Davis ADVISORS

QUARTERLY OUTLOOK | First Quarter 2025

# Tapping the Power of America Inc.

There are many reasons to remain optimistic about the future of the U.S. economy. Its battle-tested resilience simplifies an investor's job. The opportunity to own facets of the economy and participate successfully in its growth exist today...as long as investors don't pay too much for the privilege.

**Following are highlights from an interview with Peter Sackmann,** a 27-year veteran at Davis Advisors whose responsibilities have included portfolio management, leading global institutional services, and serving on the firm's Portfolio Review Committee. Below is a summary from a recent interview, where Peter addresses questions from financial advisors on the state of the economy and equity markets, inflation and interest rates, growth and value investing, tariffs and other risks, and recent portfolio positioning.

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## Optimism in the Face of Uncertainty

**Dodd Kittsley:** What is Davis Advisors' outlook for the U.S. economy?

**Peter Sackmann:** We are constructive on the economy, given recent economic data. GDP growth for the country was 2.8%. The unemployment rate is slightly over 4%, which would characterize a tight employment situation and a healthy economy. Inflation, as measured by the consumer price index (CPI), has been hovering around 2.7%, which we think is very manageable. We don't think it's necessary to hit the Fed's 2% annual inflation target to make an assessment that the overall inflation outlook has become much more stable and positive.

While we have concerns headed into 2025, we believe there are also offsetting factors in place that compensate investors. Our first concern is the continued strong enthusiasm for certain areas of the equity market. If you look at different equity segments by style, for example, it's clear to us that large growth with a price/earnings multiple of 38x, is stretched.

Another concern is that 58% of the market capitalization of the Russell 1000 Growth Index is in the top 10 holdings. It's a concentrated and richly valued segment of the market right now. If we were to have an unexpected slowdown in the economy—that part of the market could become a vulnerability to investors.

The caveat to this scenario is that we are currently finding compelling businesses under the radar that are trading at much lower multiples. Davis New York Venture Fund, for example, has a forward P/E of 15x, which compares favorably to the S&P 500 Index at 25x, the Russell 1000 Growth Index at 38x and even the Russell 1000 Value Index at 19x. Clearly, there are places with real value and we believe this will continue into 2025.

The type of economic recession that people are most afraid of would be a systemic correction. By and large, we do not see balance sheet or leverage issues across the economy that would presage something like this. Overall we are constructive and believe some areas of the equity market are better than others for taking measured risk. The overall economy seems to be fairly stable and we don't see any imminent issues that would cause it to abruptly reverse.

In the event there is a slowdown in the economy, we always look at both bull and bear cases in our models and invest on an opportunistic basis. While an unexpected recession may occur at any time, the resiliency of the U.S. economy has been proven time and time again. We do not think a recession now would be fatal, and could actually be quite attenuated given our starting point.

## **Dodd:** How about interest rates?

**Peter:** U.S. monetary policy is driven by the Fed's efforts to find the right balance between supporting economic expansion and controlling inflation. They are mindful that at times, financial repression is needed to prevent the economy from overheating and to keep inflation in check.

The real question is whether the current level of interest rates is negative or positive for the economy. While the Fed appears to be accommodating, 2.8% GDP growth is shy of what our economy historically has been able to do in the best of times. There are certain segments of the economy that would benefit from lower rates, such as residential real estate. Lower interest rates would likely drive more activity in that market with knock-on benefits for millions of realtors, contractors, home improvement stores, insulation and roofing companies. There is definitely potential for greater productivity. However, it would be hard to argue that the Fed thus far has been acting irrationally. It is neither stifling the economy, nor is it stimulating as much as potentially could, which in turn could possibly translate into lower rates.

## **Dodd:** What about expectation for a recession and if so, how should investors prepare?

**Peter:** Historically, there's been a 20% correction in the equity market roughly every three-and-a-half years. Starting from today's valuations we can't imagine there would not be a correction at some point. Multiples are high enough that if some deterioration in earnings occurs and investors rethink valuations, you could certainly see a correction. While the S&P 500 Index is expensive at 25x earnings, we do not believe it is in speculative bubble territory. At these multiples, dividend yields are on par with the risk-free rate. However, it does probably suggest lower expected average returns for the index going forward.

Historically, market corrections have occurred on a fairly regular basis. When we look at businesses, we expect setbacks will occur from time to time, but prefer them to be income statement related as opposed to balance sheet driven. The balance sheets of corporate America look pretty good right now and experience has shown that income statement volatility in most cases is to be expected.

We prepare for volatility, but not necessarily in a defensive way. In the past when there's been a market correction of some kind—perhaps 10% or 20%—it has often been a palate cleanser for a longer term bull run. We actually prefer having pressure blow-offs from time to time to extend the longevity of a bull market without it becoming a systemic speculative bubble, which could be more serious and have a longer-lasting impact.

Corrections also offer buying opportunities. We had seen this in the previous collapse in technology stocks in 2022, when we were able to go headlong into our Meta investment at about 9x earnings. This is an environment where active management can add significant value. Active strategies can be opportunistic and capitalize on short-term corrections.

## **Dodd:** What about the tariffs proposed by the incoming administration?

**Peter:** It is certainly interesting and of shock value to talk about tariffs mentioned thus far by the incoming administration. However, it is important to balance initial proposals with how our political system actually works, our relationships with other countries and the diplomacy required. Each president has their own unique negotiating style. We assume a series of negotiations will occur, as opposed to ultimatums. What we have heard thus far, we view as opening salvos in a conversation or negotiation. Much like a legal contract, the first draft includes everything one could possibly ask for prior to entering negotiations with the understanding that compromises will be necessary to ultimately reach a deal.

We do think it is very important to consider and be prepared for the many possible implications for non-U.S. companies and supply chain management. In Europe, we tend to favor companies that have truly global businesses. In contrast, within Asia, we have more of a tilt to domestic companies as opposed to exporters, which could be more severely impacted by new tariffs.

Ultimately, tariffs will come out of a negotiation process and it will take time for specifics to become apparent. However, this type of uncertainty can upset the market. With a 38x P/E in the Russell 1000 Growth Index, we don't have to predict what exactly could go wrong. We know that there will inevitably be some unforeseen negative events whether related to tariffs, a natural disaster or something else. This feeds into our general thought process which is to be cautious on valuations, own businesses that are not binary relative to tariffs and let negotiations play out while being willing to make adjustments as needed.

## **Dodd:** How does Davis view the increased concentration in large cap stock indices?

**Peter:** We believe that many investors would be well suited to consider a shift proportionally from growth towards value, but then look for and invest in true value as opposed to the way the Russell 1000 Value Index is currently constituted. In our view, it is important investors adapt and prepare for the next decade which, starting from today's valuations, is likely going to be very different from the past decade.

Just as we're paring high-valuation stocks in our portfolios, paring an asset class the way it's currently constituted may make sense. It may also be a good time for investors to revisit their views on active versus passive strategies. Within active, we see some of the best opportunities in the relative value space with truly differentiated exposures than the currently concentrated large cap indices.

The real question then is whether one has the flexibility, choice, and appetite to make adjustments. Investors often have a preponderance of enthusiasm for labels and categories. That kind of dogmatic thinking is commonplace and also germane to how we might think about the indices today. Given the fact that indices evolve over time and can often represent very different exposures than originally intended, surely investors should adjust accordingly. There is no reason why investors should feel the need to maintain a 60–40 allocation to stocks and bonds; or a 50–50 split between growth and value, just because such allocations were appropriate in the past.

## Changes in Market Leadership

### **Dodd:** Do you expect a change in market leadership in 2025?

**Peter:** Market leadership hasn't shifted that much recently. If anything, we have seen it tilt further toward the growth companies given their advantages over value stocks in terms of pure economics and revenue growth. The key question is whether investors are overpaying for a leadership group. At some point, leadership groups tend to change for one reason or another. The fact that there is so much weight within the technology and communication sectors of the S&P 500 Index does make for real capital markets risk.

Companies leading the market today continue to be strong, fast-growing businesses. In some cases there is a dramatic degree of overpaying to own that group. The lesson of the current market environment is not to just own the 10 largest stocks or the Magnificent Seven, but rather to look beyond those names and find durable companies with sustainable earnings growth that are undervalued. Unless investors have the ability to decouple from index-centric thinking, those opportunities can be challenging to capitalize upon. We think that it's very important from both a risk and reward perspective, to detach from an index-only world view.

### **Dodd:** Financials have been one of the best-performing groups in 2024. Should we be concerned with the run-up?

**Peter:** It's rare to find financial firms trading at very high valuations with some exceptions like asset management companies and credit card businesses. In the case of diversified financial services, valuations tend to stay within reasonable bands. The last time we saw valuations really get ahead of themselves in financials as a group was in the late 1990s when there was a speculative bubble that bled into the whole market. Currently, we believe financials can be the gift that keeps on giving. As long as you can find companies that are able to consistently grind out good economics and have strong competitive positions, then financials tend to be a highly profitable group.

We have a constructive view on what we own in financials, but have made recent adjustments as a matter of portfolio discipline. We recently reduced exposure to certain names that have become less attractively valued. For example, we've been net sellers of JP Morgan Chase which trades at about 15x earnings and 2x book, which is expensive for a bank. This is not a commentary on the sector, but rather on the valuation of a particular business. We also sold American Express and reduced our position in Wells Fargo based upon valuation.

The good news is that investors can still find attractively valued companies like Berkshire Hathaway and Capital One Financial. Berkshire currently trades at a forward P/E of 21x, despite its strong recent performance and diversified business holdings. Capital One has a price-to-book ratio of about 1.2x and a forward P/E of 12x. This is another stock that's run up over 45% in the last year and yet its valuation still looks modest.

### **Dodd:** What about the opportunities in technology?

**Peter:** Valuations of technology companies we own have risen considerably along with the rest of the tech sector, but are still justifiable in our view. We have been paring our largest technology holding, Meta Platforms, based upon its relative weight in our portfolios and not valuation. It’s multiple, at 20x forward earnings is not inappropriate for a business that can grow at a much higher rate than the average S&P 500 Index company.

The opportunity for Meta as a global social media platform is significant. In particular, Meta has a massive opportunity with their advertising business overseas and room to increase revenue. WhatsApp is becoming the default international calling platform and Instagram is doing very well. There will be evolution in the way people consume media and the Metaverse is yet to be discovered by much of the world. Given the possibilities offered by high-powered AI, we believe it would be foolish and shortsighted not to be a player in the Metaverse ecosystem.

The same could be said for cloud computing. We believe it is possible that upfront losses are actually upfront investments that can earn a handsome return over time. That said, overall technology has been a net reduction area for us, largely based on valuation. The technology businesses we continue to own are growing very quickly, yet are still trading in the low 20x neighborhood, which means they're not nose bleeds but also not giveaways.

### **Dodd:** Following up on Meta, which many consider to be a growth stock. As a value manager, why does Davis Advisors have a large position in that name?

**Peter:** There are trade-offs every investor should consider when focusing on value and growth styles. In other words, what are you getting for your money? We think it's important to look beyond labels and categories. It is important to be specific about what businesses you own and ask, "What makes the most sense on a prospective basis for the next three to five years?" To put things in perspective, Meta is trading roughly at the same multiple as the Russell 1000 Value Index. What would you rather own—Meta with its various ways of potentially winning, current momentum, and high earnings growth rate, or a stodgy index that's arguably overvalued?

### **Dodd:** Where are the opportunities in healthcare?

**Peter:** Within healthcare, we own a very selective group of companies. Despite normalized margin structures, we believe the current risk-reward and low valuations could turn a boring group into a very exciting return category.

Part of our thesis in healthcare has to do with demographics. We are talking about a pie that is growing as much as 6% per year in this country. It is very rare to find an ecosystem that is expanding so much faster than GDP. However, there are distinctions that need to be made within healthcare at the industry level to uncover value. For example, there is a lot of fear and negative sentiment around managed care insurance right now. However, in many cases, we believe companies in the managed care business are underpriced due to temporary depressed earnings.

In contrast to certain financials which have high profit margins, companies like Humana and CVS currently have net profit margins under 1.5% and operating margins that scarcely go over 2%. This is very light for what these businesses are capable of over time, in our view. They are currently in a lull and have some cost-creep headwinds, however, we think that there are meaningful ways to rationalize their cost structure going forward. Our approach is to own a basket of companies across different areas of the managed care ecosystem so we can participate in the economics of the pie as much as possible without taking unique single-stock risks. Market share shifts happen each and every year unpredictably in that group, so it is the difference between betting on a single horse in a race versus betting on the economics of the race itself.

## Opportunities in Large Cap Value

### **Dodd:** How has the investment landscape changed in the large cap value space?

**Peter:** There is always a contrast between index-based passive portfolios and what is available through active management. Right now we think the comparison certainly favors enlightened active management. It is surprising to many that the forward P/E multiple for the Russell 1000 Value Index today is 19x. That's very high relative to its historical level, and its dividend yield is now below 2%. We think there is a strong argument for active management in the large cap value space. Investors have some compelling options and don't have to accept the index's high valuation and low dividend yield.

The performance of the Russell 1000 Value Index over the last 10 years has been shy of the broader market but nonetheless in the low double digits. However, from a valuation standpoint, multiples today are almost twice as high than a decade ago. Currently, investors are paying 18.9x for a 9.6% 5-year earnings per share growth rate with about a 2.1% dividend yield. The dividend used to be a real allure for the index when combined with a low valuation. A decade ago you could buy companies under 10x earnings in the value space with dividend yields over 4% when the risk-free rate was zero. Today it's the mirror image. The risk-free rate is over 4% and the dividend yield is only 1.9%. So the Russell 1000 Value Index appears expensive and stretched from our vantage point.

Within value there is a risk that certain sectors have recently experienced high earnings that are unsustainable. If you think about consumer staples stocks in particular, it is hard to argue that they have justifiably high and appropriate multiples at 19x. These are businesses that are not growing much on a unit volume basis and have been beneficiaries of price-driven revenue surges over the last three years because of inflation. If inflation continues to moderate, you will likely see some cracks in the value camp that may not be immediately apparent right now.

## **Dodd:** Among the many approaches within large cap value, which is best positioned for the future?

**Peter:** Historically, investors treated large-cap value as a single monolithic category. Utilizing a single value manager, whether it was index-based or other, was considered sufficient to satisfy value exposure within an asset allocation model. However, currently the Russell 1000 Value Index contains 869 companies, while its sister, the Russell 1000 Growth Index, has only 312. Value currently offers a much bigger opportunity set and a plethora of different investment approaches for exposure. You don't often see as much differentiation in large-cap growth. There is a strong case to be made to invest in several large cap value managers for investors seeking more complete coverage and exposure to the value universe.

Today we're seeing investors categorize active strategies for large cap value into four primary segments, each with differing characteristics. The most frequently used segments within value today are: deep value, dividend focused, benchmark sensitive and relative value.

**Deep value** is an approach that seeks extraordinarily cheap businesses often trading at cash or liquidation value. It's very hard to find good businesses that are trading at those low multiples today, so it may not be the most available opportunity set at the moment.

**Dividend focused** or equity income has recently been a popular strategy. However, we think it's going to be difficult to find businesses that have good balance sheets, a lot of free cash flow and competitive dividend yields above a benchmark. If you look at who the high dividend payers have been, they're generally not in rapidly growing businesses, don't have strong balance sheets, or possess an ability to increase dividends. We think it is important to keep an open mind about whether this is the right time to start a dividends-first mindset again. The last decade arguably was, but that may no longer be the case.

**Benchmark sensitive** approaches often have similar characteristics and risk exposures as the overall value universe. Given today's average valuation within large cap value, we believe that a selective high conviction approach, can add meaningful value in today's environment. In other words, what you don't own is as important as what you do own. While the large cap value space looks fully valued overall, it's possible to build a compelling and well-diversified portfolio at a far lower multiple, such as Davis New York Venture Fund at around 14.5x.

**Relative value** is a category that emphasizes the trade-off between the price of a company's stock and the future earnings growth of its business. It is an approach that looks deeply into what you're paying versus what you're getting in terms of economics—margin structure, return on equity, return on invested capital, and growth rate. Relative value strategies follow a total return approach and are agnostic as to its source, whether it comes from dividends, share buybacks, or other factors. Whatever the most rational and constructive capital allocation decision is and how it contributes to total return is most important.

This is probably the most flexible definition of value. Given all the crosscurrents and uncertainties today in the market and economy, we think maintaining flexibility has a real advantage. We see relative value as being the best game in town given its flexibility and ability to offset business economics against the multiple.

## Preparing for the Unexpected

### **Dodd:** How is Davis Advisor's perspective on today's market unique?

**Peter:** One of the big differences in our perspective at Davis is a degree of humility in the face of an uncertain world. No one really knows what will happen with tariffs, policy changes coming from a new administration in Washington, or the impact of geopolitical unrest—not to mention any black swan events, which by definition are unpredictable.

Our approach is to find businesses that on a self-contained basis represent good productivity, high return on equity, sustainable free cash flow yields, and strong competitive positions. Once such businesses are well understood, our focus is to not overpay for them and stick to areas of the market that have real longevity. That doesn't take out the uncertainty per se, but rather offers a margin of safety versus starting with very aggressive growth assumptions and high multiples in a highly uncertain world.

### **Dodd:** Any final thoughts to share as we begin a new year?

**Peter:** Every year that we've operated as a firm, over the past 54 years, the market has offered constructive things to do with the money we manage. This hasn't always had instant or obvious appeal. At the end of 2022, for example, when we started really leaning into Meta in that stormy and volatile market, that positioning didn't necessarily feel good to our investors on day one. Looking back, however, that opportunity was an important way to be constructive in a challenging market and to add value over the long term.

We've never seen an environment, up or down, that didn't offer something constructive to do. So we'd like people to come away with the idea that you have a lot of power and flexibility in your decisions. This is a time to balance greed with fear, in our view, rather than going to one extreme or the other.

Our goal is to own good businesses that are durable and have the ability to compound earnings over time. Our investment discipline is based on an inherent confidence in the economic model of the U.S.—its industry makeup, skill and education levels of its workforce, diverse population and natural resources. We think America Inc. has a real raw potential. We can buy facets of it, especially when they go on sale, and own them as constructive things happen at the corporate level. It's a positive, optimistic viewpoint based on a very long history. This is a battle-tested economy. Its resiliency and growth mean that a lot of the investor's job has already been done. The question then becomes how to execute, what to select and how to avoid being shaken out prematurely.

### **Dodd:** Peter, thank you for sharing our firm's perspective on these important topics from our shareholders.

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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.

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

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