 

Update from Portfolio Managers

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Davis Financial Fund

Annual Review 2020

Summary

- Davis Financial Fund returned 26.31% in 2019.
- Davis Financial Fund has outperformed the S&P 500 Index and S&P 500 Financials Index since inception.
- Davis Financial Fund holdings include: Capital One, Berkshire Hathaway, U.S. Bancorp, JPMorgan Chase, Wells Fargo, Bank of New York Mellon, American Express, Markel, DNB ASA, and Chubb.
- 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.

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 or call 800-279-0279.*

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. Equity markets are volatile and an investor may lose money. All fund performance discussions within this piece refer to Class A shares without a sales charge and are as of 12/31/19 unless otherwise noted. This is not a recommendation to buy, sell or hold any specific security. **Past performance is not a guarantee of future results.**

Results and Outlook

Davis Financial Fund returned 26.31% in 2019, as stock prices recovered after the sharp sell-off in late 2018. This happened despite investors' persistent fears regarding trade tensions, the potential for a hard Brexit, and unexpected gyrations in the interest rate environment. In short, the beaten-down valuations for financial stocks as of the start of the year trumped the macro factors.

Since its inception in 1991, Davis Financial Fund has invested in durable, well-managed financial services companies at value prices that can be held for the long term. In 1991, financial stocks were deeply unpopular. The scandals of the savings and loan crisis and the steep decline in commercial real estate that occurred in the late 1980s and early 1990s were fresh in investors' memories. However, where others saw unfavorable news, we recognized opportunity for the simple reason that even as investors were avoiding financial stocks, many underlying financial businesses were both durable and improving. By focusing on economic reality rather than investor sentiment, Davis Financial Fund has compounded shareholder wealth at 11.56% over the 28 years since then, outpacing both the S&P 500 Index and the S&P 500 Financials Index.

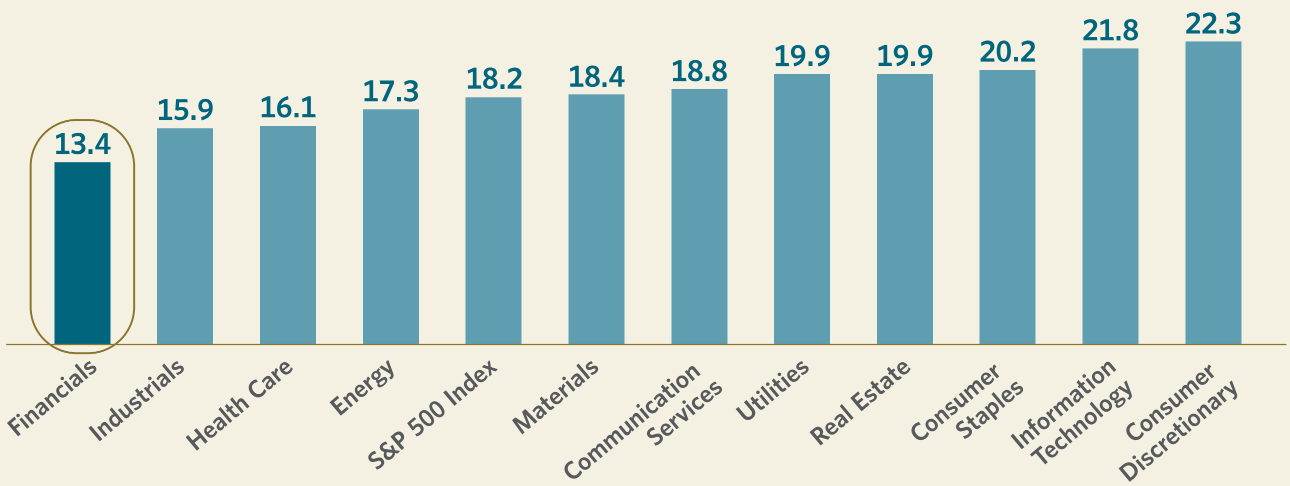
Today, the market environment is strikingly similar to what we saw in 1991. With memories of the 2008–09 financial crisis still vivid, many investors remain leery of financial stocks in general and bank stocks in particular. Contrary to investor sentiment, however, we believe today's leading financial companies are far stronger, more cautious, and better positioned than any other time in memory. And with stock prices that reflect investors' skepticism, we believe the carefully selected companies that comprise Davis Financial Fund will again generate attractive relative and absolute returns over the next decade. ■

Portfolio Update

Banks (broadly defined, whether of the retail and commercial, investment, or custody variety) make up almost 2/3 of our portfolio. We continue to think banks are quite attractively valued. Financial stocks continue to be the most cheaply priced sector of the S&P 500 Index at 13.4x and at a 30% discount to the index as a whole.

Today Financials Are the Most Attractively Priced Sector[1]

(S&P 500 Index P/E Multiples)



1. Source: Credit Suisse. Chart shows the Forward P/E ratios of the sectors in the S&P 500 Index as of 12/31/19.

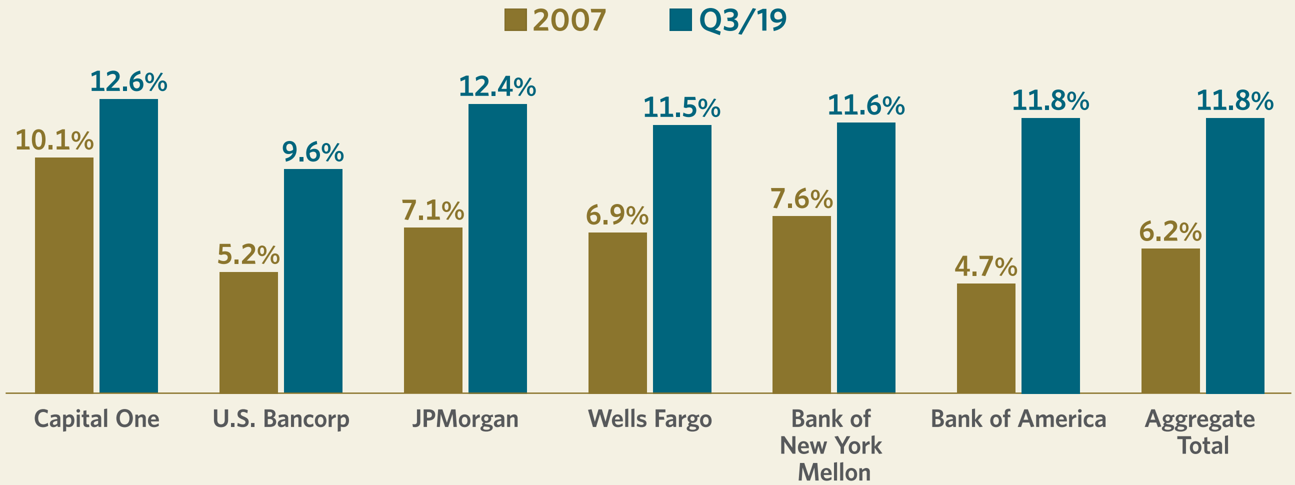
While investors continue to value banks at a discount based on sentiment and perception, the facts tell a different story. The combination of more stringent regulations and more loss-absorbing capital means that banks are far more resilient today than they were a decade-plus ago. Our six largest U.S. bank holdings have increased their collective ratio of tangible common equity to risk-weighted assets from 6.2% to 11.8% since 2007, an improvement of more than 90%. The "true" improvement in leverage arguably is better than that, as the regulatory definition of risk-weighted assets has been inflated. In the annual stress tests administered by the Federal Reserve, these six companies are modeled to lose a cumulative $54 billion (pre-tax) in the "severely adverse" scenario—which arguably would be worse economically than the 2008–09 crisis—representing less than 10% of their starting common equity capital of approximately $600 billion. (In fact, JPMorgan Chase, Bank of America, and Wells Fargo each have more equity capital than *all 18 banks* participating in the stress test are projected to lose.)

In addition to financial resiliency, banks over time have demonstrated their business models are remarkably durable. In fact, five of our top six bank holdings trace their roots back more than a century and one more than two centuries. While we must always be vigilant in studying new technologies and competitors seeking to disrupt the industry, historically the banking industry has been successful incorporating disruptive innovations and absorbing new technology, ranging from the creation of the money market fund and the mortgage-backed security to the ATM and Internet banking.

For a recent example, consider peer-to-peer payments. In the third quarter of 2019, the upstart Venmo transacted $27 billion in payments volume.[3] The banking industry admittedly had been slow off the mark in responding to Venmo, but eventually it did with the joint development of Zelle, which actually moved considerably more money for customers that quarter at $49 billion. While Venmo remains a strong competitor, it certainly appears that the banking industry is maintaining its central role in customers' financial lives (particularly those who possess greater wealth or are moving larger amounts).

Bank Capitalization—Then and Now[2]

(Tangible Common Equity/RWA)



2. Company's earnings reports as filed with the SEC, Davis Advisors. As of 9/30/19. **3.** PayPal SEC filing.

Given this year's run-up in stock prices, it is important to note that bank valuations still seem reasonable. The six largest bank positions in the fund noted above are valued today at approximately 11.5x this year's earnings.[4] While most lenders are "over-earning" due to the favorable credit environment, for many of our bank holdings, this is offset by interest income that is "under-earning" as a result of both the low interest rate environment and the lag in the re-pricing of fixed-rate loans and securities from the trough. The chart below shows the trend in interest income as a percent of loans and deposits for two of our bank holdings, Wells Fargo and U.S. Bancorp.[5] The spread has declined from 2.5–3.0% down to the low 2s. That isn't to say that the older trend levels are "right," but we'd expect some cyclical reversion over time. Each 10bps of incremental spread adds nearly 10% to pre-tax earnings. In addition, several of our bank holdings continue to hold capital above their regulatory requirements, which can get worked down over time through share repurchases (as demonstrated by Wells Fargo's Fed-approved capital plan to return approximately $32 billion to shareholders over the current year—a payout ratio of approximately 150% of earnings[6]).

The combination of significant capital generation and low valuations creates the potential for compounding machines. For banks that can earn mid-teens returns on equity, a 12x earnings multiple (for example) translates into an approximately 10% investment return even at only 3% business growth.[8] It is for this reason that decades ago Shelby Cullom Davis labeled such financial companies as "growth stocks in disguise." Furthermore, we think an argument can be made for bank multiples to expand, given that shifts in their business mix and higher capital levels have made the companies safer. ■

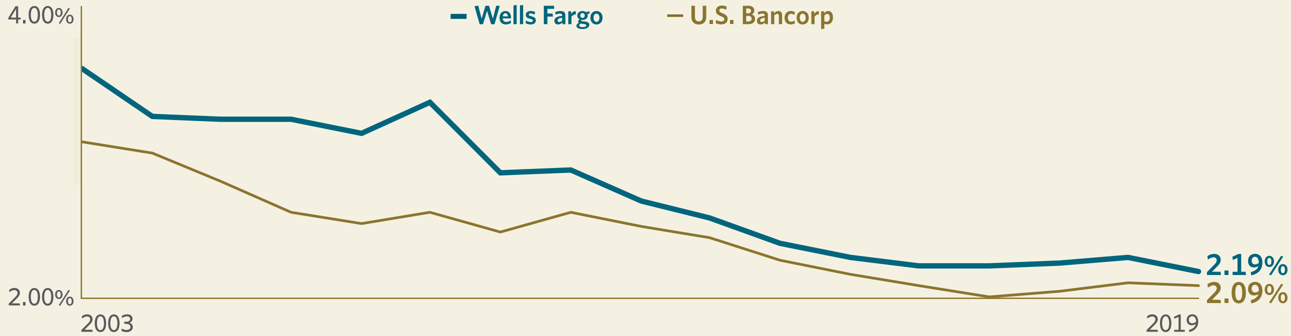
Conclusion

To sum up, we believe that banks are well positioned. Furthermore, with high capital ratios and low valuations, they are positioned to build wealth on average and over time for years, if not decades, to come.

We are excited by the investment prospects for the companies in Davis Financial Fund. Nothing provides a stronger indication of that than the fact that the Davis family and colleagues have more than $70 million invested in the Fund alongside our clients.[9] We are gratified to be able to report strong long term results and grateful for the trust you have placed in us. ■

Interest Spreads[7]

(Net Interest Income/Loans & Deposits)



4. As per consensus estimates on Bloomberg. **5.** Net interest margin is the conventional metric to measure this. Changes in capital and liquidity requirements over time have contributed to larger balance sheets, but with very little impact on interest income. We think this is a cleaner metric to look at over longer time periods. **6.** Source: Company filings. **7.** Source: Company's earnings reports as filed with the SEC, Davis Advisors. As of 9/30/19. **8.** This hypothetical example is for illustrative purposes only. Equity markets are volatile and an investor may lose money. **9.** As of 12/31/19.

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; **depositary receipts risk:** depositary 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 of Davis Financial Fund were: Capital One Financial Corp., 8.50%; Berkshire Hathaway Inc., Class A, 7.88%; U.S. Bancorp, 7.51%; JPMorgan Chase & Co., 7.50%; Wells Fargo & Co., 6.34%; Bank of New York Mellon Corp., 5.62%; American Express Co., 5.44%; Markel Corp., 5.11%; Chubb Ltd., 3.74%; and DNB ASA, 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 prospectus. Holding percentages are subject to change. Visit davisfunds.com or call 800-279-0279 for the most current public portfolio holdings information.

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

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