DISTILLATE CAPITAL

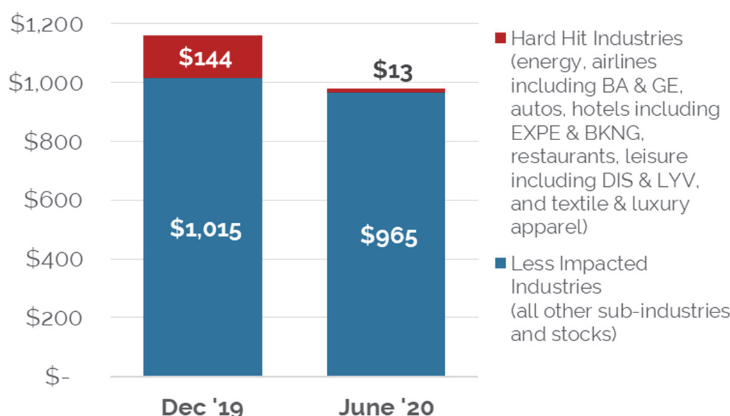
Opportunity in an Uneven Economy and Lopsided Market

The economic impact of the coronavirus crisis is extremely uneven. Certain businesses like restaurants, brick and mortar retailers, and travel-related companies are suffering enormously, while software providers, online retailers, producers of consumer staples and others have been impacted minimally. The same is true of companies that comprise the stock market, as proxied by the S&P 500 Index, though this list contains an even smaller mix of businesses most hurt by the crisis. The S&P 500 Index also consists of much larger companies on average, which are generally doing much better than the smaller local businesses that make up a larger share of the economy. Because of this mix and size benefit, the stock market is significantly less negatively impacted by this crisis than the overall economy.

Within the market though, there are enormous disparities in how companies are being affected that we believe are worth exploring. To do this, we split companies into a more at-risk segment that includes autos, airlines, energy, textile and luxury apparel, and travel and leisure companies. The remainder of the sub-industries in the market were classified as less impacted industries. At the end of 2019, the next-twelve-month free cash flow estimate for the S&P 500 was around $1.2 trillion, with roughly 90% coming from the less impacted group and the remainder from the hard-hit group. Through June 19th, estimates for the market overall fell 16% to ~$1 trillion. But this decline is massively disproportionately born by the hard-hit group where estimates are down over 90% versus a much more modest decline of just 5% for the less impacted category (**See Figure 1**). While free cash estimates are obviously imperfect and especially so at present, the magnitude of the discrepancy by group is staggering and speaks to the extremely uneven impact of the crisis.

Hard hit industries that made up around 10% of expected free cash flows in December have seen estimates fall over 90%, while the remaining 90% of the market has seen only a modest 5% decline in estimates.

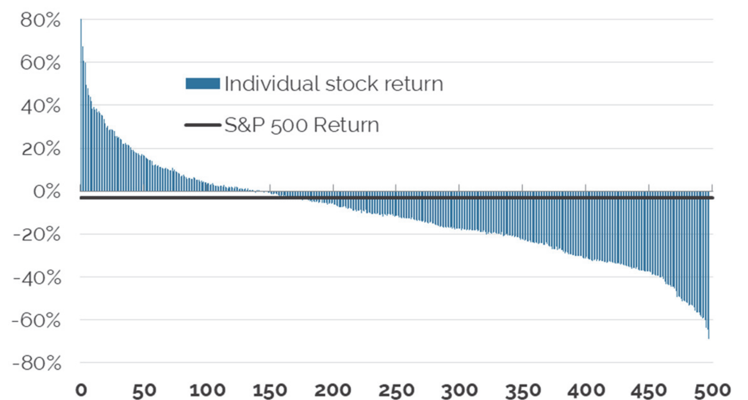
Figure 1: S&P 500 1-Year Forward Free Cash Estimates for Hard Hit and Less Impacted Industries ($ Billion)



FactSet data as of June 19th 2020, dual share class stocks consolidated into single entities and stocks without estimates on either date were excluded)

Stock price moves have been very uneven in 2020 with strength concentrated among a few very large companies.

Figure 2: S&P 500 Performance Year-to-Date by Stock



FactSet data, based on 6/23/2020 holdings, dual share classes consolidated into single names with weights adjusted.

While the majority of the economic impact of the crisis is expected to be borne by relatively few companies, the stock market has seen the reverse, with a small handful of companies performing very well while the vast majority are down much more. Through June 23rd, while the overall S&P 500 Index was down 3%, this headline figure is significantly distorted by the fact that the five largest companies are up 26% on average. The outsized impact of these stocks has skewed the overall market such that it hides much weaker performance beneath the surface. Roughly 2/3rds of stocks in the S&P 500 have underperformed the index and the average return among the worst 250 performing stocks is -29%. This uneven distribution of returns is evident in **Figure 2** which plots the year-to-date returns for all stocks in the blue bars and contrasts it with the index return shown by the horizontal black line.

There is a substantial gap between the roughly 60 stocks in the hard-hit industries group from **Figure 1** and the more than 330 that have underperformed the market year-to-date in **Figure 2**. **This disconnect between the more concentrated weakness in free cash flow estimates and the much broader weakness in stock prices creates significant opportunity.** Through its disciplined process of investing in stocks that are attractively valued based on their normalized free cash flow, this mismatch between free cash flow revisions and price moves is exactly the type of opportunity that our U.S. Fundamental Stability & Value strategy seeks to exploit.

***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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***Free Cash Flow** refers to the cash generated by a business after accounting for capital investments required to maintain or grow the business.*

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

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