DISTILLATE CAPITAL

Are Small Stocks Really Cheap? It Depends

There is an echoing chorus in the financial community that small cap stocks are cheap. While we wholeheartedly agree that there are indeed many terrific values to be had among smaller stocks, we believe attestations to the inexpensiveness of aggregate benchmarks of small stocks are dead wrong. Such claims typically rely on price-to-earnings (P/E) ratios that ignore the troublingly large share of stocks that are unprofitable and valuation measures are drastically different when these stocks are included.

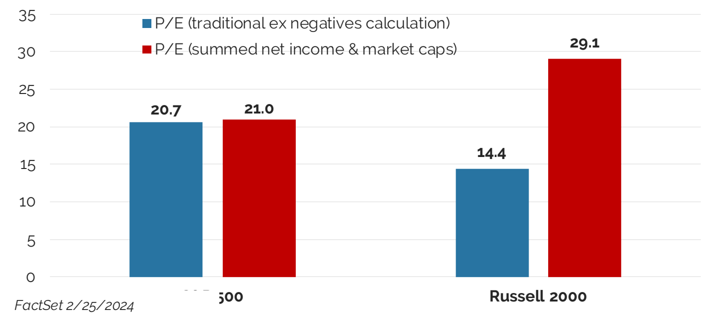
Problems With the Benchmark

In the small cap Russell 2000 ETF, 97% of the benchmark by weight has consensus estimates for next-twelve-month net income, but 17% of the benchmark is not expected to generate a positive figure. By contrast, in the large cap S&P 500 ETF, only 0.2% are expected to generate a loss. While it is troubling enough that nearly 20% of the small cap benchmark is projected to be loss making, there is also a potentially misleading impact in the way standard price-to-earnings (P/E) ratios are calculated. The traditional P/E calculation takes the weighted sum of each stock's P/E, but excludes stocks with negative P/Es as this would depress the aggregate number and flatter the valuation. At present, a P/E calculation for the Russell 2000 ETF that excludes companies with P/Es over 250 (eliminating outliers) and under zero (eliminating loss-making companies) produces a benchmark P/E valuation of 14.4x. Doing the same analysis for the S&P 500 results in a P/E of 20.7. With a valuation that is nearly 1/3rd less than the S&P 500, this P/E calculation method that excludes the large number of loss-making stocks would seem to corroborate claims that small cap stocks are indeed cheaper.

When an alternate P/E calculation methodology is used that includes the loss-making companies, this conclusion drastically changes. A second method to measure a benchmark P/E is to simply sum the market values of each stock and the net incomes. The calculation is not perfect, but for an index that is weighted by capitalization it is fairly accurate and does not suffer from the failure to include unprofitable stocks. On this methodology, the Russell 2000 ETF has a P/E of 29.1 versus the original 14.4. For the S&P 500, which has little in the way of unprofitable companies, the figure is 21.0, which is little changed from the previous 20.7. **Figure 1** contrasts these different methodologies and the impact of unprofitable companies.

Methodology matters in calculating small and large stock index P/Es.

Figure 1: P/E Ratios for Small & Large Stocks



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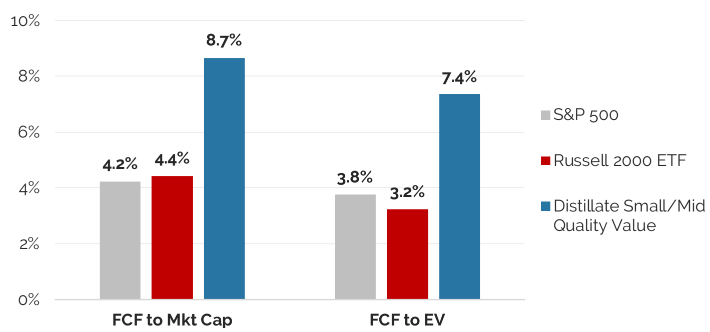
On the basis of P/E ratios, the small cap Russell 2000 ETF is either roughly 2/3 the price of the S&P 500 or nearly 40% more expensive depending on whether the significant share of negative earning companies are included. Unfortunately, it is the P/E figure that excludes loss making companies that is most often bandied about in discussions of relative value and little consideration is given to the underlying details of how this figure is measured.

Selectivity Reveals Opportunity

Just because small cap benchmarks may not be as cheap as they at first appear does not mean that small cap stocks are unattractive—far from it. By avoiding unprofitable stocks and measuring valuation on the basis of free cash flow rather than net income (see our accounting & valuation paper as to why), our small/mid quality and value strategy offers a free cash flow to market cap yield on next twelve month estimates that is substantially more attractive than either the starting Russell 2000 or the S&P 500. However, we would note one more issue. Utilizing Free Cash Flow, rather than Earnings against market prices provides better comparisons, but potentially misses the impact of debt, which is another critical issue for small stocks that we have written about. If debt is included in the denominator of the yield calculation to calculate what we believe is an even better valuation measure of free cash flow to enterprise value (FCF to EV), the picture changes even further and highlights again how small stocks in aggregate (the Russell 2000 ETF) are actually more expensive than their large cap peers (the S&P 500). Both free cash flow measures in **Figure 2** highlight the valuation differential our small/mid QV provides over the benchmarks by being selective and avoiding unprofitable and highly leveraged businesses.

Free cash flow valuation measures are not distorted like P/E metrics are.

Figure 2: Free Cash Yields for Small & Large Stocks



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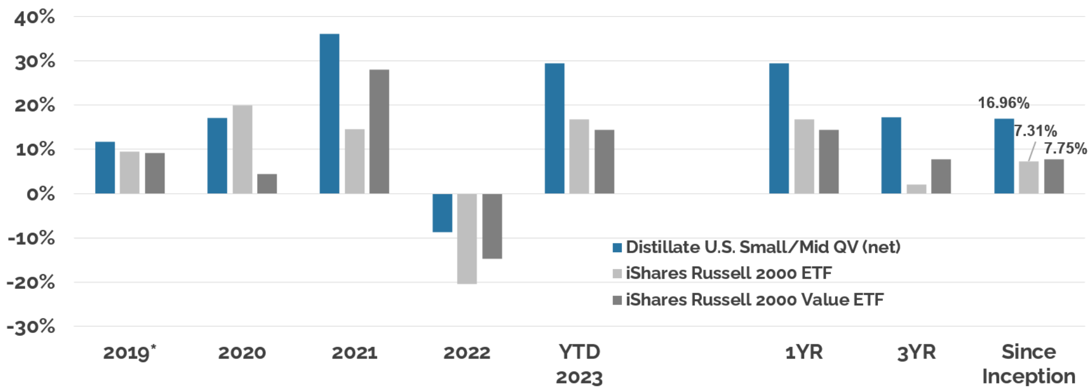
U.S. Small/Mid Cap Quality & Value Composite Performance:

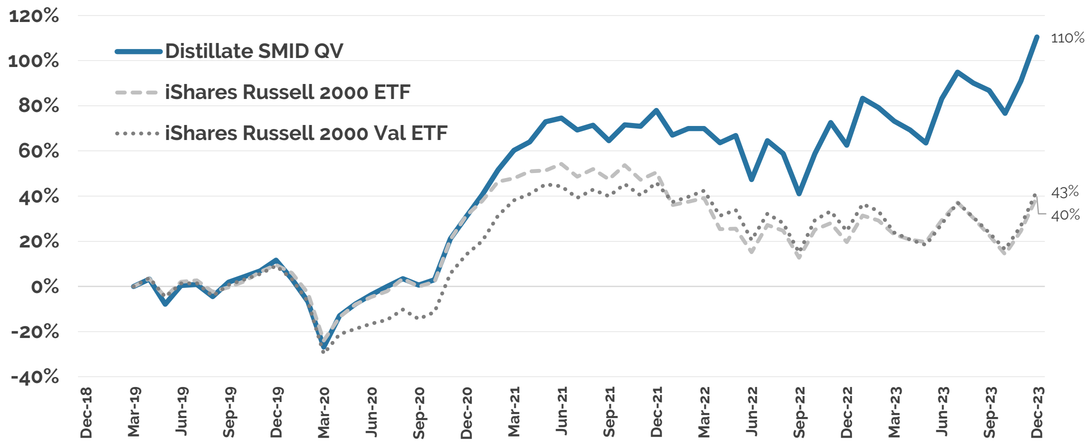
As of December 31, 2023

	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%	29.46%	29.46%	17.18%	n/a	16.96%
iShares Russell 2000 ETF	9.49%	19.91%	14.64%	-20.49%	16.81%	16.81%	2.11%	9.87%	7.31%
iShares Russell 2000 Value ETF	9.18%	4.50%	27.96%	-14.67%	14.43%	14.43%	7.70%	9.79%	7.75%



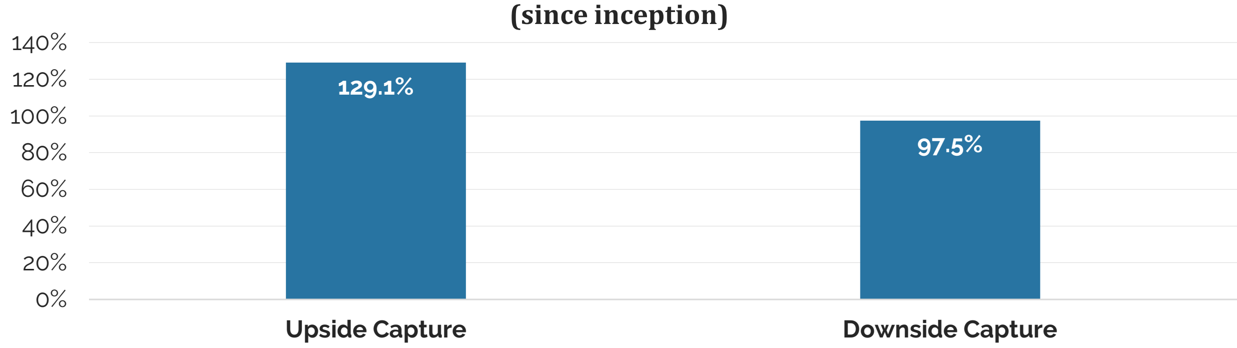
Source: U.S. Bank, Morningstar Data; Inception 3/31/2019; the period "2019*" reflects returns from inception through 12/31/2019. One cannot invest directly in an index. See performance disclosures.

Cumulative Return (Inception through 12/31/23)



Source: U.S. Bank, Morningstar Data; Inception 3/31/2019. One cannot invest directly in an index. See performance disclosures.

Distillate SMID QV: Upside & Downside Capture vs. Russell 2000 ETF (since inception)



Source: Zephyr Analytics, see definition

Past performance does not guarantee future results. See disclosures. Upside Capture reflects the relative compounded annualized return of a strategy compared to that of the benchmark in periods (months) when the benchmark rose in value; Downside Capture is the same but for periods when the benchmark fell in value. One cannot invest directly in an index.

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.*

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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.*

Free Cash Flow *refers to a company's operating cash flow, less its capital expenditures.* ***Free Cash Flow to Market Cap Yield*** *refers to a company's or group of companies' free cash flow divided by the company's (or companies') Market Capitalization, with a higher resulting ratio indicating a more attractive valuation.* ***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.*

Figure 2 *Methodology notes: 1. P/E ratio in the traditional measure calculates the inverse weighted sum of all P/Es that are under 250 and above 0. The summed net income and market cap P/E calculation sums all the net incomes and market caps for each index and calculates the ratio of one to the other. 2. Free cash flow measures exclude stocks with yields over 50 and under -50 and indexes are reweighted for their exclusion as well as for stocks without data.*

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 2000 ETF*** *is an investable benchmark used as a proxy for the underlying* ***Russell 2000 Index****, an index of U.S. listed small cap stocks.*

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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