Why Financial Stocks Represent the Most Attractive Opportunity in Today's Market

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Summary

- Despite the sharp market recovery from the COVID panic of 2020, financial stocks remain misunderstood, mispriced and primed for long-term revaluation.
- Financial stocks have a more attractive balance of risk and reward than any other sector in today's market.
- Durable Financial Strength: Our largest U.S. banks today hold 96% more capital relative to their risk-weighted assets than before the financial crisis. Every one of our major bank holdings remained profitable and built capital through the pandemic.
- Earnings Growth: Over the last 30 years, earnings of the S&P financial sector grew at more than 6% per year, twice the rate of GDP even after paying above-average dividends.
- Attractive Valuations: Financial stocks are now the cheapest group in the S&P 500 Index and trade at their lowest relative valuation in decades.
- Interest Rates: Many financial companies stand to benefit, as higher interest rates increase earnings.
- Capital Allocation: Many banks have the ability to drive significant shareholder value in the form of dividends and share repurchases.
- If history is a guide, innovations such as blockchain and other types of fintech are more likely to be incorporated into the industry than to disrupt it.

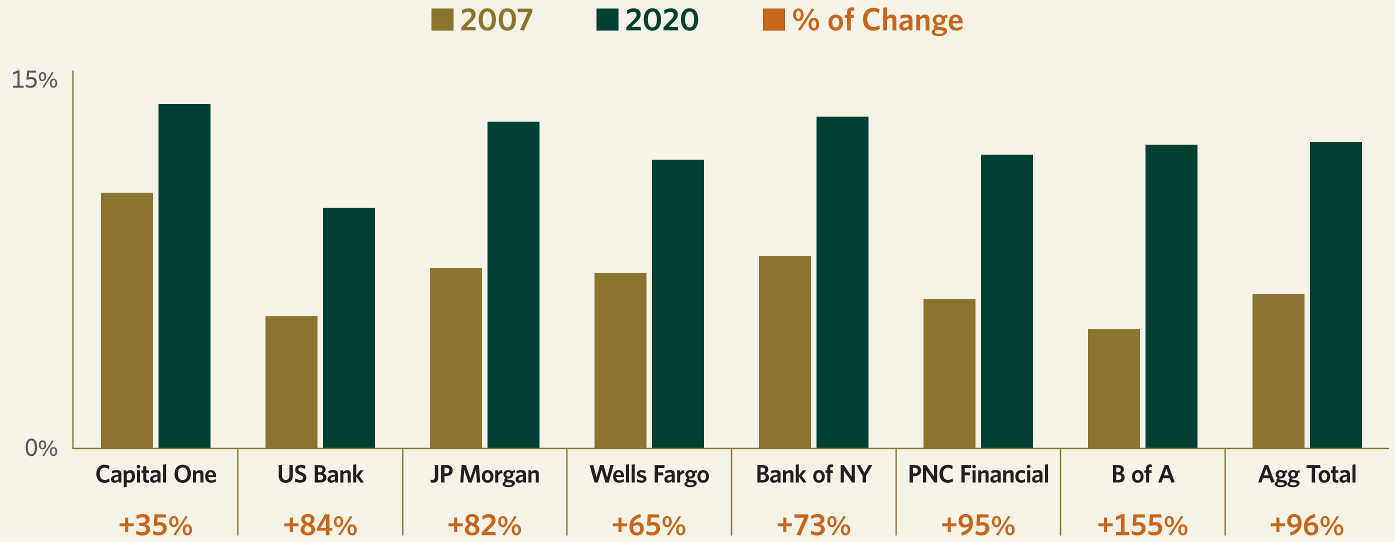
Durability

As with the Great Depression, we believe the lessons learned from the financial crisis of 2008 dramatically reduced the banking sector's risk and improved its safety and soundness. Our largest U.S. banks today hold 96% more capital relative to their risk-weighted assets than before the crisis. In addition to more capital, banks have also reduced risk through tighter underwriting standards and a greater focus on compliance. Their underwriting was put to the test in 2020 and passed with flying colors.

Rather than being part of the problem, our nation's banks were part of the solution as we dealt with the pandemic, extending credit, deferring collections and helping administer government programs. More importantly, even after significantly increasing reserves last year in anticipation of loan defaults that thus far have not materialized in a significant way, every one of our major bank holdings remained profitable and built capital through the worst economic downturn since the 1930s.

For Banks, More Capital = Less Risk[1]

Percent Increase of Tangible Common Equity/Risk-Weighted Asset Percent



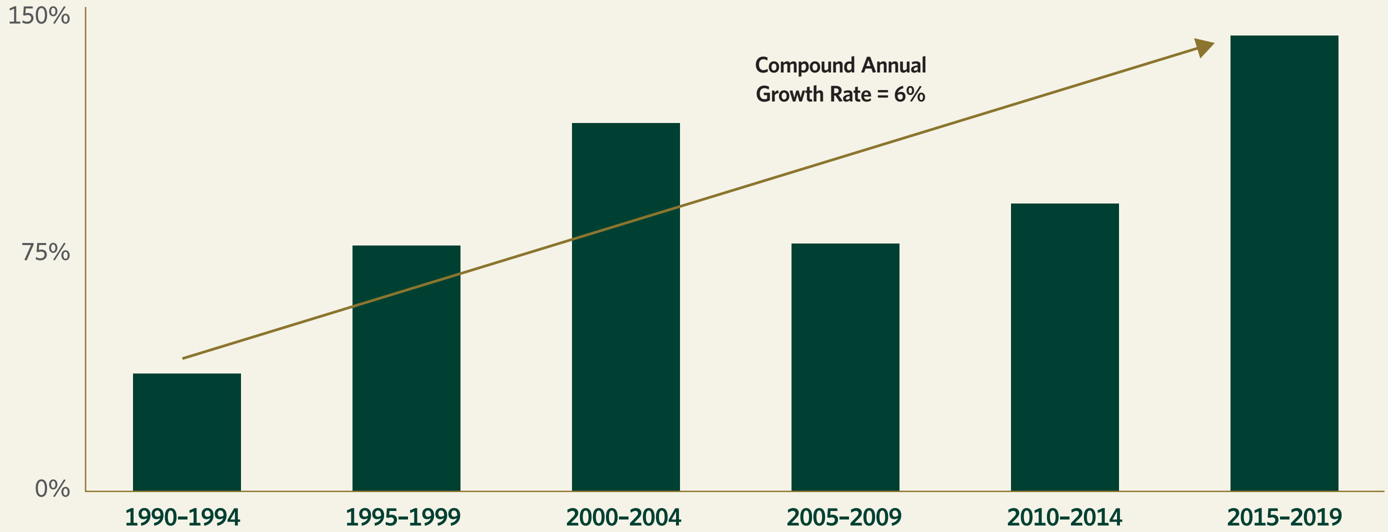
1. Source: Bloomberg and Davis Advisors.

Growth

An often overlooked characteristic of the financial services sector is its long-term growth. In fact, over the last 30 years, the earnings of the S&P financial sector have grown at more than 6% per year, twice the rate of GDP even after paying above-average dividends along the way. Beyond this sector growth, well-managed financial companies can take market share from sleepier competitors, allowing them to post truly impressive growth rates for decades. We refer to such companies as growth stocks in disguise, as investors often fail to appreciate that robust long-term growth can be found in this relatively mature industry.

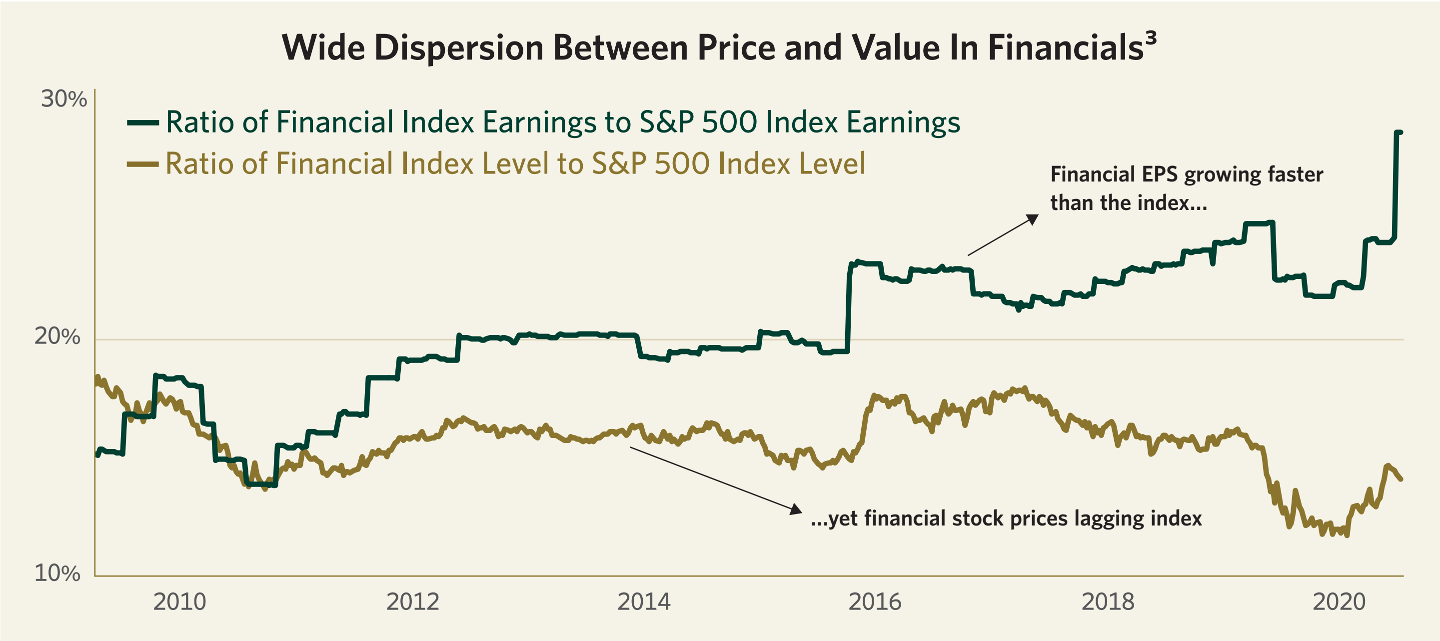
Steady Compounding Machines[2]

S&P Financial Index 5-Year Cumulative EPS Growth



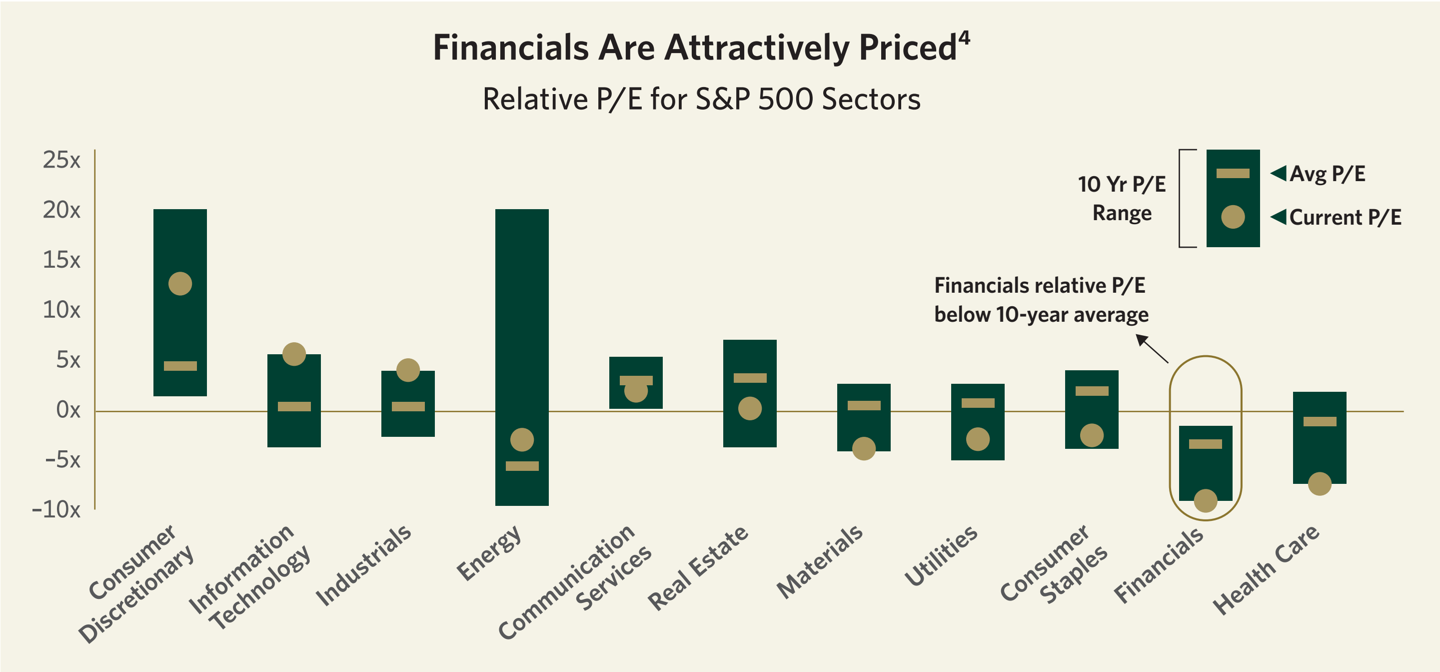
2. Source: Bloomberg and Davis Advisors.

Valuation



For more than a decade, the earnings of the financial sector have risen as a percentage of the S&P 500 Index's overall earnings (illustrated by the green line in the chart above), while their relative valuation has fallen. This combination of rising earnings and falling valuation presents investors with a wonderful opportunity to buy financials at bargain prices.

The magnitude of this discount is reflected in the fact that financial stocks are now the cheapest group in the S&P 500 Index and trade at their lowest relative valuation in decades as seen in the chart below.



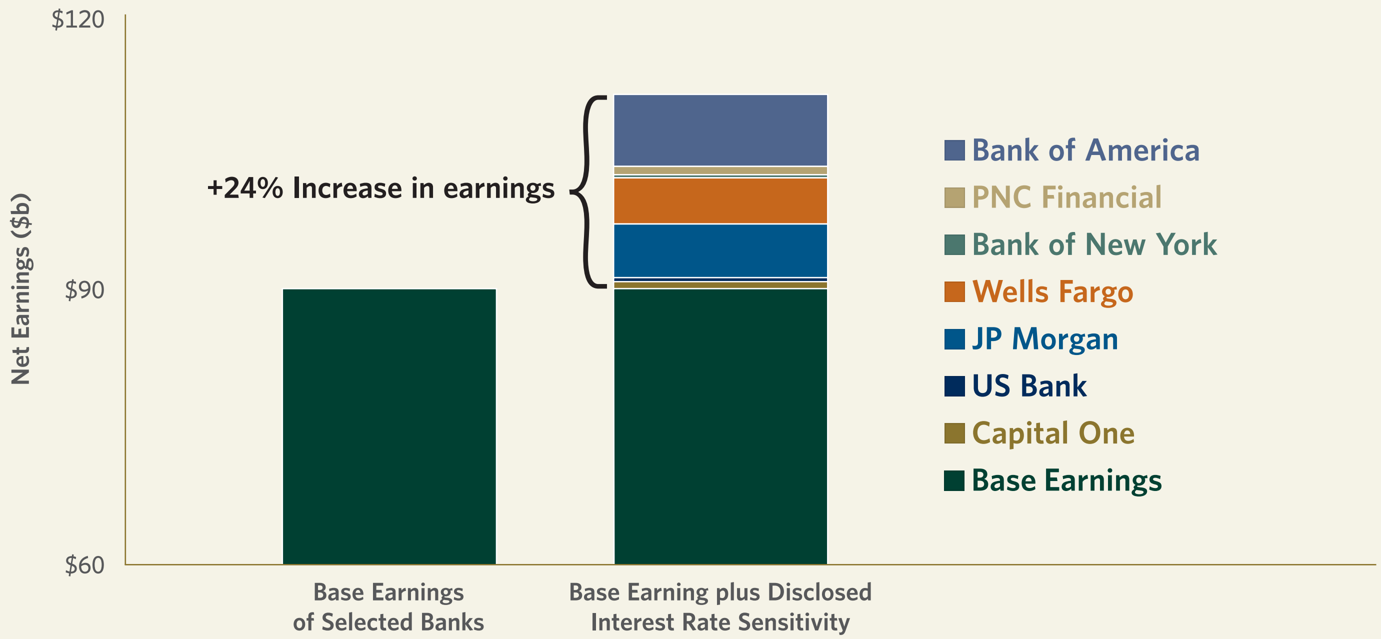
3. Source: Bloomberg and Davis Advisors as of 4/16/21. **4.** Source: Credit Suisse as of 4/22/21.

Interest Rate Sensitivity

As investors fret about the possibility of higher interest rates, many financial companies stand to benefit, as higher interest rates increase earnings. For insurance companies, higher interest rates benefit investment income, as float is invested in higher yielding bonds. For banks, higher rates increase the spread between deposits and loans. For example, based on the regulatory disclosure of our top bank holdings, a relatively modest increase of 50–100 basis points in interest rates would drive a 24% earnings increase in the first year alone.

Normalizing Interest Rates Would Increase Earnings[5]

Earning Sensitivity to Higher Interest Rates



5. Source: Davis Advisors and Company Filings as of 12/31/20.

Capital Allocation

Because many banks now hold levels of capital far in excess of historical rates, they have the ability to drive significant shareholder value in the form of dividends and share repurchases—*even in the unlikely event that net income does not grow.*

To understand how a company that doesn't grow can still generate good returns for shareholders, imagine a hypothetical bank with a market cap of $12 billion and net income of $1 billion per year. As shown in the example below, if the company allocates 35% of net income to dividends and 65% to share repurchase, the gradual reduction in shares outstanding drives a steady increase in earnings per share, dividends per share and stock price, even without any change in net income or the price-earnings ratio. Compounded out over five years, the powerful alchemy of share repurchase and dividends turns no net income growth into an 8.6% compound annual return for shareholders. What's more, this return could easily be enhanced by any growth in net income and any expansion in the price-earnings multiple from today's depressed levels which we believe is likely.

The Importance of Capital Allocation:
How No Growth in Net Income Becomes an 8.6% Total Shareholder Return[6]

Example assumes net income allocated 35% to dividends, 65% to share repurchase

Hypothetical Davis Financial Holding	Today	Next Year		Year Five
Earnings (no growth)	$1.0B	$1.0B	→	$1.0B
Shares Outstanding	$1.0B	$946M	→	$757M
EPS	$1.00	$1.06	→	$1.32
Dividends Per Share	$0.35	$0.37	→	$0.46
P/E (stays constant at 12x)	12x	12x	→	12x
Share Price	$12	$13	→	$16

6. This hypothetical example is for illustrative purposes only and does not represent the performance of any particular investment. The return of a stock's share price will vary based on a number of factors (including, but not limited to, those identified above). Equity markets are volatile and an investor may lose money.

Risks

To be successful, long-term investors in financials must always consider risk. For reasons discussed above, we believe many of the traditional risks of the financial sector—including capital, liquidity, credit and interest rates—are low. Furthermore, while regulatory risk always bears mention, the substantial reregulation of the industry following the financial crisis seems to have largely put this risk behind us for another generation.

Today, the risk most on investors' minds comes from Silicon Valley in the form of innovation, disruption and so called fintech. However, the challenges and opportunities of innovation are nothing new to the financial sector. Over the last 50 years, for example, banking has faced disruption from the invention of the money market fund, the mortgage-backed security, junk bonds, interest rate swaps, non-bank financials, the ATM, branchless credit card issuers and the internet banks, to name just a few.

Yet throughout this period, banks have proven masterful at incorporating innovation into their core business models, often with the help of regulators who understandably grow nervous when unregulated institutions make too many inroads into the economically critical financial sector. While we carefully study today's innovators, the long history of financials incorporating innovation into existing business models is reassuring. One current example that bears this out is peer-to-peer payments, an idea popularized by a Silicon Valley startup called Venmo. In response to this innovative new model, the banks created a similar platform called Zelle, which now processes nearly twice as much volume as Venmo. While we are always on the lookout for disruptive change, history teaches that financial companies are more likely to incorporate innovation than to be dislodged by it.

Conclusion

In the decade following the financial crisis, financial companies demonstrated a powerful combination of resiliency, profitability and growth while their share prices languished. This disconnect reached a stunning crescendo during the COVID crisis when panicked sellers raced for the exits, making the financial sector one of the worst performing groups of that period. The sharp recovery from this overreaction is just the beginning of what we expect to be a decade of revaluations as investors come to appreciate the durability, steady growth and low valuations of a carefully selected portfolio of financial leaders. These attributes, combined with a sensitivity to higher interest rates, shareholder-friendly capital allocation and a demonstrated ability to incorporate innovation, make financials the most attractive blend of risk and reward in today's market.

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.

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.

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.

Objectives and Risks. The investment objective of Davis New York Venture Fund and Financial Fund is long-term growth of capital. There can be no assurance that a 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; **foreign country risk:** foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified. As of 3/31/21, the DNYVF had approximately 23.3% and DFF had approximately 16.5% of net assets invested in foreign companies; **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; **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 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; **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; **credit risk (DFF Only):** 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 (DFF only):** interest rates may have a powerful influence on the earnings of financial institutions; **focused portfolio risk (DFF only):** 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; 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 3/31/21, the top ten holdings of Davis New York Venture Fund were: Capital One, 8.41%; Alphabet, 7.20%; Wells Fargo, 6.47%; Applied Materials, 5.56%; Berkshire Hathaway, 5.48%; U.S. Bancorp, 4.47%; New Oriental Education, 4.31%; JPMorgan Chase, 4.27%; Facebook, 4.20%; and Alibaba Group, 4.18%.

As of 3/31/21, the top ten holdings of Davis Financial Fund were: Capital One, 11.06%; JPMorgan Chase, 7.55%; U.S. Bancorp, 6.55%; Berkshire Hathaway, 5.96%; Wells Fargo, 5.92%; Bank of America, 5.91%; American Express, 5.54%; PNC Financial Services, 5.36%; Bank of New York Mellon, 5.24%; and Markel, 4.88%.

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.

Tangible common equity (TCE) is a measure of a company's physical capital, which is used to evaluate a financial institution's ability to deal with potential losses. Tangible common equity is calculated by subtracting intangible assets (including goodwill) and preferred equity from the company's book value. Risk-weighted assets are used to determine the minimum amount of capital that must be held by banks and other financial institutions in order to reduce the risk of insolvency. The capital requirement is based on a risk assessment for each type of bank asset.

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability. It is common for a company to report EPS that is adjusted for extraordinary items and potential share dilution.

Compound annual growth rate (CAGR) is the rate of return that would be required for an investment to grow from its beginning balance to its ending balance, assuming the profits were reinvested at the end of each year of the investment's lifespan.

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.

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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