ValueInvestor INSIGHT
The Leading Authority on Value Investing
January 31, 2024

On the Money

Expert financial-sector investor Chris Davis of Davis Advisors describes why the sector is fertile investing ground, where "outsiders" may be prone to err, and why he sees unrecognized value today in Capital One, JPMorgan and Bank of New York Mellon.

It's not uncommon to hear more investors who once regularly invested in financial companies beg off the practice today. Reasons vary, but they tend to include that the investment cases are too reliant on macro factors, there's too much leverage, or there's too much regulation. Especially for those who lived through the financial crisis of 2008/2009 and its aftermath, all are understandable and reasonable concerns.

Which may reinforce the fact that financials can still be fertile investment ground. The sector makes up 11% of the Russell 3000 index and includes many companies critical to the U.S. and global economies. Among areas of interest to experts in the sector today: commercial banking in the U.S. and Europe, trust banking and specialty finance.

Editor's Note: *To assess the opportunity set in the financial sector today, we recently spoke with an eminently qualified expert on the subject: Davis Advisors' Chris Davis, who is a member of the Berkshire Hathaway board of directors and comanages his firm's market-beating Davis Financial Fund, which launched in 1991.*

Chris Davis
Portfolio Manager, Davis Advisors

"We're in an environment where people want out of banks whenever there is even a whisper of a recession."

Unlike some of your peers, your enthusiasm for investing in financial stocks appears not to have waned. Why do you still consider the sector fertile ground?

Chris Davis: You're right to pick up on a sort of exhaustion on the part of investors, really since the financial crisis. But despite the reasons cited to hate financials – starting with too much regulation and increasing capital ratios hurting returns on equity, to fintech disrupting everything, to unrealized losses on bond portfolios and dried up liquidity – all this seemingly bad news has largely not been reflected in the underlying performance of most of the sector institutions. Good banks, for example, still generate returns on equity in the mid-teens or higher. They have super-high operating margins. They generate a lot of excess capital, such that banks on average today generate 10% of their market cap in annual distributable income.

My grandfather used to say that you could often tell a crappy investment because the bull case was always changing. First it's a growth story, then there's an exciting new product, then it's a turnaround, now it's a takeover candidate. I think the inverse is also true, that you can tell a great opportunity when the bear case is always changing. That's been the case by and large with bank and other financial stocks.

In what ways would you say sector expertise in financials is most helpful?

CD: When we started Davis Financial Fund more than 30 years ago we thought that through expertise and selectivity we could outperform the S&P 500 with a portfolio that was 100% invested in financials, and we've done that. I think there are a few things "outsiders" can get wrong. One is that they tend to be interested in the sector when things are going well and look first at the companies that are growing the most. Experience teaches you, however, that if you simply underprice risk, money will find you and you can produce almost any rate of growth you want for a period of time. That typically leads to disaster.

A second related thing people can get wrong is that a low valuation always indicates the best value. The stocks of companies that have taken on too much credit or interest-rate risk can for a time look very inexpensive. When the tide goes out, as it inevitably does, what looked like a cheap stock can look like anything but that fairly quickly.

The last thing I'd mention with almost any company that is trying to make a spread on money is the difficulty in assessing what we call the cost of foolishness. For a bank that's making loans that don't get paid back, or for an insurance company it's writing insurance policies that prove to be uneconomic. Minimizing that cost of foolishness often comes down to the company culture with respect to risk and reward, which is established over a period of many years. Assessing that is incredibly important with financials, and those who hop in and out of the sector may be less able to do that well.

What would you say is the most prevalent bear case for financial-related stocks in today's market?

CD: We're in an environment where people want out of banks whenever there is even a whisper of a recession, as if another financial crisis is around the corner. Forget that banks today have roughly twice the capital they had prior to the last crisis. They are also subject to Fed stress tests that require they're well capitalized even if we have a crisis worse than the last one.

We also regularly see investors assuming the risks that were prevalent 15 years ago are the same ones to worry about today. In consumer finance, for example, because firms in the near-prime or subprime parts of the market got killed last time, the assumption is that's where the highest risk still is.

Our favorite financial company today is Capital One [COF], which in both its credit card and auto lending businesses is materially exposed to less-than-prime customers. But thinking that makes it particularly vulnerable today is misplaced. Capital One has always been an excellent underwriter of risk and sailed through the financial crisis. The culture instilled by Richard Fairbank, who founded the company and still runs it, is highly disciplined and data-driven. At the same time, as so many competitors have gone upmarket it has less competition for business.

In this case the stock is cheap and we think that is a good indicator of the value opportunity. The shares at today's price [of around $138.50] trade at 1x book value, for a company that we think can generate a mid-teens durable return on equity. Earnings can be lumpy, but at that valuation we can earn a 14-15% IRR even if the market doesn't ever look more favorably on the stock. On a risk/return basis, this is one of the biggest disconnects in our universe.

You also have a position in JPMorgan [JPM], which has established itself as the banking gold standard in the U.S. What do you think sets it apart?

CD: For some time with the Davis Financial Fund we focused on small and mid-sized companies. I always argued there were no economies of scale in banking. Your biggest cost was interest and your second biggest was the cost of foolishness, and a well-placed Iowa branch bank system could compete well on both of those fronts with the largest banks.

ON MASTERCARD AND VISA:

To us they're almost greedy in what they take of each transaction – that makes them more ripe for disruption.

That has changed. As the cost of regulatory compliance soared after the financial crisis, spreading those costs over a bigger base has become a real economy of scale. Diversification across lines of business has become increasingly important. Probably most important is that scale allows spending on technology to drive competitive advantage. JPMorgan spends more on technology in a year than the asset size of all but something like the top 15 banks in the U.S.

The downside of size is that you can get bureaucracy, hubris and out-of-control overhead costs. Large banks to counter that need extraordinary management, which JPMorgan obviously has in Jamie Dimon. I first met him probably 35 years ago and I am not exaggerating when I call him one of the greatest business executives, period, over the last century.

So JPMorgan wins at every level. The reason it's not our largest holding is that everybody knows this and the shares I'd say are fully valued. The stock trades at more than 2x tangible book value, which indicates the market expects the company to maintain its high-teens ROE for a long time. I don't think that's an unreasonable expectation, but the shares at this level are more vulnerable to bad news than many other things we own.

Describe your interest today in a much lower-profile financial, Bank of New York Mellon [BK].

CD: Unlike Capital One that is still run by its founder, Bank of New York is not run by Alexander Hamilton. Here the name is somewhat of a misnomer because this almost isn't a bank. With banks the first risk people think about is credit risk, and Bank of New York has essentially no credit risk. It is mostly a processing company, providing all sorts of services that involve processing payments and keeping commercial assets safe. It's sort of the plumbing system for the cities of finance and financial services.

As a result it has an extremely high return on equity, well into the 20s, which it has been able to sustain for a long time. Because it isn't capital intensive it doesn't have many ways to reinvest that equity at a high rate, so almost all the capital it generates is distributable.

One difference between it and other high-value processing companies like Visa and Mastercard is that while Bank of New York operates in highly concentrated competitive markets, the companies in those markets like State Street and Northern Trust still compete quite intensely on price. Returns on equity are perfectly fine, but we have always felt that there's a bit of a free option if the players competing in the market behaved more rationally in terms of pricing.

What impact do interest rates have on the business?

CD: Bank of New York doesn't have retail deposits. It doesn't have a wealth-management business. It basically holds short-term Treasuries and short-term deposits at the Federal Reserve against commercial deposits that require market interest rates. With that mix of assets and liabilities they're able to operate with a fee and low-spread institutional model and there is virtually no interest-rate risk. Whenever they get into trouble it's because management forgets that.

How do you assess the threats of technological disruption here?

CD: This was certainly a very popular topic when fintech was at its apex a couple of years ago. Where you heard it most around this company was that blockchain could disrupt the custody business. If you could use blockchain technology to hold custody of your assets and keep them safe, you wouldn't need to use somebody like Bank of New York. The interesting follow-up question to that is what does the Bank of New York charge for that service and the answer is less than one basis point, or 1/100th of a percent. There's not a great deal to disrupt there for the incremental risk attached.

I would add that we don't own Visa or Mastercard because of exactly this topic. To us they're almost greedy in the scale of what they take of each transaction – that makes them more ripe for disruption.

Related to technology, one risk you have to get comfortable with here is cybercrime. The assets under custody are around $45 trillion. It wouldn't take fraud impacting even a small part of those assets to be a real problem relative to the equity value of the company.

Near their 52-week-high, how are you looking at valuation with the shares trading at around $56?

CD: The stock today is valued at around 10x our estimate of 2024 levered owner earnings, which includes some decline in net interest income from 2023 when rates were moving up relatively fast. The stock has done fairly well over the past few months so the price to tangible book value is now around 2.4x. For a company earning a 20%-plus return on tangible common equity and paying a 3% dividend yield, our expected IRR with no change in valuation is in the 12% range. We consider that quite attractive for a business whose competitive position is so hard to dislodge.

One last question: As a board member of Berkshire Hathaway, you had the good fortune of getting to know Charlie Munger well. What comes to mind most in thinking about him since his passing?

CD: There are so many things that it's hard to narrow it down. One would be his enormous stoicism and patience as an investor and as a person. It can take a very long time for things to play out and he was able to look over 10, 20, 30 and 40 year spans and still hold his conviction when he believed it was the right thing to do. That sort of foresight and resilience is very rare. VII

INVESTMENT SNAPSHOT

Bank of New York Mellon
(NYSE: BK)

Business: Provider of a wide range of back-office services to financial and corporate customers, including asset custody, collateral management and fund accounting solutions.

Share Information (@1/30/24):

Price	**56.04**
52-Week Range	39.65 – 56.25
Dividend Yield	3.0%
Market Cap	$42.55 billion

Financials (TTM):

Revenue	$17.38 billion
Operating Profit Margin	8.8%
Net Profit Margin	19.5%

Valuation Metrics
(@1/30/24):

	BK	S&P 500
P/E (TTM)	14.0	22.6
Forward P/E (Est.)	10.6	22.0

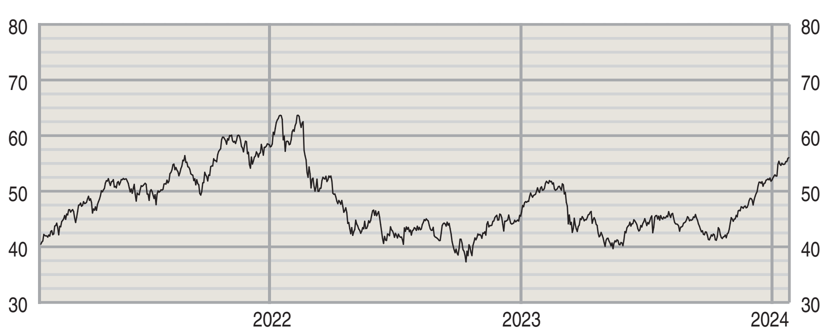
Largest Institutional Owners
(@9/30/23 or latest filing):

Company	% Owned
Vanguard Group	9.2%
BlackRock	8.5%
Dodge & Cox	7.8%
State Street	4.2%
Artisan Partners	2.6%

Short Interest (as of 1/15/24):

Shares Short/Float	0.8%

BK PRICE HISTORY



THE BOTTOM LINE

Chris Davis considers the company less a traditional bank and more "the plumbing system for the cities of finance and financial services," generating high returns on equity and high levels of distributable income that aren't adequately reflected in its shares. With no change in valuation, at today's price he expects to earn a roughly 12% IRR on the stock.

Sources: Capital IQ, company reports, other publicly available information

Before investing in the Davis Funds, you should carefully consider the investment objectives, risks, charges, and expenses of the Funds. The prospectus and summary prospectus contains this and other information about the Funds. You can obtain performance information and a current prospectus and summary prospectus by visiting davisfunds.com or calling 800-279-0279. Please read the prospectus or summary prospectus carefully before investing or sending money. Investing involves risks including possible loss of principal.

DAVIS DISTRIBUTORS, LLC (DDLLC) paid Value Investor Media, Inc. their customary licensing fee to reprint this article. Value Investor Media, Inc. is not affiliated with DDLLC, and DDLLC did not commission Value Investor Media, Inc. to create or publish this article.

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 Financial 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; **financial services risk:** investing a significant portion of assets in the financial services sector may cause the Fund to be more sensitive to problems affecting financial companies; **credit risk:** The issuer of a fixed income security (potentially even the U.S. Government) may be unable to make timely payments of interest and principal; **interest rate sensitivity risk:** interest rates may have a powerful influence on the earnings of financial institutions; **focused portfolio risk:** investing in a limited number of companies causes changes in the value of a single security to have a more significant effect on the value of the Fund's total portfolio; **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; **foreign country risk:** foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified. As of December 31, 2023, the Fund had approximately 19.6% of net assets invested in foreign companies; **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; **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; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund;

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; **emerging market risk:** securities of issuers in emerging and developing markets may present risks not found in more mature markets; and **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. 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 December 31, 2023, the top ten holdings of Davis Financial Fund were: Capital One Financial, 10.75%; Wells Fargo, 8.39%; JPMorgan Chase, 7.20%; Bank of New York Mellon, 6.12%; Fifth Third Bancorp, 5.84%; Berkshire Hathaway, 5.52%; U.S. Bancorp, 5.50%; Markel Group, 5.24%; Chubb, 5.11%; and PNC Financial Services, 5.07%.

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.

The **S&P 500 Index** is an unmanaged index of 500 selected common stocks, most of which are listed on the New York Stock Exchange. The index is adjusted for dividends, weighted towards stocks with large market capitalizations and represents approximately two-thirds of the total market value of all domestic common stocks. Investments cannot be made directly in an index.

Davis Distributors, LLC
2949 East Elvira Road, Suite 101, Tucson, AZ 85756
800-279-0279, davisfunds.com
Item #4060

Davis FUNDS