Update from Portfolio Managers

Chris Davis and Pierce Crosbie

Davis Select Financial ETF (DFNL)

Annual Review 2021

Please provide your perspective on financials in the current environment and why you are optimistic:

For the full year 2020, the S&P Financials Index declined −2%, and the KBW Bank Index fell even further at −10%; both underperformed the broader market indices. As disappointing as the first half of the year was for investors in financial companies, in the back half of the year financial stocks have clawed back much of that poor performance, with the S&P Financials Index returning +29% and the KBW Bank Index +34%, while the broader S&P 500 Index was up +22% since June 30, 2020.

The strong recovery (albeit partial) in the second half of the year we think reflects that financial companies were "vulnerable to good news" at the start of the period. We wrote to you in June that in our view, the market was at that time overly discounting the magnitude of credit losses likely to be incurred in this recession, as well as the impact to intrinsic value from lower interest rates weighing on earnings for the next couple of years.

Since then, the "good news" can be summed up as follows: (1) the *outlook* for the trajectory of the economy hasn't gotten any worse, and arguably has improved marginally on-balance; (2) U.S. banks by and large did not add further to their reserves for credit losses in Q3 (more on that later), nor are they expected to when Q4 results are reported; and (3) the interest rate curve steepened, with the U.S. 10-year Treasury yield increasing +25 basis points (bps) to 0.91%. In short, it didn't take a lot of fundamental changes to assuage investors' worst fears around financial stocks, which resulted in the partial comeback in the second half.

So where to from here? We remain optimistic that financial companies—banks and property and casualty insurance companies in particular—are among the most attractively priced in the market today. The bank stock index's −10% decline this year occurred despite the fact that banks have largely remained profitable in 2020, and therefore have greater book value now than at the start of the year. Our largest U.S. bank and consumer lending holdings in aggregate look to have earned $58 billion in 2020[1], equivalent to a 9% increase in tangible equity—a lackluster year to be sure, but hardly disastrous.[2]

Banks achieved this level of profitability in 2020 despite the adoption of "life-of-loan" accounting for credit losses. The rule means just what it says—you must reserve up front for all the losses you ever

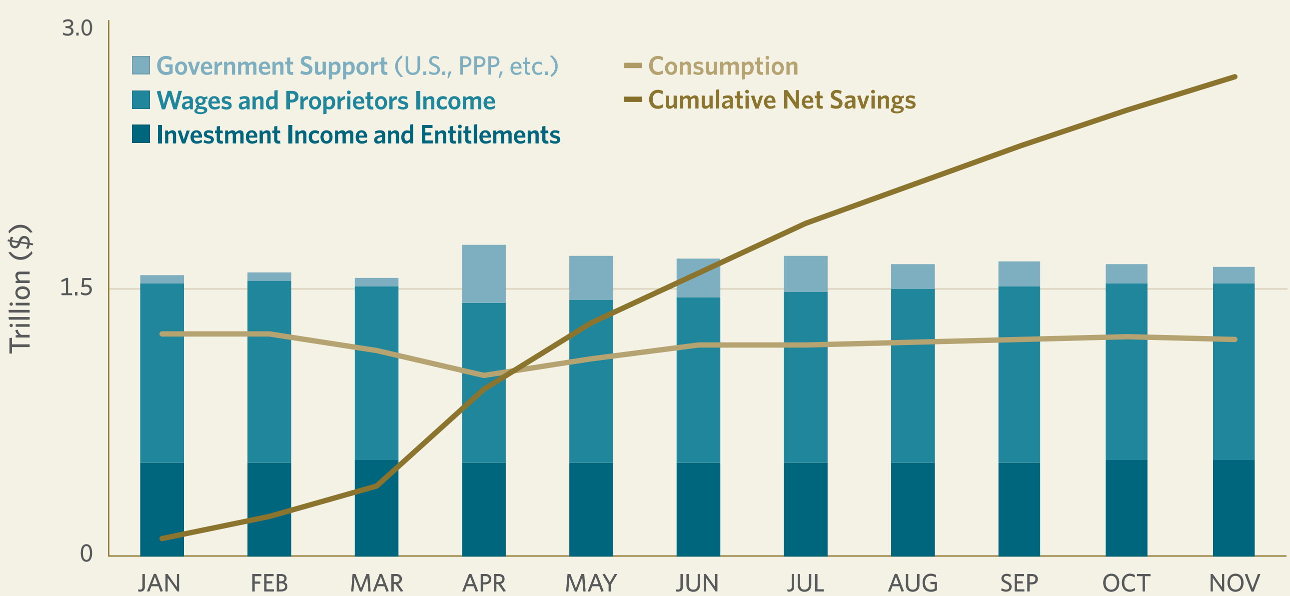
This report includes candid statements and observations regarding investment strategies, individual securities, and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct. All fund performance discussions within this piece are as of 12/31/20 unless otherwise noted. Equity markets are volatile and an investor may lose money. This is not a recommendation to buy, sell or hold any specific security. **Past performance is not a guarantee of future results.** **1.** Includes Capital One, JPMorgan Chase, U.S. Bancorp, American Express, BNY Mellon, Bank of America, PNC Financial and Wells Fargo. Used actual earnings through 9/30/20 (adjusted for certain items), and consensus earnings for Q4 2020 from Bloomberg. **2.** Tangible equity represents a company's book value minus intangible assets (including goodwill) and preferred equity.

expect to incur over the lifetime of a loan. This requires banks to take credit provisions for the *entire* recession *right away*[3]; from this point forward then—assuming that the outlook for the economy doesn't darken—banks should resume generating capital at "non-recessionary" rates, which is what was observed in the third quarter of 2020 when the same group of banks discussed above had a 15% increase in tangible equity.

Why haven't the credit provisions taken by U.S. banks and lenders been greater, given the severe depth of the recession earlier in the year, when unemployment spiked to a high of 14.7% (and arguably more like low-20s, given a drop in the participation rate and certain data misclassifications) and GDP peak-to-trough decline of −9%?[4] We are sure this will be inconclusively debated for years to come. But regardless, the fact is loans are not being charged off at nearly the pace one might have expected given the observed economic data. Capital One's Richard Fairbank has offered an explanation that seems compelling to us: the swiftness of economic decline brought on by the lockdowns led to an immediate response by borrowers (e.g., consumers cut spending, repaid debt, etc.) and by government (e.g., fiscal support in the form of enhanced unemployment, stimulus checks, and the Paycheck Protection Program for small business).

While income in aggregate earned by U.S. households from wages and proprietors' businesses declined −12% at the trough in April, with the support of these government programs, *total* household income dropped below the pre-pandemic level only in one month (March), and over the entire pandemic period has on average exceeded it by approximately $70 billion per month.[6] Consumption did of course dramatically decline by −19% through the April trough (though it has since recovered much of that and is running at down only −2% from the pre-pandemic level).

U.S. Personal Income and Consumption in 2020[5]



3. Banks did incur large credit provisions in each of Q1 2020 and Q2 2020, but only because the outlook for the economy deteriorated after Q1 ended. Had their foresight been perfect, they would have booked it all in Q1. **4.** Source: Bloomberg, 6/30/20. **5.** Source: Bureau of Economic Analysis. **6.** Source: Bureau of Economic Analysis. Average of March-November 2020 compared to February 2020.

Consequently, the net savings of households in aggregate has accelerated, with cumulative net savings through November reaching $2.7 trillion, which is about $1.5 trillion in excess of what is typical.[7] There is always a danger in focusing on aggregates, which misses individuals for whom the recession has hit severely such that their share of government support won't have offset their foregone income. But banks' loan portfolios are themselves aggregates—while there will be specific credit losses taken for sure (particularly in the hardest-hit industries such as hospitality and retail), broad-based credit losses at this moment appear less likely to be severe. Although an additional stimulus package was passed at the close of the year, it's uncertain still if it will be sufficient and if there will be additional fiscal support behind it, as well as when the vaccine will be sufficiently distributed to permit full reopening of our economy. But because of the actions that were already taken by households and governments, the "jumping off" point for banks' loan books looks more like a recession where unemployment peaks in the high single digits, rather than the extreme levels we witnessed in the second quarter.

For our bank holdings that possess sizeable investment banking businesses, the surge in trading and underwriting activity spurred on by the COVID-driven recession helped to cushion the impact of elevated credit provisions discussed above. At the investment banking segments of JPMorgan Chase and Bank of America (which are the two among our largest bank holdings that disclose an investment banking segment), the increase in tangible equity through the first nine months of the year was 19% in aggregate (inclusive of the segments' share of credit provisions discussed above), which is roughly a third better than the prior year.[8] It isn't unusual for financial markets turmoil to be followed by a robust period of investment banking activity—the same pattern was observed in 2009.

What was different in this period is that investment banks took very little in market-related losses at the onset of financial distress and market volatility, which stands in stark contrast to 2008. Some might say that was due merely to good fortune or to the extraordinary intervention by central banks, but it seems reasonable to us that it is also the result of changes to investment banks' business models that have made them less risky than in the past (albeit also less profitable). While we fully expect this pace of profitability at investment banks is unsustainable, it did serve to partially offset the hit to book value from having to build credit reserves.

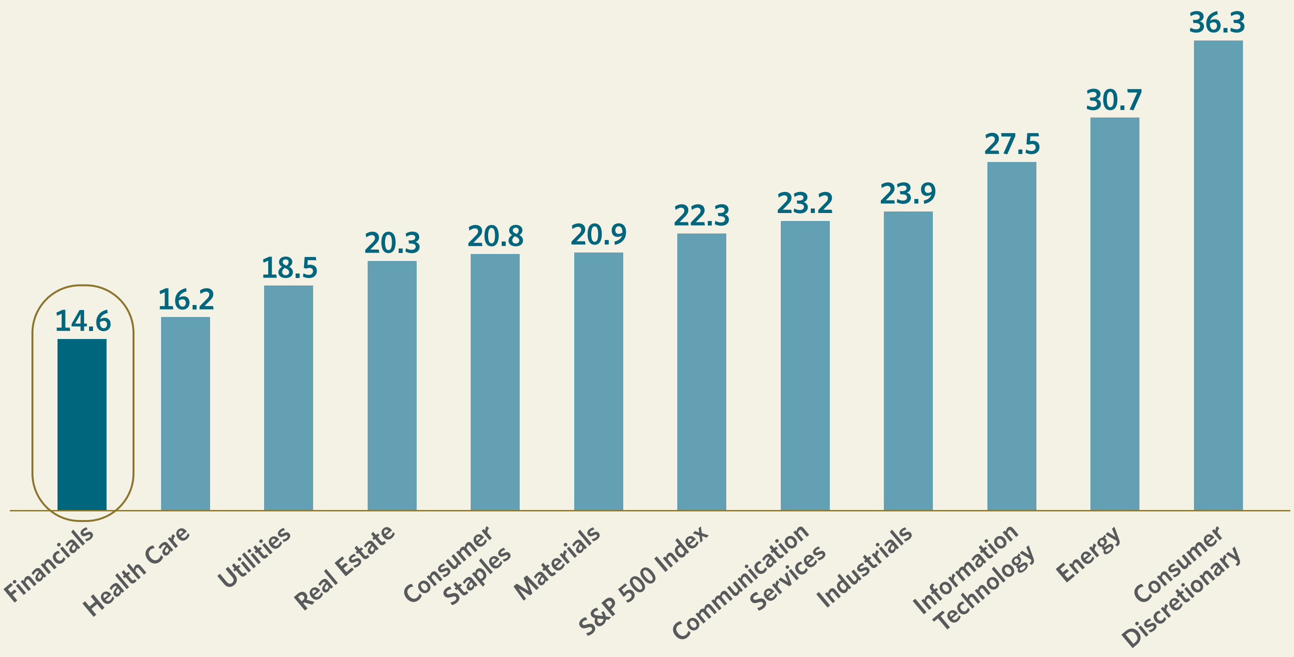
Concerns around capital and banks' ability to deploy it in dividends and buybacks also were a hot topic in 2020. At the dawn of the crisis, U.S. banks voluntarily suspended their buybacks. At the end of the second quarter, the Federal Reserve made it official by imposing a moratorium on buybacks, and it also created a new, backward-looking earnings test for dividends. When this earnings test is combined with the accounting change for loan loss reserves discussed above, the perverse result is some banks were forced to cut their dividends despite earning well above what is required to cover it in the very next quarter (e.g., Capital One Financial and Wells Fargo).

7. Source: Bureau of Economic Analysis. **8.** Tangible equity represents a company's book value minus intangible assets (including goodwill) and preferred equity.

From our perspective as long-term investors, the buildup of excess capital—so long as it's temporary—does not impair intrinsic value (though we are disappointed that our banks were unable to buy in shares at lower prices). In December, the Federal Reserve released the results of its COVID-specific stress testing, and gave banks permission to resume share repurchases (albeit subject to the same backward-looking earnings test noted above for now), and even prior to that it had consented to sizeable acquisitions by Morgan Stanley and PNC Financial Services Group, which effectively consume some of those banks' excess capital in the same way as a buyback. At the end of Q3, the largest U.S. bank holdings in our Fund had approximately 12% Tier 1 common equity ratio, which is >25% in excess of their required minimums (weighted by position size).[9] We believe that excess capital will be a driver of *per share* earnings growth for quite some time as this excess gets worked down.

A year ago, we wrote to you that financial stock valuations—and banks in particular—were attractive on both an absolute and relative basis. Since then, their prices have gone down and their book value up, resulting in a 16% improvement in the weighted average price/book value multiple of our largest U.S. bank holdings. The broader S&P 500 Index is priced higher, and forward-looking earnings are lower (even looking out beyond the recession), so on that metric at least, the valuations for financial stocks have only become more attractive. The chart below highlights the current valuations for financials which we believe make them attractive long-term investments at this time especially when compared with the rest of the market.

S&P 500 Index P/E Multiple by Sector[10]



9. Source: company filings, DSA analysis. Required minimum as per the Federal Reserve's stress capital buffer. Tier 1 common equity ratio represents a bank's tangible common equity with certain regulatory adjustments divided by the bank's risk weighted assets. Includes Capital One, JPMorgan Chase, U.S. Bancorp, American Express, BNY Mellon, Bank of America, PNC Financial and Wells Fargo. **10.** As of 12/31/20. Source: Credit Suisse.

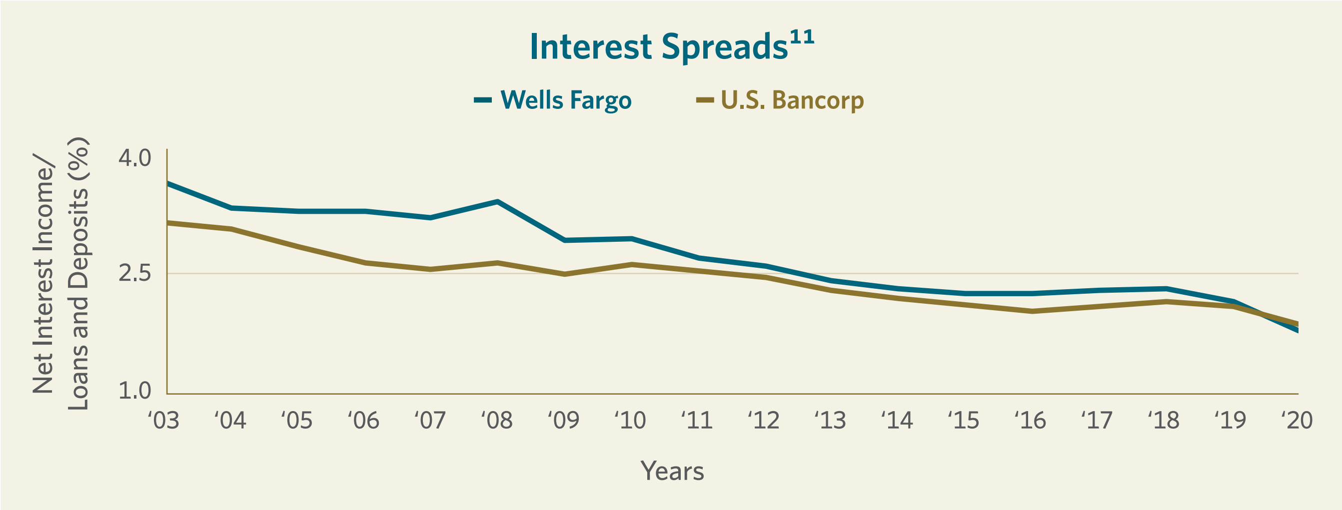
Now, of course, the decline in interest rates at both the short and the long end of the curve in 2020 reduces the earnings power of banks for the time being—a financial result that is largely already running through their income statements. Make no mistake: the compression in spreads has been dramatic. But we consider it a mistake to capitalize the earnings impact of these rates as if the trend was permanent. Without being macroeconomic forecasters, in our view, rates will in time revert to a level sufficiently above zero to restore banks' earnings power.

Please provide an update on the Fund's long-term performance and more recent results:

In 2020, Davis Select Financial ETF declined −5.1%, exceeding the decrease in the S&P Financials Index by approximately 3.4 percentage points. The primary source of that relative performance stems from our underweight positions in "non-balance sheet" financials such as exchanges, ratings agencies, insurance brokers, and asset managers (one in particular), whose stocks have actually performed quite well this year. While we admire many of these companies, in our view, they had become quite expensive, and in some cases, have become more expensive, trading at multiples of 20x, 25x, and even 30x earnings. We are not prepared to call our portfolio positioning a mistake just yet, but it certainly has hurt returns so far. As Ben Graham said, "In the short run, the stock market is a voting machine. In the long run, it is a weighing machine."

Please discuss how Davis Select Financial ETF is positioned today and notable changes during this period:

Our approach in assembling our portfolio has remained consistent over time: we look for companies with durable competitive advantages,



The average annual total returns for Davis Select Financial ETF for period ending December 31, 2020 are: NAV Return, 1 year, −5.06%; Inception (1/11/17), 6.57%; Market Price Return, 1 year, −4.97%; Inception, 6.57%. 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. NAV prices are used to calculate market price performance prior to the date when the Fund first traded on NASDAQ. 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. For the Fund's most recent month end performance, please call 800-279-0279 or visit www.davisetfs.com. The total annual operating expense ratio as of the most recent prospectus was 0.64%. The total annual operating expense ratio may vary in future years. Current performance may be higher or lower than the performance quoted. The Fund recently experienced significant negative short-term performance due to market volatility associated with the COVID-19 pandemic.*

11. Source: Company filings, DSA analysis. As of 11/30/20.

coupled with competent and honest management, priced at a discount to their intrinsic value. We invest under the presumption that we will own our companies through business cycles. We do not attempt to build a portfolio around a particular speculative forecast of where interest rates or the economy will go, but strive to construct a portfolio that will perform well over the long term across a range of outcomes. The resulting portfolio is diversified across leading franchises earning above-average returns on capital in banking, payments, custody, wealth management and property and casualty (P&C) insurance.

In the first half of 2020, we leaned into banks and consumer lenders as investors' fears increased and the companies' valuations declined (most notably PNC Financial Services Group, Bank of America, and Capital One Financial). In the second half of the year, because we felt there was a mispricing opportunity in P&C insurance, we added to our positions in Chubb, Loews and Alleghany. Funding for this came largely from trimming our "non-financial" holdings that had not suffered as severe a decline in their stock prices (Google) and exiting Goldman Sachs (whose share price had held up better, presumably reflecting the above-average profitability of securities trading and underwriting this year).

Chubb is now among the Fund's largest P&C holdings at 5.4% and illustrates well why we thought there was an opportunity to add to our P&C names. Through September 30, 2020, Chubb had significantly declined for the year-to-date, reflecting investors' fears that (1) the insurance industry would be compelled to cover substantial business interruption claims that were never intended as part of insured's policies, (2) declining long-term rates would diminish the value of "float" (i.e., customers' funds that insurers get to hold and invest until claims are paid), and (3) adverse trends (pre-dating the pandemic) in insured loss rates (e.g., rising litigation and settlement costs, increased frequency and severity of catastrophe losses, etc.).

With industry economics already soft, it was only a matter of time before insurance pricing would have to adjust. In fact, P&C pricing had already begun to increase in a number of business lines before COVID hit, and that trend has only increased and broadened since then. Chubb disclosed in Q3 2020 that North American commercial P&C pricing increased by more than 15% in aggregate. Some of the price increase will go to cover rising insurance loss rates, but we certainly do anticipate some dropping into underwriting profit too. Admittedly, some of that increased underwriting profit will itself get offset by a decline in investment income owing to lower interest rates, but that is a "feature," if you will, of P&C insurance companies. Unlike a bank, where the floor on its deposit funding costs practically speaking is zero, there is in theory no reason underwriting profit cannot increase to offset low interest rates, so it is feasible for its earnings to "normalize" far in advance of an eventual rise in long-term rates.

With respect to the setting of loss reserves, we have always admired Chubb's conservative approach in establishing cautious initial loss estimates and in recognizing the bad news first. In terms of COVID-related losses, Chubb reserved $1.4 billion for customers' claims in the second quarter, the majority of which were "incurred but not reported" loss estimates for professional and general liability lines that would be the second- and third-order impacts of the virus. Like the banks' "life-of-loan" reserving described above, Chubb has made an honest effort to put all of COVID's financial impact behind it.

When we started adding to our position in Chubb this year, it was valued at 1.6x tangible book value, and we expect it has the potential to earn a mid-teens return on capital over time and for it to grow decently and gain market share over time.

Looking ahead, what is your outlook for Davis Select Financial ETF?

While investors' fears of the credit losses that could be incurred during the COVID-driven recession have moderated since the first half of the year, they remain overly apprehensive about the risk, which, combined with the decline in interest rates, are weighing on the stock prices of financial companies, notably banks. We believe that banks are far better positioned to withstand a recession than they were before 2008, and their valuations are sufficiently low that we think they should generate attractive returns from here.

We are 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 invested in the ETF alongside our clients. We are grateful for the trust you have placed in us.

This report 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.

Shares of DFNL are bought and sold at market price (not NAV) and are not individually redeemed from the ETF. There can be no guarantee that an active trading market for ETF shares will develop or be maintained, or that their listing will continue or remain unchanged. Buying or selling ETF shares on an exchange may require the payment of brokerage commissions and frequent trading may incur brokerage costs that detract significantly from investment returns.

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.

Objective and Risks. Davis Select Financial ETF'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: **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; **fees and expenses risk; foreign currency risk; intraday indicative value risk:** the Fund's INAV agent intends to disseminate the approximate per share value of the Fund's published basket of portfolio securities every 15 seconds. The IIV should not be viewed as a "real-time" update of the NAV per share of the Fund because the IIV may not be calculated in the same manner as the NAV, the calculation of NAV may be subject to fair valuation at different prices, the IIV does not take into account Fund expenses, and the IIV calculations are based on local market prices and may not reflect events that occur subsequent to the local market's close; **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 12/31/20, the top ten holdings of Davis Select Financial ETF were: Capital One Financial, 9.70%; U.S. Bancorp, 7.59%; Berkshire Hathaway, 6.56%; American Express, 5.79%; Chubb, 5.40%; PNC Financial Services, 5.21%; Wells Fargo, 5.14%; Markel, 4.83%; JPMorgan Chase, 4.80%; and Bank of America, 4.68%.

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 prospectus. Holding percentages are subject to change. Visit davisetfs.com or call 800-279-0279 for the most current public portfolio holdings information.

LIBOR is the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another. LIBOR comes in 7 maturities (from overnight to 12 months) and in 5 different currencies. The official LIBOR interest rates are announced once per working day at around 11:45 a.m.

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. The **KBW 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. Investments cannot be made directly in an index.

After 4/30/21, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

Shares of the Davis Fundamental ETF Trust 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.

Foreside Fund Services, LLC
3 Canal Plaza, Suite 100, Portland, Maine 04101
800-279-0279, davisetfs.com

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