DISTILLATE CAPITAL

2022 Q2 Letter to Investors: YTD Sell-Off Drives Rotation

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 on valuation and indebtedness.

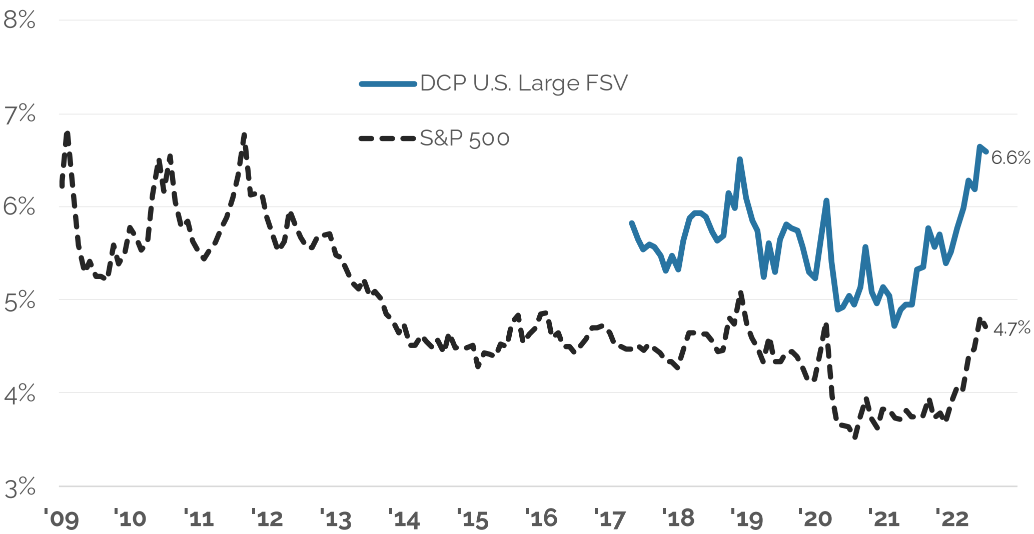
Performance Summary

U.S. Fundamental Stability & Value (U.S. FSV): Through the sharp sell-off in the first half of 2022, Distillate's U.S. FSV strategy held up better than the overall market with a decline of 15.80% net of fees vs. a 19.96% decline for the S&P 500 Index. This performance did lag the iShares Russell 1000 Value ETF's total return of -12.95%, but comes after significantly outperforming that benchmark in prior years (See **Figure 2** on the following page). Most importantly, the valuation of the U.S. FSV strategy remains attractive, both in relative and absolute terms, even after outperforming (See **Figure 1**).

International Fundamental Stability & Value (Intl. FSV): In the first half of 2022, Distillate's Intl. FSV strategy performed roughly in line with the iShares MSCI ACWI ex-US ETF, posting a total return of -18.07% net of fees versus -18.00% for the benchmark (See **Figure 2** on the following page). Annualized returns net of fees since inception remain 1.01% ahead of the benchmark. Similar to its domestic counterpart, the international FSV offers a free cash to enterprise value yield on next-twelve-month estimates (NTM FCF to EV yield) that at 7.4% is also near a record in both in absolute and relative terms.

U.S. Small Quality & Value (U.S. SQV): Distillate's U.S. SQV's 2022 first half total return after fees of -17.22% was better than the total return for the iShares Russell 2000 ETF of -23.48% and the iShares Russell 2000 Value ETF's total return of -17.43%. Following significant previous gains over each benchmark, the strategy is substantially ahead of the Russell 2000 and Russell 2000 Value ETFs, by 8.21% and 6.74% on an annualized net-of-fee basis since inception (See **Figure 3** on the following page). The strategy offers a substantially better NTM FCF to EV yield of 10.9% and looks meaningfully differentiated from its benchmarks in terms of quality as measured by indebtedness and the share of stocks with negative expected free cash flows.

Figure 1: Free Cash Flow (Next-Twelve-Month Consensus Estimate) to Enterprise Value Yield for Distillate's U.S. FSV Strategy vs. the S&P 500



Source: FactSet, See end-notes for methodology. 7/15/'22

Performance Charts: **Figures 2 through 4** 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 2: Performance of Distillate's U.S. FSV Strategy (through 6/30/2022)

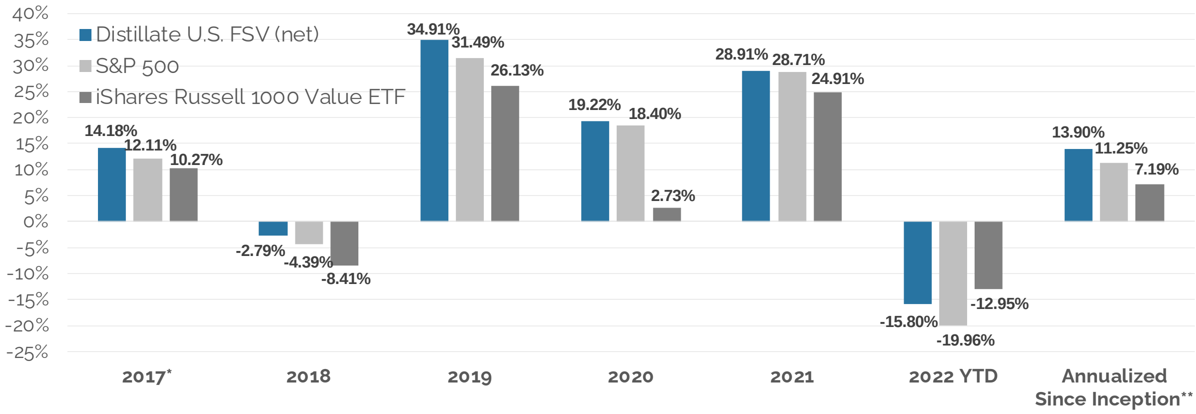


Figure 3: Performance of Distillate's International FSV Strategy (through 6/30/2022)

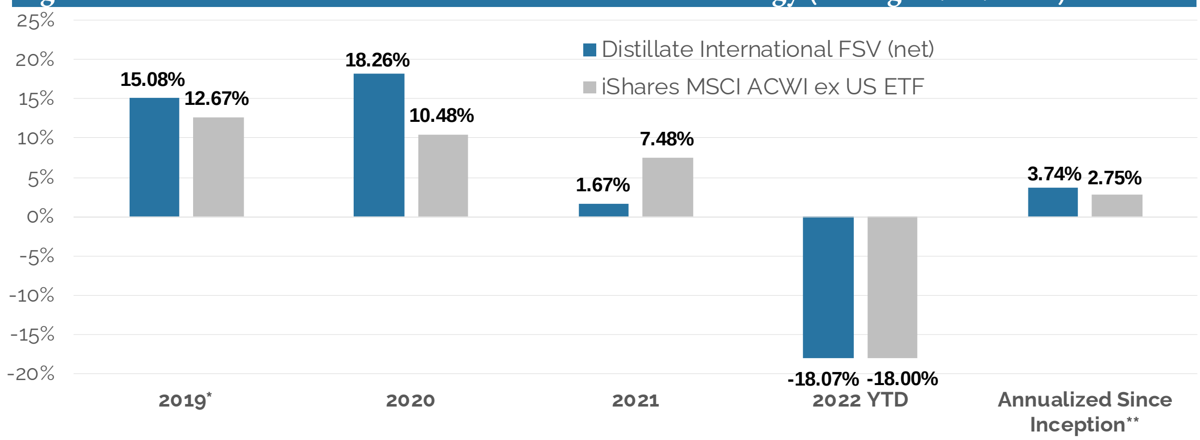
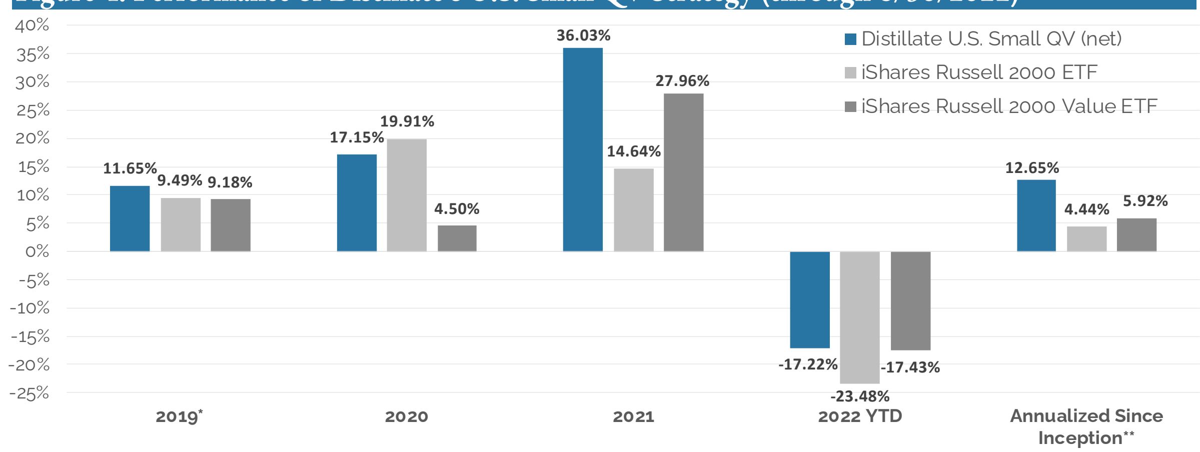


Figure 4: Performance of Distillate's U.S. Small QV Strategy (through 6/30/2022)



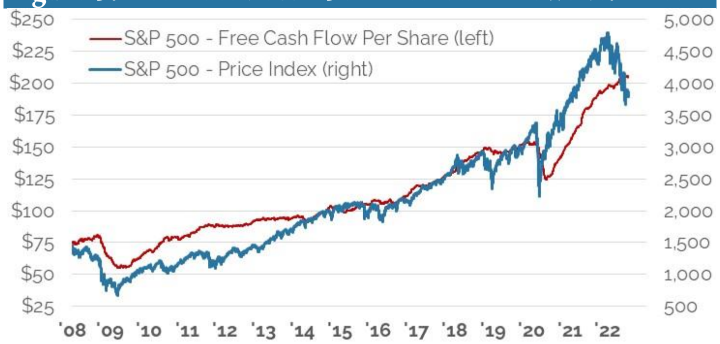
* Strategy inception of 5/31/2017 to 12/31/2017 for US FSV; 1/31/2019 to 12/31/2019 for INTL FSV; and 3/31/2019 to 12/31/2019 for US SQV.
** Strategy inception of 5/31/2017 for US FSV; 1/31/2019 for INTL FSV; and 3/31/2019 for US SQV.
Sources: U.S. Bank, Morningstar Data. Please see important performance disclosures at the end of this document.

Market Commentary:

Equity markets declined sharply in the first half of 2022 amid geopolitical turmoil and fears about inflation that then morphed into worries about economic weakness related to interest rate hikes. Despite the decline, consensus estimated next-twelve-month free cash flows have held steady (See **Figure 5**).

Free cash flow estimates have held up well so far despite price weakness.

Figure 5: Estimated S&P 500 Free Cash Flows vs. Price

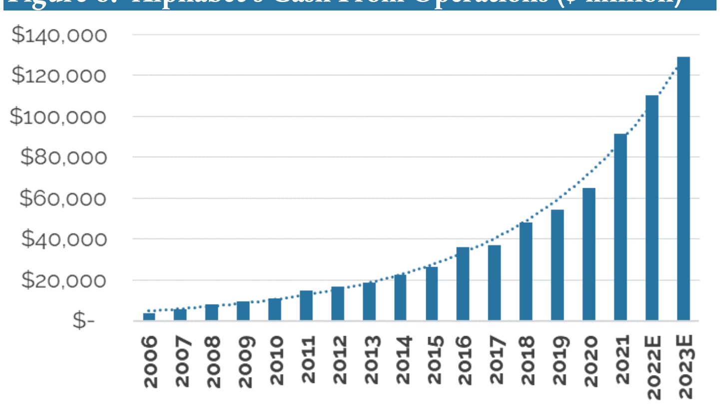


Source: FactSet, data as of 7/15/2022

With growing talk of an economic recession, there is a fair amount of pessimism around the consensus estimates in the figure above, with some commentators forecasting declines of 30% or more. Economic growth is clearly moderating, and a recession is certainly a possibility, but a drop of that magnitude would be double what occurred in the very unusual and extreme conditions of the pandemic. While such forecasts seem exceedingly dour, for our strategies, we do not try to divine the future and instead try to guard against adverse economic conditions of all varieties by investing in companies with low debt levels that have very stable long-term cash generation profiles. Fundamentals for such companies, we believe, may hold up relatively well in periods of economic weakness and the lack of leverage is a crucial element of their potential resilience. Our current largest holding in the U.S. FSV strategy, Alphabet, which we will discuss more later, highlights exactly this cash flow stability through periods economic turmoil (see **Figure 6**).

Alphabet's cash flow has been stable even in times of economic distress.

Figure 6: Alphabet's Cash From Operations ($ million)



Source: FactSet

Valuation & Quality vs. Indexes

Key quality and value differences between our strategies and their benchmarks are highlighted in the charts on the following page.

Starting with valuation, **Figure 7** compares next-twelve-month estimated free cash flow to enterprise value, and highlights substantial valuation advantages for each of Distillate's strategies versus their relevant benchmarks. The yield differential of the U.S. FSV strategy over the S&P 500 Index is near a peak despite significant recent outperformance, and the international and small cap strategies also enjoy significantly more attractive valuations than their benchmarks.

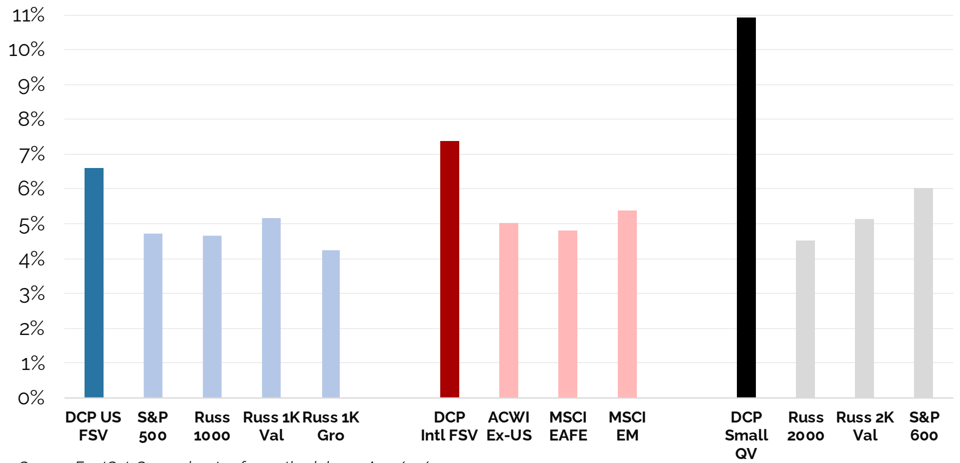
Figure 8 looks at fundamental stability by assessing the through-cycle variability of cash flows (similar to what was shown in **Figure 6**), with a higher score equating to greater stability. We believe the greater stability available through our strategies is particularly important to our goal of preserving capital in adverse scenarios, including recessions. 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 modestly better stability than the comparable benchmarks.

Figure 9 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 impacted the overall benchmark figure in recent years, masking the build-up of leverage away from the largest companies. Internationally, leverage is higher in the benchmark than it is domestically and the International FSV strategy is much more differentiated in this regard—a figure that we consider critical given the tendency to see cyclical businesses and industries making up a larger portion of that benchmark. 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 on average less able to support higher debt burdens. We believe this is a key risk among smaller companies and an attribute that is crucially differentiated in our small cap strategy, especially amid rising rates and economic uncertainty.

Another differentiator in the small cap space (not shown) is the weight of the companies in each benchmark that are expected to generate negative free cash flows in the next twelve months. For our Small Quality & Value strategy, that figure is zero. For the Russell 2000 ETF, Russell 2000 Value ETF and S&P 600, the weight is 19%, 20%, and 7%, respectively. For the Russell 2000 benchmarks, in particular, such a large weight in companies that are not expected to generate positive free cash flows, with a potential recession on the horizon, is a potential risk we are happy to avoid.

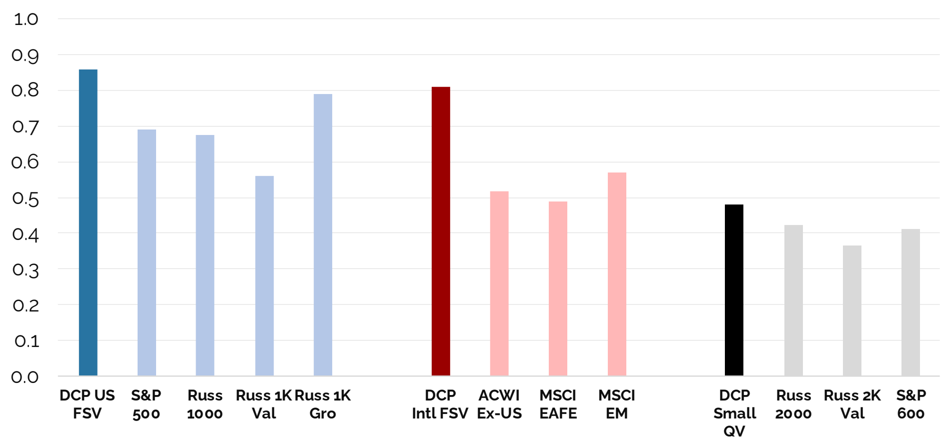
Positioning: **Figure 7** shows the current valuations for Distillate's U.S. and International Fundamental Stability and Value (FSV) strategies and its U.S. Small Quality and Value strategy versus various benchmarks. **Figure 8** compares the same Distillate strategies and corresponding benchmarks on our cash flow stability scores, and **Figure 9** examines the degree of financial leverage across the same strategies and benchmarks.

Figure 7: Next 12-Month Free Cash Flow to Enterprise Value



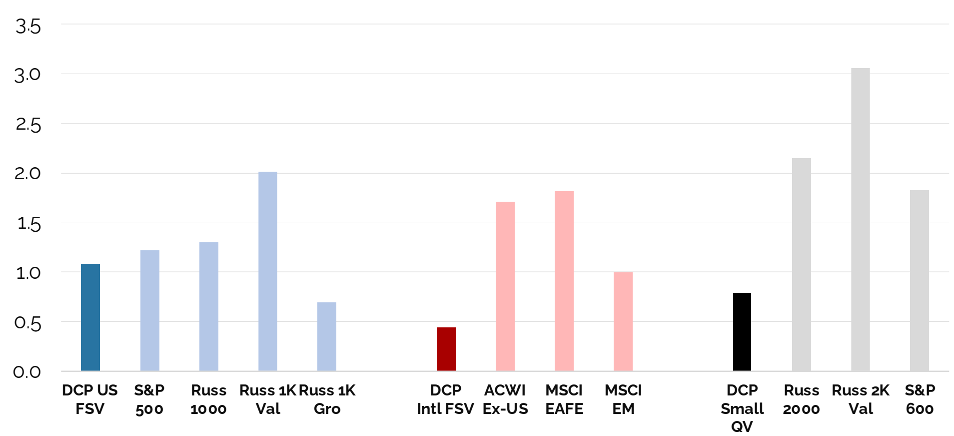
Source: FactSet, See end-notes for methodology. As 7/15/2022

Figure 8 (Quality): Distillate's Cash Flow Stability Score



Source: FactSet, See end-notes for methodology. As of 7/15/2022

Figure 9 (Quality): Net Debt to Adjusted EBITDA



Source: FactSet, See end-notes for methodology. As of 7/15/2022

Performance

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

Distillate's U.S. FSV strategy declined 15.80% in the first half of 2022 compared to a decline of 19.96% for the S&P 500 benchmark, despite a 1.5% performance headwind from being underweight the energy and utilities sectors where cash flow instability and leverage tend to limit our holdings domestically. Relatively little of the overall performance differential resulted from sector selection, with the vast majority due to stock selection. Among owned stocks, AbbVie and McKesson were the largest contributors to relative performance, generating 55 and 40 basis points of alpha. Unowned names, Amazon, Nvidia, and Tesla, which we deemed expensive, contributed a combined 150 basis points in relative performance given their steep declines, while unowned Exxon, Chevron, and Eli Lilly subtracted around 40, 25, and 20 basis points of relative performance.

International Fundamental Stability & Value (Intl. FSV)

Distillate's International FSV performed roughly in line with its benchmark in the first half of 2022. As was the case last year, strong performance of financial stocks, and bank stocks in particular, remained a headwind and detracted around 1.3% in relative performance. High leverage, low stability, and lacking free cash flows limit our ownership in financials in our International FSV strategy and can cause somewhat greater swings in relative performance as a consequence. Despite potentially more volatile relative short-term performance, we believe this will help reduce risk and strengthen long-term compounded returns. Outside of the drag from financials, sector and region weights did not have outsized impacts on relative performance. This is consistent with the goal of letting individual stock selection determine weights and drive performance. As a reminder, region weights are limited to 150% of the benchmark weight to avoid any outsized risk to a particular region. Among holdings, Tourmaline Oil, China Tower, and Nippon Telephone and Telegraph were the strongest contributors to relative returns at 60, 50, and 45 basis points each and Samsung Electronics was the largest detractor at 50 basis points.

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

Better relative performance for Distillate's U.S. SQV strategy continued into 2022 with performance of -17.22% exceeding that of the Russell 2000 ETF at -23.48% and the Russell 2000 Value ETF's first half return of -17.43%. The strategy's cumulative annualized performance is now 8.21% and 6.74% ahead of the same benchmarks since inception in 2019. Top contributors in 2022 ytd include Helmerich & Payne, Warrior Met Coal, and Patterson-UTI Energy, with each contributing around 60 basis points to relative performance against the Russell 2000 ETF benchmark. The largest detractors from relative performance were Kohl's, Rent-A-Center, and Loyalty Ventures, which each subtracted around 25 basis points of relative performance.

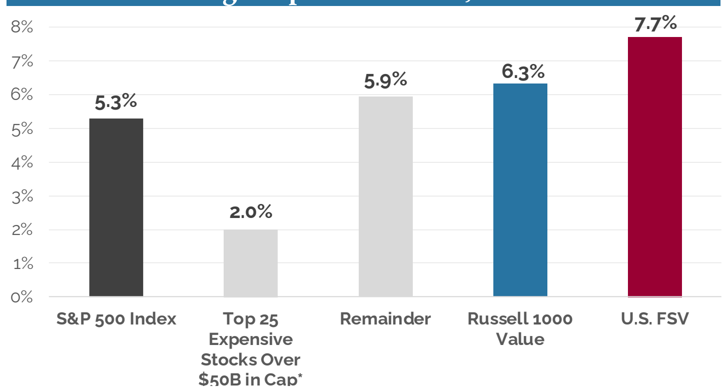
Portfolio Changes & Valuation

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

As highlighted in Figure 1, despite the performance differential versus the S&P 500, the relative valuation of the U.S. FSV strategy remains very attractive, near an all-time peak free cash flow yield spread over the benchmark. After rebalancing, the free cash flow to market cap yield on next-twelve-estimates for the U.S. FSV strategy is 7.7%, versus a comparable 5.3% for the S&P 500, and the free cash flow to enterprise value yield is 6.6% vs. 4.7%.[1] Even after the sharp sell-off in some stocks we had considered egregiously valued, there remains a wide divergence in valuations across the market. This has allowed us a substantial opportunity 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 that there remains a large (albeit smaller than before) downward pull of the most expensive 25 stocks with market values over $50 billion, which collectively have a free cash yield of just 2.0%. If those stocks are removed from the index, the free cash flow yield on the remainder rises to 5.9%, providing a reasonable starting point from which to select attractive stocks and achieve our free cash flow yield of 7.7%.

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, 25 Large Expensive Stocks, & U.S. FSV



Source: FactSet, 7/15/2022
*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 1** on the following page. Also shown in **Table 1**, the FSV strategy has a lower level of indebtedness than the market (it should be noted that this metric excludes a number of financials where forward estimates for EBITDA are not available and so likely flatters the benchmark figures). As stated earlier, these attributes stand to show their importance if economic conditions deteriorate, as many are predicting.

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

Table 1 U.S. FSV Portfolio Characteristics*

	U.S. FSV	S&P 500
Free Cash Yield to Mkt Cap[1]	7.7%	5.3%
Free Cash Yield to EV[1]	6.6%	4.7%
P/E[2]	14.3	21.9
Leverage[3]	1.08	1.22
Fundamental Stability[4]	0.86	0.69

*as of 7/15/2022

Sector Changes: The largest changes in sector weights include a six-percentage point reduction in consumer staples and a five point decline in health care, both of which outperformed considerably in Q2. Offsetting this were increases in the industrials, technology, and communication services sectors. As a reminder, sector weights are driven by bottom-up stock selection based on the combination of valuation and quality in our investment process. Current sector weights relative to the S&P 500 are shown in **Table 2** which also breaks out the distortive impact of several mega-cap stocks in certain sectors for better comparison. Sector weights are generally in line with the benchmark with the exception of industrials, where a number of stocks look very attractive at present.

Sector weights are driven by bottom-up stock selection.

Table 2: U.S. FSV Sector Exposure*

	U.S. FSV	S&P 500
Communication Services	10.7%	8.9%
Consumer Staples	0.8%	6.9%
Consumer Discretionary	12.2%	10.9%
Ex Amazon & Tesla	*12.2%*	*5.9%*
Energy	1.7%	4.1%
Financials	4.4%	10.7%
Health Care	17.0%	15.1%
Industrials	23.3%	7.6%
Information Technology	24.4%	27.4%
Ex Apple & Microsoft	*22.3%*	*14.4%*
Materials	4.6%	2.5%
Real Estate	0.8%	2.9%
Utilities	0.0%	3.0%

*as of 7/15/2022

Sells: The largest exited positions in the quarter were Philip Morris International, General Mills, Colgate-Palmolive, and Monster Beverage which all saw significant price outperformance in the second quarter (+6%, +12%, +6%, & +16% vs. -16% for the S&P 500). The stocks were sold due to their resultingly valuations.

Buys: Apple was largest new purchase in the quarter, at a 2% weight. Apple underperformed the overall market last quarter, and given very minimal debt, this price weakness translated into a commensurate fall in its enterprise value. For stocks with higher debt levels, it takes a disproportionately bigger market cap drop to achieve the same valuation improvement and this is a key reason we avoid highly leveraged names where significant price weakness can be experienced during a revaluation process. Alongside this decline in EV for Apple, its estimated free cash flows have risen steadily throughout the year. This contrast between a falling enterprise value and rising free cash flow, which is highlighted in **Figure 12**, made the stock sufficiently better valued such that it entered the portfolio. While Apple's valuation is now attractive enough to warrant inclusion in the portfolio, it still ranks in the bottom quartile of the portfolio's holdings and so the stock's initiating weight is capped at a 2%. This contrasts significantly with Apple's near-7% position in the S&P 500 benchmark, and reflects both our preference to avoid too much concentration risk as well our goal of ensuring that the overall portfolio valuation is as attractive as possible while balancing characteristics of stability and low indebtedness.

Warner Bros. Discovery was the next largest position added to the portfolio and came after a nearly-50% price decline in the quarter. Consequently, the stock offers a mid-teens free cash flow yield and is expected to earn nearly half of its enterprise value in free cash over the next three years.

Apple's enterprise value declined nearly 25% in the first half of 2022 while its estimated free cash flows rose nearly 10%.

Figure 12: Indexed 2022 Enterprise Value vs. Free Cash

Source: FactSet, 6/30/'22

[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.
[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.
[5]Negative FCF weight is measured as the weight of stocks with negative free cash estimate as a share of those with any estimate.

Adds/Trims: UnitedHealth Group and Johnson & Johnson were the largest trims at around 1% each. Each stock was up 1% in the quarter compared to the 16% price decline for the S&P 500 and the positions were reduced as the valuations became somewhat less appealing, though still attractive enough to warrant inclusion. The largest adds were Alphabet, the parent of Google, and Meta, formerly called Facebook. Alphabet came into the portfolio at the last rebalance after Q1 2022, but was increased again as valuation improved with a decline in enterprise value despite rising free cash flow estimates. **Figure 13** plots the indexed change in Alphabet's enterprise value and free cash flow estimates since the start of the year and the overall result looks very similar to the lines for Apple on the previous page. In conjunction with the stability in cash flows highlighted earlier, this makes Alphabet look very appealing.

In contrast to Alphabet, **Figure 14** shows the same indexed enterprise value and rolling next-twelve-month consensus estimate for free cash flow for Amazon, and highlights how Amazon's performance has largely followed downward revisions in its estimated profitability. Consequently, Amazon continues to look expensive with a 1.7% NTM free cash flow to enterprise value yield, despite a 35% price decline in the first half of the year.

Like Apple, Alphabet has seen its free cash estimates rise as its enterprise value fell.

Figure 13: Indexed 2022 Enterprise Value vs. Free Cash

Source: FactSet, 6/30/'22

Amazon, by contrast, has seen its EV follow its free cash estimates lower this year and its valuation has not improved.

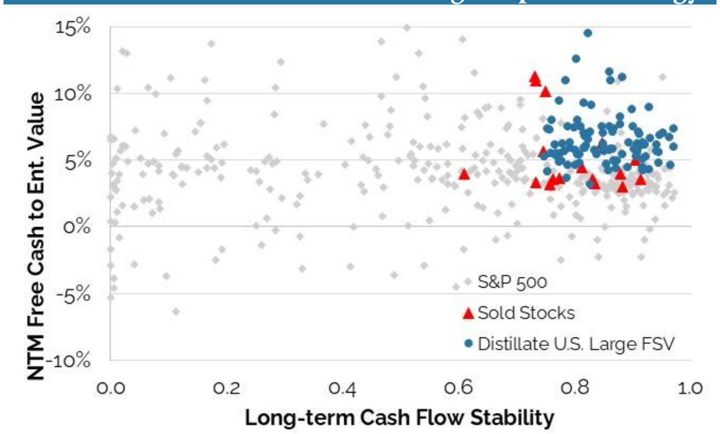
Figure 14: Indexed 2022 Enterprise Value vs. Free Cash

Source: FactSet, 6/30/'22

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 with valuation on the vertical axis and free cash flow stability on the horizontal axis (**See Figure 15**). 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 15: Valuation vs. Stability for all Stocks in the S&P 500 vs. Distillate's Large Cap FSV Strategy



Source: FactSet, Reflects 7/10/22 data post rebalancing

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 3**). 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 3: International FSV Portfolio Characteristics*

	Intl. FSV	ACWI Ex-US
Free Cash Yield to Mkt Cap[1]	8.1%	6.4%
Free Cash Yield to EV[1]	7.4%	5.0%
P/E[2]	13.1	17.4
Leverage[3]	0.44	1.70
Fundamental Stability[4]	0.81	0.52

*as of 7/15/2022, see footnotes on previous page.

Changes & Regional Weights: The largest sales in the quarter were British American Tobacco and China Tower, which outperformed by around 20% and 25%, respectively. The largest new position is Alibaba, which underperformed considerably and has seen its enterprise value fall by almost two thirds from its peak despite a net cash position on its balance sheet. SK Hynix, the Korean chip maker, was the largest increased position in the portfolio, at 40 basis points, after it lagged the overall market by 15% in the quarter, leaving a considerable valuation opportunity with an over 11% free cash flow to enterprise value yield. Aker BP, the Norwegian oil company that took over our holding of Lundin Oil, was the largest trim at around a 1% reduction after Lundin outperformed the benchmark by around 25%.

Regional weights after the quarterly rebalance remain fairly well matched with the ACWI Ex-U.S. benchmark. Japan is the largest overweight at 20% vs. 14% for the benchmark, driven by the valuation opportunities there. Europe is in-line at 42% vs. 41%, with somewhat larger relative weights in France, the U.K., Sweden, and Norway offsetting smaller relative weights in Switzerland and Germany where banks constitute large portions of the benchmark. (**See Table 4**). Country weights are shown in **Figure 16** below. As a reminder, region and country weights are determined by bottom-up stock selection, but region weights are limited to 150% of the benchmark to avoid any outsized influence from region-specific or currency risk.

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

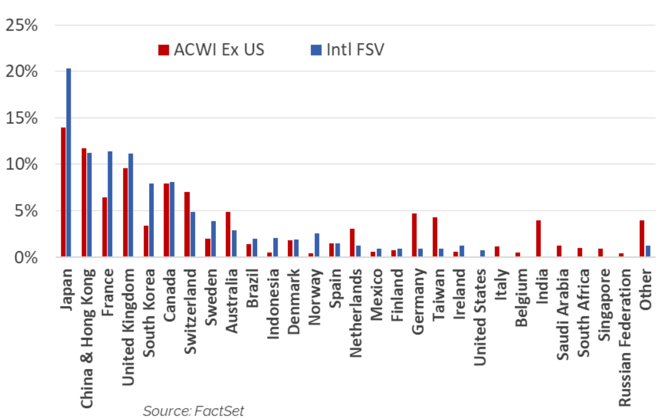
Table 4: International FSV Portfolio Region Weights*

	Intl. FSV	ACWI Ex-US
Europe	41.8%	40.8%
Japan	20.3%	14.0%
Asia Ex China & Japan	15.0%	19.3%
China (Incl. Hong Kong)	11.2%	11.8%
Americas	11.7%	10.4%
Middle East & Africa	0.0%	3.7%

*as of 7/15//2022 and based on headquarter location using FactSet data.

Country weights are relatively in line with the benchmark with an overweight in Japan, France, South Korea, the U.K., and Sweden, offset by underweights in Germany, India, Taiwan, Switzerland, and Australia.

Figure 16: International FSV Country Weights



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

Small cap stocks overall (as proxied by the Russell 2000 ETF) offer a free cash to enterprise valuation below that of their larger counterparts (as proxied by the S&P 500 Index) despite generally being of lower quality with less stable fundamentals and significantly more debt. Fortunately, as it is 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. Consequently, Distillate's small cap strategy of 150 stocks is able to achieve a very attractive 10.9% free cash flow to enterprise value yield that is substantially higher than that of either the Russell 2000 ETF or Russell 2000 Value ETF benchmarks (**See Table 5**).

Beyond the valuation differential, Distillate's Small Cap Quality and Value Strategy is also highly distinct from the Russell 2000 and 2000 Value ETF benchmarks in terms of indebtedness. Leverage is very elevated among small cap stocks broadly and could prove to be a significant risk with growth moderating and interest rates (and thus the cost of debt) rising. 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 0.8x which is significantly lower than the very elevated 2.2x and 3.1x figures of the Russell 2000 and Russell 2000 Value benchmarks (**See Table 5**).

Lastly and also related to quality, Distillate's SQV has no position in stocks that have negative next-twelve-month free cash estimates. For the Russell 2000 and Russell 2000 Value benchmarks, after reweighting for stocks without estimates, roughly 20% of each benchmark consists of equities that are not expected to earn positive free cash flow in the next twelve months. For the S&P 500, by way of comparison, this figure is 3.2%. Along with leverage, this looks to be another critical risk in the small cap segment that we believe is important to avoid.

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 5: Small Cap QV Characteristics*

	SQV	Russell 2000 ETF	Russell 2000 Value ETF
Free Cash Yield to Mkt Cap[1]	13.9%	6.3%	7.9%
Free Cash Yield to EV[1]	10.9%	4.5%	5.1%
P/E[2]	8.8	21.4	17.0
Leverage[3]	0.78	2.15	3.06
Fundamental Stability[4]	0.48	0.42	0.37
Negative FCF Weight*	0%	19%	20%

*as of 7/15/2022, see footnotes on page 6.

Final Word

Being a long-term optimist is boring, and does a poor job of selling newspapers (or banner ads on Bloomberg, CNBC, or The Wall Street Journal web sites). Not to dismiss that there are reasons to be anxious right now—a day does not go by without an accompanying headline related to the depth of the sell-off year-to-date, the surety of a pending recession, and run-away inflation as a new permanent state of affairs. Bring out the fire and pitchforks!

Certainly, there are reasons for angst and we do not dismiss the possibility that equities could continue to decline. The flip side is that it was not too long ago that Treasury bonds earning a real return, something over inflation, was a normal state of affairs. As well, it was not too long ago that we believed low single-digits interest rates would remain conducive to continued investment in our economy and facilitate growth.

As for inflation, as the old saying goes, the cure for a high price is often simply a high price. Commodity markets are flexible, and supply responses occur when a payoff is likely. Energy, foods, metals, even labor, have a long history of responding to higher prices with more goods brought to market and we are already seeing evidence now of that behavior, with declines in the prices of many commodities.

With equities, we take a long-term view. Much of today's commentary and risk strike us as typical of what we have seen over nearly four decades that has been our investment career, and our strong preference is to remain invested. Bolstering our view is valuation. With selectivity, our domestic strategy now generates an expected free cash flow yield of nearly 8% (refer back to **Table 1**). Adding to that figure some expectation for growth and inflation that have historically driven returns several percentage points above the prevailing free cash flow yield (for more, see our recent white paper "*Equity & Bond Values & Inflation*"), and the potential nominal long-term return looks fairly attractive. For the market overall, despite a lower free cash flow yield than our portfolio, potential returns also look reasonable, which is notable in the context of the roughly 10% average annual return in equites going back to 1928. **Figure 17** is in an updated chart from the above-referenced paper that compares the trailing free cash flow yield with annualized returns ten years into the future. It both supports the efficacy of using free cash flows as a valuation tool and points to attractive present valuations. Note that trailing data is used both for the longer history and to avoid concerns that estimates may be overly optimistic at present. Also, by utilizing free cash flows to assess the valuation opportunity we believe we avoid a structural distortion in earnings caused by the shift in our economy toward R&D as a key driver of value creation. Free cash flows thus reveal what might otherwise be masked by solely considering PE ratios that tend to be behind the dire headlines and calls for severe market corrections that we see so frequently. We have written extensively about this issue in the past—for example, see our "*Value Investing in a Capital Light World*" paper.

Trailing equity free cash yields have provided a good guide for 10-year forward annualized nominal returns going back to when cash flow data was first required to be reported and became available. Current valuations look attractive in this context.

Figure 17: S&P 500 Trailing Free Cash Yield vs. Annualized Total Return Over the Next Decade

Source: FactSet 6/30/'22

While future paths for the equity market are, by definition, uncertain in shape and timing, we continue to follow a process of allocating capital to companies with attractive valuations, relatively stable fundamentals and strong balance sheets. While sell-offs can be indiscriminate, businesses with stable free cash flow generation and without excessive debt may prove more durable. Our goal is to endure periods of stress better than the market benchmarks and then compound from a higher low when the headlines go from flames and pitchforks to something more constructive.

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. This metric is a valuation measure and not a form of investor yield.*

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. This metric is a valuation measure and not a form of investor yield.*

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 1 & 7: *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 7/15/22.* ***For Figure 17:*** *trailing twelve month free cash flows are used and stocks with free cash yields over 50% or below -20% are eliminated and stocks without data are excluded and the index is reweighted accordingly. All data is as of 7/15/2022.*

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 a 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.