



DISTILLATE CAPITAL

5 Years In: Our Small/Mid Cap Quality & Value Strategy

March 31st marked the 5-year anniversary of the Distillate Small/Mid Cap Quality & Value strategy. While five years hardly seems long enough to evaluate the success of an investment strategy, the roller coaster of the last five years in the markets has certainly seemed a worthy test – and we are very pleased with the results. The strategy’s annualized returns, net of fees, stands 9.8% ahead of both the Russell 2000 ETF and Russell 2000 Value ETF benchmarks, putting its peer rankings near the very top of both Small Cap Core and Small Cap Value universes (See [Figure 1](#) below).

As we discuss in our foundational paper, [Value Investing in a Capital Light World](#), our economy has seen a dramatic shift from tangible investing to more intangible research and development-driven activities over the last several decades. The paper details how differences in accounting treatments of business development expenses in a research and development-driven economy render traditional valuation measures like price/book or price/earnings problematic in accurately assessing valuations in the market. While this foundational paper originally highlighted the failure of traditional value metrics using data from the Ken French library and focusing on large companies, we found a similar pattern among small companies. When the economy was more homogeneously focused on physical investment, buying low price-to-book stocks was a winning strategy. But in the more recent stretch of time that saw activities shift to intangible investment, book value has failed as a proxy for value in both the large and small segments of the market, and buying low price-to-book stocks has not produced superior returns.

Given the pervasiveness of this investing issue, we felt there was an opportunity to provide investors a modern and rational approach to identifying better valued high-quality stocks across the smaller company spectrum, and in March 2019, we funded the Distillate Small/Mid Cap Quality & Value strategy.

Combining high quality and attractive valuation has offered an alternative to what we see as key problems in the small/medium stock market aggregates where debt levels are elevated, many companies are unprofitable, and widely-cited attractive valuations may be flattered given the typical conventions used calculating P/E ratios (we highlighted these issues in two recent papers: [here](#) and [here](#)). A good part of our outperformance we believe has resulted simply from avoiding these pitfalls, something consistent with following the wisdom of the late great Charlie Munger who quipped “It is remarkable how much long-term advantage we have gotten by trying to be consistently not stupid instead of trying to be very intelligent”.

Our approach is simple and intuitive. By treating the protection of capital as a first priority, and then consistently paying less for underlying fundamentals, we attempt to skew the odds in our favor and do so with a very diversified portfolio of companies. We take this approach in all environments and market regimes, as we have done since we began five years ago.

Thank you for your continued confidence in Distillate Capital.

Figure 1: Annual Returns & Peer Rankings of Distillate’s SMID QV Strategy

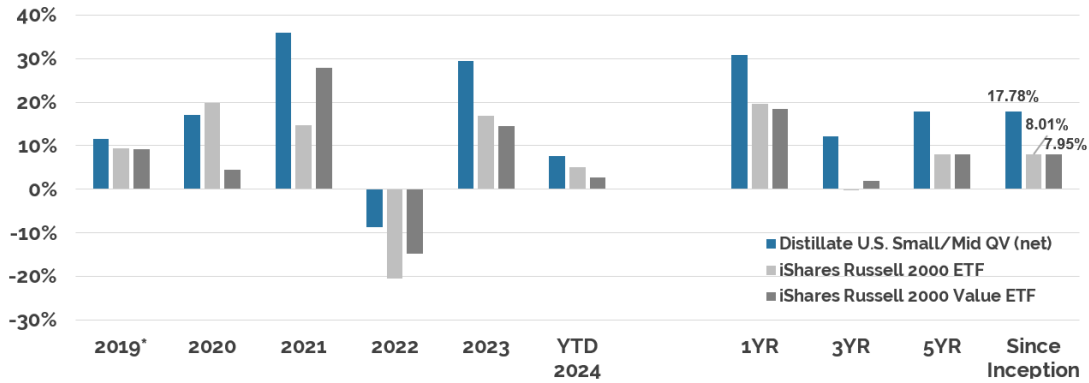
Returns & Rankings (as of 3/31/24)	2019*	2020	2021	2022	2023	YTD 2024	1YR	3YR	5YR	Since Inception
Distillate SMID QV (net of fees)	11.65%	17.15%	36.03%	-8.64%	29.46%	7.68%	30.83%	12.24%	17.78%	17.78%
iShares Russell 2000 ETF	9.49%	19.91%	14.64%	-20.49%	16.81%	5.14%	19.53%	-0.21%	8.01%	8.01%
iShares Russell 2000 Value ETF	9.18%	4.50%	27.96%	-14.67%	14.43%	2.82%	18.36%	1.99%	7.95%	7.95%
SMID QV vs. iShares Russell 2000 ETF	2.16%	-2.76%	21.40%	11.85%	12.65%	2.53%	11.30%	12.44%	9.77%	9.77%
SMID QV vs. iShares Russell 2000 Value ETF	2.48%	12.65%	8.08%	6.03%	15.03%	4.86%	12.47%	10.25%	9.83%	9.83%
Percentile Rank (Custom Small Core Universe)†	24th	35th	5th	5th	2nd	23rd	2nd	1st	1st	1st
<i>number of managers in category</i>	690	696	698	701	698	662	660	646	638	638
Percentile Rank (Custom Small Value Universe)†	24th	7th	19th	30th	2nd	13th	6th	4th	2nd	2nd
<i>number of managers in category</i>	625	634	639	641	646	610	610	574	574	574

* The 2019 period begins 3/31/19 (inception) and ends 12/31/19. Periods longer than a year annualized. Data collected 4/22/24.

† Custom Small Core Universe combines PSN’s database of separately managed accounts in the Small Core (net of fee) category and Morningstar’s database of mutual fund and ETF managers in the Small Blend category. Custom Small Value Universe does the same with corresponding Small Value categories. Any third-party ratings contained herein have been calculated fairly and equally by an entity that is not affiliated with the Firm. The ratings are, to the best of our knowledge, true and accurate results of the third-party’s rating metrics as of the date provided. Further, the Firm is not required to amend this document if the information contained herein becomes outdated at any point in the future. Annual rankings data prior to 2023 is locked to reduce survivorship bias. Investing involves risks and you may incur a profit or a loss. **Past performance is no guarantee of future results.** See end-notes for further disclosures.

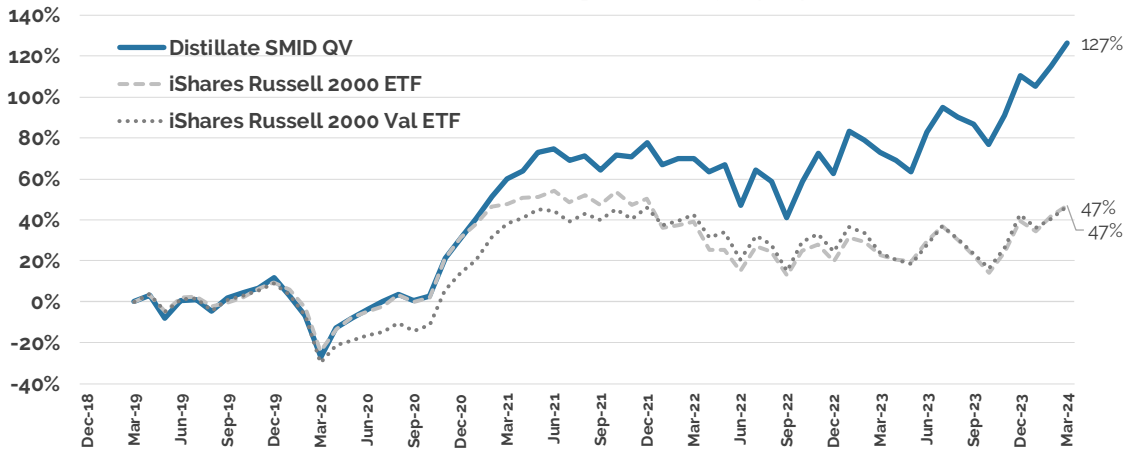
U.S. Small/Mid Cap Quality & Value Composite Performance:

	YTD						As of March 31, 2024			
	2019*	2020	2021	2022	2023	2024	1YR	3YR	5YR	Since Inception
Distillate U.S. Small/Mid QV (net)	11.65%	17.15%	36.03%	-8.64%	29.46%	7.68%	30.83%	12.24%	17.78%	17.78%
iShares Russell 2000 ETF	9.49%	19.91%	14.64%	-20.49%	16.81%	5.14%	19.53%	-0.21%	8.01%	8.01%
iShares Russell 2000 Value ETF	9.18%	4.50%	27.96%	-14.67%	14.43%	2.82%	18.36%	1.99%	7.95%	7.95%



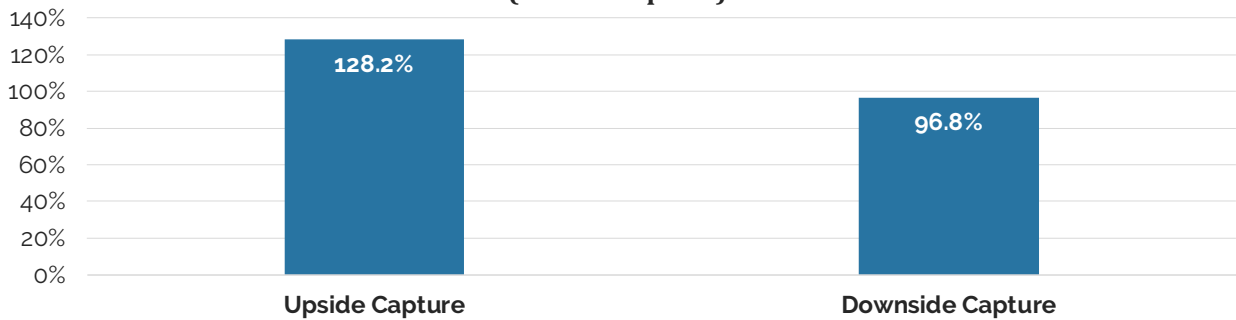
Source: U.S. Bank, Morningstar Data; Inception 3/31/2019; the period "2019" reflects returns from inception through 12/31/2019. One cannot invest directly in an index. See performance disclosures.

Cumulative Return (Inception through 3/31/24)



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.

U.S. SMID QV: Key Statistics (vs. Russell 2000, where applicable)

	Standard Deviation	Sharpe Ratio	Information Ratio	Tracking Error	Alpha	Beta	R-squared
Distillate Small/Mid Cap Quality & Value strategy	25.61	0.61	1.19	8.15%	9.25	1.02	89.90

Source: Zephyr Analytics, data as of 3/31/2024, see definitions below. These Key Statistics are for information purposes only. Please refer to Figure 1 for Annual Returns performance information. Additional performance information is available upon request.

U.S. SMID QV Portfolio Characteristics*

	SMID QV	Russell 2000 ETF	Russell 2000 Value ETF
Free Cash Yield to Mkt Cap ¹	9.0%	4.1%	5.2%
Free Cash Yield to EV ¹	7.7%	3.1%	3.8%
P/E ²	11.6	15.2	12.5
Leverage ³	0.6	1.9	2.5
Fundamental Stability ⁴	0.51	0.41	0.37
Negative FCF Weight ⁵	0.0%	14.5%	15.0%

*as of 3/31/2024, see methodology endnotes.

U.S. SMID QV Portfolio Sector Weights

	SMID QV	Russell 2000 ETF	Russell 2000 Value ETF
Communication Services	3.1%	2.1%	2.3%
Consumer Discretionary	25.6%	10.8%	11.0%
Consumer Staples	2.7%	3.3%	2.2%
Energy	16.0%	7.2%	9.9%
Financials	4.7%	15.8%	25.7%
Health Care	6.6%	15.3%	9.3%
Industrials	19.7%	17.6%	14.9%
Information Technology	10.4%	14.9%	5.9%
Materials	10.0%	4.5%	5.0%
Real Estate	1.3%	5.6%	9.7%
Utilities	0.0%	2.5%	3.7%
Not Classified	0.0%	0.3%	0.3%

*as of 3/31/2024

Past performance does not guarantee future results. Portfolio Characteristics data is sourced from FactSet. Portfolio holdings may change at any time without notice.

Standard Deviation is a measure of how much an investment's historical returns have varied from its average return. **Sharpe Ratio** is a measure of risk-adjusted return. It divides excess return by risk. Excess return is defined as the annualized return of the manager minus the annualized return of the risk-free rate. Risk is defined by standard deviation. **Information Ratio** of a manager series vs. a benchmark series is the quotient of the annualized excess return and the annualized standard deviation of excess return. The Information Ratio measures the consistency with which a manager beats a benchmark. **Tracking Error** (also known as 'active risk') is the annualized standard deviation of excess return to the benchmark. Like R-Squared, Tracking Error is calculated using the common date range of the benchmark and the weighted portfolio return series. **Beta** is a measure of an asset's sensitivity to market movements, or systematic risk. In general, the larger the Beta, the more volatile the performance. **Alpha** is the mean of the excess return of the manager over beta times benchmark. **R-Squared** measures the reliability of the statistical estimates of alpha and beta as a linear function of the market. A product with a high R-Squared can generally have most of its variance explained by the variations in the benchmark index.

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. Methodology Notes for **Portfolio Characteristics Table**: 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.

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: 0.55% for U.S. Small/Mid Quality & 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. 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 **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.

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