DISTILLATE CAPITAL

2023 Q1 Letter to Investors: Crosscurrents from Big Tech & Banks

Letter Summary

The first quarter saw a set of strong crosscurrents in the equity market. Investors returned to a select group of large growing companies after significant declines last year, and then took further refuge in some of the same companies as contagion-angst related to the collapse of Silicon Valley Bank and Signature Bank manifested itself. While these short-term crosscurrents had differing impacts on our strategies and we expect similar unpredictable events to do so in the future, they do not impact Distillate's process or investment methodology which remains focused on investing in diversified portfolios of stocks that are attractively valued on free cash flows, have little debt, and consistently generate cash flows.

Performance Summary

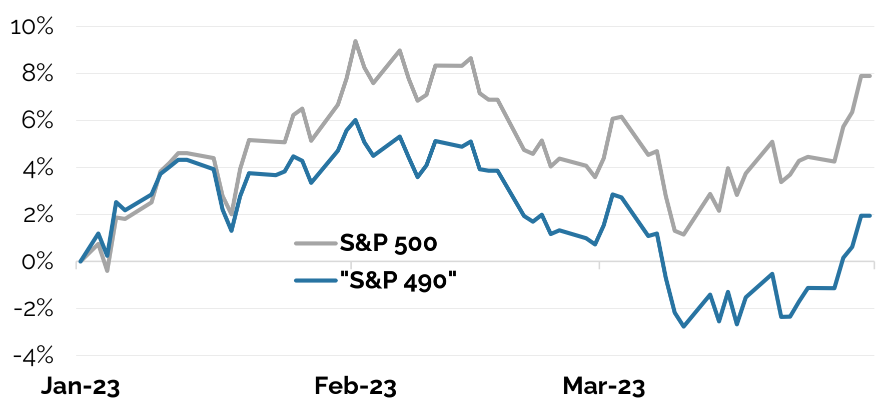
U.S. Fundamental Stability & Value (U.S. FSV): In the first quarter of 2023, our U.S. large-cap strategy lagged the S&P 500 by 1.46%, as a headwind from very concentrated gains among a small number of unowned stocks more than offset the more modest benefit of our lack of exposure to bank stocks. The drag from just five large outperforming unowned stocks (NVIDIA, Microsoft, Tesla, Meta, and Amazon) was around 3.25%, and more than offset the benefit (around 0.75%) from being without any exposure to the bank industry that comprises 4% of the benchmark and declined by around 10%. The impact of the outperformance of the largest stocks is evident in **Figure 1** which compares the performance of the S&P 500 and the "S&P 490" which removes the 10 biggest stocks and significantly lagged the full market index. Against the Russell 1000 Value ETF, our U.S. FSV strategy outperformed by 5.07%. Annualized returns remain solidly ahead of each benchmark since inception and net of fees, at 2.77% and 6.83% compared to the S&P 500 Index and Russell 1000 ETF (See **Figure 2** on the following page).

U.S. Small/Mid Cap Quality & Value (SMID QV): Our SMID QV strategy outperformed its Russell 2000 benchmark by 3.79% and its Russell 2000 Value benchmark by 7.14% in the quarter, and annualized excess returns since inception and net of fees are 9.41% and 9.23% ahead of each benchmark (See **Figure 3** on the following page). The strategy did not face the same headwind from the outperformance of several of the biggest stocks and had a slightly larger benefit of 1.5% from being without banks.

U.S. Large Cap Value Long 130%/Short 30% (U.S. Value 130/30): Our 130/30 strategy declined by 0.81% net of fees on a total return basis, trailing well behind the comparable 7.50% figure for the S&P 500 Index. This underperformance follows significant outperformance last year such that annualized net of fee returns are still solidly ahead of the S&P 500 Index by 8.35% and above the Russell 1000 Value ETF by 12.16% (See **Figure 4** on the following page).

International Fundamental Stability & Value (Intl. FSV): Our International FSV strategy returned 11.33% after fees in the first quarter, which was 4.18% ahead of the MSCI All Country Ex US ETF benchmark (see **Figure 5**). Again, there was a benefit from not owning large balance-sheet driven banks where high leverage keeps us on the sidelines, but this accounted for less than a percent of the outperformance with the rest being broad-based across regions and sectors. Annualized net of fee performance since inception is ahead of its benchmark by 0.99%.

Figure 1: S&P 500 Index Performance vs. "S&P 490" (Year-to-Date)



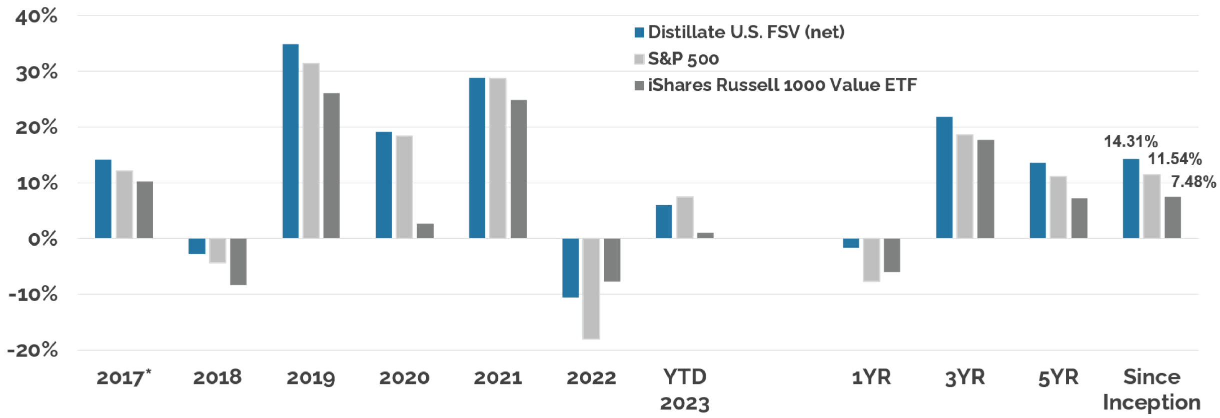
The "S&P 490" is a hypothetical index that removes the largest 10 stocks by weight from the S&P 500 Index. One cannot invest directly in an index. See disclosures.

Performance Charts: **Figures 2 through 5** depict net returns for Distillate's U.S. FSV, SMID QV, U.S. Value 130/30 and Int'l FSV composite strategies versus their respective benchmarks since inception.

Figure 2: Distillate U.S. Fundamental Stability & Value Composite Performance

As of March 31, 2023

	2017*	2018	2019	2020	2021	2022	YTD 2023	1YR	3YR	5YR	Since Inception
Distillate U.S. FSV (net)	14.18%	-2.79%	34.91%	19.22%	28.91%	-10.58%	6.04%	-1.64%	21.82%	13.62%	14.31%
S&P 500	12.11%	-4.39%	31.49%	18.40%	28.71%	-18.11%	7.50%	-7.73%	18.60%	11.19%	11.54%
iShares Russell 1000 Value ETF	10.27%	-8.41%	26.13%	2.73%	24.91%	-7.72%	0.97%	-6.07%	17.73%	7.30%	7.48%

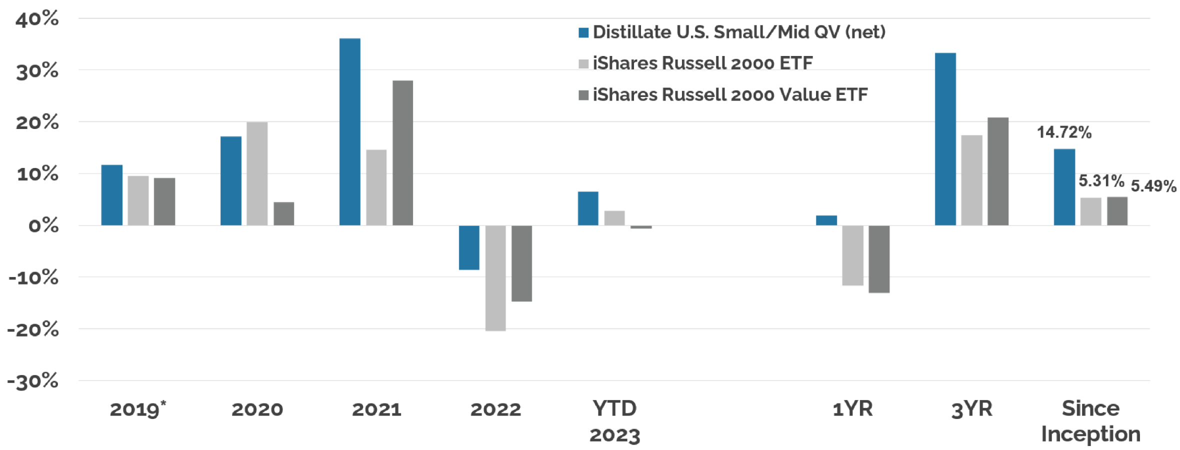


Source: U.S. Bank, Morningstar Data; Inception 5/31/2017; the period "2017*" reflects returns from inception through 12/31/2017; See performance disclosures.

Figure 3: Distillate U.S. Small/Mid Quality & Value Composite Performance

As of March 31, 2023

	2019*	2020	2021	2022	YTD 2023	1YR	3YR	5YR	Since Inception
Distillate U.S. Small/Mid QV (net)	11.65%	17.15%	36.03%	-8.64%	6.55%	1.92%	33.28%		14.72%
iShares Russell 2000 ETF	9.49%	19.91%	14.64%	-20.49%	2.76%	-11.64%	17.42%		5.31%
iShares Russell 2000 Value ETF	9.18%	4.50%	27.96%	-14.67%	-0.59%	-13.04%	20.83%		5.49%



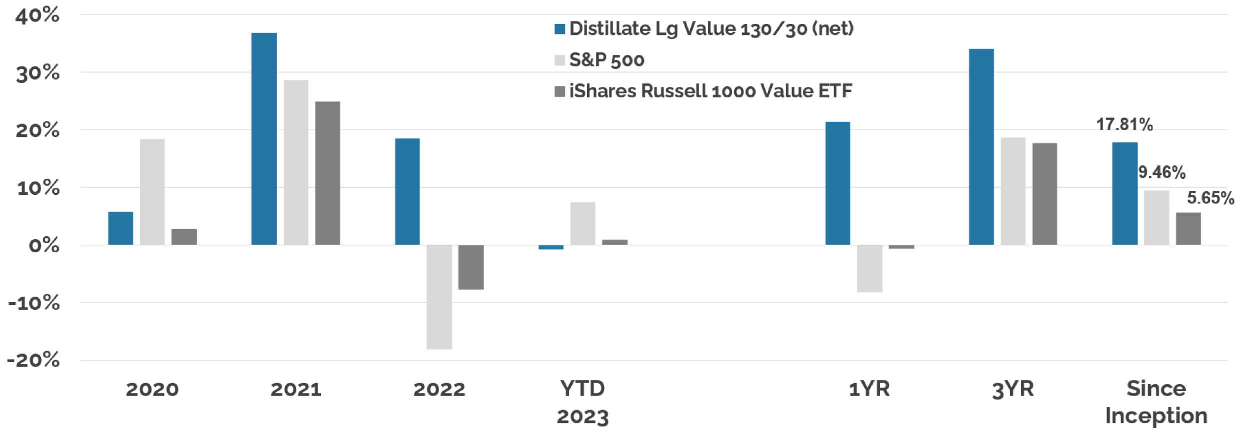
Source: U.S. Bank, Morningstar Data; Inception 3/31/2019; the period "2019*" reflects returns from inception through 12/31/2019; See performance disclosures.

Past performance does not guarantee future results. One cannot invest directly in an index. See disclosures.

Figure 4: Distillate U.S. Large Cap Value 130/30 Composite Performance

As of March 31, 2023

	2020	2021	2022	YTD 2023	1YR	3YR	5YR	Since Inception
Distillate Lg Value 130/30 (net)	5.81%	36.86%	18.59%	-0.81%	21.45%	34.04%		17.81%
S&P 500	18.40%	28.71%	-18.11%	7.50%	-8.22%	18.60%		9.46%
iShares Russell 1000 Value ETF	2.73%	24.91%	-7.72%	0.97%	-0.61%	17.73%		5.65%

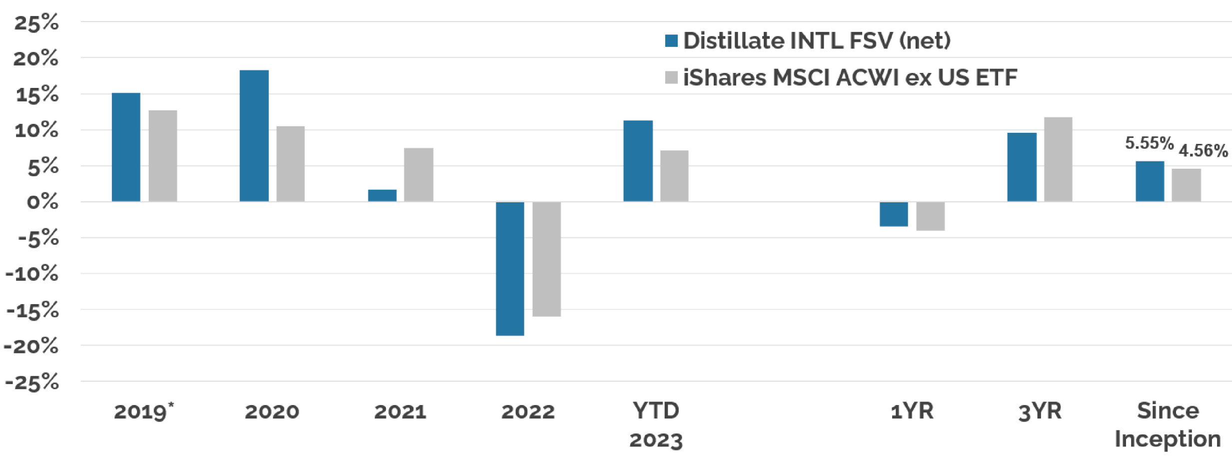


Source: U.S. Bank, Morningstar Data; Inception 12/31/2019; See performance disclosures.

Figure 5: Distillate INTL Fundamental Stability & Value Composite Performance

As of March 31, 2023

	2019*	2020	2021	2022	YTD 2023	1YR	3YR	5YR	Since Inception
Distillate INTL FSV (net)	15.08%	18.26%	1.67%	-18.68%	11.33%	-3.49%	9.55%		5.55%
iShares MSCI ACWI ex US ETF	12.67%	10.48%	7.48%	-16.01%	7.15%	-4.00%	11.78%		4.56%



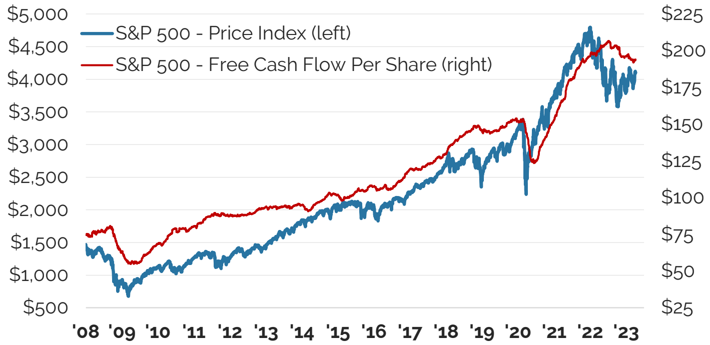
Source: U.S. Bank, Morningstar Data; Inception 1/31/2019; the period "2019*" reflects returns from inception through 12/31/2019; See performance disclosures.

Market Commentary:

The S&P 500 rose 7.5% in the first three months of 2023, while estimated free cash flows (NTM FCF) fell by 1% (See **Figure 6**). The free cash flow yield on the overall market stands at 4.8%, a reasonable level by historical standards and well above the 4% rate that prevailed in the prior several years. While equity valuations look reasonable in this context, much more focus is being given to a number of macroeconomic issues.

The S&P 500 Index rose 7.5% in 1Q while free cash flow estimates (NTM) for the market fell by around 1% in the period.

Figure 6: Estimated S&P 500 Free Cash Flows vs. Price

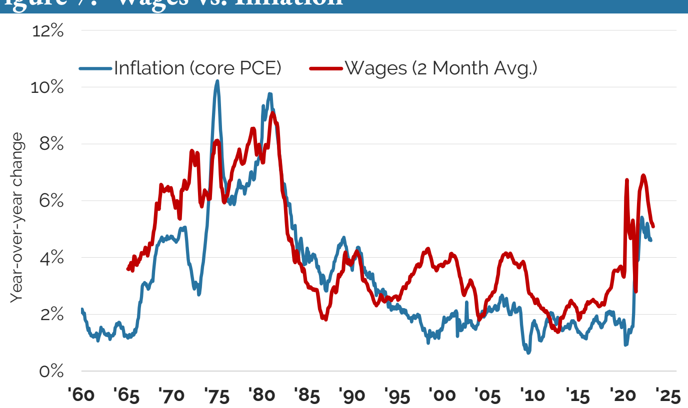


Source: FactSet, data as of 4/5/2023

Elevated inflation has caused the Federal Reserve to sharply raise interest rates. This has sparked fears over the path of interest rates with much debate about when the Fed will stop and whether they will soon reverse course. While we appreciate the downside scenarios that might come with significantly higher interest rates, we are encouraged to see inflation and its drivers moderating, as is evident in **Figure 7** which compares wage growth with the Fed's preferred measure of inflation, the Personal Consumption Expenditure index ex-food and energy. This easing in inflationary pressures and well-anchored levels of inflation expectations suggest the risk of a return to the kind of unchecked inflation that prevailed in the 1970s and early 1980s, and that drove the Federal Funds rate to 20% and the 10-year yield to nearly 16%, is low.

Wages and inflation have begun to moderate.

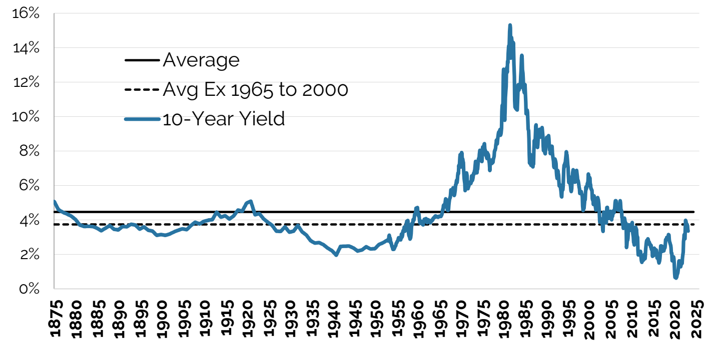
Figure 7: Wages vs. Inflation



Source: FactSet, data as of 4/7/2023

The current 10-year yield looks very reasonable in a long-term context after a period of being anomalously low during the pandemic.

Figure 8: U.S. 10 Year Treasury Yield



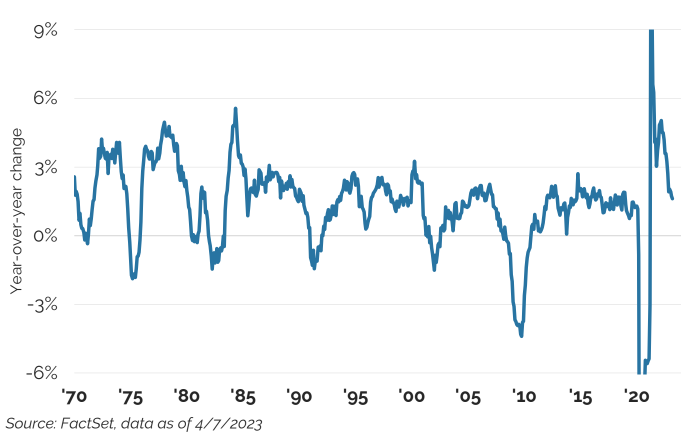
Source: FactSet

With less risk of dramatically higher rates, current levels or something in their proximity do not look anomalous in historical context. **Figure 8** shows 10-year rates over the long-term. Importantly, whether rates move up or down modestly, such levels historically have not significantly impeded economic growth or longer-term equity returns. With that backdrop in mind, we are much less concerned over the exact near-term path of rates than many investors and pundits seem to be. We do, however, agree that the impact of higher rates may reverberate through pockets of economy in deleterious ways as there are a number of companies that borrowed heavily in the period when debt was virtually free. On the next page we will discuss the impact that already occurred in this regard in the banking system

But while slower wage growth is beneficial from an inflation perspective, alongside more modest employment growth, it portends a further softening in economic activity. This is evident in **Figure 9** which shows that employment is slowing in synchrony with wages from **Figure 7**. This will translate into less income growth and less consumer spending especially later in the year when much of the excess savings related to pandemic stimulus is expected to be exhausted. While this will help to cool inflation, economic conditions may become more sclerotic in the near-term.

Slower employment and wage growth portend weaker economic activity.

Figure 9: Employment Growth



Source: FactSet, data as of 4/7/2023

Economic activity is clearly softening and a recession is a distinct possibility, but the depth of a potential recession is likely to be very different from the last two when economic output during the pandemic and financial crisis caused very severe downturns. We think much commentary about economic conditions and the possibility of a recession may be overly focused on the binary classification of such an outcome rather than the possible duration and severity, which look distinctly different from the recessions of recent memory. That is not to say that a slowdown in growth or recession is not without harm, but it is important to keep in mind the longer-term historical context in which periods of faster and weaker growth are quite normal, and most companies are adept at navigating through them.

The last issue buffeting the market is the recent collapse of Silicon Valley Bank and Signature Bank and associated fears of weakness in other regional banks and lending activity more broadly. Silicon Valley Bank had a maturity mismatch between its deposits, which are short-term in nature and can be volatile in periods of uncertainty, and its assets, which were invested in longer-term bonds and owned in a much larger scale through leverage that is typical of banks. On an accounting basis, the bank classified their bond holdings as held-to-maturity instead of available-for-sale and so was able to avoid having to recognize losses on those holdings as rising interest rates caused bond prices to fall. When low yields offered on deposits led some depositors to pull their funds in favor of better rates elsewhere, the bank was forced to sell some of its bond holdings to fund deposit withdrawal. That selling caused the bank to recognize losses on its bond holdings that it had not previously been required to do. Recognized losses sparked more fears and led to more deposit flight, especially of uninsured deposits over $250,000, which made up a disproportionately large share of the banks' deposits. A downward spiral ensued and led to the bank's failure. This caused solvency fears at other smaller banks and led to the similar failure of Signature Bank, a rescue of First Republic Bank, and stock price pressures among many of the other smaller bank stocks.

The situation at First Republic was quite similar as at year-end it reported equity of $17.4 billion and loans valued at $166.1 billion. But footnoted was the fair market value of those same loans at only $143.9 billion. The difference between the accounting and fair market values -- $22.2 billion -- exceeded the equity of the bank! Most larger banks, in general, have held up much better as they are thought to be less at risk of deposit flight, are better capitalized (less leverage), and have less mismatch in the duration of their assets and liabilities. For now, the contagion seems contained though the effect of higher rates may show itself again.

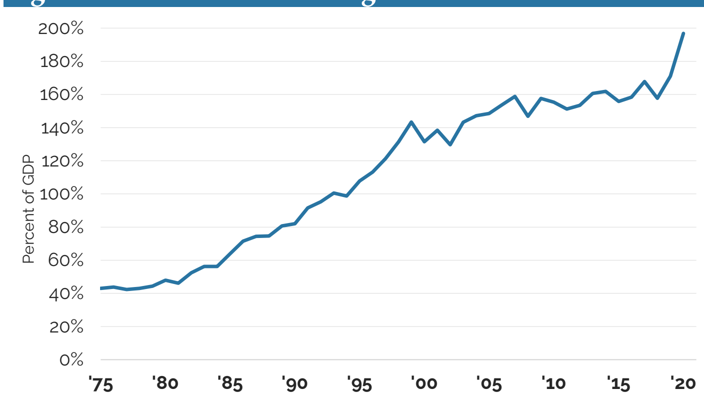
Also in the first quarter, Credit Suisse was forced into a sale to UBS after its stock price collapsed and some of the bank's credit investors were wiped out. The causes were unrelated to the turmoil among smaller U.S. banks, stemming instead from a number of issues that included large losses on lending to the Archegos Capital Management family office and the supply-chain financing firm Greensill Capital, both of which collapsed amid fraudulent activities. Client outflows then pressured the bank further and its collapse was ultimately precipitated by its largest shareholder, the Saudi National Bank, publicly stating that it would not make any further investments in Credit Suisse.

Together these collapses have heightened fears of further distress in the banking system. There are worries that pressures in commercial real estate and the office sector in particular could cause further losses at smaller banks that have disproportionately made those loans. There are also fears surrounding the dramatic increase in non-bank lending that has occurred in recent years evident in **Figure 10**. Credit quality is also an area of concern amid this rapid rise in nonbank debt. An offsetting positive is that the overall level of household and corporate debt is fairly reasonable even though there are pockets of the economy where debt levels are very high. Many of the largest public corporations have relatively little debt and this has contributed to overall debt levels being fairly low. This is evident in the difference between the relatively low leverage among large-cap public companies as proxied by the S&P 500 and much higher overall leverage rate among smaller companies that constitute the Russell 2000 benchmark (as described on page 7 and illustrated in Figure 13 on the following page). While it is a positive that household debt has been on the decline and corporate debt overall is very reasonable, these concerns do highlight potential issues that could add to stress in the financial system and further slow growth if lending activity is further curtailed.

So where does this leave us? Inflation is easing, but so too is economic activity. A recession is a possibility, though unlikely to be anywhere near as severe as the previous two downturns. There are strains in the banking system particularly among smaller banks and risks of further distress given pockets of high leverage, lower credit quality, and uncertainty around commercial lending. We certainly do not know how these risks will play out just as we did not anticipate the current banking pressures or pandemic. What we can do, however, is take advantage of valuation opportunities that short-term pressures create to invest for the long-term in high quality companies that have little debt and successful track records of navigating economic challenges. Also, we are happy to avoid banking stocks where we believe the enormous leverage creates an unfavorable risk/reward skew.

Non-bank lending has increased in recent years.

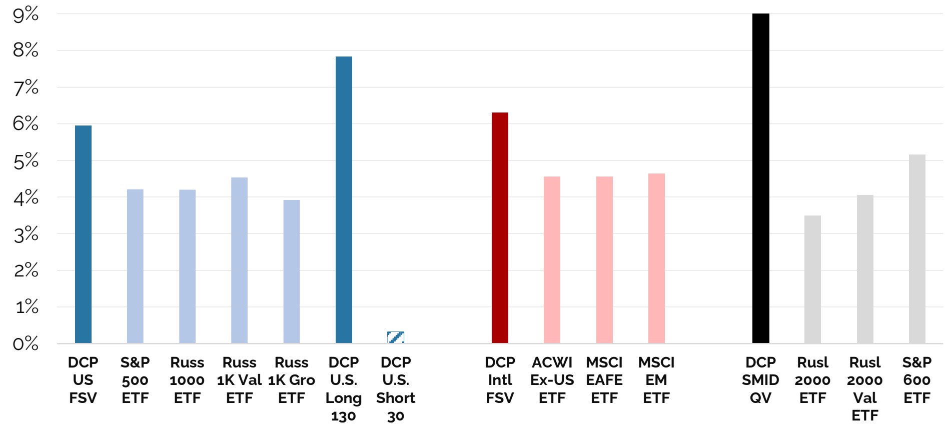
Figure 10: Non-Bank Lending as a Share of GDP



Source: FactSet, St. Louis Federal Reserve, World Bank data as of 12/31/2020

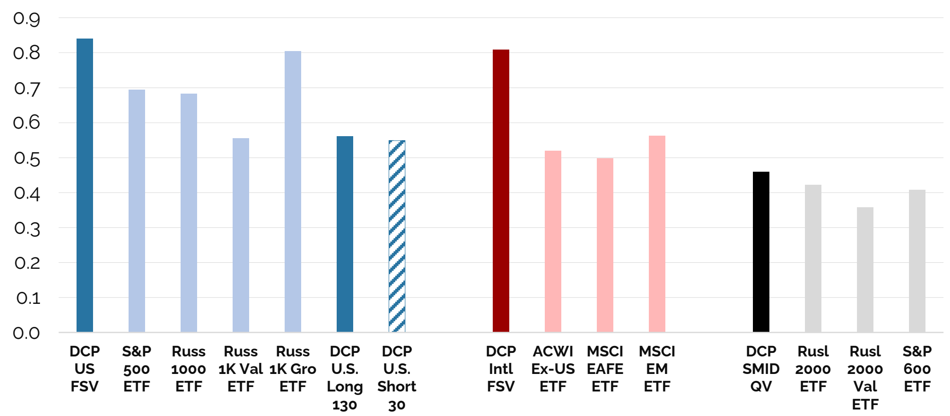
Valuation & Quality Statistics: **Figure 11** shows the current valuations for Distillate's U.S. and International Fundamental Stability & Value (FSV), its U.S. Small/Mid Cap Quality & Value strategy versus various benchmarks, as well as the long and short components of our U.S. Large Cap Value 130/30 strategy. **Figure 12** compares the same Distillate strategies and corresponding benchmarks on our cash flow stability scores, and **Figure 13** examines the degree of financial leverage across the same strategies and benchmarks.

Figure 11: Next 12-Month Free Cash Flow to Enterprise Value



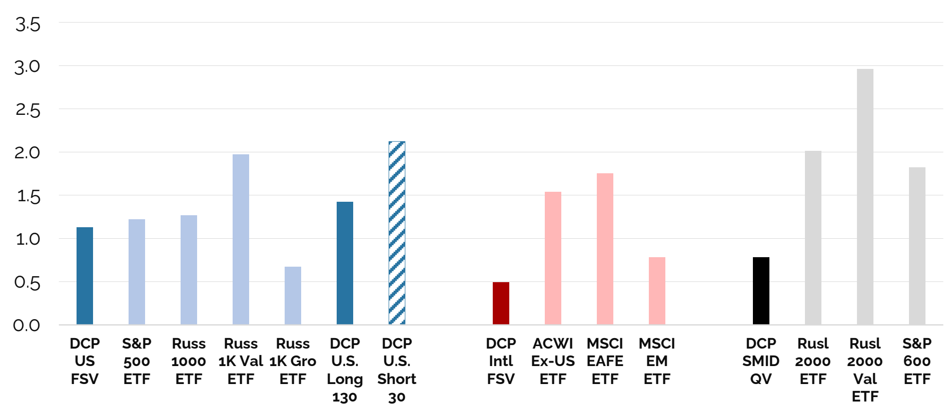
Source: FactSet, See end-notes for methodology. As 4/5/2023

Figure 12 (Quality): Distillate's Cash Flow Stability Score



Source: FactSet, See end-notes for methodology. As of 4/5/2023

Figure 13 (Quality): Net Debt to Adjusted EBITDA



Source: FactSet, See end-notes for methodology. As of 4/5/2023

Valuation & Quality vs. Indexes:

Starting with valuations, **Figure 11** 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 remains very elevated despite significant recent outperformance, and the international and small/mid cap strategies also enjoy significantly more attractive valuations than their benchmarks. Likewise, the nearly 8 percentage point spread between the long and short components of the U.S. large cap value 130/30 strategy speaks to the valuation dispersion in the market and opportunity available through stock selection.

Figure 12 looks at fundamental stability by assessing the through-cycle variability of cash flows, 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/mid 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 smaller 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 13 measures leverage in the form of total debt relative to normalized lease-adjusted consensus estimates for earnings before interest, taxation, depreciation, and amortization (EBITDA). Amid rising interest rates and bond yields, we believe this is a critical risk to avoid and a key differentiator for our strategies. We have clearly seen the dangers of leverage playing out with regard to smaller U.S. banks this year. In the small cap space, leverage is an even bigger issue as it is high among smaller cap companies generally 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. Potentially compounding the issue is the weight in companies that are expected to generate negative free cash flow in the next twelve months. For our Small/Mid Quality & Value strategy, that figure is zero. For the Russell 2000 ETF and Russell 2000 Value ETF, the weight is 17% and 16% (and 3.5% for the S&P 500 as a point of reference).

In the long/short components of the Large-Cap U.S. Value 130/30 strategy, this is also a metric that speaks to the wide array of risk in the market, with 39% the short portfolio in names not expected to earn positive free cash flows, compared to expected positive free cash flow generation in all of the names held in the long side of the strategy.

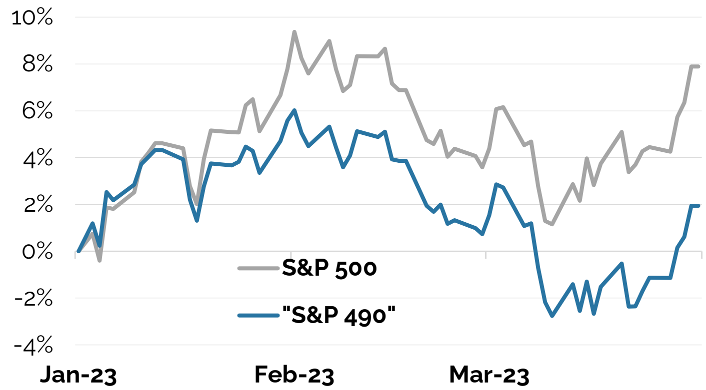
Performance:

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

Distillate's U.S. FSV strategy returned 6.04% in Q1 2023 on a total return basis net of fees, compared to 7.50% for the S&P 500 benchmark. Performance suffered from a 3.25% headwind from not owning just five stocks (NVIDIA, Microsoft, Tesla, Meta, and Amazon). The impact of large gains among just a few of the biggest stocks is evident in the wide gap in performance between the S&P 500 Index with all constituents and the "S&P 490" which removes the 10 biggest stocks (See Figure 14). Outside of this drag, there was a modest benefit of around 0.75% from not owning any banks where high leverage keeps us on the sidelines. Among owned stocks, Fortinet, Skyworks Solutions and Jabil Inc. were the largest contributors to relative performance at around 20 basis points of contribution to excess return. CVS, Cigna, and Fidelity National Information Services were the biggest detractors among owned names at -30, -30, and -20 basis points of drag to relative performance.

The significant outperformance of a small number of the biggest stocks has led to a big gap between the S&P 500 and remaining 490 stocks.

Figure 14: S&P 500 Index Performance vs. "S&P 490"



Source: FactSet

U.S. Small/Mid Quality & Value (SMID QV)

Distillate's SMID QV strategy returned 6.55% on a total return net-of-fee basis in Q1 2023 which was 3.79% ahead of the 2.76% return for the Russell 2000 ETF and 7.14% above the -0.59% return for the Russell 2000 Value ETF. After strong relative performance in prior years, the strategy's annualized performance is now 9.41% and 9.23% ahead of the same benchmarks since inception in 2019. Top contributors in Q1 include AutoNation, PulteGroup, and PROG Holdings, contributing around 30, 30, and 20 basis points of relative performance against the Russell 2000 ETF benchmark, respectively. The largest detractors from relative performance were Western Union, Advanced Auto Parts, and WestRock, which subtracted around 20 basis points of relative performance each. The lack of ownership of regional banks where leverage limits our exposure benefited the portfolio by around 1.5% in the quarter.

U.S. Large Cap Long 130/Short 30 (U.S. 130/30)

Our U.S. 130/30 strategy supplements our U.S. FSV strategy as more of a pure value-driven strategy that is designed to benefit not only from buying the 100 cheapest names among the largest 500 U.S. stocks, but also from being able to short the most expensive 100 in that group. Performance for the strategy has been and will likely be much more varied than its U.S. FSV counterpart that emphasizes fundamental stability in addition to valuation. U.S. FSV also operates without leverage, while 130/30 is, by definition, a levered portfolio. In the first quarter of 2023, the strategy returned -0.81% net of fees which trailed well behind the 7.50% gain of the S&P 500 ETF. Similar to the headwind faced by the U.S. FSV strategy, relative returns faced a significant headwind of 4.5% from not owning Apple, NVIDIA, Microsoft, Tesla, Meta, and Amazon. The short side of the strategy also struggled as a number of names that looked expensive on a free cash flow basis outperformed the market in the quarter. This underperformance in Q1 of 2023 comes on the heels of significant outperformance in each of the prior two years such that annualized net of fee performance since inception in 2020 is 7.95% ahead of the S&P 500 Index and 12.16% above that of the Russell 1000 Value ETF.

International Fundamental Stability & Value (Intl. FSV)

Distillate's Intl. FSV strategy returned 11.33% net of fees in Q1 of 2023 and eclipsed the 7.15% return MSCI ACWI Ex-US benchmark by 4.18%. The strategy's underweight in the financial sector where highly leveraged banks make up roughly 15% of the benchmark added around 1% to performance after being a significant drag in each of the past two years when bank stocks rallied with higher interest rates. Among owned stocks, LVMH Moet Hennessy Louis Vuitton, JD Sports Fashion, and Industria de Diseno Textil added 40, 35, and 30 basis points to relative performance against the MSCI ACWI Ex-US benchmark. Relative performance was positive across almost all sectors and in all regions. As a reminder, region weights are kept at 150% of the benchmark weight to limit the potential for any one region to have an outsized impact on performance, but weights are otherwise determined by bottom-up stock selection. The largest detractors from relative performance were Roche, Smoore International Holdings, and Aker, which subtracted 40, 20, and 20 basis points from relative performance.

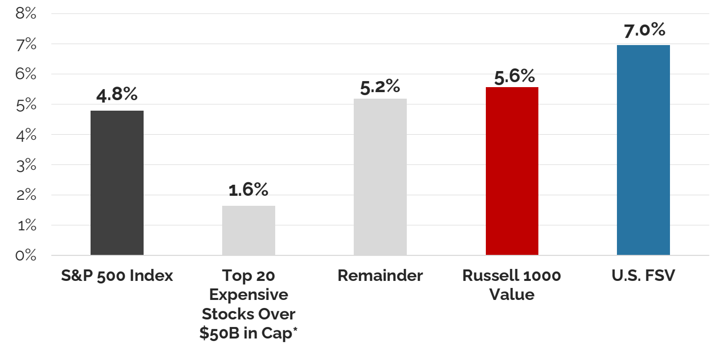
Changes & Valuation

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

After rebalancing, Distillate's U.S. FSV strategy's free cash flow to market cap yield valuation of 7.0% compares very favorably to 4.8% for the same measure for the S&P 500. There remains a wide dispersion in valuations in the market and in our view a significant opportunity is available through selectivity. If the most expensive 20 stocks with market values over $50B are removed from the overall S&P 500, the free cash flow yield on the remainder rises to a more attractive 5.2% (see **Figure 15**). It is through similar selectivity while also focusing on long-term cash flow stability that our portfolio achieves its 7.0% yield.

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 16: Free Cash to Mkt Cap Yield for the S&P 500, 25 Large Expensive Stocks, & U.S. FSV



Source: FactSet, 4/5/2023
Stocks without estimates are excluded and the index re-weighted

In addition to the valuation advantage, Distillate's U.S. FSV strategy also enjoys significantly more stable long-term fundamentals, as evidenced by the higher fundamental stability score, and less leverage, (see **Table 1**.)

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]	7.0%	4.8%
Free Cash Yield to EV[1]	5.9%	4.2%
P/E[2]	16.1	23.8
Leverage[3]	1.13	1.23
Fundamental Stability[4]	0.84	0.69

*as of 4/5/2023, see methodology endnotes.

Sector Changes: The largest sector change in the rebalance was a 7.5 percentage point reduction in technology after the sector significantly outperformed. This was offset by roughly 3 percentage point increases in industrials, health care, and staples, which all underperformed. Broadly, sector shifts tend to mirror relative performance, as is evident in **Figure 16** which compares the changes in sector weights in our U.S. FSV portfolio in the quarterly rebalance at the end of Q1 with the relative performance of each sector against the S&P 500 overall. It makes intuitive sense that our bottom-up stock selection process would reduce the weight in places that outperformed and add to areas that were weaker. 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 driven by bottom-up stock selection.

Table 2: U.S. FSV Sector Exposure*

	U.S. FSV	S&P 500
Communication Services	8.4%	8.2%
Consumer Discretionary	9.2%	9.9%
Ex AMZN & TSLA	*9.2%*	*5.8%*
Consumer Staples	4.5%	7.3%
Energy	2.4%	4.8%
Financials	11.7%	12.8%
Ex Banks	*11.7%*	*8.9%*
Health Care	19.8%	14.7%
Industrials	19.4%	8.4%
Information Technology	20.0%	25.7%
Ex Apple & Microsoft	*20.0%*	*12.4%*
Materials	3.8%	2.6%
Real Estate	0.8%	2.5%
Utilities	0.0%	2.9%

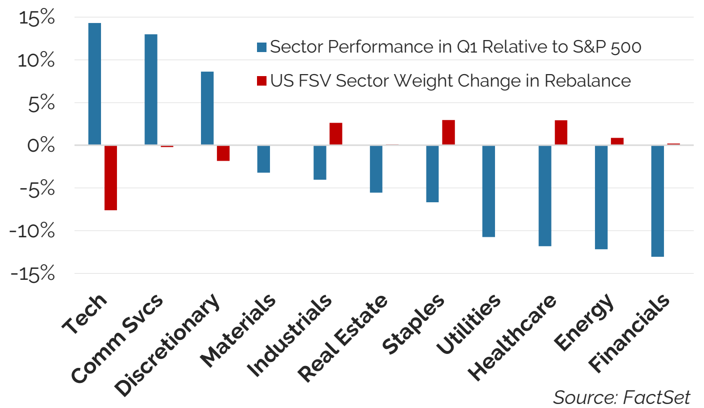
*as of 4/5/2023

Sells: The largest exited position in the quarter was Apple, which outperformed by roughly 20% such that its valuation no longer was attractive enough to continue holding the stock. Apple was added to the portfolio at the start of last quarter at a 4% weight that then rose to 4.8% over three months to become our largest holding when it was exited. Over the quarter, Apple's price increase drove its free cash yield to 3.9% on next-twelve-month estimates, well below the overall market figure of 4.8%, and considerably below the strategy's comparable 7% figure. Visa and Adobe also outperformed and were exited on valuation.

Buys: The largest new purchases were T-Mobile US, Philip Morris International, and Altria, which all underperformed the broader market in the quarter and offer roughly 8%, 6.5%, and 11% free cash to market cap yields, respectively.

Sector changes in Distillate's U.S. FSV strategy mirror sector performance..

Figure 16: Sector Changes in Distillate's U.S. FSV Strategy vs. Sector Relative Performance in Q1 2023



Source: FactSet

Adds/Trims: The largest addition was UnitedHealth Group, which rose from a 1.7% weight to 2.6% after underperforming by 20% even as its free cash estimates rose. Johnson & Johnson was likewise added to after lagging by 20% while similarly seeing its estimated free cash flows move higher and its valuation improve. The biggest reductions in weight were Alphabet, the parent of Google, and Fortinet, which outpaced the overall market gains by around 10% and 30%, respectively, in the quarter.

U.S. Small/Mid Cap Quality & Value (SMID QV)

There is an enormous range of valuations in the small and mid-cap space and those valuations can look wildly different based on whether leverage is included or unprofitable stocks are captured. Unprofitable stocks make up a large share of the most popular small cap benchmarks but are often excluded in standard P/E calculations. This wide array of valuations in individual stocks creates opportunity to construct attractive portfolios that stand out from common benchmarks in a number of ways. On valuation, Distillate's small/mid cap strategy of 150 stocks is able to achieve a very attractive 9.7% 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 3**).

Distillate's U.S. Small/Mid Cap Quality & 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 rising interest rates (and thus borrowing costs). Distillate's small/mid 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 2.0x and 2.9x figures of the Russell 2000 and Russell 2000 Value benchmarks (See **Table 3**).

Lastly and also related to quality, Distillate's SMID QV has no position in stocks that have negative next-twelve-month free cash flow estimates. For the Russell 2000 and Russell 2000 Value benchmarks, after reweighting for stocks without estimates, 17%

and 16% 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 3.5%. Along with leverage, this looks to be another critical risk to avoid in the small cap segment.

The largest new purchases, APA Corporation and Builders FirstSource, are consistent with the criteria outlined above. The biggest sale, PulteGroup, appreciated considerably in value and no longer fits the market cap criteria for the strategy. Celenese was the second largest sale and also outperformed but was exited for exceeding the debt threshold for inclusion.

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

Table 3: U.S. Small/Mid Cap QV Characteristics*

	SMID QV	Russell 2000 ETF	Russell 2000 Value ETF
Free Cash Yield to Mkt Cap[1]	12.0%	5.2%	6.5%
Free Cash Yield to EV[1]	9.7%	3.5%	4.1%
P/E[2]	9.9	20.6	16.7
Leverage[3]	0.78	2.01	2.93
Fundamental Stability[4]	0.46	0.42	0.36
Negative FCF Weight[5]	0%	17%	16%

*as of 4/5/2023, see methodology endnotes.

U.S. Large Cap Value 130/30 (U.S. 130/30)

The overall goals of the 130/30 strategy were outlined in the performance section, but are also evident in the portfolio characteristics which show a wide divergence between the valuation of the long and short portfolios (See **Table 4**). The same table also shows a wide gap in leverage, which is not directly screened for, but picked up somewhat indirectly in the FCF/EV filter. Stability, which is similar between the portfolios, is not utilized in stock selection as the goal of the strategy is less around stability and more about capturing upside from valuation divergences in the marketplace.

Distillate's 130/30 strategy seeks to capitalize on valuation divergences in the market which remain wide as evidenced by the large gap between the valuations available on the long and short portfolios.

Table 4: U.S. Large Cap Value 130/30 Characteristics*

	Long	Short	S&P 500
Free Cash Yield to Mkt Cap[1]	10.0%	-0.5%	4.8%
Free Cash Yield to EV[1]	7.8%	0.3%	4.2%
P/E[2]	12.3	44.8	23.8
Leverage[3]	1.43	2.12	1.23
Fundamental Stability[4]	0.56	0.55	0.69
Negative FCF Weight*	0%	38%	3.5%

*as of 4/5/2023, see methodology endnotes.

International Fundamental Stability & Value (Intl. FSV)

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

Distillate Capital's International FSV Strategy is less expensive, more fundamentally stable, and less levered than its benchmark.

Table 5: International FSV Portfolio Characteristics*

	Intl. FSV	ACWI Ex-US
Free Cash Yield to Mkt Cap[1]	7.1%	5.6%
Free Cash Yield to EV[1]	6.3%	4.6%
P/E[2]	16.2	17.7
Leverage[3]	0.49	1.54
Fundamental Stability[4]	0.81	0.52

*as of 4/5/2023, see methodology endnotes.

Changes & Regional Weights: The largest sale in the quarter was Alibaba. The largest new positions are British American Tobacco, which offers a 14% next twelve month estimated free cash flow to market cap yield and America Movil, which offers an 8.7% free cash flow to market cap yield on next-twelve-month consensus estimates. The biggest increased existing position was Roche, which lagged again last quarter and now offers an approximately 8% free cash flow to market cap yield on next twelve-month consensus estimates. The biggest trim was Samsung Electronics which has seen its valuation deteriorate somewhat amid large and increasing capital spending plans.

Regional weights after the quarterly rebalance remain fairly well matched with the ACWI Ex-U.S. benchmark. Japan is the largest overweight at 21% vs. 14% for the benchmark. Europe is roughly in line at 42% vs. 43%, with somewhat larger relative weights in France and Sweden offsetting relative underweights in Germany and Switzerland where banks constitute large portions of the benchmark. (See **Table 6**). 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 6: International FSV Portfolio Characteristics*

	Intl. FSV	ACWI Ex-US
Europe	41.9%	43.3%
Japan	20.6%	14.0%
Asia Ex China & Japan	12.6%	18.8%
China & Hong Kong	12.4%	10.4%
Americas	12.5%	9.9%
Middle East & Africa	0.0%	3.5%

*as of 4/5/2023 based on FactSet headquarters definition.

Final Word

Macroeconomic uncertainty relating to inflation, the corresponding path of interest rates, moderating economic activity, banking pressures, and the reverberations of higher interest rates through parts of the economy where leverage is high is taking the lion's share of headlines. How these issues will play out, we haven't a clue, just as we do not know what other issues will come to the fore and join these concerns as time progresses.

In the first quarter of 2023, these fears sparked a flight to perceived safety in a select number of large stocks that had already looked expensive to us. Like in episodes past, when the market seeks an outcome, in this case safety, without regard to the price it is paying for that attribute, it tends to end in disappointment. And a period of concentrated gains when stocks that look expensive become increasingly so is exactly the environment when we would expect to lag the broader market, and we did. A similar dynamic hindered performance emerging from the pandemic, though we had enough outperformance elsewhere to such that relative performance was still positive for the year.

We do not know how the various risks facing the economy and market will play out or whether gains among the biggest and more expensive stocks will continue or soon reverse. As the saying goes, it's hard to make predictions, especially about the future. We can, however, take advantage of the opportunities created by present macroeconomic fears and corresponding market moves and be prepared for an uncertain future by avoiding the significant downside risks that can come from high leverage, rich valuations, or business models with unpredictable or economically sensitive cash flows. Since stock moves are not as much about what happens but about what happens relative to what is expected and priced in, periods of unease can create tremendous opportunities if investors overact and overly incorporate short-term pressures into stock prices that are supposed to discount the long-term future.

Discipline is key to seeing through the opportunity. We are therefore very optimistic about the current opportunity set and the attractive valuations we are finding to invest in high quality companies.

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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 modeled management fee equal to the highest investment management fee that may be charged for the applicable composite (see fee schedule below). 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 investments, calculating performance, and preparing GIPS Reports are available upon request.

The investment management fee schedule for the strategies discussed are as follows: 0.39% for U.S. Fundamental Stability & Value; 0.55% for U.S. Small/Mid Quality & Value; 0.79% for U.S. Large Cap Value 130/30; and 0.55% for International Fundamental Stability & Value. Management fees may vary and are negotiable.

Data for the Firm's investment strategies are based on a representative account for each composite. Actual holdings and performance may differ between accounts or vehicles offered by the Firm due to the size of an account, client guidelines, or other constraints and restrictions related to that account or vehicle.

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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.*

The ***U.S. Small/Mid Cap Quality & Value*** *composite seeks to distill a starting universe of small- and mid-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 March 2019.*

The ***International Fundamental Stability & Value*** *composite seeks to distill a starting universe of large- and mid-cap non-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 January 2019.*

The ***U.S. Large Cap Value 130/30*** *composite seeks long-term capital appreciation by holding approximately 130% of an account's value in the most attractively valued large cap U.S. stocks measured using Distillate's proprietary free cash flow valuation method. The market exposure in this composite is brought back to approximately 100% by selling short 30% of an account's value of the least attractively valued stocks among the same starting set. This composite was created in December 2019.*

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 11****: 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.*

*Methodology Notes for **Portfolio Characteristics Tables**: [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.*

*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 by 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.