DISTILLATE CAPITAL

2020 Q1 Letter to Investors:
The Corona-Crisis and Prospects for Recovery

U.S. Fundamental Stability & Value Strategy Summary

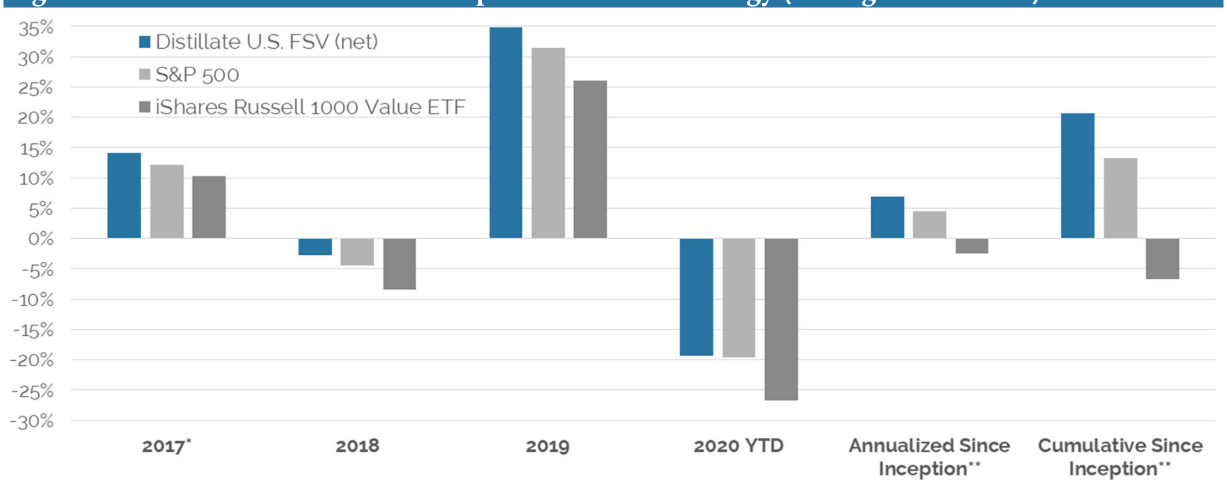
Distillate Capital's U.S. Fundamental Stability & Value (U.S. FSV) strategy seeks to outperform the equity market over the long-term by minimizing risk and investing in stocks that are more fundamentally stable, less levered, and more attractively valued. Our strategy uses cash-flow-based measures of 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: After lagging at the beginning of the year, Distillate's U.S. FSV strategy bounced back versus the S&P 500 Index in the sharp sell-off with the result that the net-of-fee return of -19.39% in Q1 2020 modestly exceeded the S&P 500 Index's decline of 19.60%. This follows outperformance in each of the three prior years with the result that annualized performance since inception is 2.4% above the index on an after-fee basis (**See Figure 1**). Compared to the iShares Russell 1000 Value ETF, Distillate's U.S. FSV strategy did 7.3% better in the quarter after fees, and annualized net of fee performance since inception is 9.3% above that benchmark.

A word about this letter: Amid the turbulence and uncertainty of the current crisis, we thought a discussion of how our investment process is designed to weather tumultuous times as well as capitalize on the opportunities they create is of more interest than trailing returns and so we have reordered our typical quarterly letter structure to reflect this.

Despite the market's decline, assets under management in the strategy are up nearly 20% since year-end (as of 4/7/20). We want to express our tremendous appreciation to our clients for partnering with us to look beyond near-term fears to focus instead on long-term opportunity.

Figure 1: Performance of Distillate Capital's U.S. FSV Strategy (through 3/31/2020)



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

** Strategy inception of 5/31/2017 through 3/31/2020

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

Coronavirus Crisis Outlook

The current coronavirus crisis is highly unusual in many ways. While pandemics are common in human history, we have not experienced one on this scale in modern times. The speed of the economic shutdown associated with containment measures is also unprecedented.

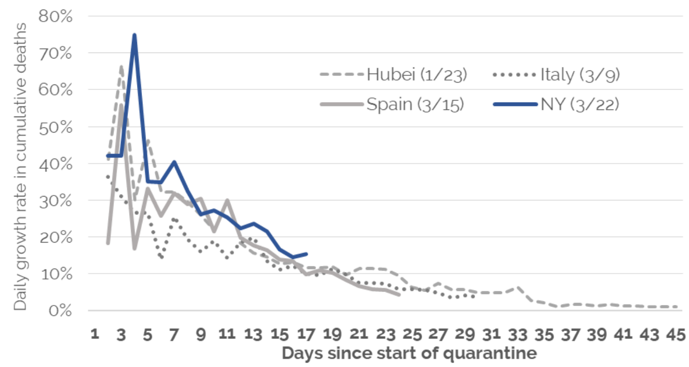
But the crisis is unusual in some more hopeful ways, as well. Most notably, we have extraordinary scientific knowledge and capacities to address the pandemic that we never had before. In addition to hopefully developing treatments to combat the virus in a very short period of time, there has already been substantial progress made in developing a vaccine. This makes this crisis anomalous from an economic perspective in that there is unusual insight as to the potential outer bounds of its duration even though the near-term remains highly uncertain. In this context, we think it is useful to think about the crisis in two phases with the first phase being the near-term period until the development of a vaccine and the second phase occurring thereafter.

Beginning with the outlook for a vaccine, there have already been a number of very positive developments. After the genome of the SARS-CoV-2 virus was sequenced in January, Moderna, a biotech company based in Boston, delivered its mRNA vaccine just 42 days later and began human vaccine trials on March 16th. The company said that while full commercial production may take 12 to 18 months, its vaccine could be available on an emergency basis for medical workers and others in the fall of 2020. Industry giant Johnson & Johnson also recently announced progress on its own vaccine, which will be made available for worldwide emergency use in 2021, as they then further ramp capacity to supply a billion doses annually. Beyond these examples, there are nearly 50 other vaccines currently being researched, according to the Milken Institute's Covid-19 treatment and vaccine tracker. This wide array of potential vaccines and the significant progress so far bode very well for the arrival of a vaccine in record time. Importantly, key leaders including Dr. Anthony Fauci and Bill Gates have discussed plans to invest heavily in vaccine manufacturing and even the stock-piling of a significant inventory of doses prior to receiving pivotal clinical data.

While there are positive signs regarding the second phase of the crisis, the near-term looks much more perilous and uncertain. From an economic perspective, it will be crucial to try to minimize the temporary economic dislocations during this difficult period by providing as much relief as possible. Any ability through testing and treatments to mitigate the depth and duration of this period and to partially normalize conditions before the advent of a vaccine will also be critical. Fortunately, despite what is likely to be a very trying time with a projected 60,000 lives lost (Institute for Health Metrics and Evaluation), there are some positive signs for this phase of the crisis, as well.

Similar growth trajectories several weeks after imposing quarantines in various countries indicate that social distancing is effective.

Figure 2: Daily Growth Rate in Deaths Post-Quarantine



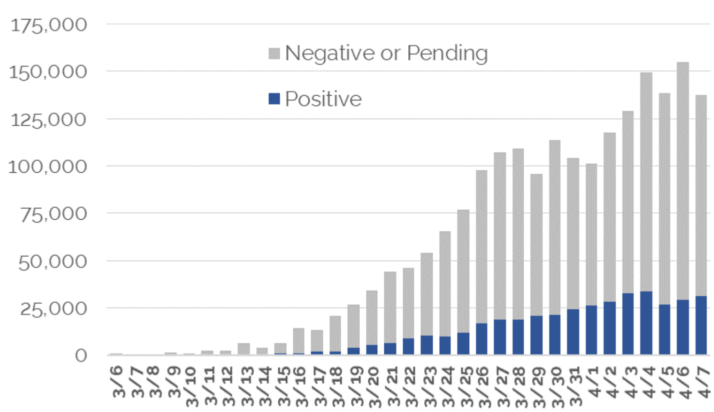
Source: Johns Hopkins University Center for Systems Science and Engineering; as of 4/7/2020

First, social-distancing is proving effective at suppressing the spread of the virus. By looking at the daily growth in deaths after the start of quarantines in different places, while there is substantial variation at the beginning, growth rates have tended to slow in a fairly consistent pattern over time from region to region (See **Figure 2**). This suggests that while it takes a period of several weeks for the growth in deaths to slow substantially and potentially five to six weeks to get near zero, quarantines are proving effective. This graph also highlights the importance of putting in place such measures early and the tragedy of compounding growth off a higher base.

Second, testing has finally started to ramp up in the U.S. (See **Figure 3**). With continued improvement, after a quarantine period suppresses the virus' growth, this may enable the U.S. to shift to a South Korea or Iceland model where substantial testing and contact tracing has allowed those economies to remain open and the virus kept largely at bay. In addition to the growth in testing that has already occurred, the development of and approval of faster tests, like Abbott's 15-minute version, are also very positive and will hopefully increase testing substantially further. The need is significant.

U.S. coronavirus testing has finally ramped up.

Figure 3: U.S. Coronavirus Tests Per Day



Source: The COVID Tracking Project (4/4 exclude the 46k decline in pending tests)

Third, in addition to increased testing for current infections, there has been substantial progress in developing antibody tests to determine whether someone has previously been infected. Such information is important not only to reveal who is immune from the virus and can more safely return to work or support the fight against the virus, but also to provide important information about the virus and its spread. Given the large numbers of asymptomatic infections reported in situations where entire populations were tested, like on the Diamond Princess or in the Italian village of Vo[1], such tests are critical. More detailed information about who had the virus would also give better insight into the true death rate and severity of the virus, which is also of critical importance. Numerous companies are progressing with such tests and one, Chembio Diagnostics, announced that it will begin shipping a 15-minute finger prick version later this month.

Fourth, there is an enormous amount of ongoing research into treatments for the virus and any progress in this regard could substantially improve outcomes and reduce the virus' severity. More than 100 clinical trials are now underway along with another 100 or more pre-clinical trials, according to data from BioCentury. While chloroquine and hydroxychloroquine have garnered substantial attention on this front, evidence on efficacy for those drugs remains largely anecdotal and has yet to be proven out in rigorous trials. Success of older drugs like chloroquine would come with the additional benefits of well-known safety profiles and be inexpensive and widely available.

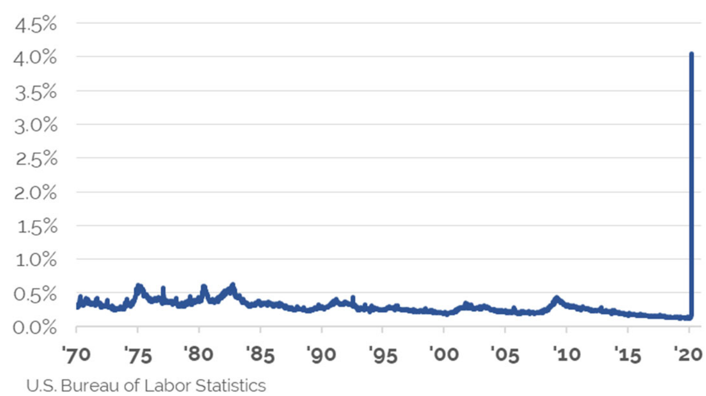
Broadly, treatments fit into three main categories: antivirals, anti-inflammatory medicines, and antibody-based treatments. In the first category, Gilead's Remdesivir has shown promising early signs and is expected to soon report results from robust double-blind trials in China that conclude in early April, and then will report data on U.S. trails after that. Fujifilm's anti-flu drug Avigan (generically called favipiravir) is also undergoing trials and has been discussed as a promising candidate. Hydroxychloroquine (used alone or in combination with azithromycin), also falls into this category. Drugs in the second category, anti-inflammatories, are being tested based on the idea that they may slow the body's immune response when it begins to over-react to the virus and then turns against the body it is supposed to protect. Such drugs include Roche's Actemra and Sanofi and Regeneron's partnership on Kevzara, in addition to numerous others. The final category, antibody-based treatments, either use the plasma from recovered patients or antibodies that are developed in a lab to help infected patients fight the virus, and are also thought to offer significant potential in combating the virus.

The degree to which a treatment or multiple treatments are discovered to be successful would obviously be enormously positive in minimizing the impact of the virus during the first phase of the crisis. In conjunction with widespread testing of both sick and asymptomatic people, this may permit a gradual return to more normal conditions. In addition, certain regions could move ahead of others or periodically slow things again if the virus is found to spread a second time. This may not mean that life and economic activity return fully to normal until phase two, but could nonetheless result in substantial progress while we await a vaccine.

Unlike in phase two when there is a high degree of confidence that economic conditions should rebound swiftly, the economic fallout during phase one is much more uncertain. Never before has the economy ground to such a sudden stop, as is clear in the extraordinary rise in weekly unemployment filings as a share of the overall labor force (See **Figure 4**). Estimates project an unheard of drop of 25% in annualized gross domestic product (GDP) in the second quarter. Partially offsetting the negative impact of the virus-related shutdown is an enormous government stimulus package of $2.2 trillion, or over 10% of annual GDP. It should be noted that the quarterly GDP decline is an annualized figure that corresponds to a drop of ~$1 trillion, while the stimulus figure is relative to the full year's GDP and so the percentage figures should not be compared. While the fiscal stimulus is enormous, it may still be inadequate and could rise further as politicians have already suggested. There has also been an extraordinary monetary stimulus as the Federal Reserve has slashed interest rates and provided liquidity injections of around $2.5 trillion. This includes the unprecedented step of directly buying corporate bonds through exchange traded funds.

The speed and severity of the economic slowdown associated with the coronavirus crisis is unprecedented.

Figure 4: U.S. Weekly Initial Unemployment Claims as a Share of the Labor Force



[1] See: https://promarket.org/why-mass-testing-is-crucial-the-us-should-study-the-veneto-model-to-fight-covid-19/

While the duration and severity of the economic decline in the first phase of the crisis will largely depend on scientific progress, it is nonetheless encouraging that the Federal Reserve and political leaders have recognized the need to provide massive support and appear willing to do more. This displays an important awareness that even as near-term economic activity will be severely challenged, there is an emphasis rightly placed on preserving the long-term potential output of our economy. This comes by protecting the health of our workforce and thus its future ongoing productive capacity.

This point about the importance of the long-term health of the economy was demonstrated in a recent study of differing responses in cities and states during the 1918 flu pandemic. The first key finding of the study, "Pandemics Depress the Economy, Public Health Interventions Do Not: Evidence from the 1918 Flu" was that cities that implemented faster and more stringent non-pharmaceutical health interventions like social distancing did not experience worse economic downturns than cities that took less aggressive actions. This suggests that a severe downturn related to a pandemic is largely unavoidable. This makes sense as even if people are not mandated to quarantine themselves at the onset of an outbreak, they will likely do so ultimately as the virus takes its toll and the ultimate spread may be much worse as a result of waiting. The second crucial finding of the study was that cities that instituted earlier and stricter social distancing measures experienced much stronger recoveries after the epidemic passed, as measured by employment, manufacturing activity, and bank assets. This supports the idea that preserving the long-term productive capacity of the economy is more important than trying to keep near-term activity elevated.

Overall, this crisis is a unique and tremendously sad event. Scientific progress and human ingenuity, however, will ultimately prevail. While the advent of a vaccine may seem like a distant prospect at present, substantial progress thus far points to an incredibly rapid arrival by historical standards. In the interim, we have demonstrated that we can suppress the virus through social distancing and this will buy precious time for numerous ongoing clinical trials to potentially reveal effective treatments. In conjunction with widespread testing, this could dramatically alleviate the pains of the first phase of this crisis. To cope with the economic fallout during this period and to help provide a financial bridge to the recovery, massive fiscal and monetary stimulus are being provided. The effects of this stimulus, however, will likely be more gradual than the sudden stop in activity that has occurred and near-term economic conditions will weaken sharply. Still, such support and potential additional measures should ultimately help to mitigate any impairment to our longer-term productive capacity. Along with substantial support mechanisms that will likely remain in place, like extremely low interest rates, this should help stoke a very strong recovery in phase two of the crisis.

Equity Valuations & Our Process

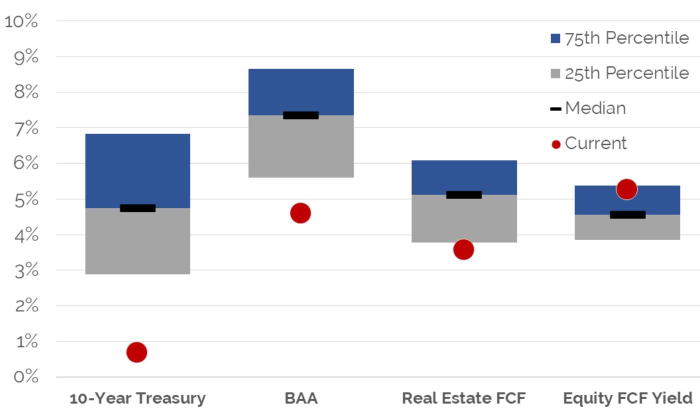
The general outlook for this crisis involves a very sudden and steep near-term economic decline followed by some gradual normalization and then a likely very strong recovery aided by the advent of a vaccine. For stocks of financially healthy companies that can endure the challenging near-term environment, the stream of cash flows in the post-recovery period should matter much more to stock price valuations than any near-term shortfalls. However, as history and Nobel-Prize-winning economist Robert Shiller have showed, the reverse is true and stock prices tend to be far more volatile than the long-term fundamentals that they are supposed to reflect.

Given the highly uncertain near-term outlook, valuing equities on this year's earnings or cash flows is unlikely to give a fair picture of a company's true worth. Accounting based valuation metrics, as we discuss in our paper on valuation and accounting, are problematic in making absolute and comparative judgements in normal times, and are likely more problematic in a period as abnormal as the present one. We might turn to valuation comparisons based on next-twelve-month free cash flow estimates. Those show that equities are very inexpensive with a 5.4% free-cash-flow yield, but estimates are likely to fall further and already may understate what companies can likely earn on a normalized basis.

Trailing free cash flows may therefore, at present, offer the fairest picture of valuations as they better reflect the level of ongoing profitability companies can generate over the longer-term. On this measure, current equity valuations (red dot in chart) rank very attractively versus their history and extremely so when compared to alternatives. This is true even after the significant spike in corporate bond yields that has taken place (See **Figure 5**).

Current yields for 10-year treasuries, BAA bonds, and real estate free cash flows are near the lowest of their historic ranges even after spiking higher, while equity free cash flow yields look substantially more attractive.

Figure 5: Current Yields vs. Historical Ranges for Various Asset Classes (1985 to March 2020)



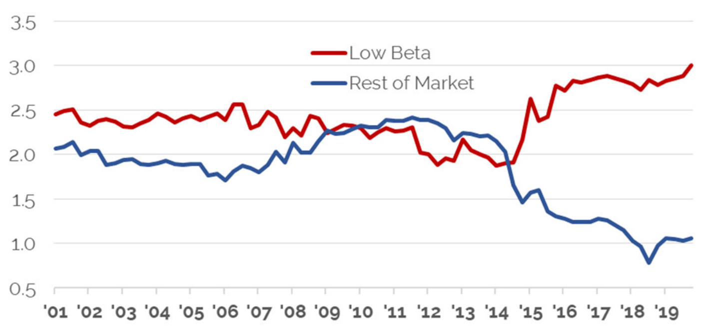
See end notes for sources and methodology of Figure 5.

But even if equity prices overall look highly attractive to long-term investors, there is an enormous amount of variation in valuations within the market. Additionally, some companies are much better positioned to weather the current economic shock and some may face long-term impairments to their businesses as a result of the crisis. While obviously not designed for this environment specifically, our U.S. FSV strategy seeks to purchase stocks that are attractively valued on a normalized basis, but that also have the balance sheet strength and overall quality to endure the downturn. This leaves us very optimistic about the current opportunity set and our ability to differentiate the probable winners and losers.

Debt looks like an especially important consideration at present. Corporate financial leverage across the economy has increased meaningfully in recent years. The issue is often cited as critical among smaller companies, but it is also very relevant for larger companies like those in the S&P 500 Index. Even though debt levels for that index remain healthy overall, the aggregate figure is skewed by very low debt levels among several extremely large companies and also masks the recent accumulation of unusually high levels of debt among low beta stocks (See **Figure 6**). This is a notable risk for a group of stocks which investors typically turn to in times of distress for their perceived safety. We worry that because of this debt overhang, such stocks might not provide the same safety through challenging times that is expected and that investors paying rich valuations for such stocks may thus end up very disappointed by their performance. We avoid this risk by looking directly to underlying company level fundamentals and debt levels instead of backward-looking stock price moves to assess risk.

While overall leverage among large-cap stocks has declined, it has increased substantially among low-beta stocks.

Figure 6: S&P 500 Leverage: Low Beta Stocks vs. the Rest of the Market



Source: FactSet

Portfolio Changes and Valuation

After rebalancing, the weighted average free cash flow yield for the U.S. FSV strategy of 7.6% is substantially higher than the comparable yield of 5.4% for the S&P 500. On the basis of our normalized free cash flow metric, which may provide a fairer comparison than forward-estimated free cash flows in the current environment, our portfolio's yield of 6.4% also significantly exceeds the S&P 500 Index's level of 4.7%. In addition to being substantially better valued on a free-cash-basis, 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 1: U.S. FSV Portfolio Characteristics*

	U.S. FSV Strategy	S&P 500
Free Cash Flow Yield[2]	7.6%	5.4%
P/E[3]	15.6	22.9
Fundamental Stability[4]	0.86	0.70
Leverage[5]	1.18	1.37

*as of 4/7/2020

Turnover with the most recently quarterly rebalancing was higher than usual at over 20% of the portfolio, and reflects the significant opportunities created by the market turmoil.

Sector Changes: Sector changes largely reflect sector performance experienced in the quarter. After substantial relative outperformance, the technology and consumer staples weights declined by around seven and five percentage points, respectively. Offsetting this were increases in the communication services, industrials, materials, health care, and financials sectors.

Despite their weak returns in the quarter, balance-sheet-driven financials and energy stocks did not enter into the portfolio in a significant way. In the case of levered financials, our strategy's focus on debt tends to limit their inclusion. Also contributing, a prolonged period of ultra-low interest rates relating to the crisis may impair the ongoing ability of such companies to generate profits. Energy related stocks also remain unattractive on our methodology despite substantial price declines, as they have higher debt levels generally and are not expected to earn

[2] 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.
[3] 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.
[4] Fundamental stability is Distillate Capital's proprietary measure of through-cycle cash flow stability with a higher value indicating greater stability.
[5] 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.)

meaningfully positive free cash flows even several years into the future when the oil price is forecasted to recover substantially.

New Buys: The largest new positions are Facebook (FB) and AT&T (T). In each case, their shares underperformed the market while normalized forward free cash flow estimates held up better than those of the market overall, such that relative valuations became more attractive. Facebook in particular highlights the kind of opportunity that has become available recently. Against a market cap of near $480 billion, the company has net cash of over $50 billion and is projected to generate around $30 billion in free cash flow in 2021. For a company that is still seeing substantial growth, this provides a very attractive valuation and especially so given the company's balance sheet strength and fundamental stability.

Sales: The largest exited positions were Microsoft (MSFT), Visa (V), and Proctor and Gamble (PG). For several quarters, our weight in MSFT has been declining following strong performance, but after beating the S&P 500 Index by over 25% last quarter, the relative valuation has weakened such that the stock no longer warrants inclusion in the portfolio. P&G's shares similarly exceeded the market by about 20% in the quarter, and therefore its valuation become less attractive on a relative basis. In the case of Visa, outperformance was more modest, but coupled with deteriorating normalized free cash flow estimates, it was sold as other stocks became significantly more attractive. The next three largest sales include outperformers Critix (CTXS), Colgate-Palmolive Company (CL), and Hershey (HSY).

Additions: The biggest addition by weight in the rebalance was Expedia (EXPE), the travel company. While it is clear that the company faces a very challenging near-term environment for travel, the roughly 55% fall in the company's share price has created a potentially very attractive longer-term opportunity. Against a market cap of just under $8 billion, the company has total debt of around $4.9 billion but offsetting cash of around $4.6 billion, which should help it to withstand near-term challenges. Looking forward, the company is projected to generate well over $1.5 billion of free cash flow per year, which gives it an extremely attractive valuation. Given that companies in our strategy are weighted on the basis of their normalized cash flows, the disconnect between the steep price decline and more stable normalized free cash flows drives a substantial increase in the position weight.

Reductions: The largest reduction in the quarter was Regeneron (REGN), the pharmaceutical company that is working on several Covid-19 treatments. REGN remains attractively valued even after substantially outperforming the market, but is being reduced in weight as its projected normalized free cash flow has lagged its price performance.

Investment Implications:

In sum, while we are in the midst of a very difficult and tumultuous time, the extraordinary might of human ingenuity and scientific fire power will ultimately bring this tragic event to an end. Beyond the painful headlines, there has been considerable progress made in the first phase of this crisis and conditions could improve substantially as social distancing buys precious time to prove out the efficacy of treatments and as additional testing is put in place.

The severe but ultimately temporary dislocations of the crisis should leave intact the ongoing free cash generating capacity of financially healthy companies that are able to endure near-term challenges. Despite this, stock prices that in theory are supposed to look beyond near-term fluctuations to discount the longer-term future have fallen sharply and rapidly. Consequently, many stocks (particularly those with strong balance sheets and stable underlying fundamentals) look like extraordinarily attractive investment opportunities.

While we believe this backdrop will ultimately prove to be very rewarding for long-term investors who are able to look beyond short-term challenges, we think investors should seek to avoid highly indebted companies in trying to navigate the crisis. Counterintuitively, this risk looks particularly acute among low beta stocks where investors typically turn for safety in tumultuous times. We fully understand the importance of preserving capital in challenging environments and have designed our investment process with this in mind, but think it is much better to identify such companies directly by their fundamentals, rather than indirectly through their trailing price movements.

Our strategy remains unchanged. By emphasizing valuations based on long-term free cash flow characteristics, we are able to see through the current volatile and noise-generating environment in an effort to make more accurate valuation assessments. As well, consistent with prior down-turns, an emphasis on low financial leverage and stable underlying businesses, we believe, will preserve capital yet allow us to capture unusual pricing anomalies as we experience what will ultimately be a recovery to normalcy.

We wish everyone reading this letter safety and good health, for you and those around you. Most sincerely, take care.

***Distillate Capital Partners LLC** ("Distillate"), is a registered investment adviser with United States Securities and Exchange Commission in accordance with the Investment Advisers Act of 1940. The firm's list of composite descriptions is available upon request.*

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

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

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

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

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

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***U.S. FSV Assets Under Management** includes amounts associated with creation transactions (inflows) in the exchange traded fund vehicle that have occurred but are yet to settle.*

***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.*

***Figure 5 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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