DISTILLATE CAPITAL

2019 Year-end Letter to Investors: The Market Rally in a Long-Term Context

Strategy Summary: *Distillate Capital's U.S. Fundamental Stability & Value (U.S. FSV) strategy seeks to outperform the equity market over the long-term by minimizing risk and investing in stocks that are more fundamentally stable, less levered, and more attractively valued. Our strategy uses cash-flow-based measures of value and quality that are designed to avoid accounting distortions that we believe have rendered many traditional metrics less relevant in an increasingly asset-light world.*

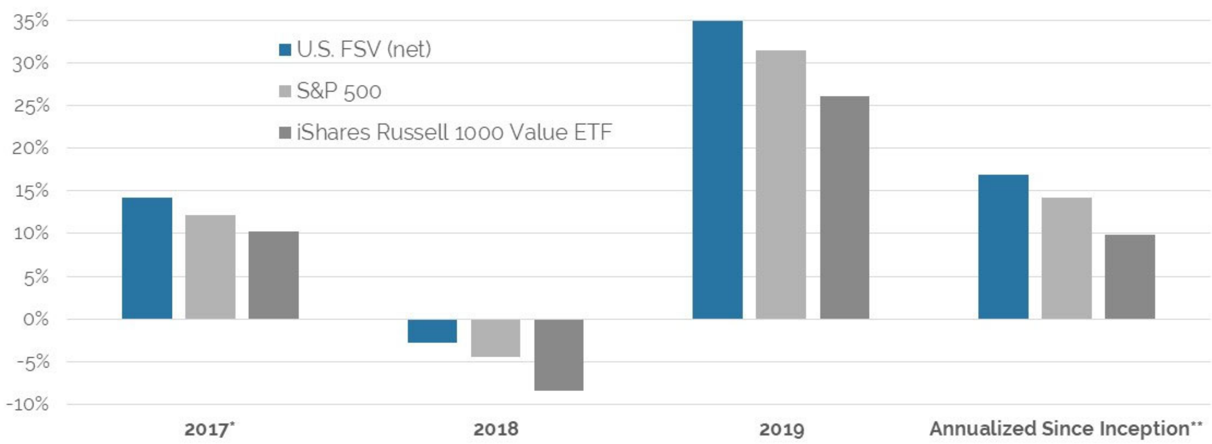
Performance: Distillate's U.S. FSV strategy's 2019 net-of-fee return of 34.9% exceeded the S&P 500 Index return of 31.5% by 3.4%. This follows outperformance in 2017 and 2018 with the result that annualized performance since inception is 2.7% above the index on an after-fee basis (**See Figure 1**). Performance compared to the iShares Russell 1000 Value ETF was even greater with an excess return of 8.6% in 2019, and annualized net of fee performance is 7.1% above that benchmark since inception.

Outperformance relative to the S&P 500 Index in 2019 resulted from both sector positioning and individual stock selection, with each contributing roughly half of the 3.4% total. Sector weightings are driven by stock selection, but in all sectors, save health care and communication services, the stocks held out-performed sector averages, and the two shortfalls were very minor drags to relative performance of around 15 and 10 basis points, respectively.

Considering individual stocks, Apple was the largest contributor to relative performance versus the S&P 500 Index at around 50 basis points of favorable attribution. The next five largest contributors to performance versus the S&P 500 Index were KLA, Skyworks, Qorvo, Target, and Moody's. On the negative side, CVS was the largest detractor with a drag on relative performance of around 35 basis points.

Overall, performance was consistent with the strategy's goal of avoiding a disproportionate share of relative underperformers and capturing and outsized share of relative winners. Outperformance was not concentrated in a few stocks or sectors but was widespread with 15 stocks adding over 20 basis points of relative performance versus the S&P 500 and only 4 subtracting as much.

Figure 1: Performance of Distillate Capital's U.S. FSV Strategy (through 12/31/2019)



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

** Strategy inception of 5/31/2017 through 12/31/2019

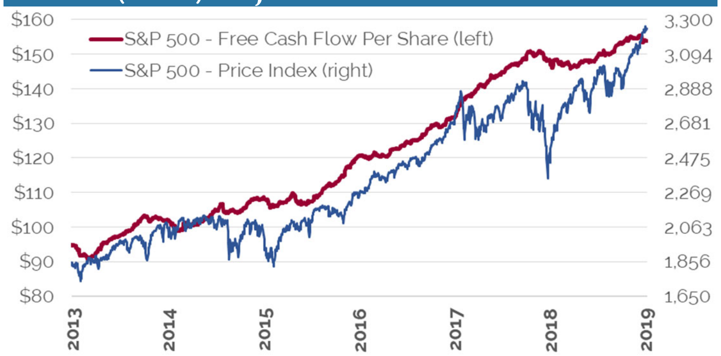
Please see important performance disclosures at the end of this document.

Market Backdrop

The 2019 equity market rally was driven by a recovery in valuation multiples from inexpensive levels at the end of 2018, when the market price decline toward year-end far exceeded the more modest deterioration in fundamentals. This is evident in **Figure 2** which shows the index price falling much more sharply than free cash flow per share for the S&P 500. In 2019, free cash flows rebounded from the modest 2018 decline, but the vast majority of the market's gain was due to a recovery in valuation multiples as prices caught up with fundamentals.

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

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



Source: FactSet

Splitting the price recovery into its multiple and fundamental components in **Table 1** highlights that the valuation recovery drove 24% of the 29% price gain in 2019. Over the longer-term, however, the opposite is true and since 2013, only 8% of the 175% price return is explained by multiple expansion, with the rest coming from free cash flow per share growth and a tiny remainder from the favorable interaction between the two. That the near tripling of the market since the end of 2013 is due to fundamental gains and not valuation expansion may come as a surprise as it contrasts sharply with frequent commentary to the contrary.

While valuation supported gains this year, it contributed little since '13.

Table 1: S&P 500 Return Split by Free Cash & Valuation

	Price	FCF	Multiple	Yield
2013 (YE)	1,848	$94.7	19.5x	5.1%
2018 (YE)	2,507	$148.3	16.4x	5.9%
2019 (YE)	3,231	$154.1	21.0x	4.8%
'18 to '19 Chg	29%	4%	24%	
'13 to '19 Chg	175%	163%	8%	

Portfolio Changes and Valuation

After rebalancing, the weighted average free cash flow yield for the U.S. FSV strategy is 5.8% versus a comparable yield of 4.7% for the S&P 500.[1] The rebalanced U.S. FSV strategy also has significantly more stable long-term fundamentals and less financial leverage than the S&P 500 Index (**See Table 1**).

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

Table 2: U.S. FSV Portfolio Characteristics*

	U.S. FSV Strategy	S&P 500
Free Cash Flow Yield[1]	5.8%	4.7%
P/E[2]	18.9	23.5
Fundamental Stability[3]	0.87	0.68
Leverage[4]	1.20	1.49

*as of 1/8/2020

Sector Changes: communication services saw the biggest decline as both Facebook and AT&T were exited and contributed to a roughly 4% reduction in the sector's overall weight. Changes otherwise largely mirror sector performance in Q4 of 2019 with the outperforming information technology and health care sectors seeing their weights come down modestly, while the underperforming consumer staples sector's weight rose by 4.5% due to its improved relative valuation.

Technology and industrials remain the largest relative overweights to the S&P 500 as both sectors appear attractive in terms of cash flow stability and valuation. The high level of cash-flow stability in the tech sector is a notable change from the past when it was dominated by more fundamentally volatile companies in the hardware space and many generated little if any free cash flow. Many stocks in the sector now are much different and like Microsoft (one of our largest holdings) derive their cash flow predominantly from more stable recurring revenue businesses. The same is true for many of the internet and software companies also included in the portfolio. Other holdings like payments company Visa do not seem like tech companies in the classic sense, but are nonetheless in the sector.

The industrial sector also looks very different. It now includes numerous companies that have shifted their underlying businesses up the value chain to sell products and services that are backed by substantial research and development that evidence better margins and more protection from competition.

[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.)

Sector weights are not our focus as there is a large amount of variation within sectors as well as some blurring across sectors. For example, the consumer discretionary sector includes stocks with very disparate drivers. Amazon, General Motors, Las Vegas Sands, and Tractor Supply Co. all reside as consumer discretionary companies, but their underlying businesses are vastly different. At the same time, some companies across sectors are becoming more similar. In the industrial sector there has been more and more technological innovation and the value drivers for some companies now look similar to certain tech companies. Last, by allowing individual holdings determine our overall sector positioning we also avoid issues that occur when index providers reclassify component companies. Before a reclassification near the end of 2018, the communications sector was a minor 2% weight in the overall S&P 500, but after companies such as Alphabet, Facebook, and media companies like Fox and Netflix were shifted into it from other sectors, its weight increased to around 10%. Changes like this don't strike us as valuable in influencing prudent investment decisions.

New Buys: The largest new positions are Proctor & Gamble (PG) and United Technologies (UTX). In the case of PG, the stock underperformed the market despite rising free cash flow estimates such that its valuation became attractive enough to warrant inclusion in the portfolio. UTX was previously unowned due to elevated debt levels, which recently came down by enough to fit the strategy's criteria.

Sales: The largest exited positions were Facebook (FB) and AT&T (T). In the case of FB, price performance outpaced the overall market and forward free cash flow estimates with the result that its valuation became somewhat stretched and no longer appealing enough to hold. The position in T was exited due to a deterioration in its quality attributes.

Additions: The biggest additions by weight in the rebalance were International Business Machines (IBM) and Walmart (WMT), both of which significantly underperformed and saw their valuations improve as their prices fell more sharply than their projected free cash flows.

Reductions: The largest reductions in the quarter were Apple (AAPL) and United Healthcare (UNH), each of which outperformed significantly and saw their valuations become somewhat less appealing to the degree that the positions were trimmed but not so much so that the positions were exited. In the case of Apple, it remains the largest position in the strategy at approximately 5% due to its enormous free cash generation. Despite a somewhat volatile stock price, Apple's underlying fundamentals are more stable and the company is increasingly generating its free cash flow from more stable services businesses, which are estimated to make up around a third of gross income in FY '20. In terms of valuation, even after its strong performance relative to the market in 2019, Apple still looks attractively valued at a free cash flow to enterprise value yield of around 5% on FY'20 estimates.

The Market Recovery in a Long-Term Context

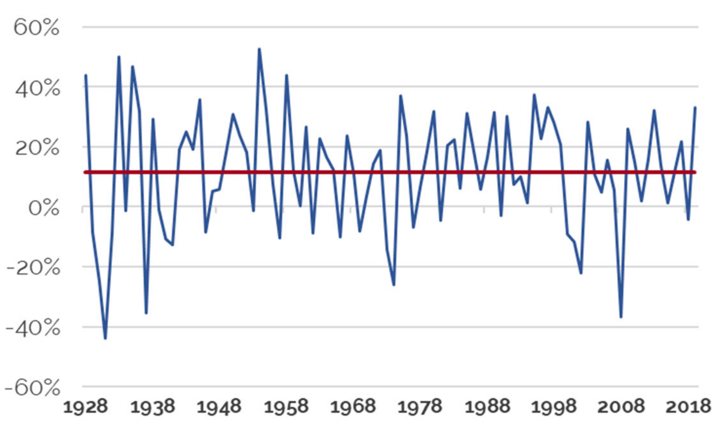
Ten years beyond the depths of the financial crisis, there is a lot of discussion about the strength and duration of the stock market recovery and what this may portend for its future. The typical commentary suggests that the good run must be reaching a conclusion. We thought providing some historical context around the current rally may therefore be useful. This exercise also provides an opportunity to revisit Warren Buffett's advice about time horizon, which we explored in greater depth in our piece "Long-Term Investing: The Cost of Myopic Thinking."

Buffett's point, and it is a simple and powerful one, is that most investors' time horizons should be long—much longer than investor behavior indicates is the case and infinitely longer than the seesawing advice often heard from the talking heads on TV. Buffett argues that while one-year periods are interesting, they are a poor guide to making the right decisions related to risk and returns. When time horizon is properly considered, he contends that very different choices may be undertaken. With Buffett's advice in mind, we will consider the current market recovery in a long-term context.

One-year total returns for the S&P 500, since the rally began in 2009, while volatile, have averaged 15.3%. This figure is above the much longer-term average of 11.6% **(See Figure 3)** but somewhat closer to the long-term median of 13.9%. While this is interesting, since the distribution of annual returns is not normal, and because investors earn compounded rather than average returns, we question whether it is a useful measurement. A more appropriate measure, as Buffett advises, is to think about risk and return over a time horizon that is consistent with one's actual intended holding period.

Returns over a 1-year period are very volatile and the current year-to-date return does not look unusual compared to the long-term range.

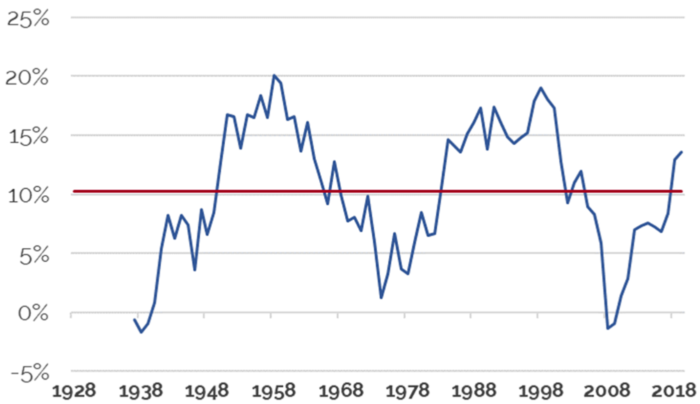
Figure 3: 1 Year S&P 500 Total Returns (1928-2019)



Over longer periods that are more consistent with investors' actual time horizons, the picture becomes more enlightening. After 2019, the trailing 10-year annualized return for the S&P 500 of 13.6% is above the long-term average of 10.3%, but by no means unusually so **(See Figure 4)**. Out of 83 data points, the current trailing 10-year period ranks as only the 31st strongest. This puts it in just the 37th percentile of all rolling 10-year periods going back to 1928 when this data series begins.[5] From this perspective, the current market rally is somewhat above average, but by no means exceptional. This may come as a surprise given frequent commentary about the rally's extraordinary strength.

Over periods of 10-years, returns are much smoother and the trailing 10-year return is only slightly above average.

Figure 4: 10-Year Annualized S&P 500 Total Returns



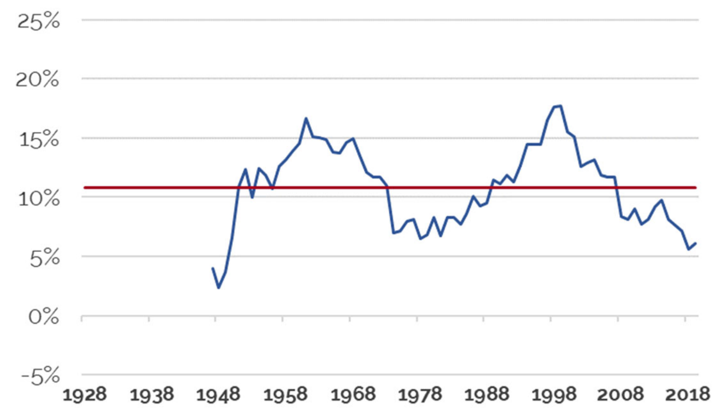
The examination of annualized 10-year rolling returns is also noteworthy in that it highlights the smoothing effect of time. Only twice have 10-year returns dropped below zero since 1929. The first incident followed the Great Depression and the second started with the dot-com bubble when valuations were extremely stretched. The other period of subdued but not negative 10-year returns occurred when inflation rose sharply in the 1970s and caused interest rates to spike and stock valuation multiples and prices to suffer.

While current returns over the prior 10 years are slightly above average, returns over the prior 20-years are among the worst on record **(See Figure 5)**. The trailing 20-year annualized return of 6.1% ranks 69th worst out of 73 observations going back to 1928. The 20-year figure makes intuitive sense since this period began with the bursting of the dot-com bubble and included the sharp decline during the financial crisis.

Returns over 20-year periods are also noticeably smoother than 10-year annualized returns and no 20-year period experienced a negative return. This was true even when the starting point was the Great Depression.

The current trailing 20-year return ranks near the bottom of all prior rolling 20-year periods back to 1928

Figure 5: 20-Year Annualized S&P 500 Total Returns

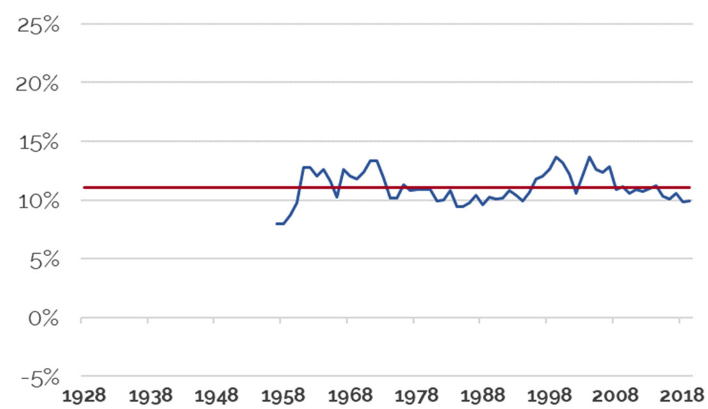


When the time horizon is extended to 30 years, returns flatten out even more to the degree that the current trailing period does not look too dissimilar from any other trailing 30-year period **(See Figure 6)**. In this context, while the current trailing 30-year annualized return of 9.9% ranks poorly at 53rd out of 63 observations, it is still very close to the 11.1% long-term average.

The remarkable consistency of returns in the 30-year chart is an extraordinary contrast to the volatility of the annual return chart. While one-year returns range from around -45% to over 50%, rolling 30-year annualized returns have been much tighter at a range of roughly 8% to 11%. It is precisely this contrast between one-year and 30-year annualized returns that is relevant to Buffett's discussion of thinking about returns in multi-decade terms that are consistent with most investors' actual time horizons.

Over rolling 30-year periods, annualized returns are remarkable stable. The current trailing return is among the lowest, but still near the average.

Figure 6: 30-Year Annualized S&P 500 Total Returns



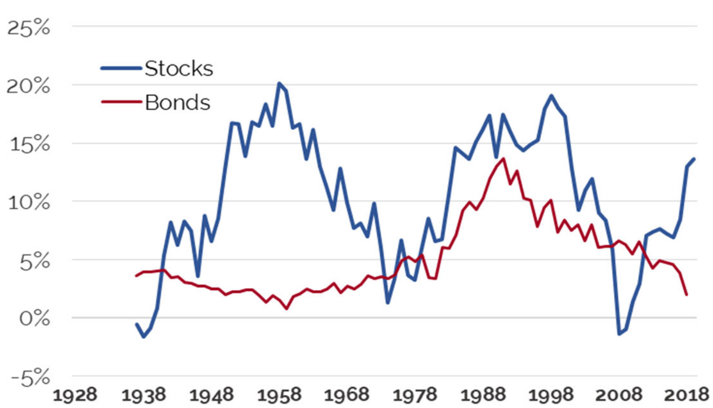
[5] Note that the S&P 500 Index was formed in 1957, but reconstructed data is used to create returns prior to that in the Damodaran return series used in this analysis.

Long-Term Stock vs Bond Returns

Turning to asset allocation in the same time frame, equities have generally done substantially better than bonds. But examining 10-year rolling periods, this is clearly not always the case **(See Figure 7)**. During the 1970's, equities on a trailing basis briefly underperformed bonds twice. With the energy crisis and an increase in inflation, bond yields had risen sharply and equity valuations were pushed down. In the more recent period when bonds exceeded equities, the period began when equity valuations were stretched in the dot com-bubble and 10-year treasury bonds offered yields of 6.5%.

Over rolling ten-year periods, 10-year treasury bonds outperformed stocks on several occasions.

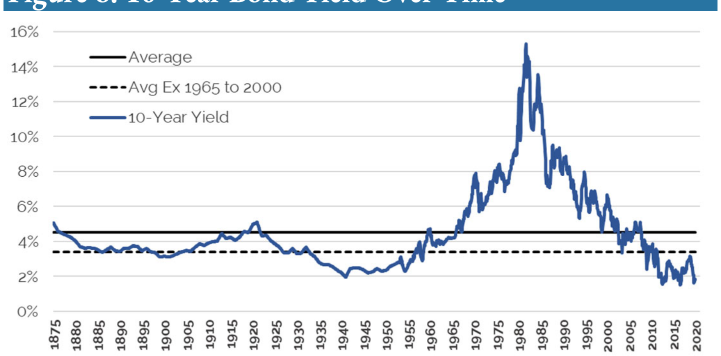
Figure 7: Annualized 10-Year Bond vs. Stock Returns



It is also important to consider the very unusual pattern in bond yields over this period. As a result of high inflation in the 1960s and 1970s, rates surged higher. While this initially depressed bond returns, the subsequent multi-decade period of normalization, from a peak 10-year U.S. Treasury yield of nearly 15% in 1981 to around 2% currently, provided a tremendous tail-wind for bond investors **(See Figure 8)**. With yields now back near their longer-term range (excluding the spike), prospective returns are likely to be much lower than those experienced in the last nearly 40 years.

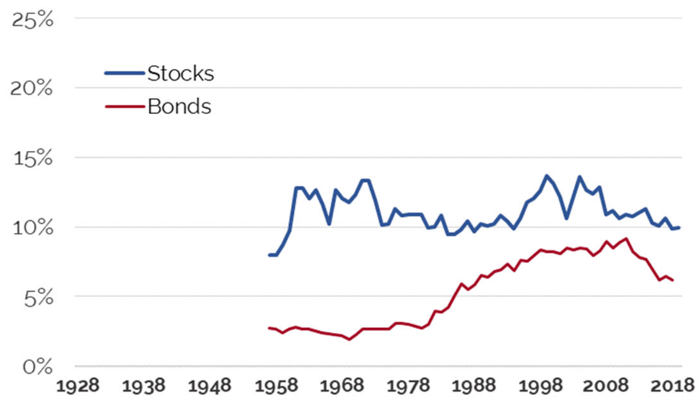
10-Year bond yields have generally been between 2% to 4% with the exception of the spike in the 1970s that took several decades to normalize.

Figure 8: 10-Year Bond Yield Over Time



Over the multi-decade horizon that Buffett talks about, stocks have consistently outperformed bonds even when starting with rich valuations and during periods of unusually high bond yields.

Figure 9: Annualized 30-Year Bond vs. Stock Returns



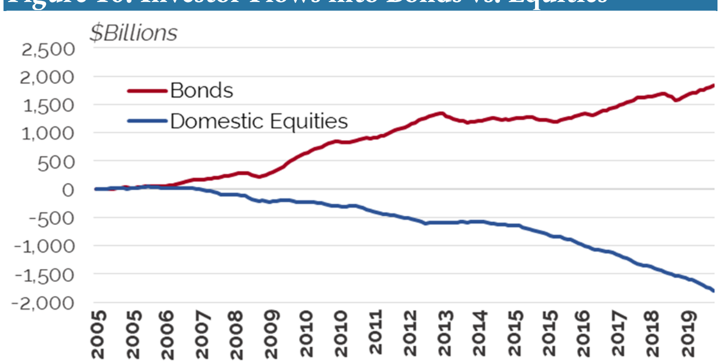
Comparing stock and bond returns over the 30-year stretches that are more consistent with Buffett's suggested horizon shows that stocks have consistently outperformed 10-year treasury returns **(See Figure 9)**. This was true even when starting equity valuations were extremely elevated and when bonds benefitted from yields that were anomalously high in a historical context. This very long-term comparison between stock and bond returns suggests that truly long-term investors should be very cautious in trying to time a shift from equities to bonds in an effort to enhance returns. This is especially true if the impact of taxes is considered.

Importantly, current valuations also support that same caution as the S&P 500 free cash flow yield of around 5% on forward estimates looks reasonably attractive versus its own history, and especially so compared to 10-year treasury yields of just under 2%.

Yet despite this valuation disparity and the long-term return data for equities, investors have continued to shift money into fixed income securities over equities in recent years. This is evident in data on flows that show nearly $2 trillion of inflows into bond funds and nearly as much in outflows from equity funds over the past 15 years **(See Figure 10)**.

In spite of relative valuations and historical returns strongly favoring equities, investor have heavily preferred bonds to equities in recent years..

Figure 10: Investor Flows into Bonds vs. Equities



Investment Implications:

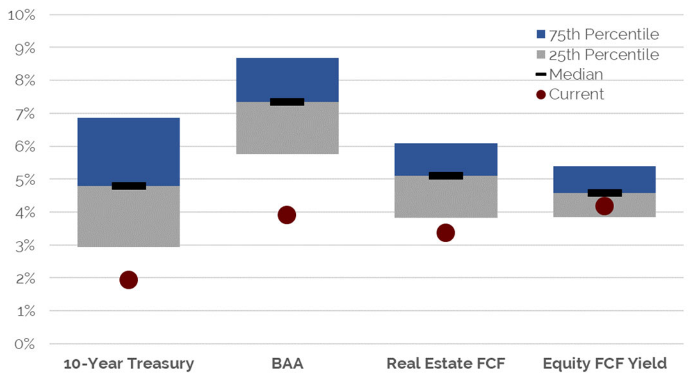
Examining the current recovery in a longer-term context highlights two key points. First, the answer to the question about the strength of the current stock market depends on the time period over which it is examined. Generally, the recovery does not look unusually strong and over many time periods it actually looks fairly weak versus history. Second, returns tend to smooth considerably when time periods extend to lengths that are more consistent with investors' actual time horizons. Over these longer periods, not only were equity returns more stable, but their returns have also been significantly stronger than bonds.

Despite this result, human nature and behavioral biases make it extremely tempting to try to time the volatile market moves over the short-term. The evidence, however, overwhelmingly shows that this strategy is deleterious to investors' actual realized returns as the vast majority of capital is repositioned with extraordinarily bad timing.[6] Behavioral research supports these findings as well and has repeatedly documented our inclination as humans to take risk at the wrong time and run from it at equally poor moments when opportunities are at their greatest.

Fund flows suggest that many investors at present are heavily favoring bonds over equities despite the long-term history of equity versus bond returns and equity valuations that look reasonable versus history and very attractive compared to alternative asset classes where yields are near historical lows **(See Figure 11)**. That equities look reasonably valued is another point that runs counter to much of the consensus commentary.

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

Figure 11: Current Yields vs. Historical Ranges for Various Asset Classes



History seems to repeat. The move to bonds from equities, which is corroborated by surveys and other allocation data, suggest that many investors at present may be more focused on minimizing short-term price volatility than they are on achieving adequate long-term returns. While there are always reasons to be cautious, committing capital to bonds at historically low rates, it might be argued, could be riskier than accepting the uncertainty of long-term returns in equities that both history and current valuations suggest are likely to be much higher.

It is exactly this issue of focusing on short-term volatility instead of growing long-term purchasing power that Buffett warned about in his 2014 Berkshire Hathaway Annual Letter to Shareholders when he wrote:

> *"Over the long term… volatility is far from synonymous with risk…For the great majority of investors…who can—and should—invest with a multi-decade horizon, quotational declines are unimportant. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, bought over time, will prove far less risky than dollar-based securities. If the investor, instead, fears price volatility, erroneously viewing it as a measure of risk, he may, ironically, end up doing some very risky things."*

Although five years old, this advice seems as relevant as ever given the strange current circumstance in which investors are accepting the guarantee of a loss on over $10 trillion of negative yielding debt despite the availability of reasonable valuations in equites. For investors who are instead focused on long-term shortfall, as Buffett advises, and who are willing to accept short-term price fluctuations to achieve this goal, we think equities still appear very attractive in spite of misleading commentary about the rally's extraordinary strength and equity valuations.

This is not to suggest that we think equities are without risk. We have discussed in past letters our concern about high concentrations of debt and stretched valuations in certain parts of the equity market. Additionally, while we think it is a mistake to focus on short-term price volatility at the expense of longer-term opportunities, steep price falls do have enormously detrimental impacts on long-term compounded returns. It is precisely for these reasons and with multi-decade returns in mind that we designed our FSV strategy with a goal of protecting capital in negative economic environments by investing in companies that are more fundamentally stable, less leveraged, and more attractively valued.

[6] See Morningstar's "Mind the Gap" reports, Dalbar's "Quantitative Analysis of Investor Behavior" studies, and Hsu, Myers, & Whitby "Timing Poorly: A guide to Generating Poor Returns While Investing in Successful Strategies", 2016

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Distillate claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Distillate has been independently verified for the periods June 1, 2017 through November 30, 2018. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

To receive a GIPS compliance presentation and/or our firm's list of composite descriptions please email your request to ***info@distillatecapital.com****.*

The U.S. Dollar is the currency used to express performance. Returns are presented net of management fees and include the reinvestment of all income. For non-fee-paying accounts, net of fee performance was calculated using a model management fee of 0.39%, which is the highest investment management fee that may be charged for this composite. For accounts calculated with a per share, net-of fee NAV, gross performance was calculated by adding back the unitary fee associated with that fund. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The investment management fee schedule for the composite is 0.39%; however, actual investment advisory fees incurred by clients may vary.

The U.S. Fundamental Stability & Value composite seeks to distill a starting universe of large cap U.S. equities into only the stocks where quality and value overlap using Distillate's proprietary definitions. Its goal is to achieve superior compounded long-term returns by limiting downside in periods of market stress, while still providing strong performance in up markets. This composite was created in May 2017.

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Free Cash Flow *refers to a company's operating cash flow, less its capital expenditures.*

Enterprise Value *refers to a company's market capitalization plus its net debt balance.*

Free Cash Flow to Enterprise Value Yield *refers to a company's or group of companies' free cash flow divided by the company's (or companies') Enterprise Value, with a higher resulting ratio indicating a more attractive valuation.*

Distilled Cash Yield *refers to the firm's proprietary valuation measure that looks at estimated, adjusted free cash flow relative to a company's adjusted enterprise value. References to historical stocks that ranked well using this methodology (such as Figure 3 above) refer only to these stocks' historical valuation and not their inclusion in any actual or hypothetical strategies/accounts managed by Distillate Capital Partners LLC.*

Figure 11 Methodology: Equity yield *is based on trailing free cash flow data from FactSet and the index is reweighted each quarter to exclude companies without data.* ***Real estate FCF*** *data is based on capitalization rate yields for apartment buildings from RERC and adjusted by the historic ~30% free cash flow discount to net operating income per the NCREIF Q2 2018 Indices Review as well as Joseph Paglia's 2017 "Some Thoughts on Real Estate Pricing". Lastly, it should be noted that the RERC data is based on surveyed estimates of forward year net operating income and is thus more akin to forward estimated equity free cash flow. Yield data for* ***10-Year Treasury and BAA Bonds*** *are sourced from FactSet.* ***BAA Bonds*** *are U.S. corporate bonds rated "Baa" by Moody's Investors Service.*

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

Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs, which would reduce returns.

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