ValueInvestor INSIGHT
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Investor Insight: Davis Advisors

Davis Advisors' Chris Davis and Danton Goei describe what they believe sets true "compounding machines" apart from pretenders, their hoped-for value-add in assessing management, the soul searching they've done after a relative-performance swoon, and why they see mispriced value in Lafarge, Wells Fargo, Encana, Ultra Petroleum and Express Scripts.

You've said your research process starts with asking, "What kind of businesses do we want to own?" What's the general answer to that question?

Christopher Davis: We're looking for businesses with high or improving returns on capital that are run by first-class management teams and that have the financial strength to weather difficult environments. Equally important is the sustainability of those returns, supported by things like strong brands, intellectual property, low costs, distribution advantages, growing end markets and limited risk of technological obsolescence. We'll often find opportunity because the market doesn't look out far enough to correctly value durable competitive advantages. Sometimes we'll just perceive a business as being great that the market doesn't – my grandfather called them "growth stocks in disguise."

Two examples we've owned for a long time – related in the news of late because the nature of their relationship changed – would be Costco [COST] and American Express [AXP]. Both have produced excellent returns on equity over long periods. Both have quantifiable competitive advantages: Amex cards generate more than three times the amount of spend per card of the competition, while Costco has roughly twice the sales per square foot of other major warehouse chains. The business models are obviously different – for Amex it's about brand, security and service, for Costco it's about scale, low costs and low prices – but similarly durable.

The appeal of these types of businesses is their ability to compound value. If you're going to own a company for a long time, the earnings it generates today will be a small component of the eventual return. Much more important will be how those earnings can be reinvested over time to build value. When companies with positive compounding characteristics become available at really attractive prices, we'll hope to take advantage.

You mention the importance of first-class management. What do you consider your – or any investor's – value-add in judging that?

CD: There is a risk of the halo effect, where if the business has done well, everybody assumes management must be good. We try to differentiate ourselves in judging management around this idea of understanding reinvestment. You often see companies invest at increasingly lower rates of return simply to get bigger. CEOs of bigger companies, by and large, make more money, so they'll reinvest in growth even if the incremental returns from that investment are low.

That's exactly what we don't want to see. We want there to be a clear understanding of incremental returns on capital and that returns matter more than size. That gets to the heart of a company's culture, along with things like how management communicates, how they pay themselves and the accounting choices they make. What constitutes great management isn't as universally held as you might think, and to figure it out takes quite a bit more insight than just analyzing trailing financial results.

Christopher Davis, Danton Goei

Joint Effort

Though he's known for holding what he considers "compounding machines" indefinitely, certain events give Chris Davis particular pause about even his highest-conviction positions. For example, he says, "Risk increases when we see a management transition."

His firm went through a transition of its own at the start of 2014, when Danton Goei replaced 20-year Davis Advisors' veteran Ken Feinberg as the co-manager with Davis of the firm's flagship New York Venture and Selected American Shares funds. With the large-cap funds' mired in a relative-performance slump, Davis decided the risk of inaction warranted rocking the boat.

Why not take the reins alone? "The funds have been run mostly with co-managers since my father started them," says Davis. "I prefer that because so many risks in investing are behavioral and having the right partner can help mitigate those types of risks. It requires an enormous amount of trust and the willingness to challenge each other, and Danton and I share full responsibility for every decision. We enjoy working like that and fully believe it's in the best interest of our investors – of which my family is the largest."

How would you handicap the management of portfolio holding Google [GOOG]?

CD: The fact that Google has a spectacular business was obviously the result of a stunning insight by the founders, and the fact they've been able to capitalize on it as they have is a demonstration of good management. But what will define Google as a successful investment over the next 10 to 20 years will be how they reinvest the profits made from this extraordinarily good business they have today. We have to have insight into their ability to invest to create value over time.

On the plus side, we very much like their long-term focus on building a durable business, not just maximizing today's profits and revenues. They have invested to protect the moat around the search business and there's data to indicate thoughtful reinvestment in M&A, research and development and infrastructure. Things that seemed odd at the time – acquiring YouTube for $1.65 billion, or DoubleClick for $3.1 billion, or even Android for $50 million – make a lot of sense now. We also admire that Larry Page and Sergey Brin take virtually no compensation and don't annually load themselves up with additional stock options, which often happens in technology companies.

On the other hand, we're not fond of the two-tier stock system and the overall disregard for shareholder input. We're concerned, for example, by the large compensation packages granted to non-technical executives. Is that really necessary? In many areas being at Google is probably much easier than the comparable position would be at, say, General Motors. Given the strength of Google's cash flow and balance sheet the company should also be returning capital to shareholders. So it's not a perfect management record, but the positives outweigh the negatives.

What's typically going on that makes quality businesses mispriced?

CD: I don't know that there's a "typical" situation, but opportunities do fall in common buckets. We often look where there's complex accounting that may cause misunderstanding about the quality of the business. We are attracted to management changes – particularly when we know well the person or people coming in – which generate uncertainty and can be a result of recent or even chronic underperformance.

We pay attention when industries are under a cloud or transforming, a classic example being the managed-care business a few years ago when everyone was scared about the introduction of the Affordable Care Act and we could buy something like UnitedHealth [UNH] at 10x earnings even though we saw it thriving long-term in almost any plausible regulatory scenario. We also try to take advantage of cyclicality and earnings volatility, but around a rising long-term trend rather than a stagnant one or worse.

We find sometimes that the market doesn't recognize how scalable companies with proven records of success can be. It's now more reflected in the stock, but a good example we own is Costco [COST] as it has transformed itself from a domestic company to more of an international one. If you earn a 15% return on capital and a 13% return on opening new stores and the saturation point is expected to be five years, the valuation changes dramatically when that saturation point because of global growth moves out to 20 years. In a similar way, investors were slow to appreciate the global potential of a number of U.S.-based Internet companies.

Spinouts continue to provide opportunity. Late last year we bought shares of Citizens Financial [CFG], the U.S. regional bank spun off by Royal Bank of Scotland. You had a large foreign bank being forced by regulators to divest its U.S. business at a time when very few U.S. banks were in a position to do acquisitions. The CEO was relatively unknown, coming over from the CFO position at RBS, and Citizens had no track record as a public company. There was 25-30% more capital in the business than it needed. All that to us indicated this was a good place to look.

ON AIRLINES:

Our view is that this is still a capital-intensive, commodity business where barriers to entry are not that high.

Are there industries you tend to avoid out of hand?

CD: When you write off an industry because everybody knows it's been so bad for so long, that's often the time you should be looking. Think of energy in the late 1990s when oil was at $12 and it had been a lousy business since 1981, or of railroads until the last decade or so. The willingness to keep an open mind and take a fresh look is something we challenge ourselves to do all the time, but it never comes easily.

On long-considered-lousy businesses, have you taken a fresh look at U.S. airlines?

Danton Goei: We have, and certainly missed the run in their stocks to date as consolidation has had a very positive impact. Our view, though, is that this is still a tough, capital-intensive, commodity business where barriers to entry are not that high. We're not convinced today's positive dynamics will persist over time.

CD: We think the comparison here with railroads is being made a bit lightly. Airline consolidation has been powerful, but one big difference with railroads is that they own the track. Airlines' control over routes and gates is less certain. In addition, while there are scale advantages, upstart airline competitors will likely still be able to cream off a route or two at a time, or they'll start with a new fleet of planes and capitalize on the fuel-cost advantage. We're not sure things are really as different this time as the market seems to believe.

DG: Given how we invest, it's critical that we always challenge the assumption that a business model is carved in stone, good or bad. Our biggest sale over the past year or so has been Bed Bath & Beyond [BBBY], which we had owned for a long time. Warren Buffett has said that 20% of the S&P 500 will earn less in five years than they earn today, and the changed competitive dynamics in Bed Bath & Beyond's business leads us to believe it very well may fall in that category. We have only the highest regard for the company and its management, but their hand has just gotten much tougher to play.

Describe your valuation discipline and its emphasis on "owner earnings."

DG: We value companies based on normalized free cash flow, where we strip out the quirks of generally accepted accounting principles to arrive at the excess cash a business generates – or could generate – after reinvesting enough to maintain current capacity and competitive advantages, but before investing in growth. That can result in any number of adjustments, relating to things like extraordinary items, differences between maintenance capital spending and depreciation, pension assumptions or the cost of stock options.

We look out three to five years, targeting a 10% owner-earnings yield on the current stock price at some point over that period. If we believe at the point it hits 10% that the business will still have durable competitive advantages and that capital will be invested at high incremental rates, the current price can be a great starting point for us.

CD: For most companies, GAAP reporting reflects accounting policies that maximize current reportable income, say by capitalizing things that ought to be expensed, or by using depreciation schedules that are unrealistically long. For those companies our calculation of owner earnings will be less than the earnings reported. The companies we want to own, on the other hand, are those with owner earnings that are the same or higher than GAAP earnings. That's a smaller universe, with companies that might appear optically expensive but that we consider actually quite cheap. The accounting choices made also give us insight into the management and culture.

Your large-cap portfolios hold around 60 positions. Why is that?

CD: The simple answer is that we like the benefits of concentration and focus, but we like the benefits of diversification too. Our 20 largest holdings make up close to half of the portfolio, so our best ideas can make a real difference. At the same time, we're leery of outsized positions. As a general rule, we don't want our top five positions to exceed 25% of the portfolio.

ON AMERICAN EXPRESS:

We expect the business to be as resilient and adaptable to future challenges as it has been to past ones.

What is your typical holding period?

DG: Annual turnover averages 15-20% over time. In the last five to six years it's been closer to 10%. What's going to drive our performance over time is maintaining core holdings of compounders, not from trading in and out of positions.

Have the recent travails at American Express sparked any action?

CD: To give you some color on how we think about things, American Express was founded by three people in 1852, two of whom, Mr. Wells and Mr. Fargo, a couple years later started a bank you may have heard of. Amex is a company that has shown enormous resiliency and adaptability for the past 163 years.

We don't believe the short-term issues impacting the stock, like Costco finding another credit-card partner, take away from American Express' core strengths and ability to compound long-term value for shareholders. What we worry more about are challenges in the future from technological change. So far the company has mostly been a beneficiary of that change as credit and debit cards take share from cash and checks, which has only been amplified as commerce shifts online. We expect the business to be as resilient and adaptable to future challenges as it has been to past ones.

DG: To your question of whether we've traded in the stock on the recent weakness, the answer is no. It was already a large position and remains a large position.

None of this is to say we won't sell into strength and buy into weakness. As Costco's owner-earnings yield has fallen as low as 4%, for example, we still own it but have reduced our position. On the other hand, we've added to our position in Las Vegas Sands [LVS], the casino company whose shares have been hit hard by a sharp decline in its Macau business. We've concluded that while the near-term outlook in Macau overall is bad, the company still makes good money there and is less exposed to the junket-driven and VIP businesses that have fallen off a cliff. That leaves it well positioned in a high-barrier market that over time should benefit from powerful secular trends. While we wait for that to play out, we're earning a dividend yield on the current price of over 4.5%.

Turning to specific ideas, what do you think the market is missing in cement and aggregates company Lafarge [LG:FP]?

CD: We have a long history investing in these types of companies in the U.S., having been large holders at times in both Martin Marietta Materials [MLM] and Vulcan Materials [VMC]. We like the dynamics of the business, as permitting restrictions and high transportation costs relative to the end product's value tend to favor established players and limit competition in local markets. We've watched such businesses create considerable value over long periods.

Lafarge, based in France, is the world's largest producer of cement, aggregates and concrete, with cement accounting for roughly 60% of revenue and 80% of operating profit. The company has a poor record of capital allocation, but one positive from excessively priced acquisitions is that it generates roughly two-thirds of its business in emerging markets, where modernizing economies will drive strong infrastructure spending for decades to come.

We think there are a number of things helping to create the investment opportunity here. The company is merging with Holcim – the #2 to Lafarge's #1 globally – which has engendered both controversy and uncertainty. While the U.S. recovery in cement and aggregates is underway, the business in Europe and emerging markets is cyclically weak. There's also the legacy of lousy capital discipline, particularly on the Lafarge side.

We don't believe the market is recognizing the potential synergies from the merger. While it's true that scale economies don't mean much across an entire geographic portfolio, there are plenty of centralized costs to cut and in local markets, particularly in Europe, the combination with Holcim should take out excess capacity and have a positive impact on pricing power over time. We've seen that happen after consolidation in the U.S.

We also think corporate governance has and will continue to improve now that around one-third of the combined business will be owned by two shareholders with long track records of smart capital allocation: Nassef Sawaris, who built competitor Orascom prior to selling out to Lafarge, and GBL, the second-largest listed holding company in Europe. There was some drama over who should run the combined company, but while we expect the new CEO to do a fine job, we think board oversight is what will really matter in the end. Having Nassef Sawaris and GBL weighing in at the board level helps reduce the execution risk.

Finally, if you believe a rebound in infrastructure spending eventually happens across a number of challenged markets, the upside is even more interesting.

How interesting relative to today's share price of around €63?

DG: We think the cyclical improvement in the relevant developed and emerging markets gets us to an 8.5% owner earnings yield on today's price within a couple years. When we build in the cost and other benefits of the merger over that period, the earnings yield looks more like 12-13%. At that point we expect to own a business with attractive returns and above-average, if cyclical, growth potential.

The Holcim shareholder vote to approve the merger is on May 8. Is there risk it doesn't go through?

DG: The benefits of the deal are considerable, so we'd be surprised if it's voted down. A bigger risk is that to get final regulatory approval they have to make divestments beyond what has already been announced. There's some uncertainty there, but again, if the U.S. experience is a guide, there will be plenty of opportunity to improve the competitive dynamics across a very large portfolio of businesses.

You've been branded, not always favorably, as a fan of big banks. Explain your enthusiasm today for Wells Fargo [WFC].

CD: I wouldn't say we have any particularly high regard for financial stocks in general. For example, the idea to me of investing in a financial-services ETF has zero appeal. But banking today has many of the characteristics we look for. It can be complicated to analyze and there's some

INVESTMENT SNAPSHOT

Lafarge
(Paris: LG)

Business: Provider of building materials such as cement and aggregates to contractors, wholesalers and manufacturers in Europe, Africa, Asia and the Americas.

Share Information
(@4/29/15, Exchange Rate: $1 = €0.899):

Price	**€62.94**
52-Week Range	€48.51 – €67.94
Dividend Yield	2.0%
Market Cap	€18.12 billion

Financials (2014):

Revenue	€12.84 billion
Operating Profit Margin	11.4%
Net Profit Margin	2.1%

Valuation Metrics
(@4/29/15):

	LG	S&P 500
P/E (TTM)	125.9	21.0
Forward P/E (2015 Est.)	22.8	18.0

THE BOTTOM LINE

Merger uncertainty, cyclical economic weakness and a history of poor capital allocation are weighing more heavily on the company's stock than its long-term prospects should warrant, says Chris Davis. Driven by organic growth and merger synergies, he expects within two years to be earning a 12-13% owner-earnings yield on today's share price.

Sources: Company reports, other publicly available information

subjectivity in how results are presented. Banks are difficult to make obsolete and if they're good, they can grow for a long time without saturation.

We also like that a company's culture, which doesn't show up in a computer screen, can be a defining competitive advantage. Well-run banks regularly surprise on the upside, with their reserves constantly proving redundant, or their credit quality constantly better than the allowances for losses. That can make for an extremely durable business, yet there's still a perception because of the financial crisis that it's a very risky one to own. That provides in certain cases the last piece of the puzzle today, an attractive share price.

Wells Fargo is an excellent example of all that. If you looked at its return on equity over the past 40 years, you'd see it in the double digits probably 90% of the time, averaging 15% and never negative. Benchmark that against a quality consumer-products or pharmaceutical company, and you'd expect it to trade today at a 20x P/E, not 13x on below-normal earnings.

What in your view makes Wells unique?

CD: We basically expect its owner earnings to be more predictable and durable. That's partly a function of its culture, which is one of focus, pragmatism and execution. Its business model is narrower than other big banks, so it has less funding risk, less capital-markets exposure and lower regulatory risk. They know what they do well and they stick to it.

Wells also benefits considerably from its size. Its market share of new loans being generated across its lending categories is almost uniformly higher than its market share of existing loans. People whose mortgages are coming due, for example, have fewer choices than they've historically had, so Wells is able to take share. We also pay a lot of attention to deposit density, because banks with top deposit shares in individual markets typically take a disproportionate share of the profits in those markets. Wells is #1 in deposits in more U.S. metropolitan statistical areas than any other large bank.

How cheap do you consider the shares at today's $55.50?

DG: We're expecting about $4.20 per share of owner earnings this year, resulting in a current earnings yield of 7.6%. We think that's a great starting point for a business of this quality, which while it may be overearning a bit on credit is underearning in other areas such as net interest margin. Within two or three years we expect normal earnings of around $5.50 per share, at which point our owner-earnings yield rises to 10%.

One risk would seem to be if Wells' return-on-equity history turns out not to be applicable to the environment going forward for banks. How do you assess that?

CD: It is true that if banks have to hold more capital, all things being equal, their returns on capital will be lower. That would depress valuation. But we believe offsetting that is that there is likely to be less competition, which should incrementally benefit returns of the biggest and best banks like Wells. We expect its incremental ROE to be 12-14%, maybe a bit below historical levels but still satisfactory.

INVESTMENT SNAPSHOT

Wells Fargo
(NYSE: WFC)

Business: Provider of banking, insurance, investments, mortgage, and consumer and commercial finance services through a broad U.S branch network and online.

Share Information
(@4/29/15):

Price	**55.46**
52-Week Range	46.44 – 56.29
Dividend Yield	2.6%
Market Cap	$286.33 billion

Financials (TTM):

Revenue	$83.32 billion
Operating Profit Margin	43.2%
Net Profit Margin	27.6%

Valuation Metrics
(@4/29/15):

	WFC	S&P 500
P/E (TTM)	13.6	21.0
Forward P/E (Est.)	13.3	18.0

Largest Institutional Owners
(@12/31/14):

Company	% Owned
Berkshire Hathaway	9.0%
Vanguard Group	5.2%
State Street	4.2%
BlackRock	3.5%
Fidelity Mgmt & Research	3.0%

Short Interest (as of 4/15/15):

Shares Short/Float	0.6%

WFC PRICE HISTORY

THE BOTTOM LINE

Benchmark the company's 40-year history of returns on equity against quality consumer-products or pharmaceutical firms, says Chris Davis, and you'd expect its shares to trade at a 20x P/E rather than the current 13x. On his $5.50 estimate of normalized EPS, the stock today trades at what he considers a highly attractive 10% owner-earnings yield.

Sources: Company reports, other publicly available information

The higher capital requirements also make banks far safer investments, which should support higher valuations.

I come back to my earlier point: Compared to the average American business, Wells has well-above-average resiliency and durability, reasonable earnings-per-share growth potential and below-average risk of competitive erosion, but its stock trades at a below-average valuation. It's really hard for me to imagine a U.S. large-cap manager who owns 40 to 50 positions not having a good-sized stake in Wells.

The dislocation in energy has attracted your interest. Why does Encana [ECA] go to the head of the class?

CD: The market from time to time gives us the opportunity to buy businesses that may not fit the profile of a classic compounding machine, but are so out of favor that you can see value compounding very well nonetheless. That's true today in energy, where our focus has been on companies that due to the nature of their assets can reinvest over long periods at predictable rates of return, subject only to the energy price. That description fits Encana to a tee.

DG: The company has largely finished a transformation started in mid-2013 when Doug Suttles took over as CEO. It's gone from a top-heavy, do-everything company focused on volumes and reserves to a leaner, highly focused one focused on incremental returns and profitability. Selling, general and administrative costs have been cut in half. Nearly 30 asset plays have been reduced to seven, including properties in the highly productive Montney and Duvernay in Canada and Eagle Ford and Permian in the U.S. Oil production is growing 20-25% annually, but natural gas currently accounts for 80% of total production.

CD: What's transformational about shale resources is the predictability of costs and the ability to turn on and off production spending based on prevailing energy prices. Just those four plays Danton mentioned represent about 8,000 drilling sites, in proven formations, which is about 20 years of activity at the current run rate. So in our analysis we can have high conviction on both the production levels and costs, and then just swing prices around to understand sensitivities.

The transformation effort included two poorly timed acquisitions of U.S. assets last year. Didn't that give you pause?

CD: There's no question they bought at the wrong time, which became doubly negative when they had to raise equity capital because the debt they put on at higher oil prices became riskier at lower oil prices. That's a real black mark, but it's been outweighed in our minds by the asset quality, the long-lived reserves, the predictable rates of return and the strength of the operational execution.

With the shares at a recent $14.20, how are you looking at valuation?

CD: If we use $4 gas and $60 oil, we estimate owner earnings two to three years out at around $1.05 per share. At the longer-term market-clearing prices we expect

INVESTMENT SNAPSHOT

Encana
(NYSE: ECA)

Business: Development, exploration, production and marketing of natural gas, oil and natural gas liquids from properties located in the United States and Canada.

Share Information
(@4/29/15):

Price	**14.20**
52-Week Range	10.53 – 24.83
Dividend Yield	2.3%
Market Cap	$10.53 billion

Financials (TTM):

Revenue	$8.02 billion
Operating Profit Margin	29.5%
Net Profit Margin	42.3%

Valuation Metrics
(@4/29/15):

	ECA	S&P 500
P/E (TTM)	2.8	21.0
Forward P/E (Est.)	n/a	18.0

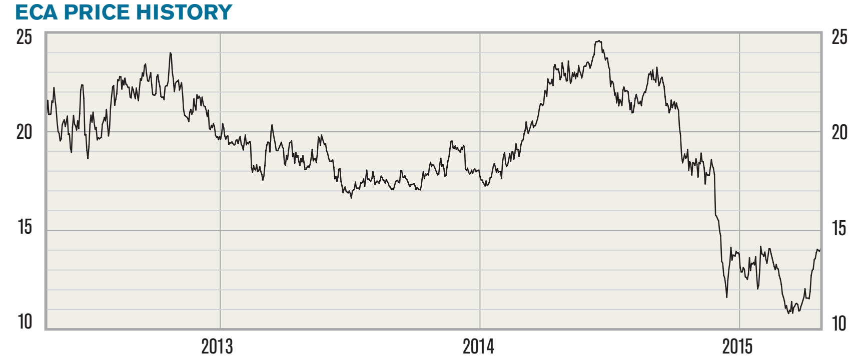
Largest Institutional Owners
(@12/31/14):

Company	% Owned
Davis Advisors	5.3%
RBC Global Asset Mgmt	4.7%
Caisse de Depot et Placement	3.3%
Manning & Napier	3.0%
TD Asset Mgmt	2.7%

Short Interest (as of 4/15/15):

Shares Short/Float	2.0%

ECA PRICE HISTORY



THE BOTTOM LINE

Given the quality, nature and size of its reserve base, the company can continue to reinvest cash flow at 20% returns on equity for a long time, says Chris Davis, driving long-term profit growth that isn't reflected in the current share price. On the normalized $1.50 in EPS he expects within five years, the shares today trade at an earnings yield of 10.5%.

Sources: Company reports, other publicly available information

of closer to $5 gas and $75 oil, that EPS number goes to over $1.50.

So the way we look at it, the earnings yield on today's price is unlikely to go much under 7% and is more likely to be 11-13% five years out. So we have plenty of staying power on the downside and what we think is a nice option on the upside. With proven reserves in proven fields with proven infrastructure, we think they can continue reinvesting cash flow at 20% returns on equity for a long time.

Is your thesis for Ultra Petroleum [UPL] similar?

CD: Ultra is basically a more concentrated version of Encana. The strategy is even more narrow, focused almost exclusively on gas and on one field, 47,600 acres in the Pinedale in southwestern Wyoming. The field is low-cost – returns at $4 gas are over 30% on the capital they need to deploy – is hooked up to great infrastructure, and is only about 35% developed. That means that like Encana, Ultra has many, many years of profitable and predictable production growth ahead.

DG: We didn't mention this earlier, but we don't ascribe to the conventional wisdom that natural gas is forever doomed to stay at current prices. The supply side continues to correct sharply, and while it will be slower, we believe demand for natural gas will materially increase as well. We own shares of OCI N.V. [OCI:NA], a Netherlands-based fertilizer company that has spent heavily to build capacity in the U.S. to take advantage of low prices for natural gas, its primary input. You see that type of thing happening in a variety of industries and we believe will help drive North American gas prices higher long-term.

So we're particularly interested in producers that are still profitable at low prices and have the greatest upside in a higher-price environment. The market is less likely to pay up for that when "everyone knows" natural gas is in oversupply.

Is Ultra's stock, now $16.35, cheaper or more dear than Encana's?

CD: Ultra is a bit higher risk, with higher debt and very little resource diversification. We believe the incremental returns are higher as well so we'd probably pay a higher valuation, but we don't need to.

Using the same base estimates of $4 gas and $60 oil, two to three years' out we estimate per-share owner earnings at around $1.35. That would give us an 8.3% earnings yield on today's price, but we could imagine that at 12% within five years and then doubling from there over the next five years. That's what can happen with 30% incremental returns on invested capital.

Describe your investment thesis for Express Scripts [ESRX].

DG: Our healthcare exposure historically was mostly through large-cap pharma, where we liked the research intensity, the intellectual property and, of course, the growing demand both from aging populations and developing countries. But in recent years we've concluded the opportunity as a healthcare investor will be more in companies focused on helping control costs. In the U.S., healthcare spending accounts for nearly 18% of GDP, a huge gap over Europe at 10-11% and developing

INVESTMENT SNAPSHOT

Ultra Petroleum
(NYSE: UPL)

Business: Exploration and production of natural gas and oil from properties located primarily in Wyoming's Green River Basin and Pennsylvania's Marcellus Shale.

Share Information
(@4/29/15):

Price	**16.34**
52-Week Range	11.31 – 31.43
Dividend Yield	0.0%
Market Cap	$2.50 billion

Financials (TTM):

Revenue	$1.23 billion
Operating Profit Margin	52.2%
Net Profit Margin	44.1%

Valuation Metrics
(@4/29/15):

	UPL	Russell 2000
P/E (TTM)	4.7	70.5
Forward P/E (Est.)	40.8	19.3

Largest Institutional Owners
(@12/31/14):

Company	% Owned
Davis Advisors	12.8%
Baillie Gifford	10.1%
CI Investments	7.6%
Invesco	6.6%
Vanguard Group	5.8%

Short Interest (as of 4/15/15):

Shares Short/Float	18.6%

UPL PRICE HISTORY

THE BOTTOM LINE

The company's resource base is largely undeveloped, with low production costs and excellent access to take-away infrastructure, says Chris Davis, giving it "many, many years of profitable and predictable growth ahead." Based on his EPS estimates, he expects within five years to be earning a 12% owner-earnings yield on today's share price.

Sources: Company reports, other publicly available information

countries in the 5-6% range. Firms that benefit from and contribute to cost control in the system – including big managed-care organizations, third-party lab operators and pharmacy benefit managers [PBMs] – should be well positioned.

PBMs manage the drug benefits offered by managed-care organizations, large corporations and government payers. That involves any number of policy-setting and administrative tasks, but also means negotiating supply agreements and prices paid to drug manufacturers, distributors and pharmacies. Scale in such a business is extremely important both in terms of cost efficiency and buying power, and Express Scripts is the biggest U.S. player in a market in which the top three – CVS Caremark and UnitedHealth are the others – control around 70% of the business.

CD: I would emphasize that we like investing in companies that take cost out of the system in ways that don't feel offensive to the end user. There are sometimes sensitivities around things like pushing a generic substitution, but by and large the efforts a PBM like Express Scripts makes to save money for its customers and their end users are considered win-wins. If getting your prescription filled through the mail under Express Scripts' direction saves money and everyone shares in that, that's not overly controversial.

This is also a good example of a business that is able to grow without spending that much capital. Earnings for several years have compounded at more than 20% per year, but the company at the same time is returning a significant amount of cash to shareholders. Over the last four years it has bought back 7-8% of its shares each year.

The shares, now around $85, have doubled since the peak healthcare-reform fears in 2011. What upside do you see from here?

DG: We estimate 2015 owner earnings at around $5.40, so the stock trades today at a below-market P/E of less than 16x. If EPS grows as we expect over the next two to three years at 12% or so annually, we'll get to an earnings yield on today's price of around 7.5%. While that's not remarkably cheap, we consider it attractive for a market leader in a non-obsoletable business where size matters and where it should benefit from secular tailwinds for many years to come. This is the type of compounder we could see holding onto for a long time.

When we first spoke [*VII*, May 31, 2007] you were proud of your flagship large-cap fund beating the S&P 500 in every 10-year rolling period since 1969. Talk about the soul searching that's gone on as that winning streak has been broken.

CD: We've always had two goals, protect our shareholders' capital by producing positive absolute returns, while also providing above-market returns on average over time. Over the past four or five years we've done a great job with the first goal, but haven't lived up to our standards on the second.

The first point I'd make is that having excellent absolute results and lagging relative results is neither a new or particularly uncomfortable position for us. We operate

INVESTMENT SNAPSHOT

Express Scripts
(Nasdaq: ESRX)

Business: Provider of pharmacy benefit management services to customers including HMOs, health insurers, employers, unions and governmental health programs.

Share Information
(@4/29/15):

Price	**84.79**
52-Week Range	64.64 – 89.59
Dividend Yield	0.0%
Market Cap	$61.79 billion

Financials (TTM):

Revenue	$100.89 billion
Operating Profit Margin	4.6%
Net Profit Margin	2.0%

Valuation Metrics
(@4/29/15):

	ESRX	S&P 500
P/E (TTM)	31.9	21.0
Forward P/E (Est.)	15.6	18.0

Largest Institutional Owners
(@12/31/14):

Company	% Owned
Vanguard Group	5.5%
Capital Research & Mgmt	5.0%
State Street	4.4%
BlackRock	3.9%
GMO	3.3%

Short Interest (as of 4/15/15):

Shares Short/Float	2.7%

ESRX PRICE HISTORY

THE BOTTOM LINE

A company like this – "a leader in a non-obsoletable business where size matters and it should benefit from secular tailwinds for many years" – should not trade at a discount to the market, says Danton Goei. If that proves true, he expects as a shareholder to at least benefit from the company's low-teens annual EPS growth over the next few years.

Sources: Company reports, other publicly available information

in a world where given the choice of producing a 4% return when the index earns 3% or producing a 12% return when the index earns 14%, most managers would probably choose the first one. Their goal is to get a lot of assets under management and to do so you want to beat the benchmark. We absolutely expect over time to beat the benchmark, but would much prefer in any given year to earn the higher return for our clients.

Against the benchmark we've been hurt more by what we've chosen not to own doing well than by what we've owned doing poorly. We have generally steered clear of companies with high leverage ratios, which have benefited from low interest rates but risk significant problems if the environment changes. We have avoided companies with high dividend yields because of their below-average growth rates and above-average valuations as the market irrationally overpays for yield. As is often the case in longer bull markets, we rarely own the market darlings because we question the long-term durability of their competitive advantages.

What would greatly concern me is if we owned too many things that destroyed value. But that hasn't been the problem, it's been not owning enough of the things that have done well for what our analysis, judgment and discipline tell us are temporary reasons.

History gives us comfort here. Since 1969 the Davis New York Venture Fund has underperformed in 30% of all five-year periods. But in the five years that followed these disappointing periods, the fund beat the market by an average of 6.8% per year. We don't assume the current environment is the permanent state of affairs. VII

The average annual total returns for Davis New York Venture Fund's Class A shares for periods ending March 31, 2015, including a maximum 4.75% sales charge, are: 1 year, 1.49%; 5 years, 10.03%; and 10 years, 5.90%. The performance presented represents past performance and is not a guarantee of future results. Total return assumes reinvestment of dividends and capital gain distributions. Investment return and principal value will vary so that, when redeemed, an investor's shares may be worth more or less than their original cost. The total annual operating expense ratio for Class A shares as of the most recent prospectus was 0.86%. The total annual operating expense ratio may vary in future years. Returns and expenses for other classes of shares will vary. Current performance may be higher or lower than the performance quoted. For most recent month-end performance, visit davisfunds.com or call 800-279-0279.

This reprint is authorized for use by existing shareholders. A current Davis New York Venture Fund prospectus must accompany or precede this material if it is distributed to prospective shareholders. You should carefully consider the Fund's investment objective, risks, charges, and expenses before investing. Read the prospectus carefully before you invest or send money.

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Objective and Risks. Davis New York Venture Fund's investment objective is long-term growth of capital. There can be no assurance that the Fund will achieve its objective. The Fund invests primarily in equity securities issued by large companies with market capitalizations of at least $10 billion. Some important risks of an investment in the Fund are: stock market risk, manager risk, common stock risk, large-capitalization companies risk, mid- and small-capitalization companies risk, headline risk, financial services risk, foreign country risk, emerging market risk, foreign currency risk, depositary receipts risk, and fees and expenses risk. See the prospectus for a complete description of the principal risks.

Davis Advisors is committed to communicating with our investment partners as candidly as possible because we believe our investors benefit from understanding our investment philosophy and approach. Our views and opinions include "forward-looking statements" which may or may not be accurate over the long term. Forward-looking statements can be identified by words like "believe," "expect," "anticipate," or similar expressions. You should not place undue reliance on forward-looking statements, which are current as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate.

The information provided in this material should not be considered a recommendation to buy, sell, or hold any particular security. As of March 31, 2015, the top ten holdings of Davis New York Venture Fund were: Wells Fargo & Co., 6.6%; Google Inc., 6.2%; Bank of New York Mellon Corp., 5.8%; Amazon.com, Inc., 5.4%; American Express Co., 4.9%; Berkshire Hathaway Inc., Class A, 4.7%; Liberty Global PLC, Series C, 4.4%; Express Scripts Holding Co., 4.0%; JPMorgan Chase & Co., 3.6%; CarMax, Inc., 3.0%.

Davis Funds has adopted a Portfolio Holdings Disclosure policy that governs the release of non-public portfolio holding information. This policy is described in the prospectus. Holding percentages are subject to change. Visit davisfunds.com or call 800-279-0279 for the most current public portfolio holdings information.

Broker-dealers and other financial intermediaries may charge Davis Advisors substantial fees for selling its funds and providing continuing support to clients and shareholders. For example, broker-dealers and other financial intermediaries may charge: sales commissions; distribution and service fees; and record-keeping fees. In addition, payments or reimbursements may be requested for: marketing support concerning Davis Advisors' products; placement on a list of offered products; access to sales meetings, sales representatives and management representatives; and participation in conferences or seminars, sales or training programs for invited registered representatives and other employees, client and investor events, and other dealer-sponsored events. Financial advisors should not consider Davis Advisors' payment(s) to a financial intermediary as a basis for recommending Davis Advisors.

Five Year Under/Outperformance. Davis New York Venture Fund's average annual total returns were compared against the returns of the S&P 500® Index for each five year period ending December 31 from 1974 to 2014. The Fund's returns assume an investment on the first day of each period with all dividends and capital gain distributions reinvested for the time period. The Fund's returns do not include a sales charge. If a sales charge were included, returns would be lower. The figures reflect past results; past performance is not a guarantee of future results. There can be no guarantee that the Fund will continue to deliver consistent investment performance. The performance presented includes periods of bear markets when performance was negative. Equity markets are volatile and an investor may lose money. Returns for other share classes will vary.

After July 31, 2015, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

Shares of the Davis Funds are not deposits or obligations of any bank, are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risks, including possible loss of the principal amount invested.

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Item #5130 4/15 Davis Distributors, LLC, 2949 East Elvira Road, Suite 101,
Tucson, AZ 85756, 800-279-0279, davisfunds.com