



DISTILLATE CAPITAL

These Go to Eleven

Letter Summary

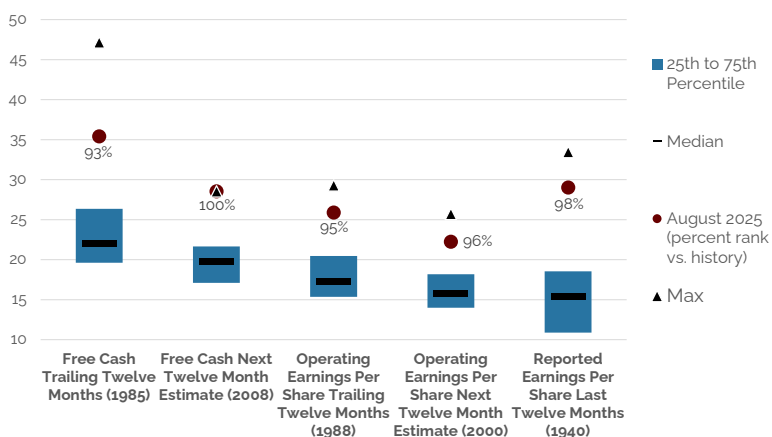
Those of you who read our work know we have a strong preference for examining equity valuations through the lens of free cash flows as it avoids distortions introduced by the significant economic shift to intangible investment activity and various accounting rule changes that have occurred over time. We think it is a much better measure of valuation and has empirically proven itself in the past decades as other more traditional metrics have been much less efficacious even though they remain the dominant value measures used on Wall Street and by index providers. Despite this preference, free cash flow data does have a more limited history and we believe it can be useful to look at the overall market valuation on a variety of measures.

In our analysis, across a number of valuation measures, the current market looks rich by any historical standard, and raises a number of questions and concerns for longer-term investors. Our analysis also asks questions around base rates—what rate of future growth is necessary to justify current market levels, and what would those earnings and future market valuations equate to as a share of global GDP? Is the scenario built into today's valuations realistic in this context? Similarly, are valuation levels in sync with their historic relationship with fixed-income alternatives?

Our analysis shows that to achieve an average equity return over the next decade, either growth will need to accelerate well above prior peak levels of growth, or valuations will need to remain at levels we have rarely seen in the past. The title of this paper, in reference to the 1984 comedy classic “This is Spinal Tap”, speaks to our concern that investors in aggregate are relying on a “these go to eleven” mentality to the extent they are considering valuation multiples at all. We have no view on how the current market will evolve, but past episodes when the market became willing to pay any price for a given exposure have ended badly. Fortunately, much of the valuation risk currently is concentrated in relatively few very large stocks and we continue to see attractive opportunities throughout the market aside from the biggest stocks, much as it was 25 years ago, the last time valuations were at similar levels.

- Equity multiples on various measures of earnings and free cash flow are near the record levels last reached in the tech bubble and point to potentially much lower 10-year forward returns. See [pages 2-4](#).
- Achieving average equity returns over the next decade will require either that multiples stay near record levels (or rise further) or that underlying fundamental growth accelerates well beyond prior peaks if multiples revert even just to the 75th percentile of their historic range. See [page 6](#) and [Figure 1](#) below.
- Relative to global economic output, the aggregate value of large cap U.S. equities is at a record level, though their profit share is more in line with history. See [page 7](#).
- Equity valuations have disconnected from their historic relationship with fixed-income alternatives. See [page 8](#).
- While equity returns 10 years into the future could disappoint the significant level of optimism discounted in current prices, much of this valuation risk is concentrated in a handful of very large stocks and there remains significant opportunity elsewhere in the market as was the case the last time the market was similarly valued. See [pages 9-10](#).

Figure 1: S&P 500 Valuation Multiple vs. Historical Range on Various Measures



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

Market Commentary:

Our strong preference is to consider valuations utilizing free cash flow given significant accounting issues with other common metrics and the impact of intangible investment spending. We also strongly favor forward-looking measures of company performance based on consensus estimates as the market is a forward-looking discounting machine and to the extent there are reliable estimates, backward looking numbers risk making mistakes.

We also, however, recognize that it can be useful to triangulate valuations across a variety of metrics and forward free cash estimates have a limited lifespan where other metrics have much longer histories to be considered. We therefore set out to examine a number of different valuation metrics using various underlying assessments of company profitability. The valuation measures used in this analysis include:

- Trailing last-twelve-month free cash flows (LTM FCF)
- Consensus estimated next-twelve-month free cash flows (NTM FCF)
- Trailing last-twelve-month operating earnings per share (LTM Op EPS)
- Consensus estimated next-twelve-month operating earnings per share (NTM Op EPS)
- Trailing last-twelve-month reported earnings per share (LTM Rep EPS)

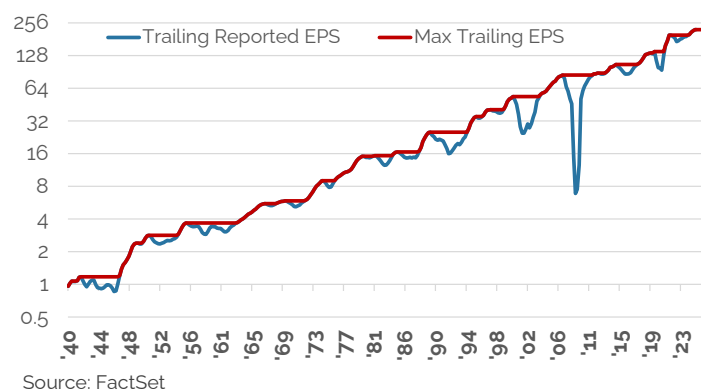
Reported earnings and operating earnings differ in that the former is a measure that conforms to mandated accounting standards while operating profit is a version of net income in which companies adjust for non-recurring items and other impacts, or in some cases where they simply do not like the accounting standards. While there is some logic to use operating earnings given non-cash charges that can cause wild swings in reported earnings, there is little standardization and adjustments unsurprisingly overwhelmingly tend to flatter company's results. Buyer beware.

A word about methodology. PE ratios, to use one example, are useful reference points and often can be linked to private market transactions or take-overs. They serve a useful purpose as a PE of 6, to pick a random small number, sounds like a bargain to most investors, where a PE of 30 suggests big expectations where current earnings are a fraction of what is expected in the future. We all can relate. But PE ratios analyzed over time are subject to wild swings based on cyclical results, one-off charges, and mark-to-market accounting. In periods of economic volatility, reported earnings can move toward zero or even negative levels that result in temporarily nonsensical PE ratios. In those cases, the market typically looks through current issues and stock prices reflect what the market assumes is the ongoing earnings power of the business. If this simple version of reported EPS were used to analyze historical valuations, the data would be corrupted by those data points.

To smooth this volatility, we measure valuation against the highest prior level for the underlying fundamental metric in question. **Figure 2** offers a graphical depiction of both actual trailing twelve month reported earnings per share and a series where declines are ignored and only the prior max is used. The valuation measures based on the prior max eliminates the extremes from the original data set to provide a better measure of overall valuation. This approach also has much stronger relationship with future returns, which is ultimately the goal of any valuation metric.

Using peak earnings per share smooths out volatility in valuation multiples to provide a more useful measure.

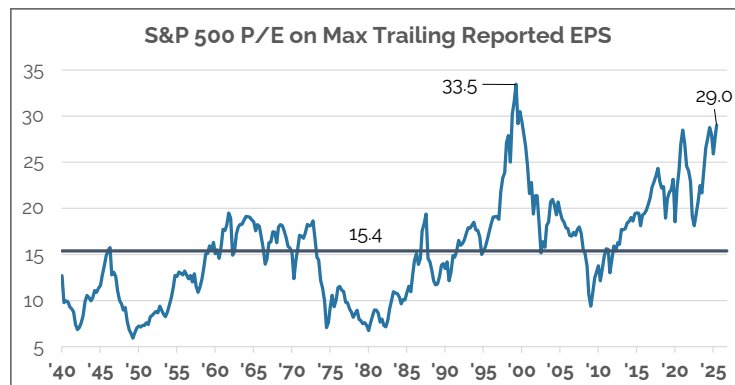
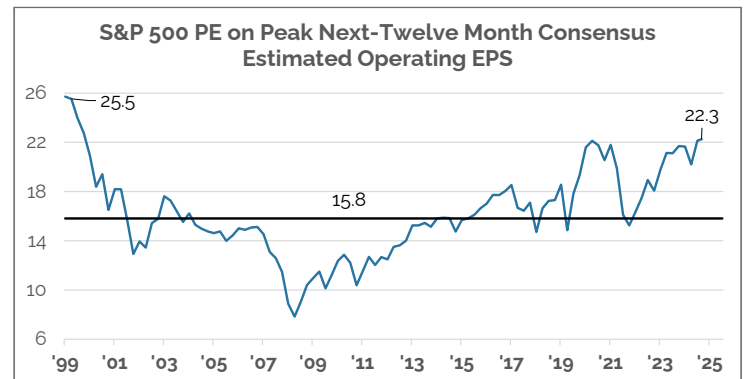
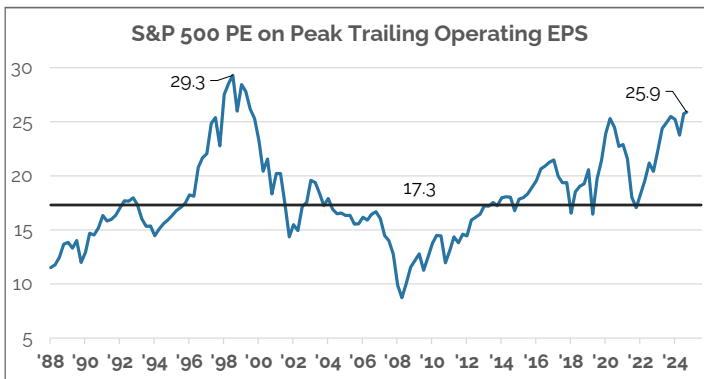
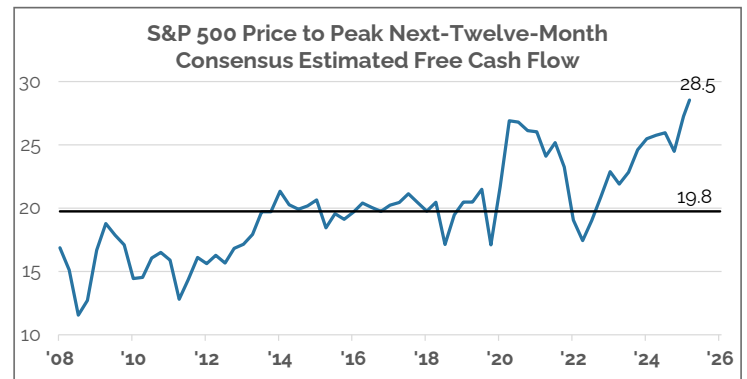
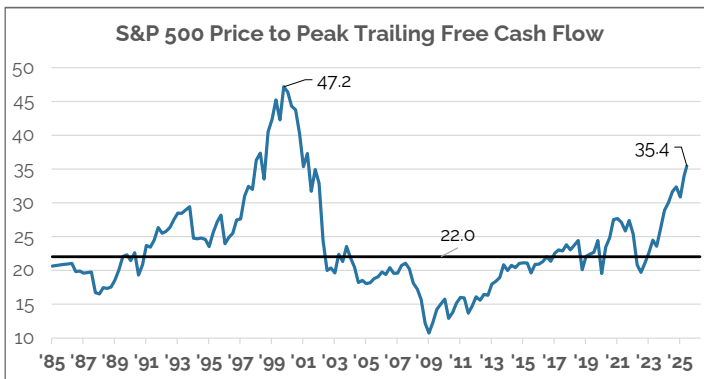
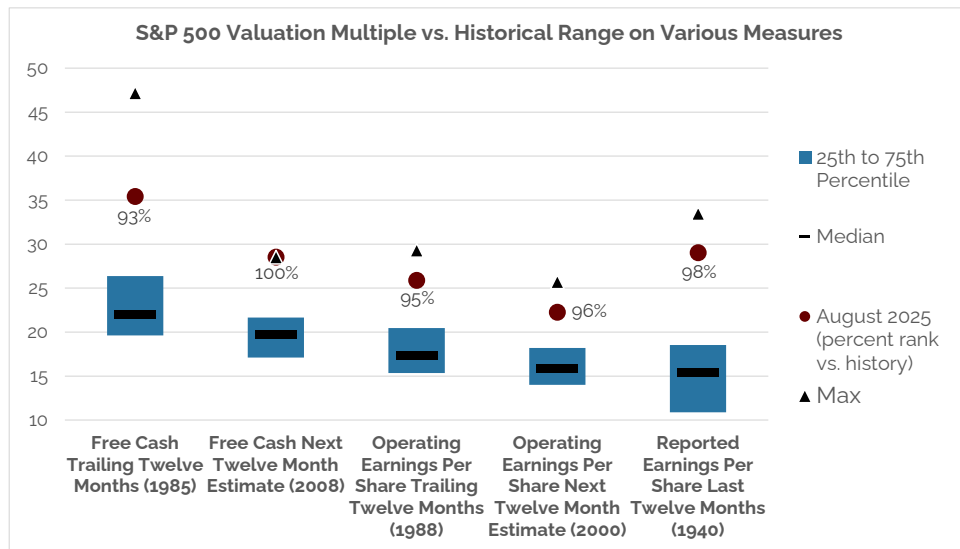
Figure 2: Trailing Reported Earnings Per Share vs. Peak

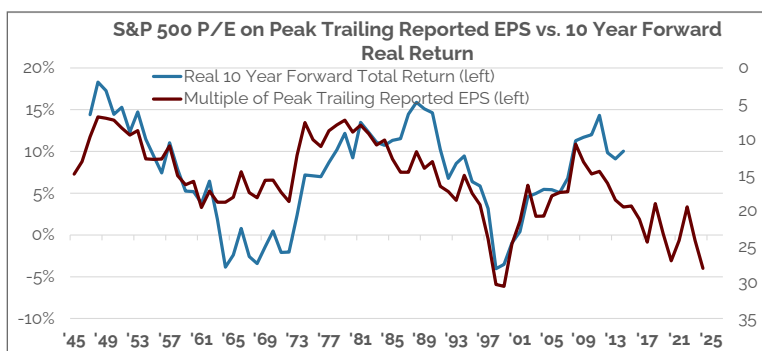
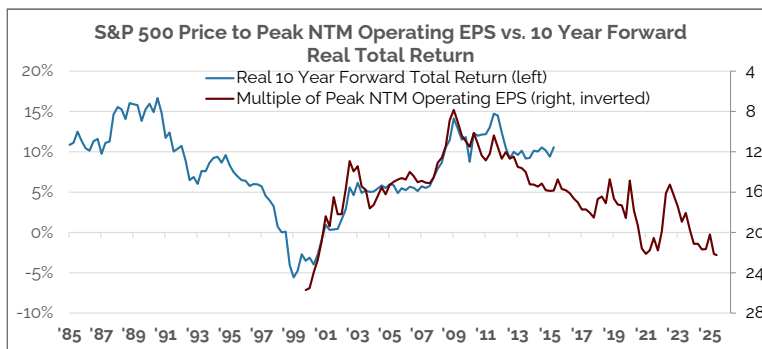
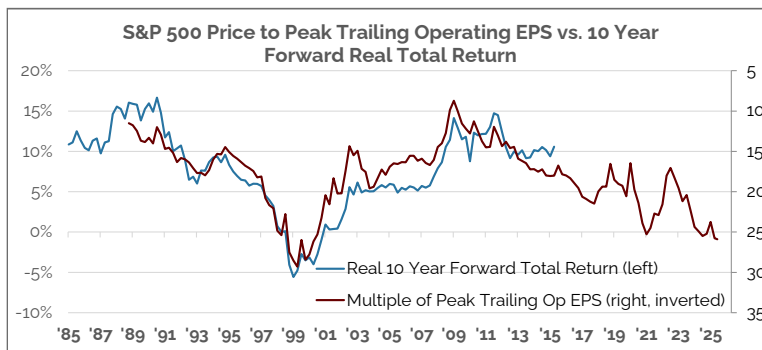
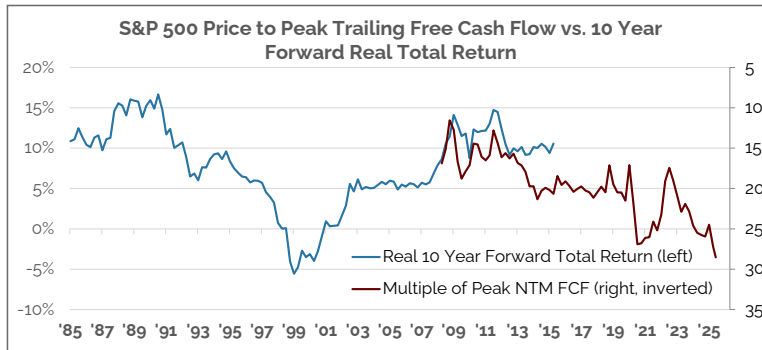
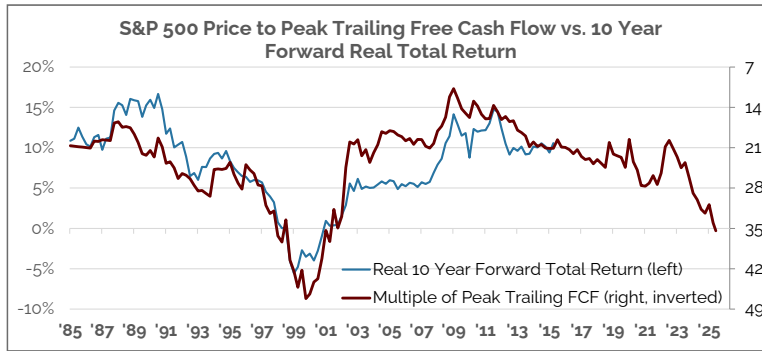


Using this max version of each of the profit measures mentioned earlier produces a historical set of historic valuation levels for the market for as far back as each metric has history. These valuations and are shown on the following page along with a chart at the top that shows the current level for each metric alongside the historical average, 25th to 75th percentile range, and max (See [Page 3](#)). As is clear in the charts, of the end of August 2025, valuation multiples were near historic peaks against all of these profit measures.

The charts that follow on [Page 4](#) shows the same set of historical valuation levels on each of these metrics overlaid with 10-year forward annualized real total returns. While valuation is a famously bad timing tool in the short-term, these charts show that it has historically done a fairly good job of predicting 10-year forward returns. While there are nuances between the various measures of profitability we use to judge valuation in this analysis, they tell a similar story—that large cap stocks are historically expensive and 10-year forward returns may be challenged.

As we will show later in this analysis and to put current valuations in context, if today's historically rich multiples moderated even to the 75th percentile of their historic ranges over the next decade, fundamental growth would need to accelerate far above prior record levels just to achieve average returns. This highlights the level of optimism about equities at present and the significant valuation risk of owning the market in aggregate.





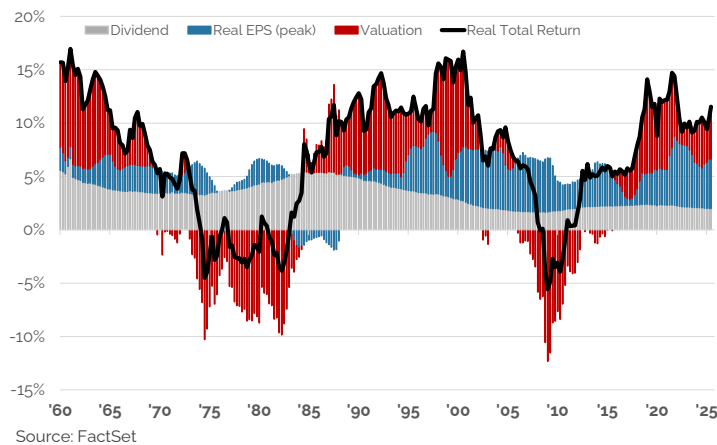
Source for all charts: FactSet, Standard & Poors. One cannot invest directly in an index.

Equity Return Drivers

To understand the historic relationship between valuation and longer-term returns, **Figure 3** deconstructs rolling 10-year annualized real returns for the S&P 500 back to around 10 years after the consumer price index began and splits returns into dividends, real earnings per share growth using the peak methodology, and valuation changes.

Dividends and real earnings growth are the more stable drivers of long-term returns while valuation changes are more volatile and cyclical.

Figure 3: Components of S&P 500 10-Year Rolling Real Returns



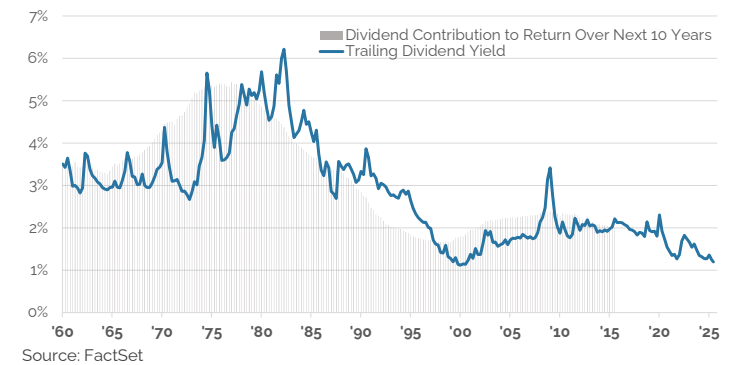
Broadly, dividends and net income growth form the key pillars of real returns over time and are much more stable than valuation changes. Dividends were larger when the payout ratio was higher fifty years ago and earnings growth has increased since then with the benefit of greater reinvestment of retained earnings due to the lower payout ratio more recently. Over the full period, the two have combined to average just over 6% per year and have accounted for the vast majority of the 7.5% average real 10-year annualized return.

Valuation changes are the much more volatile component of 10-year returns and appear somewhat cyclical in nature with stretches where they add to returns like in the 1960s, 1990s, and most recent period, punctuated by contractionary periods in the 1970s and 1980s and the 2000 period. Over the very long-term, these ups and downs mostly net out and valuation changes are a negligible contributor to returns, as would make logical sense. That the long-term average for valuation changes is positive at present is due to the current high level of valuations versus history.

In terms of future predictability, dividends are the most straight forward with the 10-year forward return contribution matching up closely with the trailing yield (See **Figure 4**). This shows both that the current yield of 1.2% is only slightly above the 1.1% trough in the tech bubble, but also that dividend yields are generally lower than in the past due to a lower payout ratio of income than was previously the case.

Dividend contributions to return track starting dividend yields.

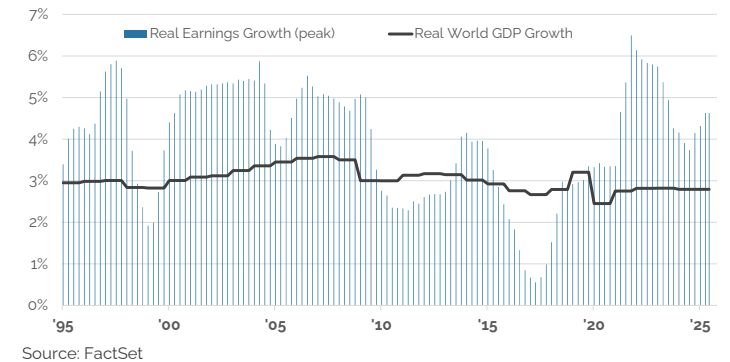
Figure 4: Dividend Yield vs. Return Contribution



Real net income growth is more variable than dividends, but in the period since the dividend payout ratio has declined and more retained profits have been reinvested for growth, it has generally tracked a few percentage points ahead of real gross domestic product growth over rolling 10-year periods (See **Figure 5**). 10-year rolling real growth has generally ranged from 3% to 6% over this period and has averaged 4.0%.

Real earnings per share growth has averaged around 4% with a range of 3%-6% and tends to run a few percentage points above real GDP growth..

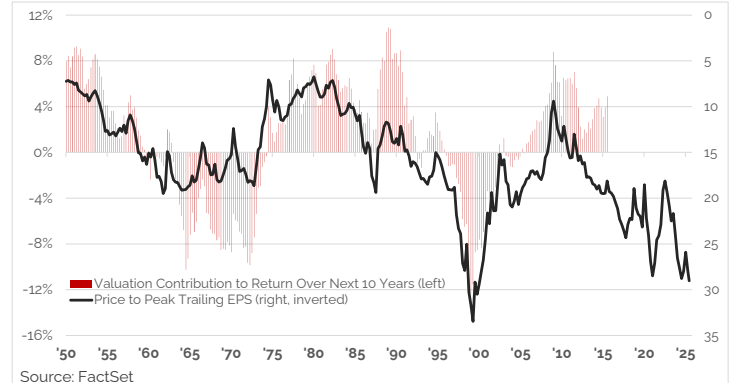
Figure 5: Real 10-Year Earnings Growth vs. GDP



Valuation changes are the biggest swing factor in 10-year returns, but also have some predictability as they are closely related to starting valuation. The multiple of peak trailing earnings lines up well with the valuation contribution to returns 10 years into the future (See **Figure 6**).

Starting valuation is closely linked with the valuation contribution to returns 10 years later.

Figure 6: Valuation Multiple vs. Return Contribution



What's Priced In

Current valuations across each of the measures of profitability we consider are pointing to lower returns over the next 10 years. Valuations and 10-year forward returns are inversely correlated largely due to the fact that while the dividends and net income or free cash flow growth tend to be fairly stable, valuations have historically mean reverted over longer time horizons. While it is possible that “this time is different” and that multiples can remain elevated at a “permanently high plateau” to borrow two famous investing idioms, we think it is prudent to consider scenarios where this does not occur and where equity multiples do revert to more typical levels. Since multiples reflect expectations for future fundamental growth, it is useful to consider how multiple changes and fundamental growth may balance against one another in the next decade. This analysis examines the growth rates necessary to produce average returns if multiples normalize.

Based on current multiples, we can back into what level of growth would be needed to generate an average real return if valuations revert back to the 75th percentile of their historical range on each metric. Said differently, if multiples stay high, but recede somewhat from their current record levels, in order for equity investors to earn what they have earned over long term periods in the past, what growth is needed?

Assuming a dividend contribution of 1.5% based on the current 1.2% yield, in order to produce a 6% real price return (equating to a 7.5% real total return), growth would need to accelerate sharply if multiples 10 years ahead trade at their 75th percentile. This is shown in [Figure 7](#) which depicts the necessary growth rate for each profit measure in this scenario along with the historic growth rates.

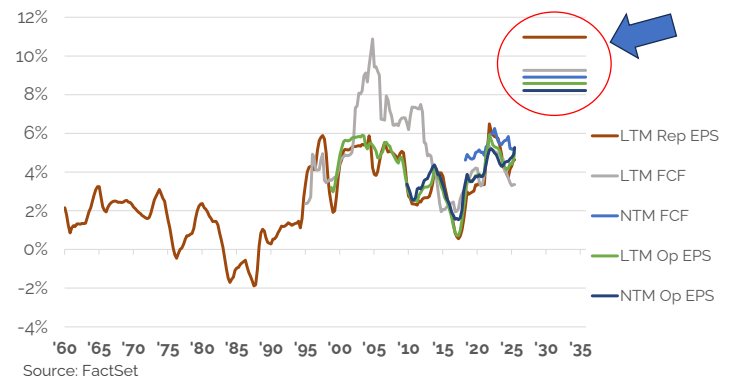
In the case of next twelve month consensus estimated operating earnings, for example, if the market in 2035 trades at the 75th percentile of its historic range (20.5x), in order to achieve an average real total return of 7.5%, real earnings growth over the next decade would need to rise to a 9% rate. This would be more than double the 4.1% historic average and 50% above the 5.9% real 10-year historic peak. Similar comparisons exist across the other metrics, none of which suggest returns are likely going to match historic averages unless peak multiples hold or growth breaks out well above peaks reached in prior periods of enormous technological innovation and much stronger underlying macroeconomic and demographic growth.

We would note that trailing free cash flow growth did grow substantially in the early 2000s and stands out in the chart. This largely reflects a lower starting point as free cash flow in the late 1990s and 2000 was somewhat depressed in relation to other measures of profitability. This also resulted in the market multiple of trailing free cash flow standing out in those years in the valuation charts from earlier. At present, this is not the case and free cash levels in aggregate are fairly consistent with other measures and so a similar divergence in 10-year growth rates to what occurred back then would seem less likely from here.

This analysis shows that an enormous amount of growth is discounted into current prices. Since investing is not so much about what happens but what happens relative to what is already priced in, even extremely strong fundamental growth over the next decade could fall well short of expectations.

To produce a return in line with the historic average (7.5% real) if equity multiples revert to the 75th percentile of their historic range, growth would have to accelerate to new peaks.

Figure 7: Fundamental Growth Required for Average Return With Multiples at 75th Percentile



U.S. Equities vs. World GDP

As another point of reference and to take a more macro view regarding the equity market and valuation, we next take a step back to consider the value of U.S. equities in aggregate in relation to total economic output. Since large U.S. companies are global in nature and derive significant profits from overseas, it makes sense to look at world rather than domestic gross domestic product (GDP). On this measure, U.S. equities are at a new high, representing 51% of Global GDP (See [Figure 8](#)), an astounding figure.

If equities trade at the median multiple in 10 years, growth will need to accelerate to generate a 4.5% real total return.

Figure 8: U.S. Equity Value as a Share of World GDP

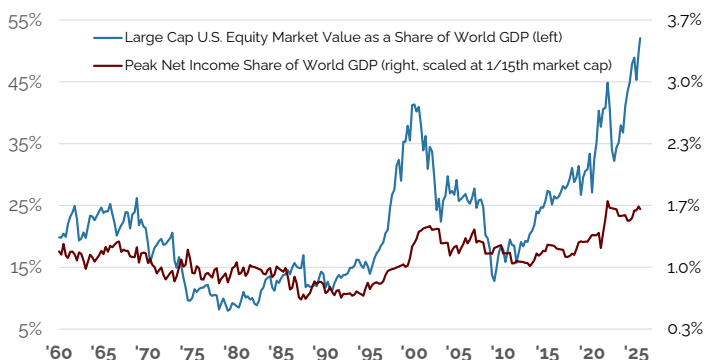


Source: FactSet

Some increase is reasonable as U.S. equities have become more global over time and their underlying profits as a share of world GDP have increased. [Figure 9](#) reflects this by adding trailing peak net income as a share of world GDP on the left axis of the chart with a matched scale at 1/15th the market cap share on the right axis. In this case we are looking only at large cap stocks using the S&P 500. The exhibit shows that while profits have indeed increased as a share of world GDP, valuation has inflated to a much larger degree.

While profits for large cap U.S. equities have increased as a share of world GDP, values have gone up much more.

Figure 9: U.S. Equity Value as a Share of World GDP vs. Profit Share

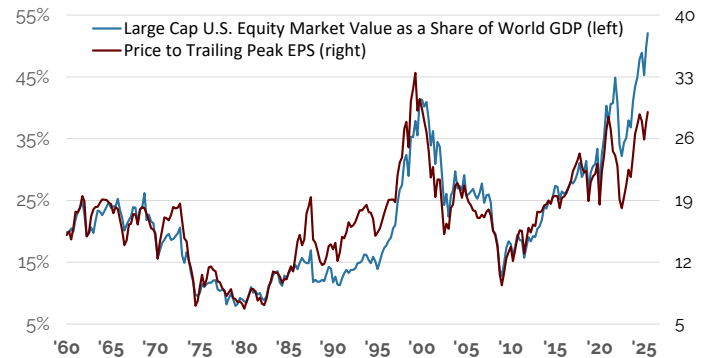


Source: FactSet

[Figure 10](#) depicts total market value of large cap U.S. equities in relation to world GDP but overlays it with the valuation multiple of peak reported trailing net income. Consistent with the earlier analysis of valuations using a variety of metrics, the total value of U.S. large cap stocks is at a record level of world GDP because of historically rich valuation multiples, though not at the record level set during the TMT bubble.

While profits for large cap U.S. equities have increased as a share of world GDP, values have gone up much more.

Figure 10: U.S. Equity Value as a Share of World GDP vs. Multiple



Source: FactSet

We think it is useful to look at equities in relation to world economic activity or GDP because this ratio provides an intuitive check and natural limit to how valuable equities can become as U.S. equity profits can only grow so large in relation to the total global economic output. While this latter figure has risen, it has increased in a way that makes sense given the increasingly global nature of U.S. corporations and does not look untethered from what would seem reasonable. The value of U.S. stocks as a share of global GDP, on the other hand, looks much more worrying in a historic context and is consistent with the valuation concerns discussed earlier.

Equity Valuations vs. Bonds

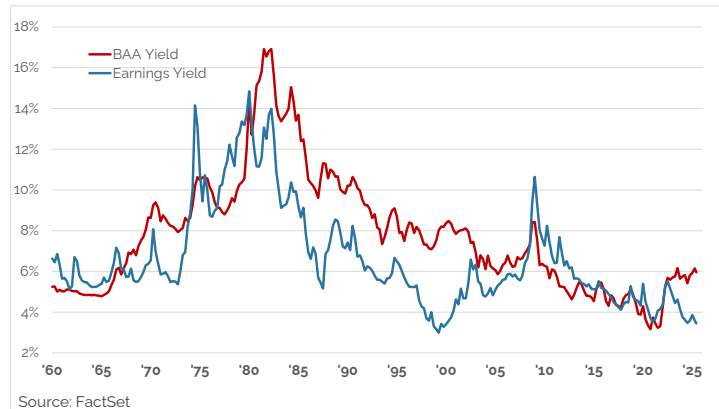
What explains the richness of equity multiples at present? To start with, equity multiples are a function of interest rates. If an investor can earn a 10% risk free rate on a 10-year government bond, he or she will demand a higher equity free cash yield or earnings yield (the inverse of the valuation multiple) to compete with that alternative. Underlying earnings and cash flows grow, however, while the bond payments underpinning that treasury yield do not, and so growth expectations also factor into the relationship between the two. So too does the risk that equities may trade at a lower multiple in the future or that expected future growth could disappoint. Because views about future growth as well as the demanded risk premium are subject to investor sentiment, equity valuations can fluctuate significantly over time and indeed have.

Historically, the earnings yield (inverse of the P/E) on peak trailing reported earnings per share has generally tracked the yield on riskier BAA-rated corporate bonds (See [Figure 11](#)). Since BAA bonds also carry a risk premium over risk free government bonds and trade at a spread to the government rate, this means that the additional equity risk premium over BAA bonds has historically been roughly equivalent to expected growth in earnings. While the relationship isn't perfect and at times the equity yield has been lower or higher, the two yields have broadly moved in tandem for much of history.

During the final stages of the TMT bubble, however, the two moved in opposite directions and they have done so again most recently. Then as now, there was enormous optimism about future growth and seemingly little concern about downside risk and thus a diminished risk premium.

The S&P 500 yield (inverse of P/E) on peak reported earnings has generally tracked the BAA corporate bond yield.

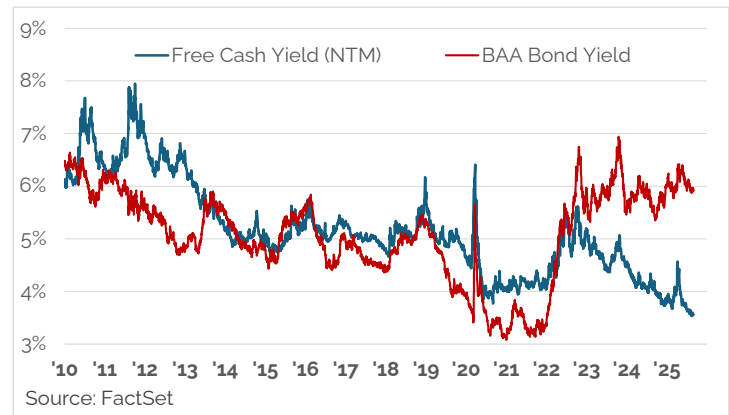
Figure 11: S&P 500 Peak EPS Yield vs. BAA Yield



The same analysis utilizing forward estimated free cash flows tells a similar story. That data series for the S&P 500 begins only around 15 years ago, but over that time the equity free cash yield has generally tracked the BAA yield fairly closely. Starting a few years ago, however, the two began to separate (See [Figure 12](#)).

The equity free cash yield similarly tracked the BAA yield until recently.

Figure 12: S&P 500 NTM Free Cash Yield vs. BAA Yield

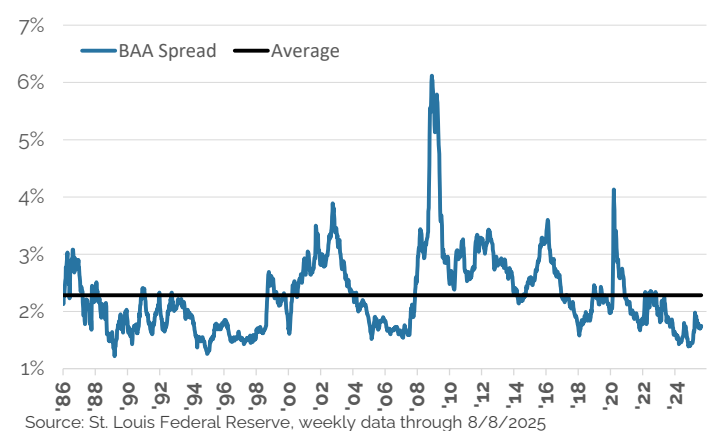


This divergence between equity valuations and fixed income alternatives suggests that equity investors are pricing in significantly better growth prospects than they have historically, are demanding a much lower risk premium, or a combination of the two.

As an alternate measure of risk appetite in financial assets, high yield bonds (those rated worse than BAA and that are at even greater risk of default) are trading near the lowest ever spread versus 10-year government bonds. This is indicative of aggressive investor behavior toward risk generally (See [Figure 13](#)). That bonds are trading at a near record low spread to the underlying government rate also means that the equity divergence from those bond yields is even more anomalous and potentially risky on a going forward basis.

Junk bond spreads are near record lows.

Figure 13: High Yield Bond Spread



Big 8 Growth Scenarios

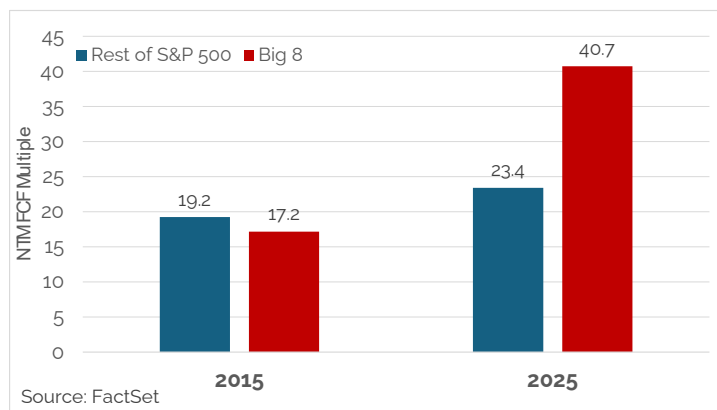
At present, the market looks to be pricing in extraordinary levels of future growth and there is substantial risk even in scenarios where fundamentals do accelerate sharply. Much of this risk, however, is concentrated in a small number of very large stocks. While those stocks have seen significant fundamental growth over the past ten years and this has helped propel them to their current dominance in the market, they have also benefited from enormous valuation expansion.

Ten years ago, the current largest eight stocks in the S&P 500 with forward free cash estimates (NVDA, MSFT, AAPL, GOOGL, AMZN, META, AVGO, TSLA) accounted for 12.5% of the S&P 500 by market cap but 13.8% of total expected next twelve-month free cash flows. Since that time, next twelve-month free cash flows for this group have grown at a staggering 16% annualized nominal rate and now account for 27% of expected next twelve-month free cash flows for all S&P 500 stocks with estimates. While this growth and scale is incredibly impressive, they now account for a much larger 39% of the market cap of S&P 500 companies with free cash flow estimates. This disconnect is the result of the collective value of these companies growing 10 percentage points more per year than their underlying free cash flows as their valuations expanded enormously.

The market ten years ago did not expect this outcome. These 8 stocks a decade ago traded at a below market multiple of 17.2x NTM FCF versus the rest of the market at 19.2x. Post 10 years of 16% growth in cash flows and a much larger market cap increase, this group of 8 stocks is now trading at a multiple of 40.7 vs. 23.4x for the rest of the market (See [Figure 14](#)). Said differently, the market 10 years ago missed that these stocks would grow rapidly and priced them at a slight discount, but today it is pricing them for enormous continued growth at nearly double the valuation of the rest of the market.

The current biggest 8 stocks with free cash estimates traded at a discount to the market before growing much faster than it but now trade at nearly double the valuation of the rest of the market and are discounting enormous continued growth.

Figure 14: Big 8 vs. Rest of Market Valuation in '15 & '25



Given the substantial continued growth implicit in the stock prices of these companies and given their sheer size, it is worth returning to our earlier analysis of different growth and valuation scenarios as well as what is implied against the metric of world GDP.

Should these eight stocks continue growing free cash flows at the 16% rate of the prior ten years while the rest of the market grows at the rate it experienced over that period and if multiples were to stay at current levels for each group, those eight stocks would see their collective market cap grow to \$91 trillion which would equate to 50% of world GDP. That figure is larger than the entire S&P 500's current 47% of world GDP. Similarly, the group's collective free cash share of world GDP would amount to 1.2% versus the entire S&P 500's current 1.7%. The eight stocks would also comprise around 60% of the S&P 500 by market cap (See [Table 1](#) below). While none of this is entirely implausible, it does stretch economic logic and suggests that it is unlikely that these stocks will see a repeat of the last decade over the coming one. We would also note that while capital expenditures for some of these stocks are elevated and one could argue free cash is therefore understated, NVDA and AVGO are primary beneficiaries of this spend and so free cash flows for the full group as a whole do not seem low.

Table 1

FCF Growth Same as Last 10 & 2035 Multiple Same			
	Big 8	492	S&P 500
FCF 2025	\$ 510,577	\$ 1,389,345	\$ 1,899,921
Share of S&P 500	27%	73%	100.0%
Share of World GDP	0.4%	1.2%	1.7%
'25 to '35 FCF Growth	16.0%	6.7%	10.0%
FCF 2035	\$ 2,243,269	\$ 2,665,012	\$ 4,908,281
Share of S&P 500	46%	54%	
Share of World GDP	1.2%	1.5%	2.7%
2025 FCF Multiple	40.7	23.4	28.1
2025 Market Cap	\$ 20,795,731	\$ 32,518,939	\$ 53,314,670
Share of S&P 500	39%	61%	
Share of World GDP	18%	29%	47%
2035 FCF Multiple	40.7	23.4	31.3
2035 Market Cap	\$ 91,368,052	\$ 62,377,167	\$ 153,745,219
Share of S&P 500	59%	41%	
Share of World GDP	50%	34%	84%
'25 to '35 Mkt Cap Growth	16.0%	6.7%	11.2%

Consider an alternate scenario where fundamental growth for the group of eight slows to a still remarkable 10% nominal rate for the next decade while the rest of the market grows at the same 6.7% rate it generated in the last 10 years. In this scenario, we also presume a more normal 25x multiple of free cash flows at the end of the period for the group of eight given moderated growth over time. The scenario keeps constant the 23.4x multiple for the rest of the market. The net result in this scenario is that while the group of eight will generate a 4.8% return to investors over the period, it will lag the balance of the market by almost 2% per year. So even in a scenario where these stocks still grow rapidly and their free cash flow share of global GDP increases from 0.4% to 0.7%, they could still trail behind the rest of the market if multiples adjust. Details are shown in [Table 2](#).

Table 2

FCF Growth 10% & Multiple 25x			
	Big 8	492	S&P 500
FCF 2025	\$ 510,577	\$ 1,389,345	\$ 1,899,921
Share of S&P 500	27%	73%	100.0%
Share of World GDP	0.4%	1.2%	1.7%
'25 to '35 FCF Growth	10.0%	6.7%	7.7%
FCF 2035	\$ 1,324,305	\$ 2,657,383	\$ 3,981,688
Share of S&P 500	33%	67%	
Share of World GDP	0.7%	1.4%	2.2%
2025 FCF Multiple	40.7	23.4	28.1
2025 Market Cap	\$ 20,795,731	\$ 32,518,939	\$ 53,314,670
Share of S&P 500	39%	61%	
Share of World GDP	18%	29%	47%
2035 FCF Multiple	25.0	23.4	23.9
2035 Market Cap	\$ 33,107,625	\$ 62,182,762	\$ 95,290,388
Share of S&P 500	35%	65%	
Share of World GDP	18%	34%	52%
'25 to '35 Mkt Cap Growth	4.8%	6.7%	6.0%

Finally, in a scenario where these eight companies do not grow faster, but instead grow free cash flow in line with the balance of the market at a 7% rate and all stocks trade at a NTM FCF multiple of 20x at the end of the period, the annualized market cap growth of the big 8 stocks would trail the other 492 stocks by 5.6 percentage points per year (See [Table 3](#)). Even in this scenario, the free cash flow share of GDP for these eight stocks would increase to 0.55%, a figure that many forces, regulatory and competitive, would seek to diminish.

Table 3

FCF Growth 7% & Multiple 20x			
	Big 8	492	S&P 500
FCF 2025	\$ 510,577	\$ 1,389,345	\$ 1,899,921
Share of S&P 500	27%	73%	100.0%
Share of World GDP	0.4%	1.2%	1.7%
'25 to '35 FCF Growth	7.0%	7.0%	7.0%
FCF 2035	\$ 1,004,382	\$ 2,733,051	\$ 3,737,433
Share of S&P 500	27%	73%	
Share of World GDP	0.5%	1.5%	2.0%
2025 FCF Multiple	40.7	23.4	28.1
2025 Market Cap	\$ 20,795,731	\$ 32,518,939	\$ 53,314,670
Share of S&P 500	39%	61%	
Share of World GDP	18%	29%	47%
2035 FCF Multiple	20.0	20.0	20.0
2035 Market Cap	\$ 20,087,641	\$ 54,661,020	\$ 74,748,661
Share of S&P 500	27%	73%	
Share of World GDP	11%	30%	41%
'25 to '35 Mkt Cap Growth	-0.3%	5.3%	3.4%

The purpose of these scenarios is to show that even if this group of stocks does continue growing at levels well above the rest of the market over the next decade, there is significant price risk from their current valuation levels. The market mispriced these stocks ten years ago when they traded at a discount before growing much more rapidly and it is entirely possible that it is doing so again now.

Final Word

We cannot foretell the future, but we can look at what present valuations are discounting.

Equity valuations are driven by expectations about growth and some demanded risk protection and so are highly subject to sentiment. Sometimes, greed prevails, and enormous optimism gets priced into valuations. At other times, fear dominates, and investors seem only to focus on worst case scenarios. Ben Graham described it as Mr. Market 76 years ago when he wrote the *Intelligent Investor* and despite all we have learned, it still applies. It also explains how a market multiple of free cash flow can range from roughly 10x to 50x over time.

Current valuations give strong reason for caution. For the market in aggregate to offer average returns over the next decade, either multiples will have to reach new highs or stay near tech-bubble records, or growth will have to break out to levels never before achieved even in periods of tremendous economic and technological progress. In other words, and using the language from the beloved film “*Spinal Tap*”, either multiples or growth will need to go to eleven. While possible, we do not think it is prudent for long-term investors to be relying on “these go to 11” as their base case.

Fortunately, much of the optimism that is priced into the market at present and the related valuation risk is focused on a small number of very large stocks. Elsewhere in the market, there remain a large number of stocks with what we believe to be attractive valuations and favorable risk/reward profiles.

Given this market structure, for patient long-term investors we think our value-oriented strategies offer an attractive counter to the “these go to 11” dynamic that hinges on either peak multiples or growth well beyond what has been achieved historically.

The current backdrop looks reminiscent in many ways of the market 25 years ago and we worry that investors may again be ignoring significant valuation risk. The internet has been a truly transformative technology and significantly more impactful than likely even many of the biggest optimists back then imagined. But even in spite of this extraordinary success and resulting growth, share prices collapsed under the weight of enormous multiples and it took the S&P 500 almost a decade to get back to where it was as multiple compression far more than offset fundamental growth. In spite of the significant consolidation for the broader market in that period, the equal weighted index that better captures the performance of the average stock did remarkably well as it was much less encumbered by lofty valuations and expectations. While the S&P price index was essentially flat from March 2000 to July 2007, the S&P Equal Weighted index rose by over 80%. Given valuations that increasingly resemble that time, it would not seem unreasonable if a similar dynamic played out over the coming decade.

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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.

Methodology Notes for **Portfolio Characteristics Tables (Appendix)**: 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. **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 **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).

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