

# Davis Financial Fund

Interview with Chris Davis, Portfolio Manager



THE EQUITY SPECIALISTS

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Chris Davis has successfully managed financial stock portfolios for 30 years. He shares his most recent thoughts on why to invest in financial stocks, why he believes active management can add significant value in this vast inefficient sector and why investing in financial stocks offers a unique opportunity today.



“Given today’s low prices, we believe select financials will generate strong returns over the next decade because they combine what we feel are durable business models, the strongest balance sheets in half a century, resilient earnings, good returns on equity, the potential for rising dividends, falling share counts, and low valuations.”

### Summary

- Davis Financial Fund has outperformed the S&P 500 Index and S&P 500 Financials Index since inception in 1991.<sup>1</sup>
- On a cumulative basis, the Fund has returned significantly more than the Financial Select Sector SPDR ETF (XLF) since XLF’s inception in 1998.<sup>1</sup>
- Currently, financial stocks are underappreciated and out of favor with investors, offering what we believe to be an attractive long-term investment opportunity.
- Selectivity and active management are the keys to outperformance in the vast, inefficient financial sector, in our opinion. Investing in stronger companies and avoiding weaker ones can make a significant difference in investor returns.
- The Fund’s holdings include: Markel, Chubb, Berkshire Hathaway, JPMorgan Chase, BNY Mellon, American Express and Capital One Financial.<sup>2</sup>

*The average annual total returns for Davis Financial Fund’s Class A shares for periods ending December 31, 2019, including a maximum 4.75% sales charge, are: 1 year, 20.31%; 5 years, 8.18%; and 10 years, 10.16%. The performance presented represents past performance and is not a guarantee of future results. Total return assumes reinvestment of dividends and capital gain distributions. Investment return and principal value will vary so that, when redeemed, an investor’s shares may be worth more or less than their original cost. The total annual operating expense ratio for Class A shares as of the most recent prospectus was 0.94%. The total annual operating expense ratio may vary in future years. Returns and expenses for other classes of shares will vary. Current performance may be higher or lower than the performance quoted. For most recent month-end performance, visit [davisfunds.com](http://davisfunds.com) or call 800-279-0279.*

### Hypothetical Growth of a \$10,000 Investment<sup>3</sup>

\$230,913



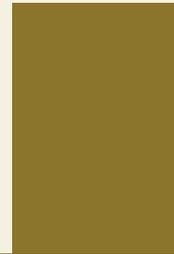
Davis Financial Fund  
(Inception 5/1/91)

\$153,149



S&P 500 Index

\$132,507



S&P 500 Financials Index

#### Davis has successfully invested in financial stocks for over five decades. Why should investors consider this sector now?

In 1947, my grandfather, Shelby Cullom Davis, began investing in financial stocks. Known as the “Dean of Insurance Stocks,” he compounded a \$100,000 investment into \$800 million over his career, largely by investing in financials.<sup>4</sup>

The characteristics my grandfather looked for in financial companies included competitive advantages, experienced management and disciplined capital allocation. We use these same criteria to select all our investments as an equity research boutique.<sup>5</sup> What is interesting and more specific to financials is we can find companies within the sector that have above-average long-term growth prospects but trade at below-average price/earnings (P/E) multiples. This is the reason my grandfather called financials “growth stocks in disguise.”

More recently, investors have tended to consider financial companies inextricably linked to the 2008 financial crisis, resulting in a lingering aversion to this out-of-favor group. However, our research shows certain high

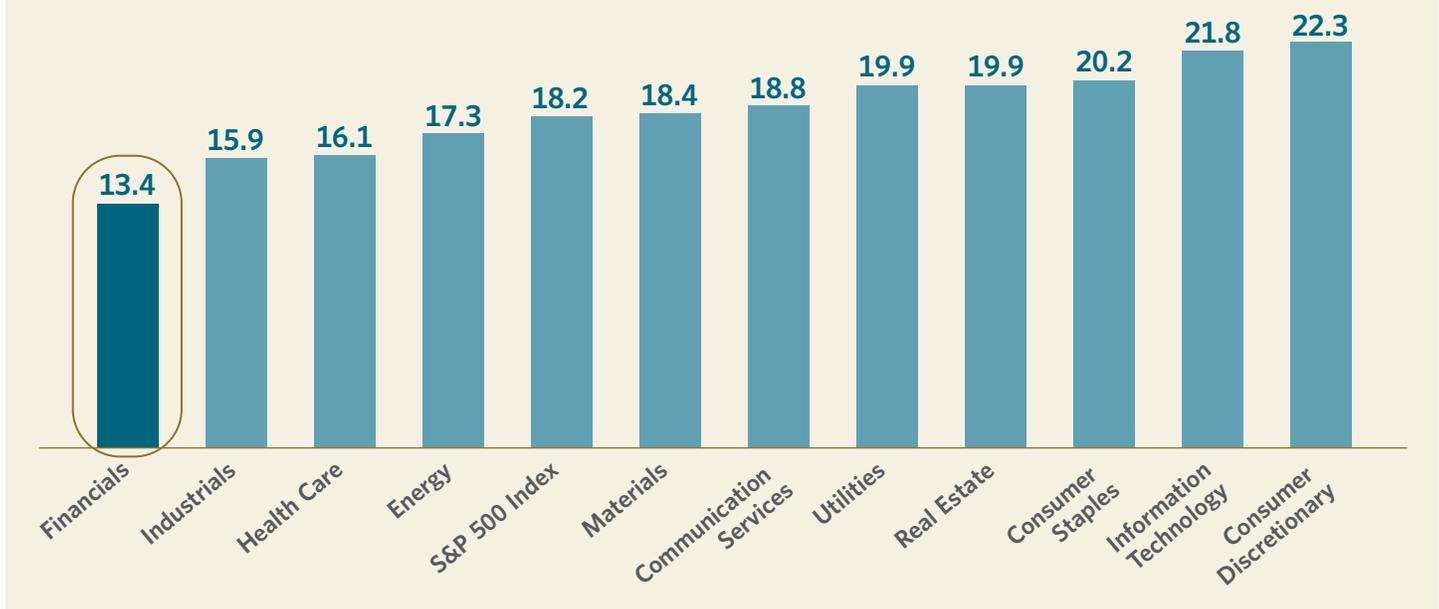
quality financial companies remained profitable during the worst financial crisis since the Great Depression, are currently trading at close to a 30% discount to the market and, most important, we believe they are less risky today as they have doubled their capital ratios.

In addition, a significant percentage of the assets on these companies’ balance sheets have been added since the financial crisis. Moreover, because of limited competition and extremely tight credit standards, these businesses have record earnings. Now, some financial companies are in a position to distribute an increasing percentage of their earnings. Lastly, should interest rates rise as a function of strong economic growth, select financials may be net beneficiaries as net interest margins expand. Put together, these developments are creating a cyclical opportunity in financial stocks in our view.

In addition to the current cyclical opportunity, we believe a strong case can be made that the right financial company is by its nature a long-term cash-compounding machine. Such a business generates strong current earnings that can be reinvested as well as providing the potential for excellent long-term growth because the

## Today Financials Are the Most Attractively Priced Sector<sup>6</sup>

(S&P 500 Index P/E Multiples)



industry is so vast and fragmented, and the products and services offered by financial institutions are as long lasting as they are ubiquitous. Almost everyone is a customer of at least one, two or three financial companies. In brief, financial companies offer products that generally do not become obsolete.

### Why are financial stocks one of the few areas that can perform well even if we are in a low growth environment as many believe?

We see three possible scenarios for financial stocks going forward in which investors benefit from some combination of: earnings growth, P/E expansion, share repurchases and dividends.

In these scenarios, over the next five years we assume a reasonable initial P/E multiple of 12x and that the financial company has to retain 20% of its earnings to increase its capital ratio or strengthen its balance sheet. And, furthermore that the remaining earnings are distributed half as dividends and half as share repurchases.<sup>7</sup>

#### Scenario 1: No earnings growth and no P/E expansion

Under this scenario we see a 7% average annual total shareholder return. Despite no change in earnings growth and no P/E expansion, a satisfactory return is achieved from share repurchases and dividends.

#### Scenario 2: Modest earnings growth no P/E expansion

Under this scenario we see a 10% average annual total shareholder return. This return is driven by modest earnings growth of 3% per year, share repurchases and dividends, while the P/E stays flat.

#### Scenario 3: Modest earnings growth and modest P/E expansion

Under this scenario we see a 13% average annual total shareholder return. This return is driven by modest earnings growth of 3% per year, modest P/E expansion from 12x to 14x, in addition to share repurchase and dividends.

Going forward, we expect an outcome between Scenario 2 and Scenario 3 to be the most likely. This would represent a very satisfactory return for shareholders.

## Why have selectivity and active management generated outperformance for Davis Financial Fund?

Davis Financial Fund has delivered significantly more than the return of Financial Select Sector SPDR ETF (XLF) since the inception of XLF in 1998, on a cumulative basis.

Investing in stronger companies and avoiding weaker ones can make a significant difference over time. Because the returns of financial stocks are widely dispersed, selectivity is key. In fact, since 2005, the average difference between the best and worst performing financial stock in the S&P 500 Financials Index has been about 124%.<sup>8</sup> What accounts for these wide differences in outcomes?

A critical factor to recognize when researching financial companies is they are first and foremost human capital businesses. As a result, management judgment, underwriting practices, and management and employee incentives play a central role in determining which financial companies should perform well through an entire

business cycle versus those that might be structured to perform well in a specific environment but not necessarily to endure over time. As bottom-up active managers, we have flexibility to invest more capital in those businesses we believe are best positioned to build long-term wealth while avoiding those with less attractive prospects.

Contrast our carefully considered approach with many passively managed strategies that indiscriminately allocate the most capital to stocks with the largest market capitalizations. This approach can subject investors to the risk of concentration in the most vulnerable areas of the sector. For instance, many investors may not know XLF has tremendous industry concentration as four of its top five holdings are banks and account for almost 32% of its assets.<sup>9</sup>

We build our Portfolio one company at a time. The Portfolio includes best-of-breed commercial banks, investment banks, insurance companies, wealth management firms, asset managers, credit card companies, diversified financial conglomerates, and rating agencies.

### Representative Holdings<sup>10</sup>

	<p>Markel, a specialty property and casualty insurer, has generated excellent investment results for decades and grown book value per share more than 13% annually over the last 20 years.</p>
	<p>Chubb is a global insurance leader specializing in property and casualty insurance, reinsurance and Asia-focused life insurance. It has a well-regarded management team, strong balance sheet and disciplined underwriting culture.</p>
	<p>Berkshire Hathaway is a collection of outstanding, profitable businesses. Exceptional world-class capital allocation.</p>
	<p>BNY Mellon, the world's largest custodian bank with more than \$32 trillion of assets under custody, is a durable franchise that benefits from economies of scale.</p>
	<p>U.S. Bancorp is the 5th largest U.S. commercial bank with more than \$450 billion in assets. It generates returns on equity of more than 15% and is one of the most innovative banks focused on digital banking. The company has distributed nearly 75% of its earnings to shareholders through dividends and buybacks in the last year alone.</p>

## What are some of the perceived risks with financial stocks today?

One of the perceived risks with financials has to do with leverage within the banking sector. Leverage ratios are at historic lows, reflecting both a conservative posture by financial institutions themselves as well as stricter regulations on leverage that were instituted following the crisis. It is worth noting that all major U.S. banks now undergo annual stress tests which more or less control the degree of leverage they are willing or able to take on, implying that they should continue to operate with far lower overall risk and greater durability than in the pre-crisis period. In short, balance sheets for major financial institutions today look very strong.

A second question that relates to financials today is the prospect of higher credit costs than what we witnessed in recent years when the credit environment was particularly benign. Credit costs are an income statement expense and are the rule, not the exception, over any economic cycle. What was unusual in recent years was the near absence of credit losses, but that meant among other things that lending remained rather muted.

Now, with a stronger economy and relatively full employment, demand for loans has risen and credit costs are normalizing which is to be expected. We believe the credit environment remains both very manageable and quite favorable.

## With all the positives, why is the opportunity in financial stocks underappreciated and not recognized by the market?

The biggest hurdles to investing in financials in this environment are psychological and emotional as investors still remember the aftermath of the 2008 financial crisis. While the overall market has more than doubled since then, financial stocks have not appreciated as much—even though select financial companies are delivering record earnings and have the strongest balance sheets in decades.

As always, investor fear is correlated with prices. When stock prices go down, people feel more fear and are less interested in buying, and when prices go up they feel reassured. This tends to result in an undesirable outcome.

We take the opposite approach. We search for companies with stock prices that have lagged the companies' true business value. We like to look in unloved or overlooked areas of the market where prices do not reflect true value. In today's environment, the financial sector offers the opportunity we seek.

1. Class A shares without a sales charge. Inception date of the Fund is 5/1/91. **Past performance is not a guarantee of future results.** Inception of XLF is 12/16/98. 2. Individual securities are discussed in this piece. 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. The return of a security to the Fund will vary based on weighting and timing of purchase. This is not a recommendation to buy, sell or hold any specific security. **Past performance is not a guarantee of future results.** 3. Class A shares without a sales charge. As of 12/31/19. Based on a hypothetical investment on 5/1/91. 4. While Shelby Cullom Davis' success forms the basis of the Davis Investment Discipline, this was an extraordinary achievement and other investors may not enjoy the same success. Davis Selected Advisers, L.P. was founded in 1969. 5. While we search for those companies possessing these characteristics, there is no guarantee that the criteria will be met or that a given security will be profitable. 6. Source: Credit Suisse. Chart shows the Forward P/E ratios of the sectors in the S&P 500 Index as of 12/31/19. 7. This hypothetical example is for illustrative purposes only and does not represent the performance of any particular investment. Actual results will vary. The return of a stock is based on a number of factors in addition to those discussed. Equity markets are volatile and there is no guarantee that these assumptions will prove to be correct. 8. As of 12/31/19. Source: Davis Advisors and Wilshire Atlas. 9. As of 12/31/19. Holdings are subject to change. 10. The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security.

*This report is authorized for use by existing shareholders. A current Davis Financial Fund prospectus must accompany or precede this material if it is distributed to prospective shareholders. You should carefully consider the Fund's investment objective, risks, charges, and expenses before investing. Read the prospectus carefully before you invest or send money.*

This report 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.

**Objective and Risks.** Davis Financial Fund's investment objective is long-term growth of capital. There can be no assurance that the Fund will achieve its objective. Under normal circumstances the Fund invests at least 80% of its net assets, plus any borrowing for investment purposes, in securities issued by companies principally engaged in the

financial services sector. Some important risks of an investment in the Fund are: **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; **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; **depository receipts risk:** depository receipts may trade at a discount (or premium) to the underlying security and may be less liquid than the underlying securities listed on an exchange; **emerging market risk:** securities of issuers in emerging and developing markets may present risks not found in more mature markets; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; **financial services risk:** investing a significant portion of assets in the financial services sector may cause the Fund to be more sensitive to systemic risk, regulatory actions, changes in interest rates, non-diversified loan portfolios, credit, and competition; **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; **foreign country risk:** foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified. As of 12/31/19, the Fund had approximately 16.5% of assets invested in foreign companies; **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; **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; **interest rate sensitivity risk:** interest rates may have a powerful influence on the earnings of financial institutions; **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; **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; and **stock market risk:** stock markets have periods of rising prices and periods of falling prices, including sharp declines. See the prospectus for a complete description of the principal risks.

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 report. 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.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of 12/31/19, the top ten holdings for Davis Financial Fund were: Capital One Financial, 8.50%; Berkshire Hathaway, 7.88%; U.S. Bancorp, 7.51%; JPMorgan Chase, 7.50%; Wells Fargo, 6.34%; Bank of New York Mellon, 5.62%; American Express, 5.44%; Markel, 5.11%; Chubb, 3.74%; DNB, 3.68%.

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](http://davisfunds.com) or call 800-279-0279 for the most current public portfolio holdings information.

The Forward P/E ratio is the aggregate of the Forward P/E ratios of the holdings. The ratio is not a forecast of performance and is calculated for each security by dividing the current ending price of the stock by a forecast of its projected Earnings Per Share (EPS). Historical 5 Year EPS Growth represents the annualized rate of net-income-per-share growth over the trailing five-year period for the stocks held by the Portfolio.

Davis Financial Fund ("Fund") and Financial Select Sector SPDR Fund ("XLF"). The Fund seeks long-term growth of capital while XLF seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of publicly traded equity securities of companies in the Financial Select Sector Index. The Fund has a sales charge of up to 4.75% while XLF can only be purchased on an exchange with no sales charge but may incur transaction costs (e.g., customary brokerage commissions). The Fund's expense ratio is 0.94% and that of XLF is 0.13%. Shares of the Fund can only be bought or sold at that day's NAV through a financial intermediary. Shares of XLF can only be bought and sold on an exchange at the current market price. Shares cannot be individually redeemed. Capital gains of the Fund may be passed on to shareholders annually while capital gains tax on XLF is incurred only upon the sale of the shares.

**Traditional Mutual Funds and ETFs.** Mutual funds have a sales charge while ETFs can only be purchased on an exchange with no sales charge but may incur transaction costs (e.g., customary brokerage commissions). Shares of mutual funds can only be bought or sold at that day's NAV through a financial intermediary. Shares of ETFs can only be bought and sold on an exchange at the current market price. Shares of ETFs cannot be individually redeemed.

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

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. The **S&P 500 Financials Index** is a capitalization-weighted index that tracks the companies in the financial sector as a subset of the S&P 500 Index. Investments cannot be made directly in an index.

After 4/30/20, this material must be accompanied by a supplement containing performance data and rating for the most recent quarter end.

**Shares of the Davis Funds are not deposits or obligations of any bank, are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risks, including possible loss of the principal amount invested.**