Davis ADVISORS

QUARTERLY OUTLOOK | Third Quarter 2024

Finding Value in a Rich Market

In a top-heavy equity market, look for the relative value sweet spot where the possibility of strong earnings growth combines with very cheap starting prices.

Following are highlights from an interview with Peter Sackmann, a 26-year veteran at Davis Advisors whose roles have included portfolio manager and head of global institutional services. Peter has also served on the firm's Portfolio Review Committee. Here Peter talks about the current state of the economy, finding opportunity in the equity markets, the economic effect of technology, and the outlook for commercial real estate. He discusses specific portfolio positions, and responds to wide-ranging questions from listeners.

Peter was interviewed by Dodd Kittsley, Davis National Director.

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Hard or Soft Landing?

Dodd Kittsley: Peter, let's start with the economy. There is angst out there, with some people talking about a hard landing and others expecting moderation and lower inflation. Would you elaborate?

Peter Sackmann: This is tantamount to asking whether the economic glass in the U.S. is half full or half empty right now. We would say it's probably more half full, and here are a few reasons why. We've been through much worse times. Right now with 4% unemployment and a slowly expanding economy—first quarter GDP growth was 1.4%—it is looking like a fairly stable jobs market for the time being. And that is important. Most of our economy, about 70%, is consumer-led. If you're going to have a strong consumption-led economy, there has to be spend, and spend comes from wages and income. So, that's one important foundation that you really do want to have in place.

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The second is financial stability. Since the 2008/09 financial crisis the banking system has been effectively revised. The old business practices and models that were extraordinarily risk seeking have mostly been regulated away. The banking system is now dominated by a handful of megabanks that by regulation and also by enlightened management hold a tremendous amount of capital, something that we have not enjoyed for quite some time. It should be viewed as a shock absorber in case of some downside in credit quality and credit conditions. Those can happen naturally even with an economic slowdown, let alone a recession.

Right now, we're in a slowdown and there's some stress at the margin. People are feeling the pinch because the economy is not growing as much as it needs to relative to the rising cost of living. However, we believe that time is on our side and the worst of the inflation surge is behind us. Inflation has certainly leveled off. The recent CPI print for May was 3.3% versus 3.4% in April.

Another good thing about this economy is that there are institutional frameworks in place that allow for resiliency. Here's a quick example relative to the cost of living. The latest inflation rate of 3.3% compares to about 4.0% a year ago. Last year, inflation was being driven by food and beverage costs, recreation and lodging, and housing, including rental costs. All of these seem to be moderating, and in some cases by a lot. The food and beverage category, for example, which was clocking a 10.1% annual rate last year, is now at about 2.7%. That's a dramatic moderation.

We see things are moving in the right direction. Of course, concerns over wages and income and job loss are always very real. But there is a difference between what we're seeing now and the worst-case scenario that some fear, a hard landing. You don't need to have a crash landing. There is a middle ground scenario, which is a moderate course forward. In our economy, crash landings have almost always followed on the heels of a massive leverage bubble. We don't have that now. We're actually in pretty good condition, in our opinion.

Technology as Catalyst

Dodd: Our research team frequently emphasizes the long-term impact of technology and the role it plays in many other sectors. Would you expand on this?

Peter: In a way, the tech sector is to other sectors what the space program was historically to the economy at large. It feeds it, and sparks innovation, which ripples through to different sectors. We're at an interesting inflection point now with everyone talking about AI. It's important to think about where and when AI shows up in the P&L. There's no doubt about its inherent value to certain types of business models, but we have to be clear about which business models.

Take a social media company like Meta that has been working on implementing AI as part of their ad service for a number of years. Today it is actually showing up in fairly material ways in their P&L. This is something you could point to and say, "Well, as the newest technologies get better and more available, they will be very powerful for that type of business model." But Meta's business model is analytically targeting demographics for ad campaigns, which naturally can gain efficiencies through more intelligent searching and algorithmic operations. It's harder when you get to healthcare and other industries.

Take pharmaceuticals, for example. You could envision the heyday of high productivity and blockbuster drug discovery of the 1990's coming back. However, it's going to take an approval process, it's going to take testing, it's going to take a long time to get to market, and that's before you consider competition and how strong each player is. So it is longer tailed.

Where the rubber meets the road right now is in semiconductors. Let's look at Texas Instruments. When we first started buying back their shares aggressively in the mid-1990s, they were positioning themselves—intelligently—to be at the heart of the digital signal processing market. This is the core component that you need in a cell phone to convert digital to audio and audio to digital. They did a fabulous job, and had a tremendous run on that. Today, this pioneering company is involved in industrial and automotive, first and foremost. If you

think about the automation of factories—sensors, brains, robotic plants—the AI and semiconductors that run these things can make a massive difference to the economics, the efficiency, the error rates, and more. That all shows up in your costs, and ultimately your P&L.

So you have to ask when it is likely that a given business or industry will be impacted and influenced by AI and other technologies. It's like the emergence of the internet—it took many years before Facebook came out, before Google grew big, before users were really immersed. So we think about it in long-wave terms. You have to study both the pioneers and the old-line players that are remaking themselves, and then figure out who can create value at the P&L level sooner rather than later.

Dodd: "Productivity creep" from advances in technology seems to be reaching into many parts of the economy beyond tech leaders. Would you agree this includes financial companies?

Peter: Absolutely. JP Morgan spends upwards of $15 billion a year on technology. To put it in context, that amount is close to half the median company market cap of the S&P 500 Index. It is estimated that the big banks globally will have to spend as much as $8 trillion on technology over the next four or five years. Some of this has to be spent on cyber defense and protection, but it is beneficial too. There is the potential for massive productivity gains in the back and front offices. If banks can reduce leakage from theft and fraud, and also transform the front-of-store experience akin to what ATMs did to bank tellers, that could result in a sea change for the industry.

Financial firms have been one of the biggest consumers and beneficiaries of technology advances. Just one example—in the 1990s, when Allstate obtained computers, it divided up its markets around the U.S. into over 150 submarkets, and was able to dynamically price each one according to localized risks. That's very difficult to do that without technology. Fast-forward to today, and the minutiae have gotten more complicated, but the basic function of pricing risk correctly remains, and it can make or break an institution over time.

Equity Market Sweet Spot

Dodd: Let's pivot to the equity market. Many investors use the S&P 500 Index as a proxy for the overall market. Is that the correct approach? What should investors be aware of?

Peter: It's a legitimate and valid goal to try to have exposure to some significant number of U.S. equities. However, we don't think the S&P 500 in its current constitution is a true proxy for the U.S. stock market. We're looking at an index that has morphed into a very concentrated, narrowly led benchmark. The top 10 holdings in the S&P 500 represent approximately 36% of the whole index by market cap. That means each of the other 493 companies would represent only about 13 basis points on average.

So you are not really getting meaningful exposure to most of those holdings. You're getting massive exposure to the top 10 and de minimis positions for most of the rest. The problem is that the top 10 are carrying fairly substantial valuations. Overall the S&P 500 is trading at a forward P/E ratio of about 23 times right now. If you're in the growth index, it's higher—almost 31 times. If you're in the value index, you're in the neighborhood of almost 17 times. That is not a nosebleed number, but it's higher than most people would want for value.

We think we can do better. Davis New York Venture Fund in the large-cap space, for example, has a forward P/E of 14.4 times.[1] This is cheaper than the S&P 500 and both its style indices. Now, you have to also ask what you are getting for it. The S&P 500 has posted annual earnings per share growth of about 14.9% for the last five years. The growth index has done better than that, but of course is sporting much higher multiples. The value index, interestingly, at a P/E of 16 times, has produced very, very

1. 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 5.13% 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.

tepid growth—in the 8% range over the past five years.[2] Our portfolios have grown earnings per share at a rate of about 15% over five years. To sum it up, you can have Davis New York Venture Fund with a forward P/E of 14.4x and a 14.8% historical earnings growth rate. Of course, the 14.8% may not continue, but it does mean that this combination of value and earnings growth is structurally possible. Compare it to the S&P 500 Index which has had comparable earnings growth rates to our portfolios, but now has a P/E multiple 57% higher than five years ago.

It's time to revisit active management. You don't need to jettison a portfolio or an entire asset allocation. However, you can make sensible adjustments away from certain valuation and concentration risks, and build in some tilts, some other type of investments, and other ways to win. In our case, the sweet spot we're occupying is in this relative value category where you have the possibility of fine growth at very cheap starting prices. That seems like a prudent way to do things in an environment where the risk-free rate is still elevated relative to the multiples of equity indexes.

Dodd: It looks as if we are seeing a lot of value today in an otherwise richly valued market?

Peter: Absolutely. Here are some examples. One is MGM Resorts, which was trading very cheaply due to its MGM China business revenues being almost eliminated for a number of years because of China's COVID lockdown policies. That's coming back in full force right now. Another is Owens Corning in fiberglass insulation and roofing. These are companies that were trading at about 10 times on either earnings or levered free cash flow. They had some very nice runs in the last year and a half, and are still well-priced, having expanded the multiple only two or three turns, while earnings have really grown. These are gifts that keep on giving when you don't have to sell. You can hold a position for a long time if a company's business model continues to look strong and its day-to-day strategic and financial and operating decisions just keep getting better. There are a lot of good businesses out there that don't happen to make the headlines.

Real Estate Risks

Dodd: Commercial real estate has clearly introduced widespread risk to the market, and there are some sub-segments which are starting to look attractive. How big of a risk do you think remains in this sector?

Peter: There has been a necessary repricing and downward adjustment of office values mainly because of the work-from-home phenomenon and the cost-saving initiatives that corporations have pursued since COVID. This probably will reset the natural level of demand and utilization for those types of properties, if they remain office properties. So there will be plenty of institutional investors and some banks that will see losses on some of these assets as they mark them down or sell them. However, it doesn't need to be a fire sale for many of the bigger banks and the more diversified institutional owners of real estate.

As long as it's not a disorderly rush for the exits, you'll likely have one-off situations, like Blackstone, for example. They bought 1740 Broadway in New York for over $600 million 10 years ago, and just sold it for $185 million. So they took a sizable loss on the principal value. However, remember that they owned it for 10 years, each year of which saw escalating cash flow from rents, so they probably did pretty well on the overall IRR of the investment.

Other than office, we see some weakness in retail, both department stores and freestanding. We also see some pick-up in student housing, in data centers, in the telecom space, and in lodging and entertainment. So commercial real estate is far from being a total wipeout. You have to be realistic about what each of the sub-asset classes and property types can produce from here, but it is certainly not a catastrophic, all-or-nothing proposition, in our view.

2. 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.

Questions from Financial Advisors

Q. *You have been trimming Wells Fargo and JP Morgan over the past month or so, and buying Tyson, Humana and Solventum as new additions. Can you comment?*

Peter: It comes down to relative attractiveness. Wells Fargo is doing much better than before, and is not expensive. But on a risk-reward basis, dollar for dollar, in terms of what you can get in potential earnings growth versus current valuation, the math just looks more attractive for Tyson Foods, and for Humana and Solventum in healthcare. The same would go for JP Morgan. We bought about a 1% position roughly in Tyson, and in Solventum, while Humana was a more substantial add.

Overall we thought we got very fair value for each of the positions we trimmed, then were able to buy some things that were truly cheap. For example, Tyson Foods is currently clocking a negative net profit margin. That's not really in line with its history at all. Historically, Tyson has not seen surges in food input costs like those that have occurred recently. Over time this should correct, the food inflation curve should moderate and, as you roll forward a year or two, you have a new cost base and a new comparable. We think they can probably do net margins north of 6%, and that makes a monumental difference in the math.

Solventum is a spin-out from 3M's healthcare business. It's not an exciting lift story but it is very cheap right now, and it is a good business which is positioning itself for a nice glide path forward. It wouldn't be a surprise if actual earnings and fundamentals don't change much for the better part of this year, but that's the difference between the way we do things and the way others think. We don't mind waiting nine months or a year before something begins to respond because we intend to hold it for five or 10 years. The cost of entry incorporates time value of money so, depending on the price you paid, you may not want to wait six years, but nine months or a year is fine.

Q. *What is your current view on Intel?*

Peter: Intel is priced where it is because there is realistically not a whole lot of immediate gratification in the offing. They're very involved in the PC market and everything related to it—servers, cloud, network, etc. Their foray into total fab services is expensive. We know the government is willing to help, but even if you throw all the money in the world at it, it still takes a lot of time and a lot of technological improvements along the way. It's not as though you get it right the first time in semiconductors.

In our view, Intel's plan does make sense strategically, but this might actually be much more of a game of patience than some of our other holdings. It's about 2% of our portfolio and we consider that to be a meaningful but not overly aggressive position size right now. We are open to new information that could change our allocation decisions but, for the time being, it has its own path to blaze, and it could be a long path.

Q. *Can you give us an update on your position in Viatris? Any change in thesis?*

Peter: Viatris reminds us a little bit of what we're seeing with Teck Resources. They're not in the same sector, obviously, but Viatris is also trying to shrink itself to better economics. It's trying to work off debt, and continues to commit to giving as much as 50% of free cash flow to back to shareholders through the high dividend and stock buybacks.

Now it is very cheap, and you don't need to have an NVIDIA-like top-line growth for this to work out. You just need to have a less pessimistic multiple on the stock. We're not saying specifically that it will expand from a P/E of x to a P/E of y. What we can say is that a valuation of four times free cash flow seems light for a business that has 1,400+ approved therapeutics in pharmaceuticals.

We are very interested in healthcare. We own Humana, Cigna, Quest Diagnostics, and now Viatris. What's interesting in all cases is that they are adjusting their costs and their cash flows and becoming much better at pure cash management. The CFOs of these companies are very focused, and that brings a lot of value—a C-suite that actually has a financial plan that they're executing on.

It may be lumpy, but these are nonlinear earnings that could become fairly smooth over time. Put another way, we think that the option value of Viatris is considerably above where the stock is trading right now.

Q. *What is the reason for your higher allocation to healthcare?*

Peter: The first thing to understand is that our healthcare companies, by and large, are under-earning. That explains why we have taken a very strong stance on Humana, for example. Their net margin right now is around 2%, which is down about a third from the normal, partly because of cost increases related to procedures that were backloaded after the post-COVID period, and took some time to resume. Also, the U.S. government has had to tighten its belt and be more parsimonious with Medicare Advantage reimbursement rates. The real opportunity there is that once you begin to manage those costs and find ways to shrink your cost structure, your margins could go up to 3.5%. It seems light, but that would be a 40% lift right there, so not bad.

Q. *Can you speak to your heavy weighting in financials?*

Peter: 8.27% of that weighting is Berkshire Hathaway. That's almost a quarter of the total allocation. We call Berkshire Hathaway a nonfinancial financial because there are so many other pieces at work. Really it's an investment portfolio in the main. With Berkshire you have $182 billion in cash and short term bonds, $17 billion in fixed income and $336 billion in equities. So a lot of its market cap is investments, and the other stuff is cash cow businesses.

Looking elsewhere, we have Capital One Financial. It's in the financials allocation but, like everything, is chosen individually for specific reasons. Capital One Financial has some of the highest lending margins and pricing of any U.S. financial institution around today. That matters because credit quality and credit conditions will get worse at some point, and then the real question is what the losses look like for your equity. If you start out being able to charge very high rates for people who are becoming less creditworthy, but at the same time work with people on different types of metrics than just FICO score—that is, work flexibly—you get a better result, both in terms of actual charge-offs and spread.

Last year Capital One was able to get a net interest margin of 668 basis points. It's almost double what you'd expect in a bank of that size. They earn enough with their cushion to accept losses that may look high for a traditional bank, but for a consumer finance are completely digestible.

Q. *How do you view your portfolios given the potential of tax cuts expiring next year. What effect would that have on equity prices and valuations?*

Peter: It's a logical and valid concern. We don't know what will happen for certain. What we can say is that the relative tax rates applied to different instruments make a big difference—that is, those where you will pay your marginal income tax rate versus those at the long-term capital gains rate. There is over 20% cash in a lot of asset allocations today. Those returns are taxed. They're not tax-free. So that's one place you could start. You could ask: "Should I own a long-term equity that can have frictionless compounding over time as long as I don't do anything with it, or should I get 4–5% on a cash-like instrument and pay 40% of that income in tax?"

One of the implications of tax cuts expiring could be a renewed interest in muni bonds. Capital markets have a way of intelligently adapting to new realities. There's never been a tax code that for decades just flattened the market. The market is smart enough to adjust.

Here's another way to think about it. If you do have surplus savings, and you were told you could either own equities for an uncertain return or you could go to cash and lock in 2% after tax while we have 3.3% inflation, what would you say? I think the math will eventually speak for itself.

> **Dodd:** Thank you for your valuable insights. We look forward to talking again in future market updates.

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Item #4703 6/24