Davis ADVISORS

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# Finding the Unwritten Headlines

## News feeds keep churning out their wall of worry but if you look carefully there are many positives to be found in the U.S. economy, markets and corporate performance—once you break them down and assess each on its own merits.

**Following are highlights from an interview with Peter Sackmann,** a 27-year veteran at Davis Advisors whose responsibilities have included being a portfolio manager, head of global institutional services, and serving on the firm's Portfolio Review Committee. Here Peter addresses questions submitted by clients, current state of the economy and equity markets, scale and technology, growth and value, geopolitics and commodities, the outlook for China, and specific companies in the Davis portfolios.

Dodd Kittsley, National Director at Davis Advisors, interviewed Peter.

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## Compartmentalize the Macro

**Dodd Kittsley:** Today's headlines on the market and economy tend to be scary and pessimistic in nature. What are some unwritten headlines that investors should also consider?

Peter Sackmann: If you watch the news feeds, you will get a healthy dose of the wall of worry today. There's a long list, like the wars in the Middle East and Ukraine, and the surge in inflation since COVID. But interestingly, if you compartmentalize things and watch the tape a little bit more, it reveals a different story altogether. For example, in terms of the positives that we see out there, first is the broader market. Given the litany of concerns people have psychologically, it's surprising that the broader market as represented by the S&P 500 Index is up over 20% this year, and that follows 2023, which was very strong as well.

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More significantly, you have a healthy jobs picture, by and large. Unemployment is slightly over 4%, which historically is a very tight labor market. Then the Federal Reserve is pivoting on its interest rate policy, reflecting the policymakers' view that the worst of the inflation surge is behind us. We will see whether that proves correct or not, but it is a data-driven view, and it seems that by all measures inflation is attenuating.

How can you justify the behavior of this market, which has been very strong for a few years now? If you look at the aggregate earnings per share of the S&P 500 on a standardized basis, it was $31.44 three-and-a-half years ago at the end of 2020, and by June of this year it was $53.12. That's about a 70% increase, which is a fairly tremendous result. However, it is also a result that has gone virtually unnoticed.

Those are some of the positives in the market backdrop and show why we think that the macro needs to be understood in a compartmentalized way—what is happening economically, what is happening in corporate America, and finally weaving in some of the important but unknowable current events. All three are important but they do not all move to the same metrics.

## **Dodd:** How are Davis portfolios currently positioned and what exposures are emphasized?

**Peter:** We can look at Davis New York Venture Fund as a proxy for our large cap strategies. It has currently about 43 holdings, and the forward P/E is about 15 times.[1] Within the businesses the portfolio holds, earnings per share grew a little over 17% on an annualized basis over the last five years.[2] I think that is also a surprising result. It reflects the ongoing health we see in the corporate sector.

We have a few different themes at work in the portfolio. For example, a long-time theme for our team has been financial services, and specifically what we consider to be high-grade financials. This would include the likes of Berkshire Hathaway, Capital One Financial, JP Morgan Chase and Chubb, among others. Financials represent a little over 35% of the portfolio.

We have a similar weighting in megacap workhorse technology companies. They range from traditional names like Google and Amazon, to e-commerce and semiconductor companies, where we hold names like Applied Materials, Texas Instruments and Intel. About 13% of the portfolio is a combination of large healthcare companies that include Cigna, Quest Diagnostics, Viatris and Humana. Some of these are at pain points currently, but nonetheless we see value in them. Finally, the balance of the portfolio consists of various industrial companies as well as consumer staples, materials and commodities businesses.

## **Dodd:** Can you share perspective on some names that have underperformed recently that we continue to hold with conviction?

**Peter:** Let's start with Intel and Humana, the reason being there have been some developments that we did not foresee. To be clear, some of the expectations or hopes we had for even the near term have not materialized. In Intel's case, the company has basically had to sit out a product cycle. This resulted from a lag in its technology capabilities vis-a-vis some competitors who today are at the forefront of AI and other areas. However, unbeknownst to most Intel observers, in our view the company has more or less caught up on the technology side. The semiconductor product cycle is iterative by nature, like the innings of a game that goes on forever. We expect them to participate more in the next wave of the product cycle. Also, it is important to understand that this is not historically a winner-take-all industry. You have some companies at the forefront of each wave, but at the end of the day, as these technologies morph, expand and diversify, there tends to be much more of an ecosystem of needs that must be filled by the semiconductor industry.

**1.** 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.
**2.** 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 6.06% 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.

We think Intel will definitely be there, and right now, it is in a pregnant pause. Consider that its market cap is around $96 billion while its asset base—total plant, property and equipment—is also worth about $96 billion. The company has about $25 billion in cash and will generate free cash flow, in our opinion. So depending on what assumptions you build in, you are looking at a company that is trading at liquidation value or less, and with a very large option value as to what it could potentially achieve. Even if it performs modestly relative to the industry and relative to the past three years, the fact that we are starting from a point of maximum pessimism could make it very meaningful.

Of course, it would not be comfortable to have the whole portfolio in that position right now, but that is why we have a basket of different types of technology companies. Although Intel itself is down about 52% this year, the aggregate technology segment of our portfolio is up high single digits in total return on balance.

Humana is similar to Intel in the sense that there have been some untoward developments, in particular the low CMS Star ratings that it received on its Medicare Advantage plans in the current round. This year's review was surprisingly low compared to past years. Humana missed the line by a marginal amount, but nonetheless fell short of some of the thresholds that feed into the Medicare reimbursements it can expect—a development that may push out margin improvements we had expected to occur sooner. This makes it a bit of a workout situation at the moment but we see real value there.

Humana has been capable for a long time of delivering real quality and needs to focus on how to get back to that. We also believe that its margin structure is under-optimized right now. Humana's net profit margin is about 1.5% and its operating margin is about 4.5%, which is very low. They have some work to do on costs, but the good news is we believe that they can eventually manage those expenses down and drive margins higher.

Viatris is an ongoing saga. It's up about 11% this year but is valued at about four times earnings. It is one of the cheapest stocks in the entire universe. We take a differentiated view that it is becoming more financially stable and interesting in terms of equity build as it works off more debt than most of the rest of the Street realizes.

## How Scale Plays Out

**Dodd:** How long do you think the Magnificent Seven can continue driving the market?[3]

**Peter:** Well, trees don't grow to the sky forever. A good analogy is Cisco Systems. At the end of March 2000, Cisco was trading at 100 times earnings and was a market darling. The key thesis among asset managers who bought Cisco in size was that the company provided foundational infrastructure for the internet and drove its democratization. They were right about the online opportunity, but were wrong about the economics of what could be supported with a stock trading at a 100x multiple. Cisco stock peaked on a split adjusted basis at $65 a share in 2000 and today, some 24 years later, is trading at $52. The point is, you may get the theme correct, but if you are overpaying, there is usually some reset in valuation that disrupts your compound over time. We are wary of things that look too good to be true.

Today, we have a situation where the top company powering the Magnificent Seven, Nvidia, is trading at about 33 times sales. That could be justified depending on what plays out economically and how large their profit margins remain. On the other hand, if there is fiercer competition, and Nvidia's profit margin contracts even slightly, it could have dramatic implications on what is a fair multiple for that business. We think there are certain companies in the Magnificent Seven that are justifiable. We own Amazon, Alphabet, and Meta but there are a handful where valuations are uncomfortably high, in our view.

**Dodd:** Looking at the Davis Large Cap portfolios today, what common thread runs through the holdings and what characteristics does the team look for in general?

**Peter:** For one thing, we pay close attention to durability before going into any investment. Going back to examples like Humana, Intel and Viatris, we believe there is a low probability of those companies going to zero. It is an important starting point. Durability is just staying power, which means you are a constant magnet for cash in the

**3.** The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla.

form of revenues. For example, the top holdings in Davis New York Venture Fund represent upwards of $4.9 trillion in combined market cap and about $1.3 trillion in revenues on a trailing 12-month basis.

So the scale we're talking about is remarkable, and it reflects businesses that have a powerful value proposition to consumers, other companies, and the public sector. As a group, they have global relevance which we think is an intangible but very important factor.

Last but not least we are comfortable with earnings that are either linear or nonlinear as long as they're fairly priced. Usually the nonlinear path is more attractively priced, but often requires the stomach and patience to endure certain off-track and off-trend quarters.

Overall we want to see resilience. If collectively trillions of dollars in revenue are being piped through these companies, we want to see them take that money and create good outcomes in terms of real earnings power and generate attractive returns on capital—i.e., effectively a company's internal reinvestment rate—over time. Some have real trampolines, which might refer to technology companies in the portfolio, while some are just grinding out earnings each day in a lower-growth but reliable way starting at low multiples. Our financial holdings are a good example of the latter—they take in large sums of cash each day by their nature and cash flows are the lifeblood of any business. We are very comfortable with the overall health of our financial businesses right now.

That's the way to think about the portfolio—how it is basically converting massive amounts of the world's revenues into margin structures that over time build earnings. That is what we see as the derivation of the value in the portfolio. It boils down to management, strength, profit potential, competitive moat and then price.

**Dodd:** Can you share an example of a business with nonlinear earnings that we currently hold?

**Peter:** One company that is not in the headlines right now is Chubb, which is interesting because the company provides property and casualty insurance. In the past when there were some weather related events, like in 2020 for example, the stock was down by double-digit percentages. When a company gets buffeted by either the unexpected or even predictable, sometimes the market really misses the mark and extrapolates the near-term result into a much worse future for the company. For Chubb specifically, while it is unquantifiable what will happen in the current situation, we have a sense based on maximum probable loss estimates that it will be containable. However, we don't know how the market would react necessarily when the true estimates for claims related to the hurricane season of weather events are known. Chubb is a good example of a company whose earnings in the near term could be disrupted but that over time we expect to be very healthy.

**Dodd:** Davis is known as a research-driven shop that looks for companies with sustainable competitive advantages. Scale is something you mentioned as a competitive advantage in certain industries. Can you explain what you mean by scale and where it matters?

**Peter:** In our view scale is playing out in different ways in different industries. The first would be relative to very large and rising levels of fixed costs in the form of technology spending, for example. When you have a company like JP Morgan Chase spending $15+ billion

a year on technology—on both front and back office functions—it should be clear that the company would not necessarily be spending that much if it didn't have to. In other words, it is a lot of money, but it's obviously necessary, and we see the same spending creep in all the major financial institutions we own. So there is a tendency on our part to own some of the bigger companies that can handle the kinds of fixed cost spending requirements of the banking or global insurance business today. Smaller institutions can have a resource and margin disadvantage.

Amazon's e-commerce business is another area where scale is critical as it plays into networking effects. This is true of any type of logistics business. For example, if you have packages being delivered to one node or another geographically, you need to amortize the cost by widening out that delivery net. Once you own those locales, it becomes hugely important to your incremental return on capital because the overall costs of delivery are spread out over a large base of customers in a locale. It is a hub-and-spoke system in nature.

Scale is becoming exceedingly important in the challenging business of heathcare. We are often asked about the implications of our rising national debt? Well, one thing it means is that budgetary constraints will potentially be foisted upon the public sector and even private sector. Healthcare spending represents almost 20% of our total GDP, so you have to posit that while revenue growth might be okay. These constraints could be a headwind to generating attractive total returns on top line and bottom line growth.

How do you deal with this? Technology can be utilized to drive cost efficiencies and replace manual processes. You can only spend billions of dollars on such cost structure transformations if you have scale. Through consolidation there have been synergies created as well, some of which have yet to be fully realized and can lead to better economics. But cost management will be extremely important in industries where revenue growth may slow.

Scale is also a reason why relative performance among large and small cap stocks may not be a strictly cyclical phenomenon. It is a structural reality that the strong are likely to get stronger and the weak or the marginalized could remain weak or marginalized. It does not mean that smaller stocks cannot have their day in the sun, performance-wise. However it does mean that structurally the megacap businesses are in general in a better position than the rest.

## Growth, Value and Income

**Dodd:** Growth stocks are again outperforming value stocks. Is value's long-running underperformance secular or cyclical? How should we think about it as the market evolves?

**Peter:** The growth indexes are currently very frothy in terms of headline valuations. The S&P 500 Growth Index is trading at a P/E of about 39x, but remember it has been growing earnings per share over 20% on an annualized basis over the past five years. The S&P 500 Value Index is sporting a multiple of about 20x now, which looks expensive for something that is growing earnings historically at around 12%. If you look at the math, with a 20x multiple you are at a 5% earnings yield in a 4% risk-free rate environment. If that yield grows at 12% annually you are still only looking at an earnings yield in the mid-7% range three or four years out—a return that is not particularly handsome above what the risk-free produces.

Now with the growth index at 39x, you have a higher bar to get over. The growth index has been compounding earnings at a much higher rate than value, but actually does worse when you calculate your earnings yield on cost three or four years out. That tells you that your starting multiple is all-important.

This is why we consider the 15x forward multiple right now in Davis New York Venture Fund compelling. If, for illustration's sake, you projected the portfolio's earnings out, in three or four years our yield on cost could be over 12%. We think a 12% earnings yield over a 4% risk-free rate makes for a very attractive risk-reward proposition.

We think the commonly used large cap value indexes today do not offer the same value proposition as in the past. You have to look at the valuations and growth rates for each different segment of the market and ask whether it is likely to produce a return commensurate with what you need for your spending policy, required rate of return, and financial goals.

### **Dodd:** How does Davis' investment approach fit with investors who focus on equity dividends?

**Peter:** Based on some of more popular dividend driven investment strategies, we think that the term "equity income" should be reversed in most cases such that it becomes "income and equity." In our case, by contrast, it would be equity and income—in that order. A risk-free rate at 4% is a 25x multiple for a 10-year Treasury. Compare that with a 2–3% dividend yield in much of the dividend-paying corporate world that in general currently trades at rich valuations and offers low growth rates. If your purpose is basically a bond-plus proxy, this might have some appeal if the dividends are stable and the companies are not reaching to pay them. However, in terms of the overall architecture of a portfolio, clients' financial plan generally calls for the need to have a *total return* above what the risk-free rate and dividends offer. We believe that current dividend yield levels, slow earnings growth and high starting valuations are headwinds to the large cap value indexes that may be persistent and not necessarily as cyclical.

Interestingly, our view is that we and the dividend investors are two sides of the same value coin, but we approach it from such different lenses that we end up with almost completely non-overlapping portfolios. We think it is possible to have a fine marriage of the two in a large cap value allocation.

## War, Oil and Commodities

### **Dodd:** With the Middle East in turmoil and no sign of an end game, what is our view on oil and energy?

**Peter:** Geopolitical effects on energy prices could be dramatic. We remember how in the two Gulf Wars oil spiked and pushed us into a near-term recession for a couple of quarters both times. Prior to that, in the Seventies you had massive shocks from energy prices following the OPEC embargo and the Iranian Revolution.

Today we think you have to be humble. Oil prices can go a lot of places, and you have to be prepared for different scenarios. One scenario is that oil prices spike, in which you need to be ready for second-order effects on our economy in terms of higher prices at the pump and their ramifications.

Where you have more control is what types of energy companies you might invest in. Instead of trying to make a tactical bet in one direction or another and own the tail of the whip, the way we feel comfortable today is with a boring but beautiful approach. For example, ConocoPhillips is one of our newer holdings. Some 85% of its approved reserves are in OECD countries—that is, developed countries with rule of law. It is the largest crude producer in Alaska on the North Slope. It has operations in unconventional fracking and a lot of acreage, both developed and undeveloped, in the Permian Basin and throughout Texas. Its acquisition of Marathon Oil earlier this year solidified and improved those assets. Finally, it has a strong foothold in the North Sea and liquified natural gas (LNG) interests in Qatar and Australia.

This is an example of a really diversified energy company, everything from oil sands to conventional and unconventional crude and LNG facilities. The diverse energy exposure that ConocoPhillips offers is comfortable to us because it hedges against a lot of different possibilities. The production is by and large outside the Middle East, yet like all companies in the global commodity business, it is a price taker, which provides revenue optionality and a functional hedge against negatives elsewhere in the portfolio. However, the main thing is to own an energy company that you think is a steady cash machine diversified in such a way that the asset base and production is in the more stable areas of the world.

**Dodd:** Chinese stocks took off following China's recent economic stimulus, after being below average performers all year. Is this sustainable?

**Peter:** Those stocks took off and then got panned because the Chinese government did not follow through right away with more stimulus. It sparked a narrative that they are out of bullets, which we believe is probably spurious. When the Federal Reserve makes a policy change, for example, they do not go all-in on day one. China is not out of bullets. Some of the things they are trying to stimulate need a little baking time.

Where you can thread the needle, in our view, is investing in select Chinese companies. Take Meituan, for example, a company that does everything from food delivery to cloud services to an Expedia-like travel service to ticket sales like Ticketmaster. This is a services business with a $500 billion market cap. It has substantial operating leverage—its operating margin is now about 10%, and that's low for what it has been capable of historically. All it needs is a bit more commerce and a little more top line growth. We are looking at companies that have the operating leverage and scale to produce tremendous earnings going forward once they hit a threshold in sales run rate. Meituan is up over 50% this year, so it shows it can be done.

**Dodd:** Average client cash positions in many retail accounts are north of 20%, which is historically very high. How do you think about cash in the portfolio as a long-term investor?

**Peter:** You can't be absolutist about it one way or another. As Shelby Davis, the founder of Davis Advisors, used to say, the right amount of cash to have is your sleeping point. You put into the market only what you can withstand in the market, and always have some cash or short-term liquidity available. However, as we said earlier, the benchmark for any individual or family is not the S&P 500. It is the spending requirement and required rate of return built into your financial plan. It would be hard to imagine a scenario where, as rates fall, you are going to meet that with cash. You have to strike the appropriate balance.

In our view a lot of portfolios may be under-optimized because people are reading the news and not the actual economic and corporate tapes. It seems that more cash could be put to work. However, you have to think carefully about where you are potentially going to get your required return. That is likely not in the most expensive places in the market, nor in the value index camp at 20x earnings, as we discussed earlier. There are plenty of other places, however—hundreds of other stocks where you could potentially find an appropriate balance of risk and reward.

**Dodd:** Any other thoughts from Shelby Davis that you would like to share?

**Peter:** When we look at the Dow Jones Index today at close to 43,000, many investors take that level for granted. However, when the Dow was at 6,000 in 1996, which is when Alan Greenspan coined the term "irrational exuberance," the chatter was all about how it could not get to much higher than 10,000. Shelby did some math and came out with a view that the Dow could be at around 48,000 in 30 years. How is that possible? Well, if you assumed the Dow would compound at 7%+ annually, it would have doubled every 10 years. So by 2026 or so it would increase *eightfold*—three doubles, from 6,000 to 48,000. Today we are 43,000, so we are not far off. It was a very instructive lesson in the power of compounding.

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

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