



# Davis Opportunity Fund

Semi-Annual Review 2023

Update from Portfolio Managers

## Key Takeaways

- In the first half of 2023 the U.S. equity market rebounded from its 2022 decline, with the S&P 1500 Index gaining 16.15%.
- Higher interest rates are forcing investors to value future earnings more conservatively, removing excessive speculation from the market. Conversely, businesses with moderate top-line growth rates have been strong performers.
- We believe that the portfolio is positioned favorably based on our expectations for our businesses' long-term earnings power, and that portfolio valuations are attractive relative to the overall market.

## Market Perspectives: Back-to-Basics Fundamentals

The U.S. equity market rose by double digits in the first six months of 2023. The S&P 1500 Index returned 16.15%, rebounding from its -17.78% decline in 2022. This appreciation occurred despite a new banking crisis, higher interest rates, the last-minute agreement on the debt ceiling limit and persistent inflation. The market has shown a degree of resilience and an ability to climb such walls of worry.

The U.S. economy has been expanding, albeit at a very sluggish, low single-digit pace. That said, the jobs situation remains favorable compared with

many other times in history, despite the headlines about major corporations slashing costs and headcount.

A major factor today is the elevated level of interest rates compared to any time in the past 15 years. One implication of elevated rates is that when you apply a higher discount rate to future earnings, the relatively full stock valuations of just a few years ago (some were trading at more than 10 times sales) are no longer supported. This has arguably removed a degree of excessive speculation from the market.

*“With the era of ‘free money’ behind us for the foreseeable future, we believe there will be a renewed appeal in back-to-basics fundamentals.”*

Conversely, many businesses at very low valuations with unexciting rates of top-line growth have been strong performers this year, based at least in part on their ability to generate strong current cashflow. As interest rates rise, near-term earnings are worth a lot more to investors than the possibility of eventual earnings materializing some years out.

An unintended consequence of rising interest rates, however, was the regional banking crisis earlier this year. It saw the collapse of a commercial bank in the U.S. and a handful of other high-profile incidents. What these institutions generally had in common was a fragility in certain banks, namely mismatched assets and liabilities. Such risks can be, and are, actively managed by more conservative lenders, especially in the tier of larger banks.

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. The Attractive Growth and Undervalued reference in this material relates to underlying characteristics of the portfolio holdings. There is no guarantee that the Fund performance will be positive as equity markets are volatile and an investor may lose money.**

The most acute moments of deposit flight have subsided considerably since the first quarter, but the business models of some risk-seeking banks have been laid bare. This may result in new forms of regulation. It is possible (but not certain) that any new regulation could be a cost burden in terms of both capital requirements and expenses related to compliance and controls.

With the era of “free money” behind us for the foreseeable future, we believe there will be a renewed appeal in back-to-basics fundamentals. These include free cash flow, balance sheet strength and liquidity, and earnings multiples that are realistically supported by near-term earnings power. We welcome such a shift in the market. Indeed, our core investment discipline is based on such attributes. ■

## ■ Portfolio Review: Exposure to Long-Term Earnings Power

Davis Opportunity Fund delivered a total return of 11.28% in the YTD period through June 30, 2023.

Overall, we believe the portfolio is positioned favorably based on our expectations for our businesses’ long-term earnings power. Equally important, we believe the portfolio on balance is attractive in terms of valuation against the broad market index.

***The average annual total returns for Davis Opportunity Fund’s Class A shares for periods ending June 30, 2023, including a maximum 4.75% sales charge, are: 1 year, 12.90%; 5 years, 6.43%; and 10 years, 10.23%. 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 0.94%. 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 IPO purchases in 2014. After purchase, the IPOs rapidly increased in value. Davis Advisors purchases shares intending to benefit from long-term growth of the underlying company; the rapid appreciation of the IPOs were unusual occurrences.***

**1.** The Attractive Growth and Undervalued reference in this material relates to underlying characteristics of the portfolio holdings. There is no guarantee that the Fund’s performance will be positive as equity markets are volatile and an investor may lose money. **Past performance is not a guarantee of future returns.** Five-year EPS Growth Rate (5-year EPS) is the average annualized earnings per share growth for a company over the past 5 years. The values shown are the weighted average of the 5-year EPS of the stocks in the Fund or Index. Approximately 6.31% of the assets of the Fund are not accounted for in the calculation of 5-year EPS as relevant information on certain companies is not available to the Fund’s data provider. Forward Price/Earnings (Forward P/E) Ratio is a stock’s price at the date indicated divided by the company’s forecasted earnings for the following 12 months based on estimates provided by the Fund’s data provider. These values for both the Fund and the Index are the weighted average of the stocks in the portfolio or Index.

As shown in the following table, we present our total number of holdings as of June 30, 2023, along with the portfolio’s five-year trailing earnings per share growth rate, and our forward price-to-earnings multiple. The number of holdings—40 companies that we have thoroughly researched—illustrates our highly selective investment process. The earnings per share growth over the last five years is not predictive, but it demonstrates that our businesses are capable of generating such earnings performance. Finally, the portfolio’s price-to-earnings multiple is much lower than that of the S&P 1500 Index, which we believe reflects it is undervalued relative to the market. ■

### Selective, Attractive Growth, Undervalued<sup>1</sup>

	Fund	Index
Holdings	40	1,506
EPS Growth (5 Year)	15.4%	9.8%
P/E (Forward)	11.9x	19.7x

## ■ Key Themes: Diversified Financials, Healthcare, Select Technology

One primary driver behind our relatively strong first-half portfolio performance was a number of online businesses, especially in social media, e-commerce and online search. Meta Platforms, Amazon.com and Alphabet are among the drivers

in these categories. In addition, semiconductor equipment manufacturer Applied Materials also delivered a high double-digit return in the period.

Financials produced a modest positive return but lagged the rest of the portfolio, having faced the industry-wide headwind from the regional banking crisis. Significantly, we had actively sought to favor banks with a track record of managing risks better than most, which includes careful management of assets and liabilities. Wells Fargo, U.S. Bancorp and Capital One Financial illustrate what we look for in financial businesses in general.

*“A normal practice at our firm is to spread capital across different types of holdings, each with fairly distinct earnings drivers.”*

A major theme in the portfolio is healthcare. Currently we are focused on businesses that improve efficiencies in the system. Representative holdings include managed care insurer Cigna Group, Quest Diagnostics, which is a leader in labs and diagnostics services, and Viatrix, a global manufacturer of generic pharmaceuticals. Total healthcare expenditures in the U.S. are nearing 20% of gross domestic product, which is approximately twice the burden on output of most developed countries. For this reason, we expect cost efficiencies to become even more of a priority—and really a constraint—in healthcare spending in future years. A common thread in our healthcare holdings is that they represent businesses which could play an important and ongoing role in future cost savings for the overall system.

Beyond the three principal themes listed above, there are other more individualized investment opportunities in the portfolio. These include Owens Corning, a manufacturer of residential and commercial roofing and insulation products, and copper producer Teck Resources, among others. ■

## ■ ■ ■ Outlook: Durable Businesses at Value Prices

Stocks performed relatively well on balance in the first half of 2023. Within each area of the market we saw a fair degree of differentiated performance at the individual stock level, which is why we often return to the axiom that investing is the “art of the specific.” It also underscores the fact that the stock market is really a vast market of individual stocks. We believe that owning shares of highly durable, well-managed businesses at value prices and holding them for the long term is a core discipline that is highly relevant to the current market and current economic conditions.

In conclusion, as stewards of our clients’ savings our most important job is growing the value of the funds entrusted to us. With more than \$2 billion of our own money invested alongside that of our clients, we are on this journey together.<sup>2</sup> This alignment with our clients is uncommon in our industry; our conviction in our portfolio of carefully selected companies is more than just words. While we do not welcome the pessimism that has characterized markets recently, we are prepared for it, and importantly, we are well-positioned for the future. ■

2. 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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Video Series with Chris Davis and Morgan Housel

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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

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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 Opportunity 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. As of 6/30/23, the Fund had approximately 14.6% of net assets invested in foreign companies; **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; **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; **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; **manager risk:** poor security selection may cause the Fund to underperform relevant benchmarks; **depository receipts risk:** depository 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; **emerging market risk:** securities of issuers in emerging and developing markets may present risks not found in more mature markets; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; and **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. 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 6/30/23, the top ten holdings of Davis Opportunity Fund were: Owens Corning, 6.46%; Wells Fargo, 6.15%; Capital One Financial, 5.27%; Viatrix, 4.91%; Quest Diagnostics, 4.89%; Teck Resources, 4.73%; Cigna Group, 4.48%; UnitedHealth Group, 3.96%; Schneider Electric, 3.81%; Markel Group, 3.45%.

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](http://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 **S&P 1500 Index** includes all stocks in the S&P 500, S&P MidCap 400, and S&P SmallCap 600. This index covers approximately 90% of U.S. market capitalization. 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.