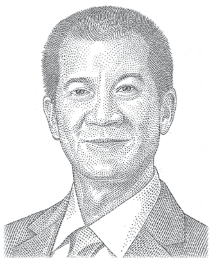
Davis FUNDS



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Update from Portfolio Manager

Danton Goei

# Davis International Fund

Semi-Annual Review 2023

## Key Takeaways

- In the first half of 2023, the Davis International Fund underperformed the MSCI ACWI (All Country World Index) ex US.
- Principle positive contributors to performance included select financials, semiconductor stocks and key industrial companies, while weakness in our Chinese internet and insurance holdings principally detracted from results.
- Current levels of inflation and interest rates are close to long-term averages, suggesting economic normalization. Companies with a history of profitable growth, proven business models and reasonable valuations look attractive once more.

## Portfolio Review: Strength in Tech, Weakness in Asia

For the first six months of 2023, Davis International Fund returned 4.57% compared with 9.47% for the MSCI ACWI ex US for an underperformance of 4.90%.

### Performance Contributors

Contributors to positive returns over the first six months of 2023 were varied and included select financials, semiconductor holdings and key industrial companies. Amongst the contributing financials, Danske Bank, the leading bank in Denmark, was up 23%, and Julius Baer Group, a leading global wealth manager based in Switzerland, returned 13%.

***The average annual total returns for Davis International Fund's Class A shares for periods ending June 30, 2023, including a maximum 4.75% sales charge, are: 1 year, 6.61%; 5 years, −3.40%; and 10 years, 2.97%. 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 Fund is subject to a 2% short-term redemption fee for shares held for fewer than 30 days. The total annual operating expense ratio for Class A shares as of the most recent prospectus was 1.13%. [The Adviser is contractually committed to waive fees and/or reimburse the Fund's expenses to the extent necessary to cap total annual fund operating expenses of Class A shares at 1.05%. The expense cap expires March 1, 2024.] The total annual operating expense ratio may vary in future years. Returns and expenses for other classes of shares will vary. The Fund's performance benefited from an IPO purchase in 2014. After purchase, the IPO rapidly increased in value. Davis Advisors purchases shares intending to benefit from long-term growth of the underlying company; the rapid appreciation of the IPO was an unusual occurrence.*

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 6/30/23 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.**

While it was a difficult start to the year for many financials (as we will discuss further in this letter), it was a strong start to the year for Danske Bank. We have owned Danske Bank for almost five years on the basis that its then valuation (6x owner earnings and 0.7x book value at purchase) was too low, given the strength of its franchise and the health of the Danish economy. Uncertainty surrounding an investigation into compliance lapses at its Estonian subsidiary was lifted in December 2022 when an agreement with regulators was announced. Since then, operating results have been solid, with increases in net interest income and low credit losses leading to healthy earnings growth.

Danske Bank now trades at a very attractive 6.5x expected 2023 owner earnings and 0.9x book value, leaving ample room for multiple expansion going forward, in our view. Furthermore, on July 21 this year, the bank declared a first-half dividend payout that will result in a 4.4% dividend yield for the half year, so it is reasonable to expect an annual dividend yield exceeding 8% at the current stock price.

Semiconductor companies Tokyo Electron and Samsung were up 47% and 27%, respectively, in the first six months of 2023 as investors started to look beyond post-COVID weakness and focus on the strong long-term outlook for semiconductors. In its second quarter earnings call, Samsung management shared its view that the recovery in memory chip sales had already started in the third quarter. We expect that with semiconductor companies cutting their production capacity and inventories falling, demand for chips will start to rise, driving stronger operating results in our semiconductor holdings.

The French manufacturer of electrical power products, Schneider Electric, was up 33% in the first six months of 2023. First-half results were very strong, driven by electrification due to the growth of energy-efficient buildings and strong demand from data centers that are riding the wave of continued investment in artificial intelligence capabilities. Ferguson, a distributor of plumbing and heating supplies in the U.S., was up 25% in the first half. The company continues to generate solid results as it grows its market share and benefits from strong industrial activity in the U.S.

## Performance Detractors

Detractors from performance included the Chinese internet companies JD.com and Meituan, which were down −38% and −30%, respectively, in the first half of 2023. Investors reacted to slower-than-expected economic recovery post-COVID (which we will discuss later) and competition from Bytedance as it seeks to grow its e-commerce and restaurant marketing businesses in China. Both JD.com and Meituan, however, had strong earnings growth in the first quarter of 2023, and retain strong competitive advantages as economic growth resumes post-COVID.

Similarly, insurers AIA and Ping An were down −8% and −1%, respectively. Worries about the pace of the economic recovery in China led to lower expectations for growth in 2023. In the first quarter, both AIA and Ping An saw a return to growth in the sales of their insurance products, but near-term results will be influenced by the strength of China's recovery. We believe the long-term outlook for AIA and Ping An remains very strong in the underpenetrated insurance markets of Asia (including China), where growing wealth and an aging population are driving demand for life and health insurance. Ping An is trading at 6x owner earnings while AIA is at 14.5x owner earnings with a higher growth rate. Both insurers looks very attractive at these levels. ■

## Market Perspective: Normalizing Inflation and Interest Rates

In 2023, the U.S. Federal Reserve continued to raise interest rates to subdue inflation. It is easy to forget that as recently as the first quarter of 2022, the Fed was pursuing a zero interest rate policy. But starting in March 2022, the Fed raised the Fed Funds rate seven times during 2022, taking it from 0% to 4.50%. Inflation, as measured by the Consumer Price Index (CPI), peaked in June 2022 at 9.1%, and although the rate increases helped, remained elevated at 6.5% by December 2022. This year the Fed has raised rates another four times, bringing the Fed Funds rate to a 5.25–5.50% target range. Inflation has cooperated so far, falling to 3.0% in the latest June reading. If inflation can continue to fall towards the Fed's target of 2%, then the expectations that we are very close to the end of this cycle of interest rate increases could prove to be true.

The current levels of 3.0% inflation with a 5.5% Fed Funds rate and a 7.4% rate on 30-year mortgages (as of July 2023) are close to the long-term averages. Many of the more surprising features of the markets seen over the last several years, including high valuations on unprofitable growth companies, highly leveraged private equity deals, and venture capital funded startups aggressively competing with established incumbents in numerous industries, are likely to fade away as the era of free money is behind us. Companies with a history of profitable growth and proven business models trading at reasonable valuations are increasingly looking attractive once more.

While designed to counteract the effect of rising inflation, raising the Fed Funds rate by over 500 basis points in little over a year has caused the value of fixed rate bonds to fall. For Silicon Valley Bank (SVB), Signature Bank and First Republic Bank—three U.S. regional banks—this caused so much distress that they failed or were taken over by larger banks. The bank runs and subsequent failure of these regional banks led investors to punish the entire banking sector, even impacting the valuations of the largest U.S. banks and even some international ones.

*"In the months since the Fed takeover or acquisition of these regional banks, the banking system, including our portfolio banks, has been stable."*

Silicon Valley Bank's failure precipitated the regional bank troubles, but SVB is a very different bank than other banks and certainly bears little resemblance to the banks we have chosen to invest in. Its undiversified deposit base coupled with large investments in long-term, fixed rate bonds made for a combustible situation. When SVB's recapitalization failed, and several private equity firms and startups decided at the same time that they preferred the safety of the larger banks, the Federal Reserve had to intervene. In the months since the Fed takeover or acquisition of these three regional banks, the banking system, including our portfolio banks, has been stable as bank balance sheets and earnings have remained healthy.

We believe our approach of focusing on the largest well-run banks has been the correct one. In fact, looking back, a document entitled "A Brief History of Deposit Insurance in the United States" written by the Federal Deposit Insurance Corporation (FDIC) in September 1998 highlights how size can lead to lower risks when it comes to banking:

*"The consolidation of banks serving different product and geographic markets can diversify risk and decrease earnings volatility, thereby decreasing the likelihood of failure. Regional recessions and sectoral downturns contributed to many of the bank and thrift failures in the late 1980s and early 1990s. Many of the institutions that failed or were troubled tended to have either geographic or product concentrations. Broader diversification of risk through mergers of institutions serving different markets can moderate the effects of economic downturns on these institutions."*

As Mark Twain supposedly said, "History does not repeat itself, but it often rhymes." Moreover, recent trends, such as the growing importance of technology in banking in such areas as mobile banking, cybersecurity and artificial intelligence, are further increasing the importance of scale.

Inflation in the U.S. declined from 6.5% to 3.0% in the first half of 2023, and in Europe from 8.6% to 5.3%, generating optimism that even higher interest rates and a recession might be avoided. There remain, however, continued risks of higher inflation in the future, including sticky wage hikes, the building of redundancy in global supply chains, and a prolonged Ukraine-Russia war.

It is difficult to predict future inflation levels, and we expect, as long-term investors, that all of our portfolio companies will eventually have to operate in a recession, so we focus on owning companies with durable competitive advantages that give them pricing power. Samsung and Tokyo Electron, for example, can raise their prices because they make critical semiconductor products for a wide range of industries. Banks historically have earned higher net interest income in higher interest environments such as the current one as compared to the anomalous zero interest rate environment of the last dozen years.

*"The weaker rebound [in China] has been due in part to a sluggish global economy which has impacted Chinese exports, but the Chinese consumer has also been surprisingly timid."*

Another set of portfolio companies that have strong balance sheets, durable competitive advantages and promising long-term outlooks are the Chinese consumer-facing companies. Their promising fundamentals and attractive valuations, however, have been overshadowed by concerns about the macro environment and China's regulatory crackdown on the high-tech consumer companies.

China can be an attractive market to invest in. It is a very large and growing economy and the government has a tremendous record over the past four decades of generating economic growth. It is also home to a number of world-class companies with some of the very best management teams we have met anywhere. Due mainly to macroeconomic and geopolitical concerns, the MSCI China Index is currently trading at a Forward P/E ratio of 11.1x compared to the S&P 500 Index's P/E ratio of 20.2x, which is a substantial 45% discount.

In November of last year, the Chinese government suddenly lifted its much-criticized COVID restrictions, leading to a jump in economic activity. After a strong start to the year, the economic rebound, however, has not met expectations. In part, the weaker rebound has been due to a sluggish global economy which has impacted Chinese exports, but the Chinese consumer has also been surprisingly timid. After Chinese New Year, retail sales grew 10.6% year-over-year in March and then leapt 18.4% in April. However in May, retail sales growth slowed to 12.7% and in June it fell to 3.1%.

This has caught the government's attention and they have clearly signaled that the measures taken earlier in the year, including a 10bps cut in interest rates and a 50bps lowering of the required reserve ratio for banks, were insufficient.

On July 24, China's top government body, the 24-member Politburo chaired by President Xi Jinping, met and addressed the weaker-than-expected economic recovery, which was candidly characterized as a process of "wave-like development and torturous process." The policy-setting session was supportive of the economy and of private enterprise and clearly aimed to bolster the real estate sector. It also for the first time mentioned "making the capital market more active and boosting investor confidence," suggesting China's government is acknowledging the need to reassure investors. Following the Politburo meeting, the chairman of the National Development Reform Commission, Vice Chairman Li Chunlin, commented, "We've noticed that the growth momentum of some consumption categories is still not solid yet, and some residents have relatively weak confidence to spend. This requires further policy support."

The strength of the actual policies to be implemented remain to be seen, but it is clear that the government is focused on boosting economic growth. The Politburo continued to signal that it expects to meet its 5% GDP growth target for the year. We anticipate that the Chinese consumer-facing companies in our portfolio will benefit from the economic stimulus as well as the government's focus on making domestic consumer demand the engine of the economy. These holdings include Tencent (the world's largest video game company and parent of WeChat messaging service, owned in the portfolio via Naspers and Prosus), Ping An Insurance (the world's second-largest life and health insurer), Meituan (food delivery leader), JD.com (e-commerce) and DiDi Global (ride-sharing leader).

Many of our Chinese holdings have also benefited from the end of the regulatory reforms China started in 2021. Over the past several months the government has signaled its support for these platform companies and brought an end to the actions and investigations that had hurt investor sentiment. Recent positive government actions have included resuming new video game approvals, allowing DiDi to return to app stores, and ending the investigations into fintech companies Ant Group and TenPay. The government has also signaled support for the resumption of initial public offerings. ■

## Notes on Holdings:
### Prosus/Naspers

The Prosus/Naspers complex (from now on referred to as Prosus) remains our favorite way of investing in the Chinese internet conglomerate Tencent. Prosus' $106 billion stake in Tencent currently makes up approximately 81% of Prosus' net asset value (NAV), making our conviction in Tencent's moat, growth prospects and management team the core of our investment thesis in Prosus. Tencent, best known for operating the ubiquitous mobile messaging super app WeChat, has market-leading positions in China across its social media, video game and payments/fintech businesses.

In addition, Tencent has earlier-stage efforts in cloud computing and enterprise software, industries that are still immature in China, but have attractive long-term growth potential. Tencent is trading at 16x our 2024 estimate of owner earnings, which is attractive as we believe earnings will grow 20%+ per year over the next few years. Given our positive outlook on Tencent and Prosus' other major assets, most of which are high-quality internet businesses (e.g., online classifieds and food delivery marketplace platforms) with strong competitive positions and robust growth prospects, we would expect meaningful underlying expansion in Prosus' NAV over time.

What makes Prosus particularly attractive is that it currently trades at approximately a 30% discount to its NAV. While this discount has proven stubborn throughout our holding period, we are increasingly confident that management's multipronged efforts to address the discount will create significant value over time. We applaud the company's open-ended program of selling Tencent shares at the market price and using the proceeds to repurchase its own shares. Given that Prosus' own shares primarily represent ownership in Tencent shares, but at a discounted price, carrying out this exercise increases Prosus' NAV per share for every Tencent share sold and Prosus share repurchased. The larger the discount the more accretive these actions are to NAV per share. As an illustrative example, selling 15% of the company's stake in Tencent and using the proceeds to repurchase shares in Prosus would result in a 7% increase in NAV per share at the current discount.

On top of this, any additional narrowing of the discount through corporate actions, some of which management has discussed publicly (e.g., simplifying its corporate structure, publicly listing underappreciated assets, etc.), would further enhance our returns beyond what we could earn from owning Tencent shares outright. We believe Prosus' management team has the means and demonstrated determination to create and protect value for shareholders, and expect that their efforts will reward patient shareholders over the long term. ■

## Outlook: Fast Earnings Growth at a Discount

In our last letter we spoke about how market corrections are unfortunately common but also create investment opportunities. We wrote how historically in the years following a 20% decline, for example, the S&P 500 Index has on average had a robust positive return of 23.9%.[1] The year 2023 is not over yet but after last year's –18.11% decline, the S&P 500 Index through July 31 has returned 20.65%. This, of course, does not work like clockwork, and there is quite a bit of variability, but it is why we advocate for long-term investing. Staying the course through the inevitable downturns and letting the power of compounding work for you over time is the goal. As Albert Einstein once said, "Compound interest is the eighth wonder of the world. He who understands it, earns it… he who doesn't… pays it."[2]

A valid question then is "what to do now that the market is up 20%?" By design, the 25 holdings in Davis International Fund look very different from the market and, we believe, present a superior investment outlook. We base this view on the careful selection of these 25 companies amongst the more than 2,300 companies in the MSCI ACWI ex US based on the quality of the business, the ability of the management team, and the attractive valuation. Davis International Fund portfolio holdings have grown earnings per share faster than the index over the past five years, yet trade at a remarkable 48% discount on a P/E basis.[3] We believe the combination of faster growth and a substantial valuation discount should be positive for future returns.

We understand that in uncertain times such as these, it is more important than ever to be able to entrust your savings to an experienced and reliable investment manager with a strong long-term record. Over the 50 years since the firm's founding, the Davis Investment Discipline has demonstrated an ability to generate above-average returns, based on in-depth fundamental analysis, a long-term investment horizon and a strong value discipline. While the times have changed, these fundamental principles are timeless and proven. Above all, we never forget that we are stewards of our clients' savings and that our most important job is growing the value of the funds entrusted to us.

**1.** https://www.wsj.com/livecoverage/stock-market-today-dow-jones-bitcoin-fed-rates-06-14-2022/card/how-the-s-p-500-performs-after-closing-in-a-bear-market-yBwgfJwW8HGSNJaKg6LB **2.** https://www.thinkindependent.com.au/still-8th-wonder-world/ **3.** 7.0x versus 13.5x as of 6/30/23.

With more than $2 billion of our own money invested alongside that of our clients, we are on this journey together.[4] This alignment with our clients is an uncommon advantage in our industry; our conviction in our portfolio of carefully selected companies is more than just words. While we do not welcome the pessimism and fear that have characterized our world recently, we are prepared for it and, importantly, we are well-positioned for the future. We thank you for your continued trust and interest in Davis International Fund. ■

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- Viewing volatility as a cost of admission to building wealth
- Saving like a pessimist, but investing like an optimist

**4.** As of 6/30/23 Davis Advisors, the Davis family and Foundation, our employees, and Fund directors have more than $2 billion invested alongside clients in similarly managed accounts and strategies.

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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. These comments may also include the expression of opinions that are speculative in nature and should not be relied on as statements of fact.

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 material. 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.

**Objective and Risks.** The investment objective of Davis International 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; **foreign country risk:** foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified; **China risk - generally:** investment in Chinese securities may subject the Fund to risks that are specific to China including, but not limited to, general development, level of government involvement, wealth distribution, and structure; **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; **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; **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; **exposure to industry or sector risk:** significant exposure to a particular industry or sector may cause the Fund to be more impacted by risks relating to and developments affecting the industry or sector; **emerging market risk:** securities of issuers in emerging and developing markets may present risks not found in more mature markets. As of 6/30/23, the Fund had approximately 44.4% of net assets invested in securities from emerging markets; **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; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; 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 Fund is subject to a 2% short-term redemption fee for shares held for fewer than 30 days.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of 6/30/23, the top ten holdings of Davis International Fund were: Danske Bank, 9.93%; Samsung Electronics, 7.29%; DBS Group, 7.24%; AIA Group, 6.55%; Ping An Insurance Group, 6.13%; Julius Baer Group, 6.04%; Naspers, 5.20%; Prosus, 5.19%; Schneider Electric, 4.65%; and Meituan, 4.59%.

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

The Consumer Price Index (CPI) measures the monthly change in prices paid by U.S. consumers. The U.S. Bureau of Labor Statistics (BLS) calculates the CPI as a weighted average of prices for a basket of goods and services representative of aggregate U.S. consumer spending.

The **MSCI ACWI (All Country World Index) ex US** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the United States. The index includes reinvestment of dividends, net of foreign withholding taxes. The **MSCI China Index** captures large- and mid-cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g., ADRs). With 698 constituents, the index covers about 85% of this China equity universe. Currently, the index includes Large Cap A and Mid Cap A shares represented at 20% of their free float adjusted market capitalization. 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. Investments cannot be made directly in an index.

After 10/31/23, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

**Davis Distributors, LLC**
**2949 East Elvira Road, Suite 101, Tucson, AZ 85756**
**800-279-0279, davisfunds.com**

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