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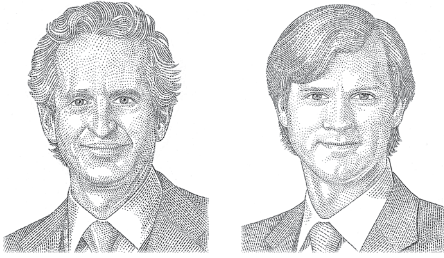


Update from Portfolio Managers
Chris Davis and Pierce Crosbie

Davis Financial Fund

Semi-Annual Review 2024

Key Takeaways

- The S&P 500 Index returned +15.29% in the first half of 2024. The S&P Financials Index lagged the broad index's performance with a gain of +10.17%. Davis Financial Fund (DFF) outperformed the S&P Financials Index with a return of +10.74%.
- U.S. banks' strong profitability today is driven by the wide spreads they can earn on their low-cost deposit bases, which is a testament to the attractiveness and durability of their business model.
- We believe that the bank companies in our portfolio are well-positioned to withstand an eventual recessionary environment. Though short-term market fluctuations are unpredictable, our companies' valuations are sufficiently low that we think they should be able to generate strong returns over the next decade.

The average annual total returns for Davis Financial Fund's Class A shares for periods ending June 30, 2024, including a maximum 4.75% sales charge, are: 1 year, 20.82%; 5 years, 9.06%; and 10 years, 8.59%. 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. For most recent month-end performance, visit davisfunds.com or call 800-279-0279. Current performance may be lower or higher than the performance quoted. The total annual operating expense ratio for Class A shares as of the most recent prospectus was 0.95%. The total annual operating expense ratio may vary in future years. Returns and expenses for other classes of shares will vary.*

This material includes candid statements and observations regarding investment strategies, individual securities, and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct. All fund performance discussed within this material refers to Class A shares without a sales charge and are as of 6/30/24, unless otherwise noted. This is not a recommendation to buy, sell or hold any specific security. **Past performance is not a guarantee of future results. There is no guarantee that the Fund performance will be positive as equity markets are volatile and an investor may lose money.**

Strategy

Since its inception in 1991, Davis Financial Fund (DFF) has invested in durable, well-managed financial services companies at value prices, which the fund could hold for the long-term. Shelby Cullom Davis's quip that financial services companies can be "growth companies in disguise" remains a bedrock tenet of our approach. Investors tend to place low valuations on financial companies because of their earnings volatility. But many financial companies generate capital through the business cycle at an attractive rate, which they use to pay dividends, buy back stock or otherwise deploy in ways that increase shareholder value. By focusing on economic reality rather than investor sentiment, DFF has compounded shareholder wealth at 11.14% over 33 years, outpacing both the S&P 500 Index and the S&P 500 Financials Index. ■

Results

The S&P 500 Index returned +15.29% in the first half of 2024. Nvidia alone contributed almost 5 percentage points to that result, and several of its other large technology holdings also posted strong returns. The "Magnificent 7" tech stocks[1] now sport a $16 trillion market capitalization and comprise approximately 33% of the index. In contrast, the equal-weighted S&P 500 Index increased by only +5.1%. As was the case in 2023, market leadership continues to be heavily concentrated in a handful of large technology companies.

The S&P Financials Index returned a gain of +10.17%, well off the pace of the S&P 500 Index but comfortably ahead of the equal weighted index. Large banks were an important driver of this outcome, while the regional banks included in the S&P Financials Index lagged the overall return and the S&P Banks Select Industry Index increased only +2.4%.[2] Property and casualty insurance also contributed favorably to the S&P Financials Index return.

DFF modestly outperformed the S&P Financials Index with a return of +10.74%. Our biggest contributors to relative performance were our large bank holdings (Wells Fargo, JP Morgan Chase and Bank of America), American Express, BNY Mellon and selected international banks (DBS Group and Danske Bank). The fund's largest relative detractors were from regional banks (U.S. Bancorp, PNC Financial and Fifth Third Bank) and selected consumer finance companies (Capital One and Rocket Companies). ■

Portfolio Positioning

Banks, globally and broadly defined—including trust banks and wealth-management firms taking on-balance-sheet client deposits but little credit risk—continue to make up approximately 70% of DFF. While the stock prices of our bank holdings have by and large fully recovered (and then some) from the drawdown in early 2023 precipitated by the failure of Silicon Valley Bank, we remain

Fig. 1: **DFF Annualized Returns, as of June 30, 2024**

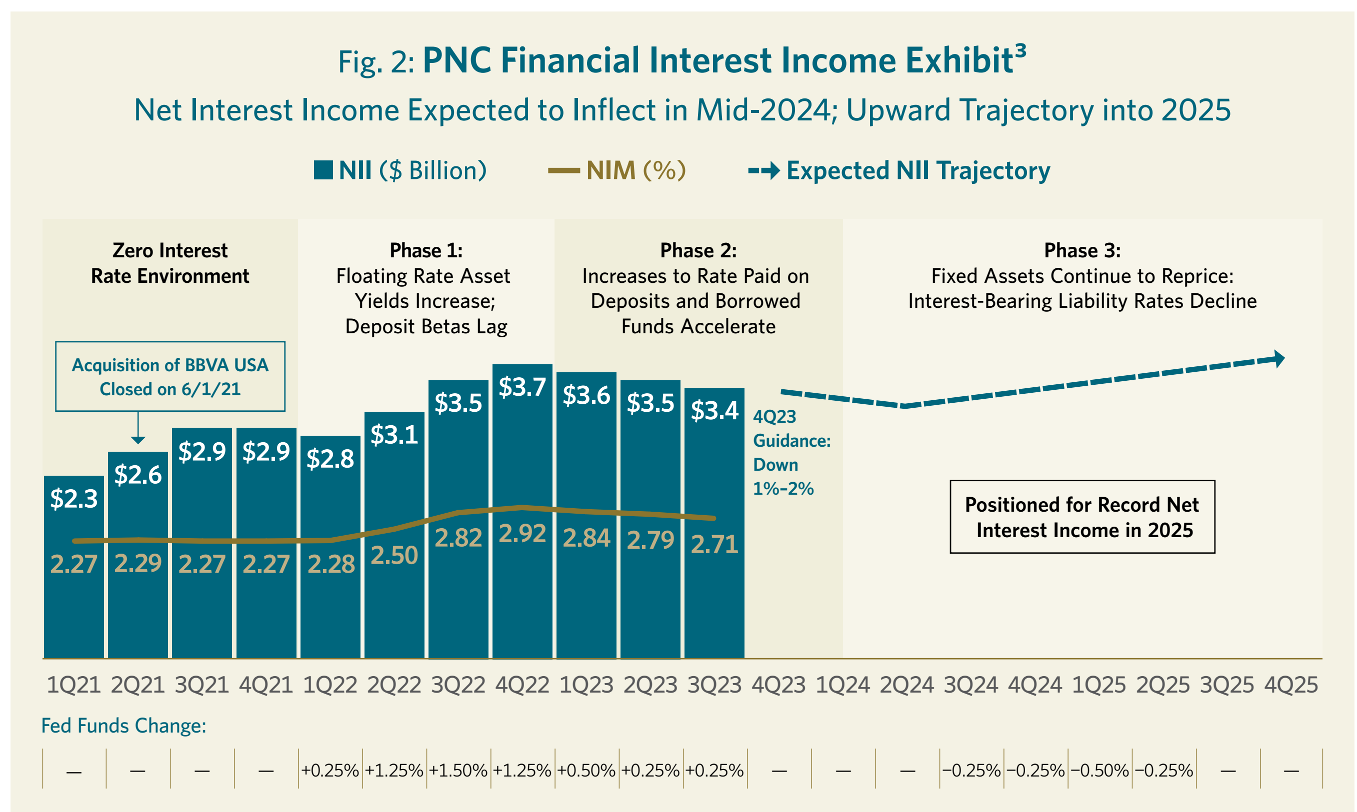
	YTD	1 Year	3 Year	5 Year	10 Year	20 Year	Inception 5/1/91
Davis Financial Fund Class A	10.74%	26.84%	6.63%	10.11%	9.11%	7.36%	11.14%
Davis Financial Fund Class Y	10.88	27.16	6.88	10.36	9.35	7.55	—
S&P 500 Financials Index	10.17	24.21	5.89	10.57	10.57	5.15	9.36
S&P 500 Index	15.29	24.56	10.00	15.03	12.85	10.28	10.54

1. Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, Nvidia and Tesla. **2.** The S&P Banks Selected Industry Index also includes smaller regional banks that are not members of the S&P Financials Index.

optimistic about their potential returns from here. We have frequently noted in these letters that we think many investors remain leery of financial stocks and banks in particular with memories of the 2008–09 financial crisis still vivid, and we continue to believe that today. In addition, we believe the nuances of this interest rate cycle, when combined with the way that generally accepted accounting principles (GAAP) reports interest income (and therefore net earnings) fails to capture just how profitable the banking business is today. Figure 2 from PNC Financial, one of our significant bank holdings, illustrates this point well.

In the first phase of the interest rate cycle, interest income rises quite sharply as a bank's floating rate assets (e.g. deposits at the Federal Reserve, floating rate loans, etc.) reprice up immediately, but the cost of its customers' deposits do not increase right away. At PNC Financial, this resulted in a trough-to-peak increase of +31% through the fourth quarter of 2022; a similar spurt was experienced by our other bank holdings generally. But the stickiness of deposit funding is, in part, just a timing phenomenon. Eventually customers—whether institutional, commercial or retail—start to respond to the changed interest rate environment, and will seek out higher-yielding cash alternatives if their bank does not offer a sufficient return.

In the second phase, when the pace of benchmark interest rate increases slows (or stops), a bank's lagging increases in deposit funding costs more than offset any benefit from increased asset yields, and the level of net interest income (NII) begins to erode from the initial peak level. The industry is now firmly settled in the midst of this second phase, with substantially all of our U.S. bank holdings experiencing sequential declines in net interest income. While it is fair to assume that there will still be some room to run with respect to the repricing (or remixing) of deposits, given that interest rates have been steady for the best part of a year now, this trend seems to have largely run its course.



NII represents net interest income. 4Q23 NII represents the mid-point of the 4Q23 guidance range of down 1%–2% compared to 3Q23. Fed Funds changes in 2024 and 2025 are PNC's forecast.

3. Source: PNC Financial investor presentation dated 12/5/23. There is no guarantee that this forecast will prove to be correct.

The third phase of this trajectory should be the one that long-term investors in bank stocks care about most. In this phase, the bank's fixed rate assets—which were generally put on the books during the prior period of low interest rates—will begin to mature and roll over into new loans and securities at the current level of medium- and long-term benchmark interest rates. There will be another inflection point once the reinvestment of maturing assets dominates the remaining lag in deposit cost repricing. Whether this inflection point occurs in the second quarter of this year or the first quarter of next year is of little consequence compared to the fact (all else equal) that it will occur. Based on the interest rate outlook at the time, PNC was sufficiently confident to share with investors its projection that it would earn record net interest income in 2025. If hypothetically PNC had generated interest income in its most recent quarter at its prior peak level in 4Q22, its net earnings would have been higher by approximately +25%, its return on tangible capital would have been approximately 15% despite currently holding excess capital and its price/earnings multiple would have been 10x.[4]

Another way of looking at this is to say that banks are far more profitable today on market terms than their reported GAAP results suggest, as their interest income is weighed down by their "legacy" fixed rate asset decisions. This is not to dismiss the consequences for intrinsic value of those decisions, but it does make us feel very good about the economics of the underlying franchises we own. This is all driven by the wide spreads that U.S. banks continue to earn on their customers' deposits (see Figure 3). Hypothetically, most banks could improve their run-rate of reported net income meaningfully—with no change to their risk profile with respect to credit or duration—by realizing the mark-to-market losses on their available-for-sale securities and immediately reinvesting into similar securities at today's yields.[7] This would of course result in recognizing a significant up-front loss-on-sale through the income statement, but there would be no impact on their GAAP shareholders' equity, nor would there even be a capital impact for the largest banks which already reflect such mark-to-market losses in their regulatory measures. We are not believers in our companies taking actions solely for the accounting treatment;[8] the point here is just to illustrate how strongly banks' deposit franchises are performing today.

Despite the strong absolute returns generated by DFF in 2023 and so far in 2024, we continue to view our holdings, particularly our bank positions, as quite attractively valued. Our eight-largest U.S. bank holdings[9] are valued in aggregate at 1.7x tangible book value. These companies are expected to earn a 14% return on equity (ROE) in 2024[10] and would be earning higher returns if their fixed rate assets were reflected at market yields, although these banks arguably are "over-earning" modestly as credit has yet to normalize fully. But we believe this group should be able to earn a mid-teens ROE on average and over time. ■

Fig. 3: **Average Deposit Costs of Selected U.S. Banks for the Quarter Ended 3/31/24[5]**

	JPM	WFC	BAC	USB	PNC	FITB	BK
Total Cost of Deposits	2.07%	1.74%	1.93%	2.30%	1.99%	2.28%	3.15%
Spread to Fed Funds (bps)[6]	324	357	338	301	332	303	216

4. Source: PNC and DSA analysis. **5.** Source: Company filings. **6.** Effective Fed Funds Rate=5.31% in Q1/24. Bps stands for Basis Points. One basis point = 0.01%. **7.** To be clear, this was effectively Silicon Valley Bank's strategy in March 2023. In their case, realizing the losses on their AFS securities consumed most of their CET1 capital, brought to the forefront the magnitude of their mark-to-market losses on their HTM securities, and necessitated raising capital in a secondary offering (which failed). Most U.S. banks today are in a far better position with respect to capital and duration risk management. **8.** And from the perspective of long-term shareholders, there is no need to. Banks' GAAP shareholders' equity (and regulatory capital for the largest banks) should over the coming years increase at a faster pace than their GAAP earnings would suggest as the unrealized losses on their securities "pull to par" as they approach maturity. **9.** Includes JP Morgan Chase, Bank of America, Wells Fargo, Capital One Financial, U.S. Bancorp, PNC Financial, Fifth Third Bank and BNY Mellon. **10.** Source: company filings, DSA analysis, Bloomberg.

Conclusion

We remain consistent in our approach to allocating capital in our portfolio. We look for companies with durable competitive advantages coupled with competent and honest managements that are priced at a discount to their intrinsic value. We invest presuming that we will own our companies through various business cycles. We do not attempt to build a portfolio around a particular speculative forecast—by trying to predict where interest rates or the economy will go, for example. Rather, we strive to construct a portfolio that will perform well over the long term across a range of economic outcomes. As such, our portfolio is diversified across leading franchises earning above-average returns on capital in banking, payments, custody, wealth management and property and casualty insurance.

We don't pretend to know the future direction of macroeconomic variables, and would still consider a recession in the next year or two as quite plausible. However, we believe that banks—especially the banks in our portfolio—are well-positioned to withstand a recessionary environment, if that should occur. And, despite the recovery in stock prices in the last months of 2023 and so far in 2024, we believe our companies' valuations remain low enough to generate strong returns over the next decade.

We remain excited by the investment prospects for the companies in Davis Financial Fund. Nothing provides a stronger indication than the fact that the Davis family and colleagues have more than $90 million invested in the fund alongside our clients.[11] We are grateful for the trust you have placed in us. ■

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Topics

- Why you make most of your money in a bear market
- Viewing volatility as a cost of admission to building wealth
- Saving like a pessimist, but investing like an optimist

11. As of 6/30/24.

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Objective and Risks. The investment objective of Davis Financial Fund is long-term growth of capital. There can be no assurance that the Fund will achieve its objective. Some important risks of an investment in the Fund are: **stock market risk:** stock markets have periods of rising prices and periods of falling prices, including sharp declines; **common stock risk:** an adverse event may have a negative impact on a company and could result in a decline in the price of its common stock; **financial services risk:** investing a significant portion of assets in the financial services sector may cause the Fund to be more sensitive to problems affecting financial companies; **credit risk:** the issuer of a fixed income security (potentially even the U.S. Government) may be unable to make timely payments of interest and principal; **interest rate sensitivity risk:** interest rates may have a powerful influence on the earnings of financial institutions; **focused portfolio risk:** investing in a limited number of companies causes changes in the value of a single security to have a more significant effect on the value of the Fund's total portfolio; **headline risk:** the Fund may invest in a company when the company becomes the center of controversy. The company's stock may never recover or may become worthless; **foreign country risk:** foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified. As of 6/30/24, the Fund had approximately 18.5% of net assets invested in foreign companies; **large-capitalization companies risk:** companies with $10 billion or more in market capitalization generally experience slower rates of growth in earnings per share than do mid- and small-capitalization companies; **manager risk:** poor security selection may cause the Fund to underperform relevant benchmarks; **depositary receipts risk:** depositary receipts involve higher expenses and may trade at a discount (or premium) to the underlying security and may be less liquid than the underlying securities listed on an exchange; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; **foreign currency risk:** the change in value of a foreign currency against the U.S. dollar will result in a change in the U.S. dollar value of securities denominated in that foreign currency; **emerging market risk:** securities of issuers in emerging and developing markets may present risks not found in more mature markets; and **mid- and small-capitalization companies risk:** companies with less than $10 billion in market capitalization typically have more limited product lines, markets and financial resources than larger companies, and may trade less frequently and in more limited volume. See the prospectus for a complete description of the principal risks.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of 6/30/24, the top ten holdings of Davis Financial Fund were: Capital One Financial, 10.08%; Wells Fargo, 8.92%; JPMorgan Chase, 7.55%; Bank of New York Mellon, 6.16%; Fifth Third Bancorp, 5.48%; Berkshire Hathaway, 5.40%; Markel Group, 5.08%; Chubb, 5.04%; PNC Financial Services, 4.52%; and U.S. Bancorp, 4.48%.

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 Statement of Additional Information. Holding percentages are subject to change. Visit davisfunds.com or call 800-279-0279 for the most current public portfolio holdings information.

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Return on equity (ROE) is a measure of a company's financial performance. It is calculated by dividing net income by shareholders' equity. Because shareholders' equity is equal to a company's assets minus its debt, ROE is a way of showing a company's return on net assets. Return on equity is considered a gauge of a corporation's profitability and how efficiently it generates those profits. The higher the ROE, the more efficient a company's management is at generating income and growth from its equity financing.

We gather our index data from a combination of reputable sources, including, but not limited to, Lipper, Wilshire, and index websites.

The **S&P 500 Index** is an unmanaged index of 500 selected common stocks, most of which are listed on the New York Stock Exchange. The index is adjusted for dividends, weighted towards stocks with large market capitalizations and represents approximately two-thirds of the total market value of all domestic common stocks. The **S&P 500 Financials** is a capitalization-weighted index that tracks the companies in the financial sector as a subset of the S&P 500 Index. The **S&P Banks Select Industry Index** comprises stocks in the S&P Total Market Index that are classified in the GICS Asset Management & Custody Banks, Diversified Banks, Regional Banks, Diversified Financial Services and Commercial & Residential Mortgage Finance sub-industries. Investments cannot be made directly in an index.

After 10/31/24, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

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Item #4438 6/24