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Update from Portfolio Managers

Chris Davis and Pierce Crosbie

Davis Select Financial ETF (DFNL)

Semi-Annual Review 2023

Key Takeaways

- The S&P 500 Index ended first-half 2023 up +16.89%. The S&P Financials Index lagged the broad index's performance at a loss of −0.53%, with regional banks specifically dragging the result. Davis Select Financial ETF (DFNL) outperformed the S&P Financials Index with a first-half return of −0.09%.
- In 2023, the changing rate environment revealed a handful of banks that had over-reached on duration risk when rates were low, which prompted fearful customers to withdraw deposits and ultimately led to several bank failures.
- In contrast, most banks—including the banks in our portfolio—have positioned their balance sheets to benefit from a higher interest rate environment. This is evinced by the recent growth in interest income and earnings and the strong returns on equity being generated.
- We believe that our banks are well-positioned to withstand an eventual recessionary environment. Though short-term market fluctuations are unpredictable, our companies' valuations are so low that we think they should generate strong returns over the next decade.

The average annual total returns for Davis Select Financial ETF for periods ending June 30, 2023, are: NAV Return, 1 year, 7.89%; 5 years, 5.40%; Inception (1/11/17), 6.95%; Market Price Return, 1 year, 8.08%; 5 years, 5.38%; Inception, 6.98%. The performance presented represents past performance and is not a guarantee of future results. 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. For the Fund's most recent month end performance, visit www.davisetfs.com or call 800-279-0279. Current performance may be lower or higher than the performance quoted. *NAV prices are used to calculate market price performance prior to the date when the Fund was first publicly traded. Market performance is determined using the closing price at 4:00 pm Eastern time, when the NAV is typically calculated. Market performance does not represent the returns you would receive if you traded shares at other times. The total annual operating expense ratio as of the most recent prospectus was 0.63%. The total annual operating expense ratio may vary in future years.*

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. All fund performance discussed within this piece are at NAV and are as of 6/30/23 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. Equity markets are volatile and an investor may lose money.**

Strategy

Since its inception, Davis Select Financial ETF (DFNL) has invested in durable, well-managed financial services companies at value prices, which the fund could hold for the long-term. Shelby Cullom Davis's quip that financial services companies can be "growth companies in disguise" remains a bedrock tenet of our approach. Investors tend to place low valuations on financial companies because of their earnings volatility. But many financial companies generate capital through the business cycle at an attractive rate, which they use to pay dividends, buy back stock or otherwise deploy in ways that generate shareholder value. ■

Results

The S&P 500 Index ended first-half 2023 up +16.89%, its performance driven by its seven large technology holdings, which in aggregate increased +61% and now sport an $11 trillion market capitalization and comprise approximately 27% of the index. In contrast, the equal-weighted S&P 500 Index increased by only +7.0%. Suffice it to say, the rising tide has not lifted all boats so far in 2023.

The S&P Financials Index lagged even the equal-weighted index's performance at a loss of −0.53%, regional banks specifically dragging the result—e.g., the KBW Bank Index declined −18.9%. The bank index began the calendar year strongly both in absolute and relative terms, before experiencing a dramatic drawdown in early March. The downturn was ignited by solvency concerns at Silicon Valley Bank that led to a run on its deposits and ultimately resolution by the FDIC.

DFNL outperformed the S&P Financials Index with a first-half return of −0.09%. Our biggest contributors to relative performance were in consumer finance (Capital One and American Express), international holdings (Julius Baer, Danske Bank) and Berkshire Hathaway. The fund's largest detractors were regional banks and Charles Schwab. ■

"The changing rate environment revealed a handful of banks had taken on considerable duration risk when rates were low and misunderstood the stickiness of their deposits. Unlike the banks in which we are invested, the earnings and financial positions at these risky banks would be hurt by rising interest rates, which led us to shy away from owning their shares."

Fig. 1: **DFNL Annualized Returns, as of June 30, 2023**

	YTD	1 Year	3 Year	5 Year	Inception 1/11/17
Davis Select Financial ETF	−0.09%	7.89%	16.09%	5.40%	6.95%
S&P 500 Financials Index	−0.53	9.50	15.65	7.19	7.92
MSCI US IMI Financials 25/50 Index	−0.99	7.27	14.25	5.57	6.45
S&P 500 Index	16.89	19.59	14.60	12.30	12.94

What Happened in Banking?

As investors in financial stocks, we have been waiting a long time for interest rates to rise. While rates were at zero, banks were unable to earn a spread on their customers' deposits. This compressed their earnings and return on equity (ROE) to "below normal" levels, all else equal. (In fairness, credit losses had also been abnormally low in recent years, which partially offset this hit to income). We've likened the situation to a "coiled spring" waiting to be released by a more favorable interest rate environment.

As the U.S. Federal Reserve began increasing interest rates in spring 2022—to 4.25% at the lower bound by year-end, and to 5.0% as of June 30, 2023—banks saw an immediate impact on their interest income. Their floating rate assets repriced immediately while the funding cost of their deposit liabilities moved at only 20–30% of the change in short-term interest rates. The aggregate increase in interest income of our largest U.S. bank holdings[1] since the start of the rate-hiking cycle exceeds 45%, with most of this dropping to the bottom line. The ROEs currently earned by these banks couldn't be much better.

And yet the KBW Bank Index is down −19% so far this year, and −38% since the end of 2021. What is going on here? In our 2022 year-end letter, we wrote that the "why" behind the significant change in interest rate policy—an unexpected and significant increase in the inflation rate that demanded a response from the Federal Reserve to slow the economy—shifted bank stock investors' concerns toward recession and credit cycles. In 2023 another concern was added: The changing rate environment revealed a handful of banks that had taken on considerable duration risk when rates were low and/or misunderstood the stickiness of their deposit franchises. Unlike the banks in which we are invested, the earnings and financial positions at these risky banks would be hurt by rising interest rates, which led us to shy away from owning the shares.

Although this risky positioning had been apparent for many months, customers and investors remained indifferent until early March when depositors at Silicon Valley Bank began pulling out their deposits in size, and the FDIC opted to intervene in the hopes of arresting contagion. Unfortunately, that effort could not stop substantially similar fates at Signature Bank and First Republic (we owned none of these three banks). It's hard to overstate how different these banks look relative to the "typical" regional bank let alone the select banks in our portfolio.

Nearly all banks engage in maturity transformation to some degree, so inevitably in a rising rate environment, banks will see mark-to-market losses on their fixed-rate assets—whether they are securities or loans and regardless of how they are accounted for in financial statements or regulatory capital. But customers' deposit balances at banks are also worth considerably more, given that the rate paid on deposits is far less than the going

1. Includes Capital One, Wells Fargo, JPMorgan Chase, Bank of America, U.S. Bancorp, PNC Financial, BNY Mellon and Fifth Third Bank.

market rate of interest (see Figure 2). The challenge is that this deposit duration is not contractual, but behavioral. So, while it would be inappropriate to mark up deposits' value in financial statements, that doesn't mean that economically there isn't a partial matching of duration risk between assets and liabilities.

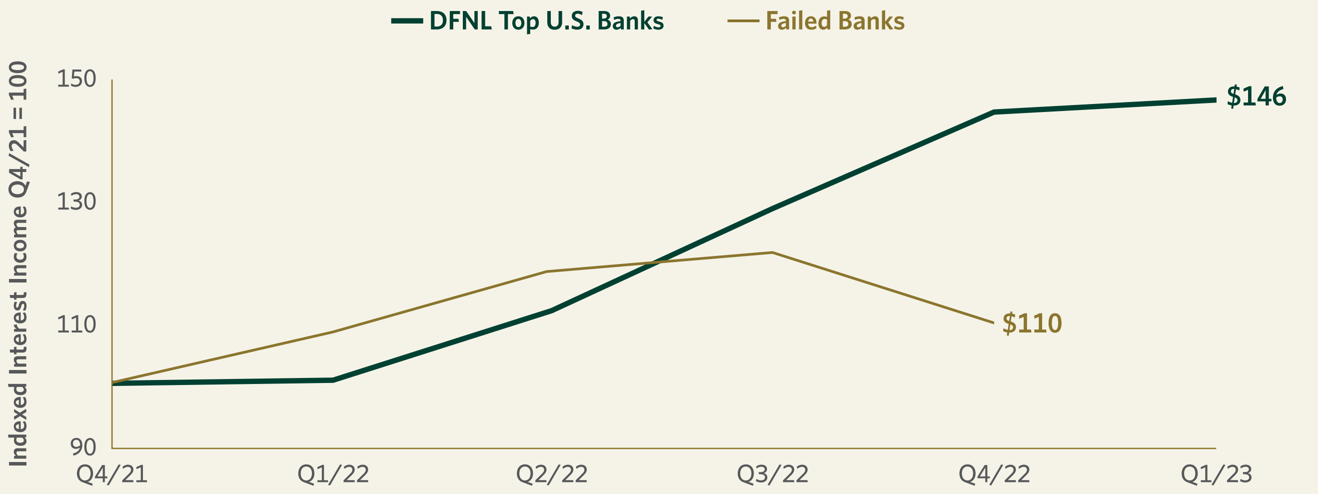
It is interesting to observe the divergence in interest income between our banks and the three failed banks during this rate-hiking cycle (see Figure 3). The failed banks saw their interest income peak in mid-2022 and were well on their way to declining below the levels earned in fourth-quarter 2021 when they failed. Our group of banks continued to see interest income increase through first-quarter 2023. And while growth has slowed and may turn sequentially negative soon, it is now running at a much higher level than it was at the start of the cycle.[2] This is a clear indication of just how far an outlier these failed banks were with respect to the mismanagement of their duration risk.

DFNL did not own any shares in the failed banks, but our regional bank holdings have declined in price sympathetically, despite the strong financial performance described above. It is possible (if not plausible) that there has been some erosion of intrinsic value at these banks: in the future, customers might be more proactive about managing their deposits; regulators likely will tweak rules for capital and liquidity, but on balance, at current valuations, we are optimistic about the shares' prospective returns in the coming years. ■

Fig. 2: **Average Deposit Costs, for the Quarter Ended March 31, 2023**[3]

	JPM	WFC	BAC	USB	PNC	BK
Total Cost of Deposits	1.33%	0.83%	0.92%	1.19%	1.20%	2.02%
Spread to Fed Funds (bps)[4]	319	369	360	333	332	250

Fig. 3: **Interest Income of DFNL Top U.S. Banks vs. Failed Banks**[5]
Q4 2021–Q1 2023



2. We believe there will be another "leg up" in interest income over time as the banks' fixed-rate assets reprice, all else equal. **3.** Source: Company filings. **4.** Effective Fed Funds Rate=4.52% in Q1 2023.Theoretically, this would have been true at the failed banks too, if they could have survived that long. **5.** Source: Company filings and DSA analysis.

Credit Cycle and Stock Prices

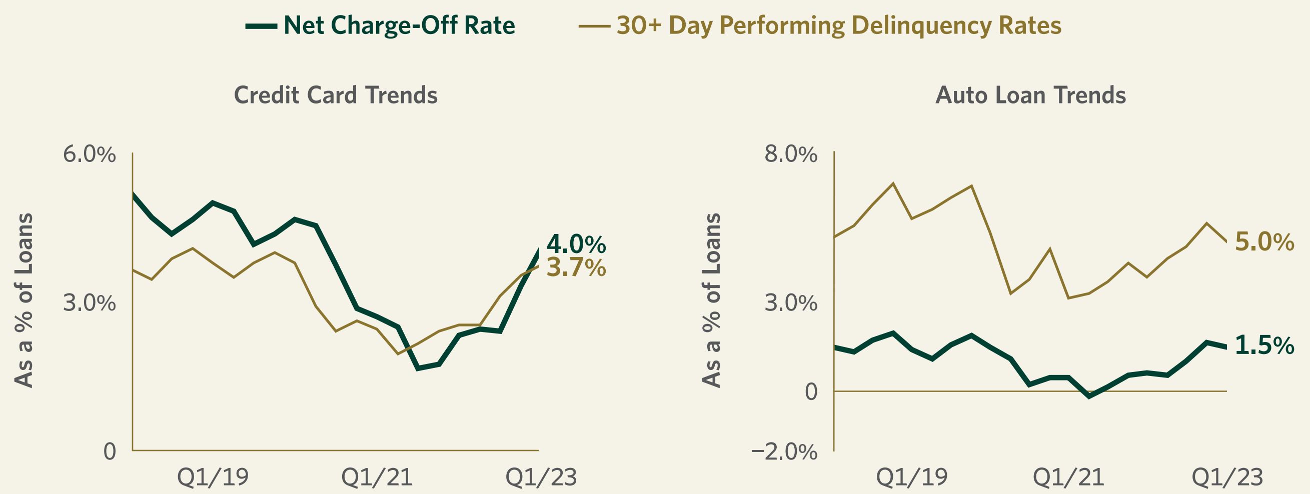
With respect to the economy and the credit cycle, as we've often said before: 1) We are not macro-forecasters trying to predict the timing and magnitude of swings in the cycle, and 2) we've always assumed that our companies would need to live through a recession at some point during our holding period. As such, we research our companies carefully to ensure that these holdings are well-prepared to withstand the ebb and flow of economic cycles.

At the end of last year, we wrote at length about our banks' positioning from a credit perspective, discussing Capital One as an example. We ended that discussion by observing that what is important for stock investors is not correctly predicting the macro, but rather correctly discerning what factors are already priced into their stocks' valuations.

Whether or not the U.S. economy enters a recession later this year remains uncertain (though that still seems quite plausible). But what's clear is that credit trends are continuing to (at least) "normalize" as illustrated by the upward trend in delinquencies and charge-offs at Capital One (see Figure 4). Despite that, Capital One stock increased +19% in the first half of 2023, ranking it among the best-performing stocks in the S&P Financials Index (along with other consumer finance companies). Arguably this was a case of the stock price being "vulnerable to good news" as we entered the year. Still priced at less than one time tangible book value, we continue to see good value in Capital One. ■

Fig. 4: **Capital One Credit Card and Auto Loan Trends**[6]

Q1 2018–Q1 2023



6. Source: Capital One company filings.

International Diversification

DFNL has a history of investing in a handful of high-quality international firms, whether they are players in global sectors like reinsurance or private banking, or leaders in their respective local markets. As of June 30, 2023, international companies make up 22% of the fund, and as a group, they have contributed positively to performance relative to the S&P Financials Index in this period. While that won't always be the case, of course, such diversification is an important and valuable feature of the fund.

A good example of one of our international investments is the Development Bank of Singapore (DBS), the largest bank in Singapore and one of the largest in Asia. With about 60% of the bank's deposit base in low-cost current accounts and savings accounts, DBS has a significant advantage in the cost of funding. In addition to a retail customer base with strong brand loyalty, DBS has increased its competitive advantage and ability to attract low-cost deposits by offering sophisticated cash management services for corporate clients and making wealth management a strategic focus. Through acquisitions and organic growth, DBS has become one of the top three banks in Asia for wealth management services. This business has been accretive to group ROE and is a natural fit to DBS' structural advantages including domicile in a triple-A-rated rule of law country and having Temasek, Singapore's Sovereign Wealth Fund, as an anchor investor. Aside from its home market in Singapore, DBS is building a presence in Greater China (China, Hong Kong and Taiwan), India and Indonesia. While this development, apart from its growth in Hong Kong, is currently diluting the company's overall return profile, we think as business efforts in any of those countries increase in scale, they will meaningfully boost DBS's earnings power.

Management also had the foresight to see the threat from nontraditional competitors and has invested to make DBS one of the most technologically advanced banks in the world. We think its approach to digital banking will maintain the company's competitive advantage in terms of efficiency and customer retention for the foreseeable future. DBS should generate mid-teens return on tangible equity, trades at around eight times estimated 2023 owner earnings and pays a 5.5% cash yield. ■

Conclusion

We remain consistent in our approach to allocating capital in our portfolio. We look for companies with durable competitive advantages coupled with competent and honest managements that are priced at a discount to their intrinsic value. We invest presuming that we will own our companies through business cycles. We do not attempt to build a portfolio around a particular speculative forecast—by trying to predict where interest rates or the economy will go, for example—but strive to construct a portfolio that will perform well over the long term across a range of economic outcomes. As such, our portfolio is diversified across leading franchises earning above-average returns on capital in banking, payments, custody, wealth management and property and casualty insurance.

Currently, investors' fears of a future recession and lingering questions about how interest rate risk is managed are weighing on the stock prices of financial services companies, notably banks. As we stated earlier, a recession is quite plausible in the next year or two. However, we believe that banks—especially the banks in our portfolio—are well-positioned to withstand a recessionary environment, should that occur. Though short-term market fluctuations are unpredictable, our companies' valuations are so low that we think they should generate strong returns over the next decade.

We remain excited by the investment prospects for the companies in Davis Select Financial ETF. Nothing provides a stronger indication of that than the fact that the Davis family and colleagues have a meaningful investment in the fund alongside our clients.[7] We are grateful for the trust you have placed in us. ■

7. As of 6/30/23.

This material is authorized for use by existing shareholders. A current Davis Select Financial ETF 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.

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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 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.

Objective and Risks. The investment objective of Davis Select Financial ETF 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; common stock risk; market trading risk:** includes the possibility of an inactive market for Fund shares, losses from trading in secondary markets, periods of high volatility, and disruptions in the creation/redemption process. **ONE OR MORE OF THESE FACTORS, AMONG OTHERS, COULD LEAD TO THE FUND'S SHARES TRADING AT A PREMIUM OR DISCOUNT TO NAV; exchange-traded fund risk:** the Fund is subject to the risks of owning the underlying securities as well as the risks of owning an exchange-traded fund generally; **financial services risk; 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; headline risk; foreign country risk; large-capitalization companies risk; manager risk; authorized participant concentration risk:** to the extent that Authorized Participants exit the business or are unable or unwilling to proceed with creation and/or redemption orders with respect to the Fund and no other Authorized Participant is able to step forward to create or redeem Creation Units, Fund shares may trade at a discount to NAV and could face delisting; **cybersecurity risk:** a cybersecurity breach may disrupt the business operations of the Fund or its service providers; **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; foreign currency risk; emerging market risk;** and **mid- and small-capitalization companies risk.** 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 6/30/23, the top ten holdings of Davis Select Financial ETF were: Capital One Financial, 7.98%; Berkshire Hathaway, 7.70%; Markel Group, 6.09%; Julius Baer Group, 6.06%; JPMorgan Chase, 5.82%; Chubb, 5.32%; Wells Fargo, 5.31%; Bank of New York Mellon, 4.99%; Danske Bank, 4.54%; and DBS Group Holdings, 4.49%.

Davis Fundamental ETF Trust 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 davisetfs.com or call 800-279-0279 for the most current public portfolio holdings information.

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We gather our index data from a combination of reputable sources, including, but not limited to, 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. The **KBW Nasdaq Bank Index** is a benchmark stock index of the banking sector. The index was developed by the investment bank Keefe, Bruyette and Woods, which specializes in the financial sector. It includes a weighting of 24 banking stocks selected as indicators of this industry group. The **MSCI US IMI Financials 25/50 Index** is designed to capture the large, mid and small cap segments of the US equity universe. All securities in the index are classified in the Financials sector as per the Global Industry Classification Standard (GICS®). The index also applies certain investment limits to help ensure diversification--limits that are imposed on regulated investment companies, or RICs, under the current US Internal Revenue Code. Investments cannot be made directly in an index.

After 10/31/23, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

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