DISTILLATE CAPITAL

Big Trends Favor Small Stocks

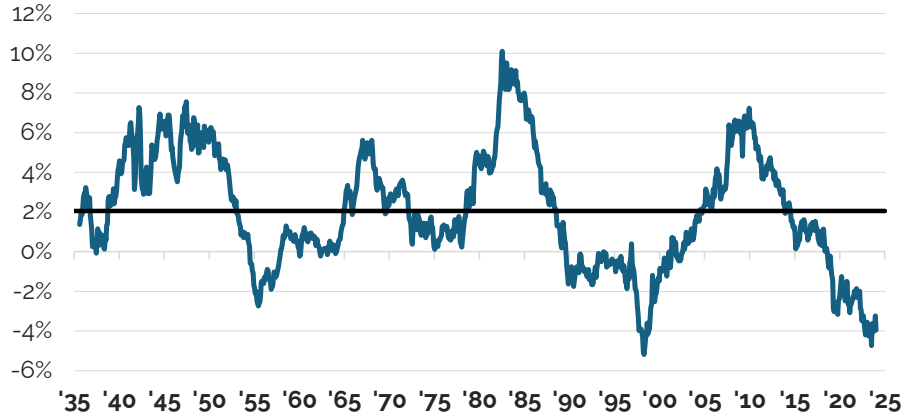
Summary

Over the long term, smaller stocks have performed significantly better than the largest ones. This performance, though consistent over nearly a century and across geographies, has occurred with significant cyclicality (see figure & table below). In that context, the present underperformance of smaller stocks is not anomalous, but is reaching levels in relative performance, valuation, and duration that have given way to powerful reversals and reversions to the mean in the past. Only 15 years ago, we were at the opposite point on these measures and larger stocks had underperformed sharply and were strongly favored on valuation. After significant outperformance by larger stocks since, current conditions and valuations suggest there may be a substantial opportunity in the years ahead for both small companies and smaller companies within the large cap universe domestically and internationally.

Focusing on the long-term, being willing to take a contrarian view, and staying disciplined on valuation have proven to be invaluable over time. These were the skills that made Sir John Templeton an investing legend. In 1933 he offered his famous advice that ultimately became the well-known investing adage that "the four most dangerous words in investing are 'this time it's different.'" Just over 20 years later in a letter to clients, he made the case that heavy inflows into equities had made "top quality" stocks very expensive and that there were much more attractive opportunities elsewhere in the market. At the age of 88 in 2000 and despite being retired, Templeton again capitalized on a contrarian view by shorting numerous Nasdaq companies with great success. These observations and actions align almost perfectly with the cyclical troughs in smaller stock relative performance and the reversals that gave way to multiyear stretches of substantial outperformance (see figure & table below).

Big trends can seem obvious in hindsight but difficult to act on in the present as they require the kind of contrarian mindset, valuation discipline, and patience that made Templeton a great investor. Those trends again look to heavily favor smaller stocks at present.

Figure: Annualized 10 Year Return Difference Between Small/Mid and Large U.S. Stocks



Source: Ken French Data Library through 2024; "Large" includes the biggest 30% of stocks that corresponds to ~550 stocks, "Smid" refers to the middle 40% of stocks by size which is currently ~900 stocks. Annualized rolling 10 year total return.

Date	Peak/ Trough	Ratio	Change	Duration
Feb '32	Trough	0.83		
May '46	Peak	2.57	211%	14.3
Dec '57	Trough	1.95	-24%	11.6
Dec '68	Peak	3.58	83%	11.0
Dec '74	Trough	2.27	-37%	6.0
Jul '83	Peak	5.52	144%	8.6
Mar '99	Trough	3.03	-45%	15.7
Feb '14	Peak	7.21	138%	14.9
Dec '24		4.66	-35%	10.8

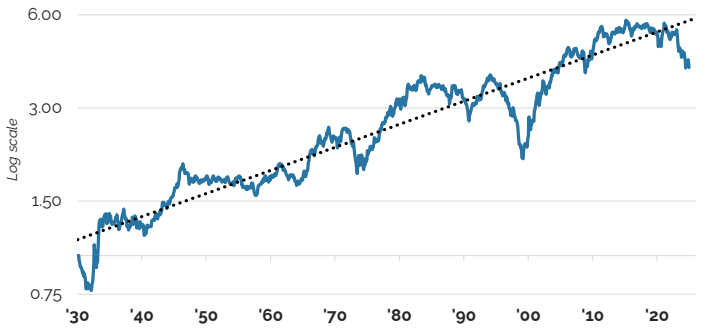
With that overview, we will take a deeper dive into the opportunity in U.S. large cap, U.S. small cap, and international stocks using a similar framework for each.

Large Cap Stocks:

Within the universe of large cap stocks (proxied by the S&P 500 benchmark or the largest 30% of stocks in the Ken French database going back to 1930 that currently equates to the largest roughly 550 stocks), smaller stocks have historically outperformed. This can be seen in **Figure 1** which plots the indexed performance of the smallest third of this large U.S. stock universe relative to the largest third by market capitalization. This outperformance by smaller stocks within the large cap universe has persisted through time including periods of conflict, technological innovation, economic strength and weakness, and inflation, but has done so with significant cyclicality.

Smaller stocks within the U.S. large cap universe have historically outperformed the largest stocks, but with significant cyclicality.

Figure 1: Smallest Third of Large Cap U.S. Stocks vs. Largest Third

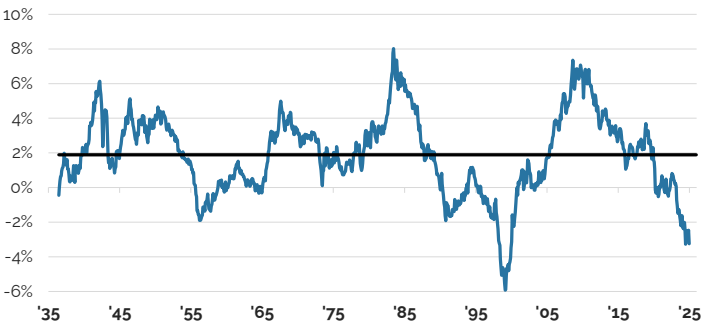


** Top 30% of all U.S. stocks which currently corresponds to ~550 stocks.*
Source: Ken French Data Library, data through 2024.

Another way to show both this outperformance and its cyclicality is the difference in the rolling 10-year annualized returns for the smallest third of large U.S. stocks versus the largest third (see **Figure 2**). The difference in the annualized 10-year returns shows that the current cycle of relative performance is near the lowest point ever on this metric, behind only the returns in the tech bubble in the late 1990s.

Smaller Large Cap stocks have rarely lagged by more over a 10-yr period.

Figure 2: Annualized 10-Yr Rolling Return Difference, Smallest Third of Large U.S. Stocks* less Largest Third



**Top 30% of all U.S. stocks which currently corresponds to ~550 stocks.*
Source: Ken French Data Library, data through 2024.

The extent of the weakness of the equal weight index in recent years is also evident in **Table 1** which highlights the peaks and troughs in the relative performance between the smallest and largest thirds of large U.S. stocks by market capitalization. This table shows that performance cycles can last many years and be significant in magnitude in both directions. In prior instances when relative returns reached similarly weak levels, reversals occurred and gave way to multi-year periods of significant outperformance. It is always impossible to time or envision what may cause such a shift, but history points to the power of mean reversion.

Peaks and troughs in the difference between the smallest and largest thirds of large cap stocks can be long in duration and significant in magnitude.

Table 1: Peaks & Troughs in Relative Performance of Smallest vs. Largest Thirds of Large U.S. Stocks

Date	Peak/ Trough	Ratio	Change	Duration (Years)
Feb '32	Trough	0.77		
May '46	Peak	1.98	157%	14.3
Nov '57	Trough	1.58	-20%	11.5
Jan '69	Peak	2.60	65%	11.2
Jun '73	Trough	1.84	-29%	4.4
Feb '94	Peak	3.84	109%	20.7
Mar '99	Trough	2.05	-47%	5.1
Mar '15	Peak	5.77	181%	16.0
Dec '24		4.06	-30%	9.8

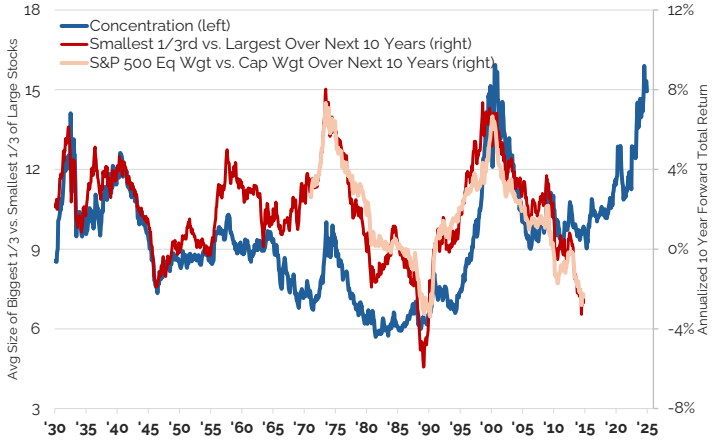
Source: FactSet

There are multiple explanations why over the very long term the smaller stocks within the large cap universe have outperformed the biggest stocks. The first set of reasons is competitive. One issue within this category focuses on the challenges of companies continuing to grow at a rapid rate once they have already become dominant and their sales become significant shares of global economic activity. No tree grows to the sky, as the saying goes. Thought leaders have also suggested that larger companies can become less innovative despite the benefits of their scale as they are afraid to challenge or cannibalize their existing businesses. Another issue is that success in a capitalistic society invites competition and new entrants eager to challenge incumbents even in industries with seemingly large barriers to entry.

The second category of explanation is valuation related. If the largest companies are also the most expensive, it may be difficult for them in aggregate to achieve the growth that is discounted in share prices. Rich valuations among the biggest stocks also tend to contribute to market concentration which itself is a strong predictor of returns for smaller stocks.

High levels of concentration in U.S. large cap stocks have historically been followed by 10 year periods of outperformance by smaller stocks.

Figure 3: U.S. Large Cap Stock Concentration vs. Subsequent 10 Year Relative Returns

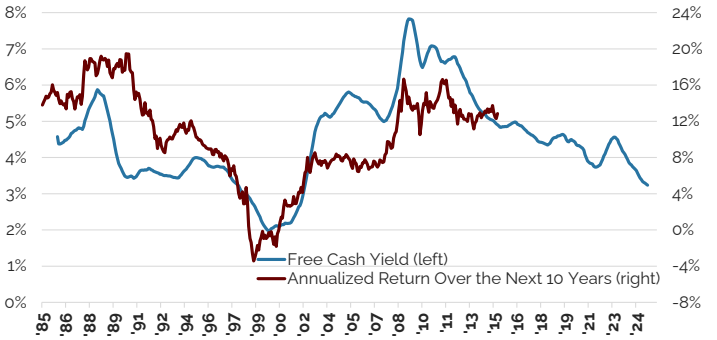


Source: Ken French Data Library. U.S. Large Cap stocks is defined as the largest 30% which equates to roughly the biggest 550 names. Data through 2024.

One way to measure market concentration within the large cap space is to look at the value of the biggest third of large cap stocks relative to the smallest third. This measure of concentration is shown in blue on the left axis of **Figure 3** and indicates that the market is similarly concentrated to where it was when the technology, media, and telecom (TMT) bubble began to unravel in March of 2000. High levels of concentration on this measure also tend to be closely linked to subsequent outperformance by smaller stocks over the following ten years. This is shown first by the red line on the right axis of **Figure 3** which plots the annualized 10-year forward return of the smallest third of the U.S. large cap equity universe versus the largest third going back to 1930. The peach-colored line on the right axis plots the similar return of the S&P 500 equal weight less the traditional capitalization weighted S&P 500 as far back as that data is available. The history demonstrates that performance of smaller stocks within the large cap space tends to be cyclical and often follows periods of high concentration such as the present.

Starting free cash yields for the S&P 500 have correlated closely with returns over the subsequent 10 year period.

Figure 4: S&P 500 Free Cash Yield vs. Annualized Return Over the Next 10 Years

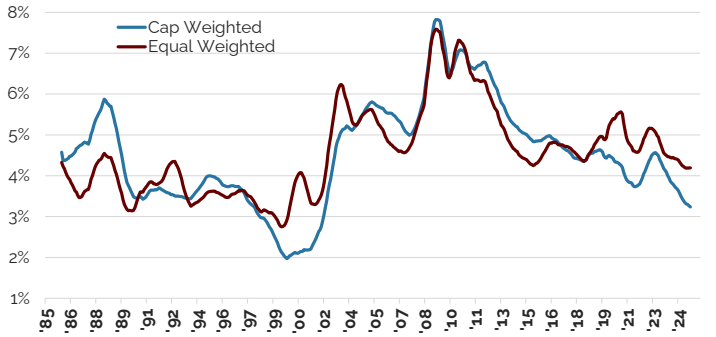


Source: FactSet 5/30/2025. Free cash uses fiscal year data until 2000 and trailing twelve month thereafter. Rolling 12 month average.

A key issue with equity concentration and an explanation for why it has historically foreshadowed underperformance among the biggest stocks is that concentration and valuation are linked. In general, the valuation of the market tends to be a good indicator of future returns. Using free cash flow data back to when cash flow statements were first mandated, the S&P 500 free cash flow valuation has fairly closely tracked returns over the subsequent 10 years (see **Figure 4**). A similar relationship exists between the S&P 500 equal weight and its returns. This means that when the equal weight benchmark offers a better starting valuation as it does at present, it typically outperforms over the next 10 years. **Figure 5** shows the free cash yield for the equal weighted and capitalization weighted S&P 500 and while the two are closely related, they can diverge at key moments as they did in 2000 and have again most recently.

The free cash yields of the cap weighted and equal weighted S&P 500 closely track each other but can separate at key moments.

Figure 5: S&P 500 Free Cash Yield vs. Annualized Return Over the Next 10 Years

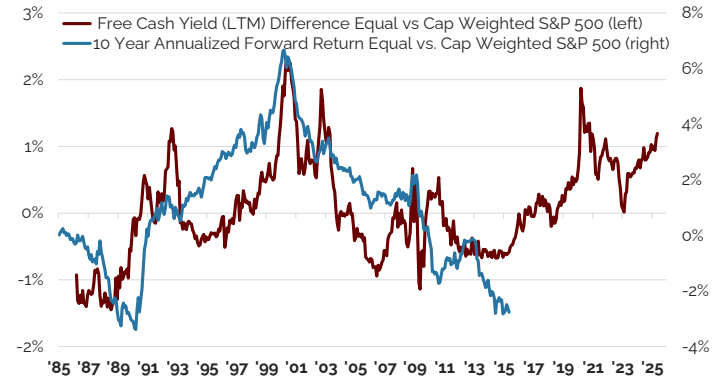


Source: FactSet 5/30/2025. Uses fiscal year data until 2000 and trailing twelve month thereafter. 1 year average.

Crucially, moments when the free cash flow yields between the equal and cap weighted S&P 500 diverge tend to result in significant return gaps in the future. This is shown in **Figure 6** which plots the difference between the free cash yield for the equal weight S&P 500 and capitalization weighted version on the left against the difference in 10 year forward returns on the right.

When the equal weighted S&P 500 is cheaper it tends to outperform.

Figure 6: Free Cash Yield Difference Between Equal & Cap Weighted S&P 500 vs. 10-Year Fwd Return Gap



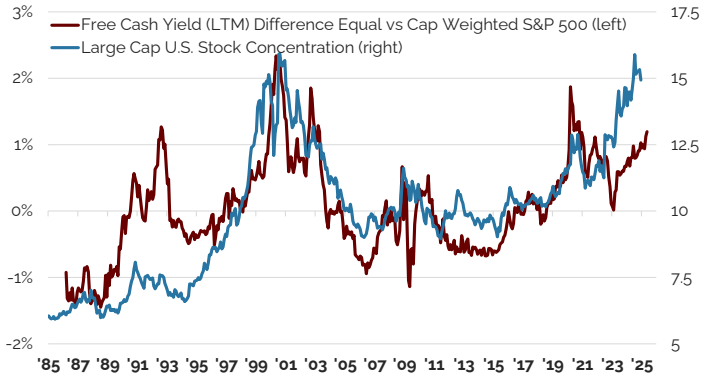
Source: FactSet 5/30/2025. Free cash yield is for the S&P 500 and uses fiscal year data until 2000 and trailing twelve month thereafter. Concentration is based on the Ken French universe of large U.S. stocks and measures the ratio of the value of the top third relative to the bottom third.

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

Figure 6 shows that when the equal weight S&P 500 is cheaper than the capitalization weighted index, it tends to outperform over the next ten years. This monthly series can be somewhat noisy and data around the pandemic should be discounted given the volatility in fundamentals at that time, but the longer-term trend clearly points to stronger returns for the less expensive version of the S&P 500. Importantly the valuation differential in this figure (with a more limited history) closely resembles the concentration measure that goes back almost a century. For the period when we have data for both of these series, **Figure 7** shows that times of high concentration like the present (blue line on the right axis) coincide with when the equal weight version of the S&P 500 is much less expensive and offers a higher free cash yield (red line on the left axis).

Concentration is closely linked to valuation.

Figure 7: Large U.S. Stock Concentration vs. Relative Valuation of Equal & Cap Weighted Indexes

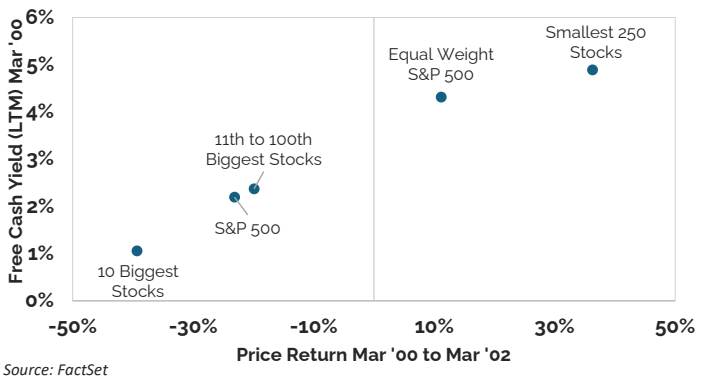


Source: FactSet 5/30/2025. Free cash yield is for the S&P 500 and uses fiscal year data until 2000 and trailing twelve month thereafter. Concentration is based on the Ken French universe of large U.S. stocks and measures the ratio of the value of the top third relative to the bottom third.

Given that measures of concentration and valuation between the equal and cap weighted S&P 500 resemble those of 25 years ago, it is worth examining that period in greater detail. Despite the richness of the overall market then and its subsequent decline, much of the damage was concentrated among the biggest and most expensive stocks while many smaller and less expensive portions of the market actually went up even as the overall market fell sharply. This divergence in price performance closely matched starting valuations. The valuation differentials within the market by size in March of 2000 are evident on the vertical axis of **Figure 8**. The biggest 10 stocks in had a very low 1.1% free cash flow yield and given the enormous weight of those stocks the overall S&P 500's comparable free cash flow yield was just 2.2% while the next 90 biggest stocks were slightly less expensive (though still very rich) at a 2.4% free cash flow yield. The equal weight version of the benchmark was considerably less expensive at 4.4% and the smallest 250 stocks with free cash flow data were cheaper still at 4.9%. The horizontal axis shows the performance of these groups over the next two years and highlights the close linkage with starting valuation.

There was enormous divergence in valuation by size in March of '00 which closely correlated to subsequent performance.

Figure 8: Free Cash Yield in March '00 vs. Performance Over the Next Two Years

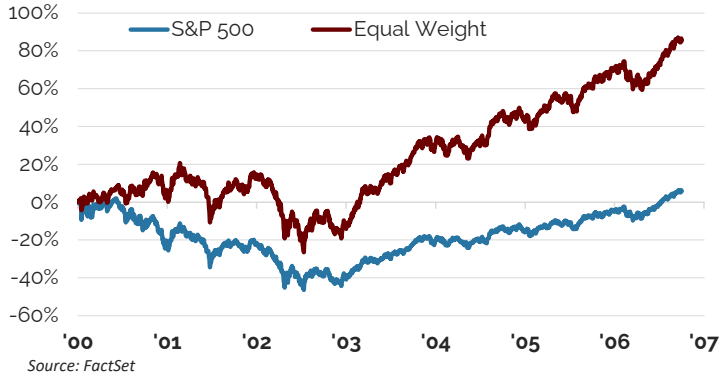


Source: FactSet

The gap in performance post March 2000 based on size and valuation in Figure 8 is staggering and continued for multiple years beyond the first two for which the analysis is easier to run. This is evident in **Figure 9** which shows that while it took the cap weighted S&P 500 nearly seven years to get back to where it was in March of 2000, the equal weighed version of the benchmark (more representative of smaller and less expensive stocks) was up over 80% in the same period.

The equal weight S&P 500 substantially outperformed the cap weighted Index after March of 2000.

Figure 9: Equal vs. Cap Weighted S&P 500 Post March '00



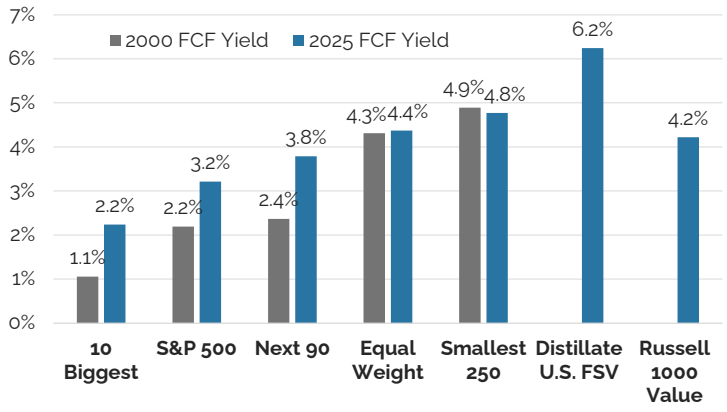
Source: FactSet

In addition to the similarities between now and 2000 in terms of the extent and duration of underperformance by the equal weight version of the large U.S. stock universe, comparable levels of concentration, and a similar divergence iin valuation, market dynamics today also closely resemble the situation 25 years ago in terms of valuation by size. This can be seen in **Figure 10** which compares trailing free cash yields by size cohort in March of 2000 with those today. The figure also includes the trailing free cash yields for our U.S. Fundamental Stability and Value strategy along with the Russell 1000 Value benchmark. This highlights both the significantly better valuation for our portfolio in addition to its focus on quality, but also that the value benchmark is not as attractively valued as one might expect and could disappoint in a reversal of the current trend.

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

Free cash yields by size today closely resemble those of March '00.

Figure 10: Figure 10: Free Cash Yield by Size March '00 vs. May '25



Source: FactSet; data as of May 2025

Summary: Valuation and big trends can be powerful tailwinds for patient investors. Within the large cap U.S. stock universe, the average stock has historically outperformed the broader capitalization weighted index, but has done so with enormous cyclicality. At present, we are deep into one of these cycles as the current underperformance of an equal weighted version of the large U.S. stock universe is close to or at historic levels of underperformance depending on how it is measured. Historically, such periods have ultimately given rise to substantial outperformance of an equal weighted index. Valuation tends to be closely linked to longer term returns and support the potential outperformance of an equal weighted version of the large cap benchmark given the current wide gap between the free cash flow yield of the equal vs cap weighted S&P 500 benchmark. The last time the equal weighted index had similarly underperformed and when the starting valuation gap was comparably wide, returns diverged sharply based on starting valuation and an equal weighted version of the S&P 500 outperformed by an enormous amount over a multiyear period.

In the short term, valuation is a terrible timing tool and cycles are impossible to predict. Large stocks also typically become so and see their valuations stretch higher in the context of a compelling story. This is not unique to the current moment but has been true through history. Since investing is not so much about what happens but what happens relative to what is already priced in, the ultimate beneficiaries of a new technology can end up being very different from what was predicted or discounted into valuations. Over the longer term, history would suggest that smaller stocks tend to outperform and that this is especially true when concentration is high and their relative valuations are low. Many of those moments have coincided with or stemmed from periods of massive technological innovation and enthusiasm, as is the case at present.

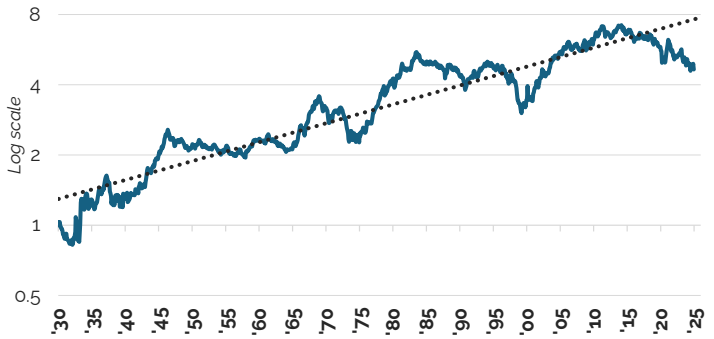
Small & Mid Cap Stocks:

Like the opportunity within the large cap space, there likewise looks to be an enormous potential for small and mid-cap stocks to do well in the coming years, especially if the low quality portions of this universe are avoided.

Using a similar framework as with the large cap space, we start with long-term performance data from the Ken French data library where we define small and mid-cap stocks as the middle 40% of the U.S. universe which corresponds to the roughly next 900 stocks beyond the largest 550, and excludes the smallest and less investible microcap universe that can be significantly distortive to this type of analysis. Since 1930, this small/mid cap group of stocks has substantially outperformed the biggest stocks in the market, but again with a great degree of cyclicality (see **Figure 11**).

Small/Mid stocks have significantly outperformed large U.S. stocks over the past nearly 100 years, but with significant cyclicality.

Figure 11: Small/Mid vs. Large U.S. Stocks

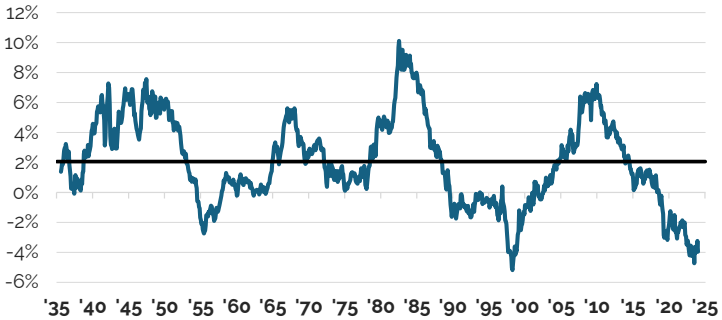


Source: Ken French Data Library through 2024; "Large" includes the biggest 30% of stocks that corresponds to ~550 stocks, "Smid" refers to the middle 40% of stocks by size which is currently ~900 stocks. Returns are value weighted.

Looking at annualized 10-year return differentials as we did in the large cap space also highlights both the degree of outperformance (averaging 2% per year), but also the cyclicality with current returns for small/mid stocks near a historic low versus large cap stocks (see **Figure 12**).

Small/Mid stock relative performance is near a record low over 10 years.

Figure 12: Annualized 10 Year Return Difference Between Small/Mid and Large U.S. Stocks



Source: Ken French Data Library through 2024; "Large" includes the biggest 30% of stocks that corresponds to ~550 stocks, "Smid" refers to the middle 40% of stocks by size which is currently ~900 stocks. Annualized rolling 10 year total return.

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

The magnitude of this cyclicality is highlighted in **Table 2** noting the peaks and troughs in the relative performance back to 1930. As was the case with the equal weight vs. cap weighted performance in the large stock universe, small/mid stock performance is highly cyclical with long stretches and enormous differentials between relative peaks and troughs. It is again true that in prior instances when relative returns reached similarly weak levels, reversals eventually occurred and gave way to multi-year stretches of significant outperformance.

Peaks and troughs in the difference between the small/mid and large cap stocks can be long in duration and significant in magnitude.

Table 2: Peaks & Troughs in Relative Performance of Small/Mid vs. Large U.S. Stocks

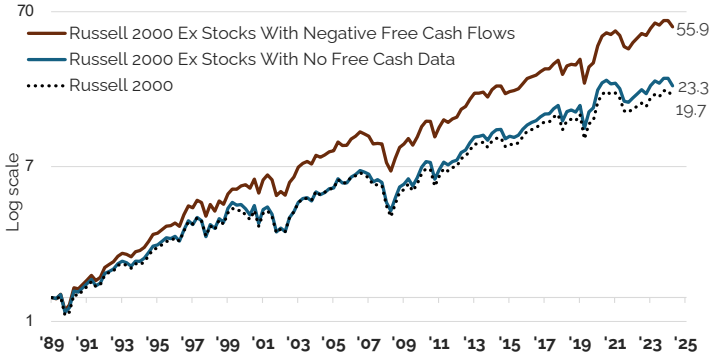
Date	Peak/ Trough	Ratio	Change	Duration
Feb '32	Trough	0.83		
May '46	Peak	2.57	211%	14.3
Dec '57	Trough	1.95	-24%	11.6
Dec '68	Peak	3.58	83%	11.0
Dec '74	Trough	2.27	-37%	6.0
Jul '83	Peak	5.52	144%	8.6
Mar '99	Trough	3.03	-45%	15.7
Feb '14	Peak	7.21	138%	14.9
Dec '24		4.66	-35%	10.8

Source: FactSet

While this longer-term performance data suggests that the duration and extent of recent small/mid stock underperformance may signal an eventual period of strong outperformance at some point, it ignores the issue of unprofitable stocks and their negative impact on overall performance and thus the opportunity for even better returns. Small stock benchmarks are hobbled by high percentages of stocks with negative free cash flows, without which performance can be substantially improved. This is evident in **Figure 13** which compares the indexed performance of the Russell 2000 back to when we have reliable free cash flow data with a version of that benchmark that excludes negative free cash flow companies on a quarterly basis. (Note: since the Russell 2000 includes a number of banks and other stocks without relevant free cash flow data, the chart also shows the performance of all Russell 2000 stocks with free cash flow data to highlight that this is not materially different from the starting universe and the benefit of excluding negative free cash stocks does not derive simply from omitting banks or other stocks without reliable free cash data.) The figure shows that while small/mid stocks have historically outperformed large stocks, the performance of small/mid stocks can be meaningfully improved upon by controlling for low quality/unprofitable companies.

Small cap stock performance can be meaningfully improved upon if unprofitable stocks are excluded.

Figure 13: Indexed Performance of Small Stocks With and Without Negative Free Cash Stocks

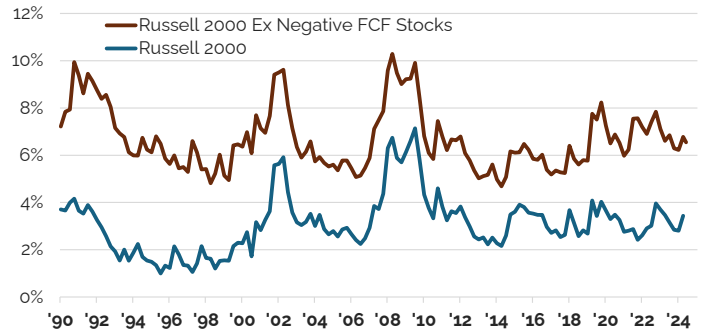


Source: FactSet, Russell
Notes: cash data is based on FY0 data from 1990 to 2000 and LTM thereafter, data through March 2024. Quarterly rebalancing.

The difference in returns for the Russell 2000 benchmark with and without negative free cash stocks is substantial and highlights the importance of valuation. **Figure 14** shows a large free cash flow yield difference between the full Russell 2000 and the version that excludes negative free cash flow stocks each quarter.

Excluding negative free cash stocks results in a substantially higher free cash yield for the Russell 2000 benchmark.

Figure 14: Russell 2000 Free Cash Yield With and Without Negative Free Cash Stocks

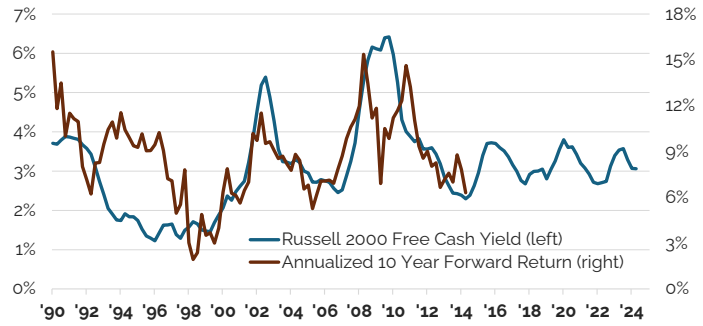


Source: FactSet, Russell; Notes: cash data is based on FY0 data from 1990 to 2000 and LTM thereafter, data through March 2024. Stocks without FCF data are omitted and the index reweighted accordingly. Return data is for the Russell 2000 total return

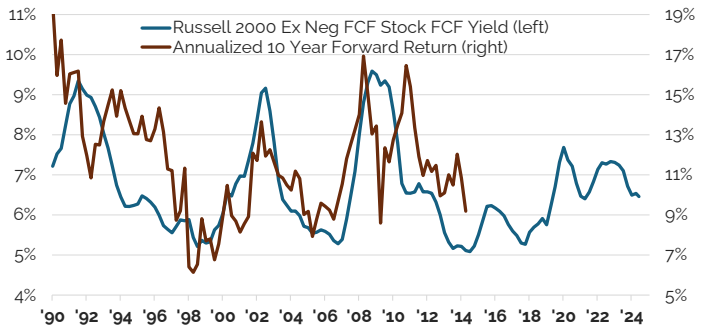
As was the case with large cap stocks, these starting free cash flow yields for both the Russell 2000 benchmark and the version that excludes negative free cash flow companies are closely correlated to annualized total returns over the subsequent 10-year period. This is shown in **Figures 15 and 16** on the following page.

Free cash yields and returns are closely linked for the Russell 2000 with and without negative free cash stocks.

Figures 15 & 16: Russell 2000 & Russell 2000 Ex Negative FCF Stocks Free Cash Yields vs. 10 Year Forward Returns



Source: FactSet, Russell; Notes: cash data is based on FY0 data from 1990 to 2000 and LTM thereafter, data through March 2024. Stocks without FCF data are omitted and the index reweighted accordingly. Return data is for the Russell 2000 total return . FCF yield is 4Q Avg.

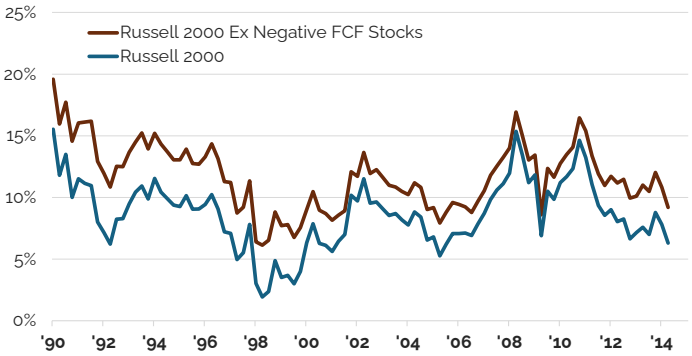


Source: FactSet, Russell; Notes: cash data is based on FY0 data from 1990 to 2000 and LTM thereafter, data through March 2024. Stocks without FCF data are omitted and the index reweighted accordingly. Return data is for the Russell 2000 total return . FCF yield is 4Q Avg.

Given the consistently better valuation for the version of the Russell 2000 without negative free cash flow companies, and the strong relationship between starting free cash yields and 10-year returns, it should come as no surprise that the rolling 10-year returns in **Figure 17** look quite similar to the valuation chart.

Rolling 10-year annualized returns are consistently better for the Russell 2000 without negative free cash stocks.

Figure 17: Annualized 10-Year Forward Returns for the Russell 2000 With and Without Negative FCF Stocks

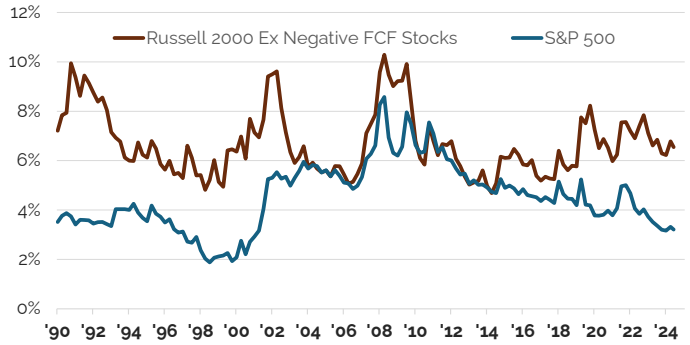


Source: FactSet, Russell; Notes: cash data is based on FY0 data from 1990 to 2000 and LTM thereafter, data through March 2024. Stocks without FCF data are omitted and the index reweighted accordingly. Return data is for the Russell 2000 total return.

The strong relationship between free cash yield and 10-year forward return in both the large cap and small/mid stock universe means we can directly compare the two. If we proceed with the more desirable Russell 2000 benchmark excluding negative free cash stocks, **Figure 18** shows that its free cash flow yield is currently significantly more attractive than that of the S&P 500. This was not always the case, however, as the two free cash flow yields were relatively similar when large cap stocks were significantly less expensive in the 2005-2014 timeframe. More recently though, the valuation of profitable small cap stocks has gotten somewhat better even as the free cash yield for the S&P 500 has gotten steadily richer and declined from around 6% to just over 3% as the smaller stock yield held steady.

Small stocks excluding negative free cash companies offer a much better valuation than large stocks at present.

Figure 18: S&P 500 Free Cash Yield vs. Russell 2000 Ex Negative FCF Stocks



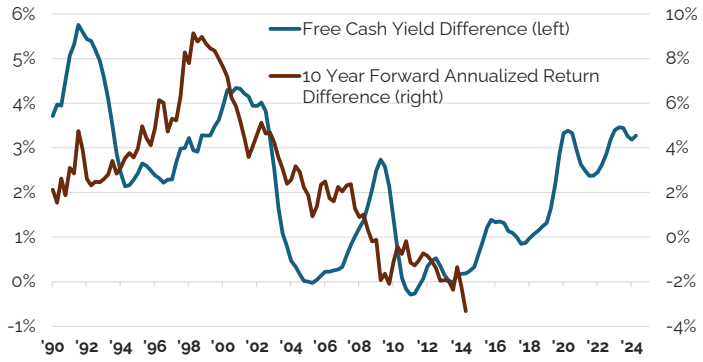
Source: FactSet, Russell; Notes: cash data is based on FY0 data from 1990 to 2000 and LTM thereafter, data through March 2024. Stocks without FCF data are omitted and the index reweighted accordingly. Return data is for the Russell 2000 total return.

Figure 19 on the following page plots the free cash flow yield difference between the S&P 500 and Russell 2000 ex negative free cash flow companies (left axis) with the difference in 10-year forward annualized returns on the right. While this is an admittedly noisy chart, there does appear to be a relationship wherein small stocks ex negative free cash companies tend to subsequently outperform large stocks when they are less expensive, as is currently the case. It is notable that small stocks stopped outperforming roughly around the time in 2004 that their valuation advantage eroded, and they significantly outperformed in the years following the tech bubble in the late 1990s and 2000 when they were considerably cheaper as they are today.

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

The starting free cash yield difference between large and small stocks (ex negatives) roughly lines up with 10 year forward return differentials.

Figure 19: Free Cash Difference vs. 10 Year Forward Return Difference for S&P 500 vs. Russell 2000 Ex Neg FCF Stocks

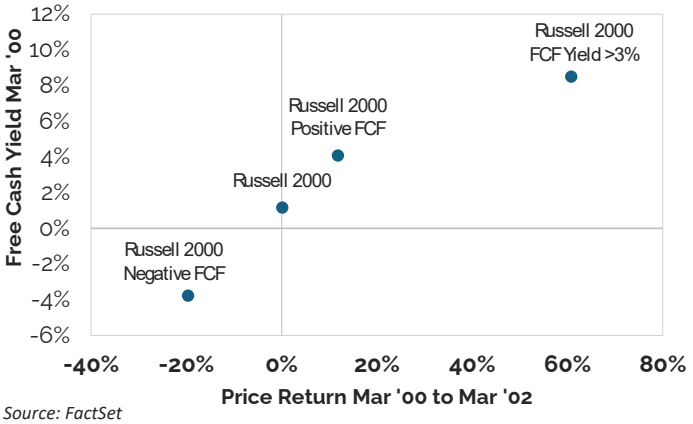


Source: FactSet, Russell; Notes: cash data is based on FY0 data from 1990 to 2000 and LTM thereafter, data through March 2024. Return data is based only on the subset of the Russell 2000 with available FCF data. Yield is 4Q Avg.

Continuing with this analysis in a similar fashion to how we examined the opportunity in the large cap space, we can look at what valuation and performance looked like the last time small stocks had similarly underperformed back in 2000. Instead of segmenting stocks by size as we did in the large cap space to highlight that the biggest stocks were also the most expensive, **Figure 20** sorts on valuation for smaller stocks. Doing this reveals on the vertical axis that while the overall Russell 2000 had a valuation of only slightly over 1%, there was enormous dispersion in valuation with the negative free cash stocks generating a negative yield of around -4%, while the positive free cash flow companies had a yield of 4% and stocks with a free cash flow yield over 3% had an 8% free cash yield. Similar to what occurred in the large space, starting valuation had an enormous impact on subsequent returns on the horizontal axis.

There was enormous divergence in valuation by size in March of '00 which closely correlated to subsequent performance.

Figure 20: Free Cash Yield in March '00 vs. Performance Over the Next Two Years

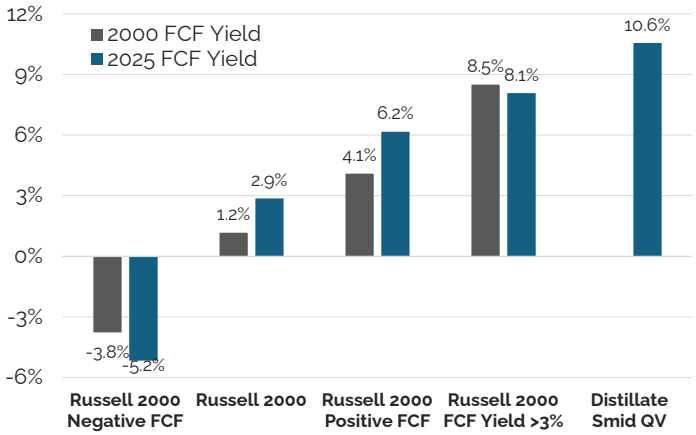


Source: FactSet

Figure 21 shows that the divergence in valuation today looks quite similar to what it was in March of 2000 with a significant spread in valuation within the small/mid universe. Negative free cash flow companies have an even lower free cash yield today than in 2000 though they make up a slightly smaller share of the index at 29% versus 36%. Positive free cash flow stocks are cheaper today than they were then and stocks with free cash yields over 3% are similarly valued though considerably larger in weight now at 48% vs. just 26% in March of 2000. Lastly, we also show the valuation of our own smaler cap portfolio (SMID QV) which offers an even higher free cash flow yield, no exposure to negative free cash stocks, and further quality controls on leverage.

The starting free cash yield difference between large and small stocks (ex negatives) roughly lines up with 10 year forward return differentials.

Figure 21: Small Cap Free Cash Yield by Group Today vs. March 2000



Source: FactSet; data as of May 2025

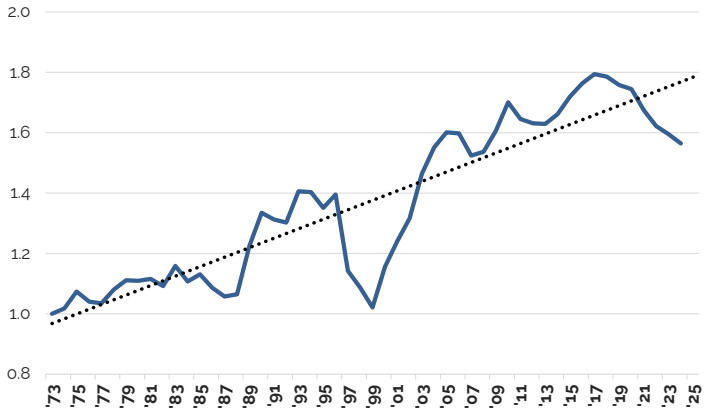
Summary: First, the set-up is there for small/mid U.S. stocks to at some point begin a strong cyclical rebound in performance relative to larger stocks given the magnitude and duration of recent underperformance amid a much longer-term trend of significant outperformance. Second, it is worth noting that small stock returns can be substantially improved upon by excluding negative free cash flow companies as our strategy does. And finally, 10-year forward small/mid stock returns are closely linked to starting valuations as they are in the large cap space, which both reinforces the opportunity for small stocks to outperform larger ones in the coming decade in addition to the potential for the less expensive portion of the small/mid stock universe to outperform the broader benchmarks.

International Stocks:

Although data is significantly more limited and we only have annual return comparisons for international stocks back to the early 1970s, smaller stocks have likewise outperformed internationally. This is evident in the indexed performance of the equal weighted version of the MSCI EAFE Index relative to the cap weighted index in **Figure 22**.

An equal weighted index of large international stocks (MSCI EAFE) has historically outperformed a cap-weighted one over time.

Figure 22: Equal vs. Cap Weighted International Stocks

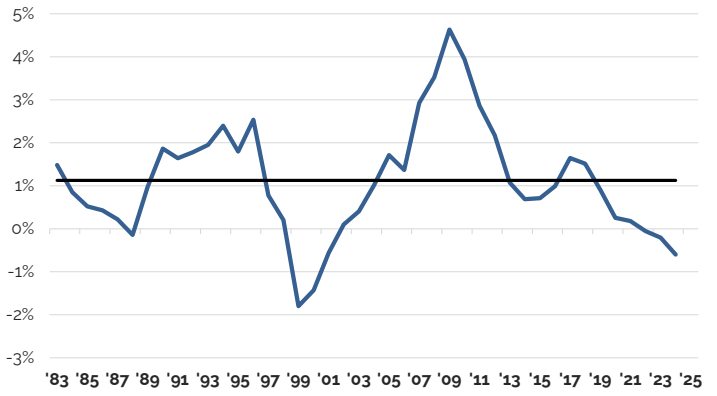


Source: MSCI, FactSet. Annual data through 2024.

Annualized rolling 10-year returns paint a similar picture with the equal weighted version of the MSCI EAFE index outperforming by over a percent point a year on average but with a range from -2% to as much as +4.6% (see **Figure 23**). While the equal weight version of the MSCI EAFE has not been nearly as weak as is the similar comparison in the U.S., it is likewise in a downcycle and the current -0.6% annualized 10-year relative return ranks below the 5th percentile in this history.

An equal weighted index of large international stocks (MSCI EAFE) has historically outperformed a cap-weighted one over time.

Figure 23: Annualized Rolling 10 Year Return Difference Between Equal & Cap Weighted International Stocks



Source: MSCI, FactSet. Annual data through 2024.

Final Word

While short term market moves show little relationship to starting valuation, there is a strong linkage over longer 10-year periods in both the small and large cap universes when value is measured using free cash flows (which allow for accurate comparisons over time.) When these valuations have lined up with cyclical trends around the longer-term context of smaller stock outperformance in the past, they have offered powerful signals for future performance.

Importantly, this is not just true in terms of potential outperformance by smaller stocks, but also the opposite. Only around 15 years ago, large stocks were historically cheap versus smaller stocks and performance was reversed with small stocks having previously outperformed by a near record amount. From that attractive starting point, large stocks then went on to outperform by a considerable margin. Conditions today, however, are flipped and there looks to be significant valuation and concentration risk in large cap stocks and much greater opportunity in smaller ones.

Current conditions look consistent with historical patterns. Smaller stocks tend to outperform over the longer term, but with cyclicality that averages just over 20 years from peak to peak or trough to trough. When these periods are split into recoveries and declines, there is a striking amount of similarity between them and current conditions look very consistent with historical averages (see **Tables 3 and 4** below). Returning to our earlier comments about John Templeton, it does not look to be all that different this time and there may be a significant opportunity for valuation focused investors willing to emulate his contrarian and valuation focused approach.

Historic declines and recoveries for small stock relative performance have been somewhat similar with current weakness looking consistent.

Tables 3 & 4: Performance Cycles Between Size Groups Within Large Caps, and Between Small and Large Caps

Smallest Third of Large U.S. Stocks vs. Largest Third		
Recoveries		
Period	**Change**	**Duration**
Feb '32 to May '46	157%	14.3
Nov '57 to Jan '69	65%	11.2
Jun '73 to Feb '94	109%	20.7
Mar '99 to Mar '15	181%	16.0
Average	**128%**	**15.5**
Declines		
Period	**Change**	**Duration**
May '46 to Nov '57	-20%	11.5
Jan '69 to Jun '73	-29%	4.4
Feb '94 to Mar '99	-47%	5.1
Mar '15 to Dec '24	-30%	9.8
Average	**-31%**	**7.7**

Small/Mid U.S. Stocks vs. Large Stocks		
Recoveries		
Period	**Change**	**Duration**
Feb '32 to May '46	211%	14.3
Dec '57 to Dec '68	83%	11.0
Dec '74 to Jul '83	144%	8.6
Mar '99 to Feb '14	138%	14.9
Average	**144%**	**12.2**
Declines		
Period	**Change**	**Duration**
May '46 to Dec '57	-24%	11.6
Dec '68 to Jun '74	-37%	6.0
Jul '83 to Mar '99	-45%	15.7
Feb '14 to Dec '24	-35%	10.8
Average	**-35%**	**11.0**

Past performance does not guarantee future results. 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.*

Distillate claims compliance with the Global Investment Performance Standards (GIPS®). GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. To receive a GIPS Report and/or our firm's list of composite and broad distribution pooled funds 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 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; 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.

This material is provided for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service or as a recommendation or determination by Distillate that any investment strategy is suitable for a specific investor. Investors should seek financial advice regarding the suitability of any investment strategy based on their objectives, financial situations, and particular needs. The investment strategies discussed herein may not be suitable for every investor. This material is not designed or intended to provide legal, investment, or other professional advice since such advice always requires consideration of individual circumstances. If legal, investment, or other professional assistance is needed, the services of an attorney or other professional should be sought. The opinions, estimates, and projections presented herein constitute the informed judgments of Distillate and are subject to change without notice. Any forecasts are subject to a number of assumptions and actual events or results may differ from underlying estimates or assumptions, which are subject to various risks and uncertainties.

All investments in securities, options and derivatives involve a risk of loss of capital and no guarantee or representation can be made that an investment will generate profits or that an investment will not incur a total loss of invested capital. ***Past performance does not guarantee future results*** *and there can be no assurance that the future performance of any specific investment, investment strategy, or product will be profitable, equal any corresponding indicated historical performance level(s), or prove successful. Investment returns and value will fluctuate in response to issuer, political, market, and economic developments, which can affect a single issuer, issuers within an industry, economic sector or geographic region, or the market as a whole. Furthermore, nothing herein is intended to imply that Distillate's investment strategies may be considered "conservative", "safe", "risk free" or "risk averse." Portfolio holdings and sector allocations are subject to change at any time and should not be considered recommendations to buy or sell any security. The information in this presentation has been obtained or derived from sources believed to be reliable, but no representation is made as to its accuracy or completeness.*

This presentation contains forward looking statements, which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project"," estimate", "intend", or "believe", or the negatives thereof or any other variations thereon or other comparable terminology. Because such forward looking statements involve risk and uncertainties, actual results may differ materially from such expectations or projections. Any such forward-looking statements should not be construed to be indicative of the actual events that will occur nor should they be considered guarantees of future events in any form.

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.* ***Fundamental (or Cash Flow) Stability*** *is Distillate Capital's proprietary measure of through-cycle cash flow stability with a higher value indicating greater stability.* ***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.)*

Methodology note for ***Figures including free cash flow yield (FCF)*** *or* ***free cash flow to enterprise value yield (FCF/EV):*** *figures reflect consensus estimates of next-twelve-months (NTM) FCF in comparison to market capitalization or enterprise value (EV) for the relevant portfolio/strategy or benchmark. Stocks*

without data are excluded and portfolios are reweighted accordingly. Stocks with FCF/Market Cap or FCF/EV values of greater than 50% or less than -20% have been eliminated to avoid distorting overall averages.

*The **S&P 500 Index** is an index of roughly the largest 500 U.S. listed stocks maintained by Standard & Poor's. The **S&P 500 Equal Weight Index** is an index of the same stocks as the S&P 500 Index, but weights the constituents equally. 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.