Davis FUNDS

50 YEARS DAVIS ADVISORS

Davis Opportunity Fund

Annual Review 2024

Mastering the Mental Game of Investing
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Update from Portfolio Managers

Key Takeaways

- The S&P 1500 Index gained 25.47% in 2023 despite headwinds that included rising interest rates, high equity valuations and geopolitical uncertainty.
- Mega-cap tech companies created valuation distortions in the index, but there were many attractive opportunities elsewhere across a wide swath of stocks for active managers willing to depart from the benchmarks.
- Our portfolio of companies remains significantly undervalued even after last year's strong market performance, and we point out that value can be its own performance catalyst as long as investors are patient.

Market Perspectives:
Climbing the Wall of Worry

In 2023 the S&P 1500 Index returned 25.47%. This was a strong result given the number of material headwinds and uncertainties investors faced during the year. These included the regional bank crisis in the early part of the year, rising interest rates, two overseas wars, and relatively elevated valuations for major stock indexes.

While there were indeed challenges, there have been favorable factors at work as well. These include a rather full employment picture with the unemployment rate down to historic lows (3.7%), the economy still expanding at a rate of about 5% on an annualized basis, and immensely greater financial stability than in past decades owing to strict regulations, more disciplined underwriting practices by the largest financial institutions in the country, and relatively low leverage.

The average annual total returns for Davis Opportunity Fund's Class A shares for periods ending December 31, 2023, including a maximum 4.75% sales charge, are: 1 year, 16.32%; 5 years, 12.07%; and 10 years, 9.34%. 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.*

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 12/31/23 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 Magnificent Seven represent a very large percentage of the market's total value today which means that they lend their high valuations to the overall index."

While the so-called Magnificent Seven mega-cap tech companies dominated the financial headlines last year, contributing an outsized portion of index performance, many stocks traded at much more reasonable valuations than those particular technology giants. The Seven represent a very large percentage of the index's total value today which means that they lend their high valuations to the overall index as well. They have caused distortions such that the weighted average price-to-earnings (P/E) multiple on the S&P 1500 Index is over 21x while the average valuation excluding the Magnificent Seven is much lower in our estimation. Davis Opportunity Fund is truly actively managed—we handpick the companies in the fund and set the weightings of each position based on its risk and reward profile—the fund has a P/E multiple of only 12x.

In short, despite all predictions to the contrary, the U.S. stock market managed to climb the "wall of worry" standing in its way and delivered returns in 2023 that were far above the long-term average return for equities, and on par with a number of record historical years. ■

Portfolio Review: Cross-Sectional Drivers

Davis Opportunity Fund returned 22.12% in 2023 versus the S&P 1500 Index return of 25.47%.

It was a strong year for the fund performance-wise, and its results were driven by a broad cross-section of holdings, with companies as far-ranging as Capital One Financial (consumer finance) and Owens Corning (roofing and insulation products) to Berkshire Hathaway (multi-industry conglomerate with investment capabilities). As such, despite a high market multiple due to weightings distortions within the index, there were many attractive opportunities available across a wide swath of stocks and sectors to active managers willing to depart from benchmarks.

The fund holds 42 different investments with the largest sector exposures being healthcare, technology, industrials and financial services.

Healthcare: Cost Efficiency in a High-Cost System

Healthcare was a relative laggard in the portfolio. Still, we are excited about our investments in the sector, each of which we believe plays an important role in bringing efficiencies to a system burdened with high costs. Healthcare spending now represents roughly 20% of U.S. gross domestic product, and

the U.S. population is only getting older on average. In our minds, this means that demographics and budgetary considerations will drive efforts to curb the rate of healthcare inflation in this country.

Our healthcare investments deliver drugs and services with comparatively greater cost efficiency. We are avoiding companies that may be perceived as overcharging the system, meaning branded pharmaceuticals manufacturers as well as certain biotech companies. This is reflected in the margins of such businesses. The largest branded pharmaceuticals companies in America have gross profit margins of more than 60%. That is effectively their "mark-up" on the products they manufacture. While we want to invest in companies that enjoy attractive margins, in this instance such high margins can make those businesses very vulnerable, especially as we are entering a period of price negotiations between the drug manufacturers and the U.S. government.

"Viatris is both underestimated and misunderstood, partly because its management strategy of 'shrinking to greatness' is very rare among large corporations."

Thematically, our healthcare investments share in common the fact that they aim to drive cost efficiencies through the system relative to the alternatives. In addition, they have margin structures that we feel are more sustainable than the peak margins we see in the more expensive pharma companies.

Viatris, one of our largest positions in the fund, manufactures mostly generics, which is an important way to contain healthcare costs. The company is one of the cheapest in our universe on a free cash flow basis. In our opinion, Viatris is both underestimated and misunderstood, partly because its management's strategy for creating value is very rare among large corporations. This involves effectively "shrinking to greatness"—that is, seeking to achieve better per-share economics by shedding certain assets, paying down debt, and returning capital. It is a highly management-intensive strategy and depends very much on the effectiveness of capital allocation decisions. We believe the right conditions are in place and that the value in the company can be effectively unlocked.

Other healthcare investments in the portfolio include independent lab and diagnostics company Quest Diagnostics as well as managed care insurance giants Cigna Group, UnitedHealth Group and Humana.

Technology: Five Key Themes

Our positions in technology generally fared well, with companies such as Alphabet, Amazon.com, Intel Corp. and, most notably, Meta Platforms, all delivering high double-digit returns. Our investments in the broad technology sector span five main areas currently—e-commerce, social media, online search, cloud computing and semiconductors.

Financials: The Strong Versus the Weak

Financial services surprised many on Wall Street last year, not least because the group defied the notion that the sector must underperform in periods of potential or real economic slowdown. Our largest financial positions, Wells Fargo and Capital One Financial, both delivered strong returns in 2023. What was perhaps the most remarkable feature of last year's financial stock performance is that the market appeared to make fairly stark distinctions between the stronger and weaker institutions, in sharp contrast to 2008–2009 when we saw a unilateral sell-off across the entire group.

We do not have a monolithic view of the financial sector. As active managers, we have selected businesses for the fund as diverse in nature as Berkshire Hathaway, Capital One Financial, Markel Group and Wells Fargo, among others.

Capital One Financial, best known as a credit card issuer, was up 44% in 2023. This made it one of the best-performing stocks in our portfolio during the period, even though consumer finance—particularly companies that engage with mid- and lower-tier FICO-score customers—is casually thought of as the epicenter of crises. Capital One Financial has a strong, extremely data-driven underwriting operation, in our opinion, and is misperceived as a risky, plain-vanilla credit card issuer.

In reality, the company is one of the most advanced fintech companies in the world housed in a traditional bank with a rich base of core deposits. In 2023, Capital One Financial raised provisions for potential credit costs as is appropriate at this point in the cycle. However, net charge-offs have remained very manageable thus far, and we believe the company's cumulative reserves plus ongoing earnings streams should be able to absorb net realized credit losses even if they rise somewhat.

"We believe that … our largest banks and consumer finance companies have the wherewithal to absorb credit costs on their income statements to a much larger extent than before, and may in fact grow earnings and book value, even net of credit costs."

Given the considerable restraints placed on major lending institutions since the last crisis, the companies we favor have been trading roughly at or in some cases below book value. This implies they are set to lose money due to credit losses. We believe the opposite will hold true this time around—specifically that our largest banks and consumer finance companies have the wherewithal to absorb credit costs on their income statements to a much larger extent than before, and may in fact grow earnings and book value, even net of credit costs. These financial businesses are cheap on a price-to-book and P/E basis, setting up the possibility of a "double play" for shareholders if they continue to deliver strong financial results, which has been the case in recent periods.

One should always exercise selectivity in choosing investments, but the general observation that the financial system of the U.S. is stronger and more equipped to handle slowdowns or contractions today holds very true based on the data that we see.

Outside of the above areas, the fund's performance last year benefited from a number of highly individual investments such as Owens Corning, Carrier Global and Eaton Corp.

The portfolio is currently invested across 42 holdings that represent exceptional businesses trading at attractive prices with an average forward P/E multiple of 12x versus 21x for the benchmark. ■

Outlook:
Building Value Over Time

A key takeaway from 2023's strong stock performance is that what matters is not whether the news flow is positive or negative but what the market is *discounting* in prices. Our portfolio of companies remains significantly undervalued even after last year's strong performance, in many cases because these investments by and large started at very depressed valuations. If asked what the catalyst is for those securities, we would point out that value can be its own catalyst as long as investors are patient.

Whatever the market environment, our goal is to have a portfolio that we believe is well-prepared and resilient through inevitable challenges. We maintain our discipline of looking at the changing landscape of businesses and valuations as objectively as possible, and with fresh eyes each day, in order to build value over time.

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.[1] This alignment with our clients is uncommon in our industry; our conviction in our portfolio of carefully selected companies is more than just words. ■

Mastering the Mental Game of Investing

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

1. As of 12/31/23 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 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 12/31/23, the Fund had approximately 15.4% 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; **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; **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 12/31/23, the top ten holdings of Davis Opportunity Fund were: Wells Fargo, 6.58%; Quest Diagnostics, 6.07%; Capital One Financial, 5.86%; Viatris, 5.62%; Cigna Group, 4.57%; Owens Corning, 4.55%; Teck Resources, 4.54%; Schneider Electric, 4.02%; UnitedHealth Group, 3.92%; and U.S. Bancorp, 3.81%.

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 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 4/30/24, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

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