place in March. By stock, AbbVie, Lockheed Martin, and Diamondback Energy were the largest contributors to relative returns at around 35 basis points each. By sector, the underweight in financials, where leverage tends to limit the portfolio weight, was a 0.2% drag versus the benchmark and the underweight in energy, where high cash flow volatility and leverage make many of the stocks look unappealing from a risk point of view, detracted another 0.9%.

International Fundamental Stability & Value (Intl. FSV)

Distillate's International FSV modestly outpaced its benchmark by just a few basis points in the first quarter of 2022. As was the case last year, strong performance of financial stocks, and bank stocks in particular, remained a headwind and detracted around 1.5% to relative performance, though this was overcome with relative gains in other sectors. As a reminder, high leverage, low stability, and lacking free cash flows will limit ownership in financials in our International FSV strategy. Given the relatively large weight of bank stocks in the international benchmark, the Intl. FSV strategy may vary in performance on a quarter-to-quarter basis more than is the case domestically if bank stocks are rising or falling sharply. Over time, given the goal of protecting capital, we believe the lower exposure to balance-sheet-driven financials makes sense, and we believe this to be especially true internationally where many banks are captive to local governments and not necessarily run for the benefit of shareholders.

U.S. Small Quality & Value (U.S. SQV)

Strong relative performance for Distillate's U.S. SQV strategy continued into 2022 with performance of -4.49% exceeding that of the Russell 2000 ETF at -7.54%, and lagging behind the Russell 2000 Value ETF's first quarter return of -2.46%. The strategy's cumulative annualized performance is now 7.7% and 6.8% ahead of the same benchmarks since inception in 2019. Top contributors in 2022 Q1 include Warrior Met Coal, Patterson-UTI Energy, and Helmerich & Payne, which each contributed around 60 basis points to relative performance against the Russell 2000 ETF benchmark.

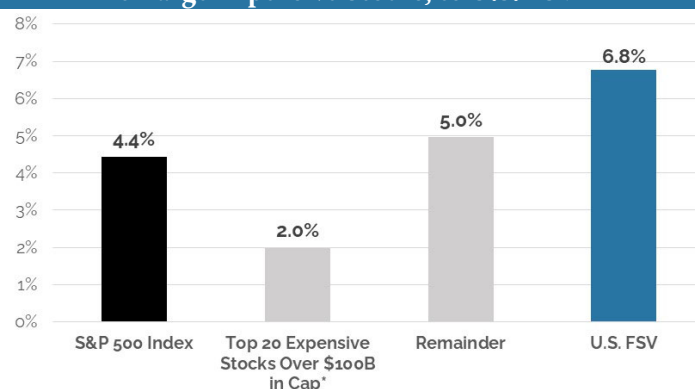
Portfolio Changes & Valuation

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

After rebalancing, the weighted average free cash flow yield to market cap for the U.S. FSV strategy on consensus estimates for next-twelve-month free cash flows is 6.8%, versus a comparable 4.4% for the S&P 500, and the free cash flow to enterprise value yield is 6.0% vs. 4.0%.¹ Both metrics are at their highest positive spread over benchmarks since the strategy's May 2017 inception. We believe this reflects both a wide dispersion in valuation opportunities as well as the depressive impact of several large richly valued stocks on the overall market. This latter point is evident in **Figure 11** which contrasts the free cash to market cap yield of Distillate's U.S. FSV strategy with that of the S&P 500. The figure shows the large downward pull of the most expensive 20 stocks with market values over \$100 billion, which collectively have a free cash yield of just 2.0%. If those stocks are removed from the analysis, the free cash flow yield on the remainder rises to 5.0%, providing a reasonable starting point with which to select attractive stocks.

Distillate's U.S. FSV strategy is avoiding several large richly valued stocks that are driving the overall S&P 500 free cash flow yield lower.

Figure 11: Free Cash to Mkt Cap Yield for the S&P 500, 20 Large Expensive Stocks, & U.S. FSV



Source: FactSet, 4/7/2022
Stocks without estimates are excluded and the index re-weighted

In addition to the valuation advantage to the market, Distillate's U.S. FSV strategy also enjoys significantly more stable long-term fundamentals, as evidenced by the higher fundamental stability score in **Table 3** on the following page. The benefit of investing in companies with more stable fundamentals was shown earlier in this letter in **Figure 7** which highlighted how the weighted average free cash flow per share for Distillate's U.S. FSV portfolio held up much better than that of the S&P 500 ETF during the pandemic. Also shown in **Table 3**, the FSV strategy has a comparable and low level of indebtedness to the market, though this metric excludes a number of financials where forward estimates for EBITDA are not available and so likely flatters the index figure.

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

Table 3 U.S. FSV Portfolio Characteristics*

	U.S. FSV	S&P 500
Free Cash Yield to Mkt Cap ¹	6.8%	4.4%
Free Cash Yield to EV ¹	6.0%	4.0%
P/E ²	16.2	26.4
Leverage ³	1.06	1.12
Fundamental Stability ⁴	0.86	0.69

*as of 4/7/2022

Sector Changes: taking advantage of valuation opportunities created by performance differences, the U.S. FSV strategy increased its weight in communications by around 2.5% by adding Meta Platforms, and added 3% to technology by similarly adding underperforming stocks PayPal and Zebra Technologies, and also increased its consumer discretionary weight by around 2.5% with the addition of laggards Etsy and NVR. Offsetting this was a 5% decrease in consumer staples where outperforming stocks like Kroger and Walmart were sold. Current sector weights relative to the S&P 500 are shown in **Table 4** which also breaks out the distortive impact of several mega-cap stocks in certain sectors for better comparison.

Sector weights are driven by bottom-up stock selection which currently favors the Industrials and Health Care sectors.

Table 4: U.S. FSV Sector Exposure*

	U.S. FSV	S&P 500
Communication Services	8.3%	9.3%
Consumer Staples	6.0%	6.3%
Consumer Discretionary	15.0%	11.8%
<i>Ex Amazon & Tesla</i>	<i>15.0%</i>	<i>5.9%</i>
Energy	1.8%	3.9%
Financials	2.7%	10.9%
Health Care	21.5%	14.2%
Industrials	18.1%	7.7%
Information Technology	21.1%	27.4%
<i>Ex Apple & Microsoft</i>	<i>21.1%</i>	<i>14.5%</i>
Materials	4.7%	2.6%
Real Estate	0.8%	2.8%
Utilities	0.0%	2.8%

*as of 4/7/2022

¹ Free Cash Yield to Market Cap and Enterprise Value (EV) are based on the next-twelve-month free cash flow estimates relative to market capitalization and EV, which adds Distillate's proprietary measure of indebtedness. Stocks without estimates in the 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.

Sells: The largest exited positions in the quarter were Walmart, Union Pacific, Texas Instruments, and General Dynamics, which all outperformed in the first quarter and saw their valuations become less attractive relative to the overall market.

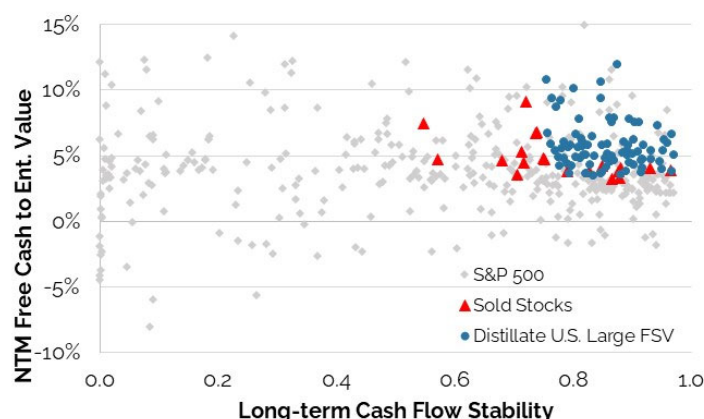
Buys: The largest new purchase was Meta Platforms, the parent of Facebook, which dropped in price by around 35% in the quarter and was repurchased after being sold at the end of last year. PayPal was the second largest new position and similarly lagged the market with a nearly 40% price decline in the first quarter.

Adds/Trims: AbbVie was the largest trimmed position after outperforming significantly with a 21% price gain, while Home Depot was the largest position that was added to after falling by 27% in price in Q1. AbbVie's weight fell by 0.5% while Home Depot's increased by the same.

Summary of Holdings vs. the Benchmark: Similar to our prior presentations, one way to visualize the current portfolio and note recent changes versus the benchmark is to look at scatter plot of all of Distillate's FSV holdings versus those in the benchmark (**See Figure 12**) with valuation on the vertical axis and free cash flow stability on the horizontal axis. The index stocks in grey are scattered across both axes, while FSV's stocks (blue circles) are clustered to the upper right where attractive valuations and high levels of fundamental stability converge. Positions that were sold (red triangles) generally shifted to the left or fell below this cluster having become less attractively valued, but could also have been exited if debt levels changed and now exceeded the threshold for inclusion. New purchases are included among the owned stocks.

Distillate's holdings are clustered where attractive valuations and high levels of stability converge while benchmark stocks are more scattered.

Figure 12: Valuation vs. Stability for all Stocks in the S&P 500 vs. Distillate's Large Cap FSV Strategy



Source: FactSet, Reflects 4/7/22 rebalancing

³ 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.)

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

International Fundamental Stability & Value (Intl. FSV)

After rebalancing, Distillate's International FSV strategy offers a higher free cash flow yield both to market cap and enterprise value and has substantially more stable fundamentals and less leverage than the index (**See Table 5**). The international FSV strategy is thus significantly differentiated from its benchmark not just on valuation, but critically on quality as well.

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 5: International FSV Portfolio Characteristics*

	Intl. FSV	ACWI Ex-US
Free Cash Yield to Mkt Cap ¹	8.0%	5.8%
Free Cash Yield to EV ¹	7.3%	4.8%
P/E ²	14.1	19.0
Leverage ³	0.53	1.68
Fundamental Stability ⁴	0.80	0.51

*as of 4/7/2022, see footnotes on previous page.

Changes & Regional Weights: The largest sale in the quarter was Agnico Eagle Mines, which outperformed by around 25%, and the largest new position is British American Tobacco, which was not owned previously due to leverage, but now passes that threshold and offers an 11% free cash flow to market cap yield. Xiaomi, the Chinese cell-phone producer, was the largest increased position in the portfolio, at 40 basis points, after it lagged the overall market by about 20% in the quarter, leading to a considerable valuation opportunity with an over-11% free cash flow to enterprise value yield. Grupo Mexico was the largest trimmed position, from a weight of 2.3% to 1.2%, following relative outperformance of 45%.

Regional weights after the quarterly rebalance remain fairly well matched with the ACWI Ex-U.S. benchmark. Japan is the largest overweight at 17% vs. 14% for the benchmark, driven by the valuation opportunities there. Europe is a modest overweight at 45% vs. 41% in the benchmark, with the larger relative weights in the U.K. and Sweden offsetting smaller relative weights in Switzerland and Germany where banks are large portions of the benchmark. (**See Table 6**).

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

Table 6: International FSV Portfolio Region Weights*

	Intl. FSV	ACWI Ex-US
Europe	44.9%	41.3%
Japan	17.1%	13.6%
Asia Ex China & Japan	15.7%	19.7%
China (Incl. Hong Kong)	12.2%	10.5%
Americas	10.1%	11.0%
Middle East & Africa	0.0%	3.9%

*as of 4/7/2022 and based on headquarter location using FactSet data.

U.S. Small Quality & Value (U.S. SQV)

Small cap stocks (proxied by the Russell 2000 Index) slightly underperformed larger stocks (proxied by the S&P 500 Index) in the first quarter of 2022. Since their pandemic lows, fundamentals have underpinned part of the rally, but valuation expansion was a significant driver of returns and stock valuations now look significantly richer, particularly in the headline Russell 2000 (refer to **Figure 8**). Fortunately, like with the large cap space, there is a wide range of valuations within this segment of the market and there remains a very attractive set of opportunities below the surface of the more expensive headline figures. Distillate's small cap strategy of 150 stocks has a yield of 9.5% using next-twelve-month estimated free cash flows against enterprise value, compared to just 4.1% for the Russell 2000 and 5.4% for the Russell 2000 Value (**See Table 7**).

Leverage is also very elevated among small cap stocks. Distillate's small cap strategy looks to avoid the risks inherent in highly levered situations by controlling for indebtedness, and after rebalancing, the portfolio has a leverage ratio of 0.7x which is significantly lower than the very elevated 2.1x and 2.9x figures of the Russell 2000 and Russell 2000 Value benchmarks (**See Table 6**). Given more volatile underlying cash flows, small cap stocks in general might be expected to have less debt than their large cap peers, yet the opposite is true and leverage looks like a key risk to avoid in the small cap space.

Distillate's U.S. Small Cap Quality & Value strategy is more attractively valued and less indebted than its Russell 2000 and Russell 2000 Value benchmarks.

Table 7: Small Cap QV Characteristics*

	SQV	Russell 2000 ETF	Russell 2000 Value ETF
Free Cash Yield to Mkt Cap ¹	11.9%	5.6%	7.8%
Free Cash Yield to EV ¹	9.5%	4.1%	5.4%
P/E ²	9.6	24.8	19.6
Leverage ⁴	0.73	2.13	2.87

*as of 4/7/2022, see footnotes on page 7.

Final Word: Inflation

Inflation is at the forefront of attention, and versus most of our experienced investment lifetimes, the levels are unusual and the upward trend is different. Had we known in the early-1980's (when one of us was sitting in an Investment Analysis class in college) that inflation was peaking, and had we recognized the path of interest rates over the next several decades, we might simply have bought equities and gone to the beach. The discounting mechanism is a powerful driver of returns and inflation is an obvious critical component.

We have no insight and no unique point of view on the future path of inflation. Relying on the evidence though, it is not clear that taking a defensive path now is the right one. Evidence suggests bouts of higher inflation and inversions in the yield curve provide modestly lower, but still positive returns in equities. Likewise, not every inversion in the yield curve correctly predicts a looming recession. Selling in 2019 during the last inversion would have left investors without a rather stunning nearly-70% return over the ensuing two years.

Taking a longer-term view, companies have the ability to adapt. Pricing products higher to defend profit margins is an obvious offset to inflationary pressures. Equities ironically are defensive in that regard versus more typically thought-of-as-defensive bonds, which obviously have no offsetting mechanism to adjust coupons. In a 2017 paper called "[*Long-Term Investing: The Costs of Myopic Thinking*](#)", we compared stock and bond returns in countries that suffered from excessive inflation and found that equities significantly outperformed bonds even in extreme circumstances.

Beyond the broad pricing power benefit of stocks in inflationary times, we believe that paying less for stocks, the essence of value investing, is always a defensive and prudent exercise as it can provide insulation from the inevitable drawdowns the market experiences, whether caused by declining fundamentals or driven by a decline in the valuation multiples paid for cash flows or earnings. As we have said many times, we put a high priority on capital preservation. Owning businesses with stable underlying fundamentals and manageable levels of debt we believe provides a solid footing on which they are able to adapt to whatever comes next. Paying less for those stable fundamentals and balance sheets protects us from the potential deflation in multiples that inflation might produce.

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.

This material is provided for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service or as a recommendation or determination by DCP that any investment strategy is suitable for a specific investor. Investors should seek financial advice regarding the suitability of any investment strategy based on their objectives, financial situations, and particular needs. The investment strategies discussed herein may not be suitable for every investor. This material is not designed or intended to provide legal, investment, or other professional advice since such advice always requires consideration of individual circumstances. If legal, investment, or other professional assistance is needed, the services of an attorney or other professional should be sought. The opinions, estimates, and projections presented herein constitute the informed judgments of DCP and are subject to change without notice. Any forecasts are subject to a number of assumptions and actual events or results may differ from underlying estimates or assumptions, which are subject to various risks and uncertainties. All investments in securities, options and derivatives involve a risk of loss of capital and no guarantee or representation can be made that an investment will generate profits or that an investment will not incur a total loss of invested capital. Furthermore, nothing herein is intended to imply that DCP's investment strategies may be considered "conservative", "safe", "risk free" or "risk averse." **No assurance can be given as to actual future results or the results of DCP's investment strategies.** Portfolio holdings and sector allocations are subject to change at any time and should not be considered recommendations to buy or sell any security. The information in this presentation has been obtained or derived from sources believed to be reliable, but no representation is made as to its accuracy or completeness.

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.

Long-term Fundamental Stability is Distillate Capital's proprietary measure of through-cycle cash flow stability with a higher value indicating greater stability.

Methodology note for Figure 6 & 8: free cash flow (FCF) figures reflect consensus estimates of next-twelve-months (NTM) FCF in comparison to enterprise value (EV) for the relevant portfolio/strategy or benchmark. Stocks without data are excluded and portfolios are reweighted accordingly. Stocks with FCF/EV values of greater than 50% or less than -20% have been eliminated to avoid distorting overall averages. Data as of 4/7/22. **For Figure 7:** uses FactSet methodology of calculating cash flow per share for ETFs corresponding to the respective index/strategies listed. Data as of 3/31/22. **For Figures 9 & 10:** stocks without data are excluded and portfolios are reweighted accordingly and stocks with leverage values of greater than 20 or less than -5 have been eliminated to avoid distorting overall averages. All data is as of 4/7/2022.

The **S&P 500 Index** is an index of roughly the largest 500 U.S. listed stocks maintained by Standard & Poor's. The **iShares Russell 1000 Value ETF** is an investable benchmark used as a proxy for its underlying index, the **Russell 1000 Value Index**, an index of U.S. listed stocks that possess attractive valuation as measured FTSE Russell. 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. The **iShares Russell 2000 ETF** and **iShares Russell 2000 Value ETF** are investable benchmarks used as proxies for the underlying indexes of the **Russell 2000 Index** (an index of U.S. listed small cap stocks) and the **Russell 2000 Value Index** (an index of U.S. listed small cap stocks that possess attractive valuation as measured FTSE Russell).

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.

The names of actual companies and products mentioned herein may be the trademarks of their respective owners.

© Copyright 2022 Distillate Capital Partners LLC

Published April 11, 2022