


Portfolio Manager VIDEO

Update from Portfolio Managers

Chris Davis and Pierce Crosbie

# Davis Select Financial ETF (DFNL)

Annual Review 2022

## Overview

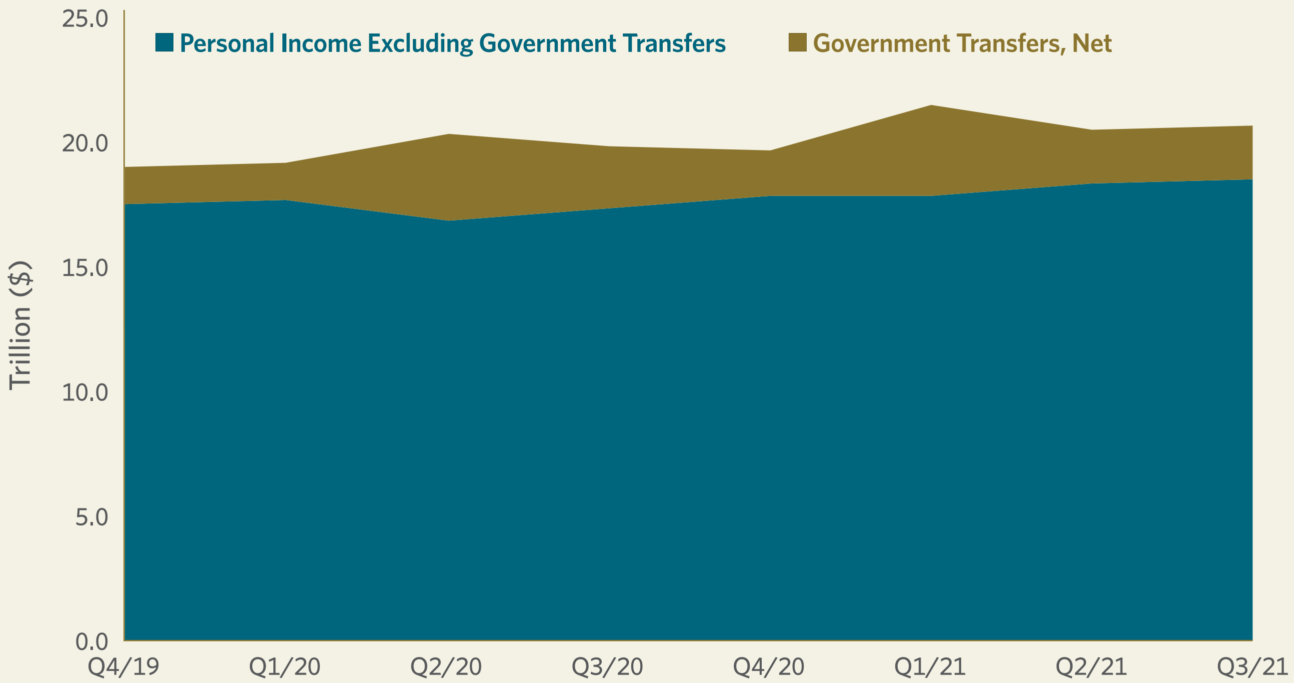
Since its inception, Davis Select Financial ETF (DFNL) has invested in durable, well-managed financial services companies at value prices that can be held for the long term. In 2021, DFNL returned 30.84%. Financial stocks outperformed the broader market last year, with the S&P Financials Index up 35.0% compared to the S&P 500 Index return of 28.7%, thus partially recovering from the relative performance deficit in 2020. The strong returns of financial stock indices in 2021 were led by constituents involved in banking, consumer finance and capital markets. These stocks were among those hit hardest at the onset of COVID-19, and despite having partially recovered in the second half of 2020, they were arguably still "vulnerable to good news" at the start of 2021. Favorable trends with respect to credit, interest rates and capital provided that good news. The S&P Financial Index's return was lagged by property and casualty insurers and Berkshire Hathaway (which is classified as a Diversified Financial and makes up approximately 13% of the index), though their contribution to absolute returns this year was also positive. ■

***The average annual total returns for Davis Select Financial ETF for period ending December 31, 2021 are: NAV Return, 1 year, 30.84%; Inception (1/11/17), 11.06%; Market Price Return, 1 year, 30.99%; Inception, 11.08%. 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 0.64%. The total annual operating expense ratio may vary in future years.*

## Trends in U.S. Banks

U.S. bank stocks were supported in 2021 by favorable trends in credit, interest rates and capital, with the KBW Bank Index increasing 38.3% for the year. Regarding credit, we believe that the market was overly discounting the losses that banks would incur as forbearance programs came to their end, the effects of Federal stimulus waned and enhanced unemployment benefits ceased. In 2021, the U.S. economy saw the unemployment rate decline from 6.7% to 3.9%.[1] Personal income grew at an 8.7% rate (now at $21 trillion, it comfortably surpassed its pre-COVID level)[2] and households saved at an above-average 13.8% rate.

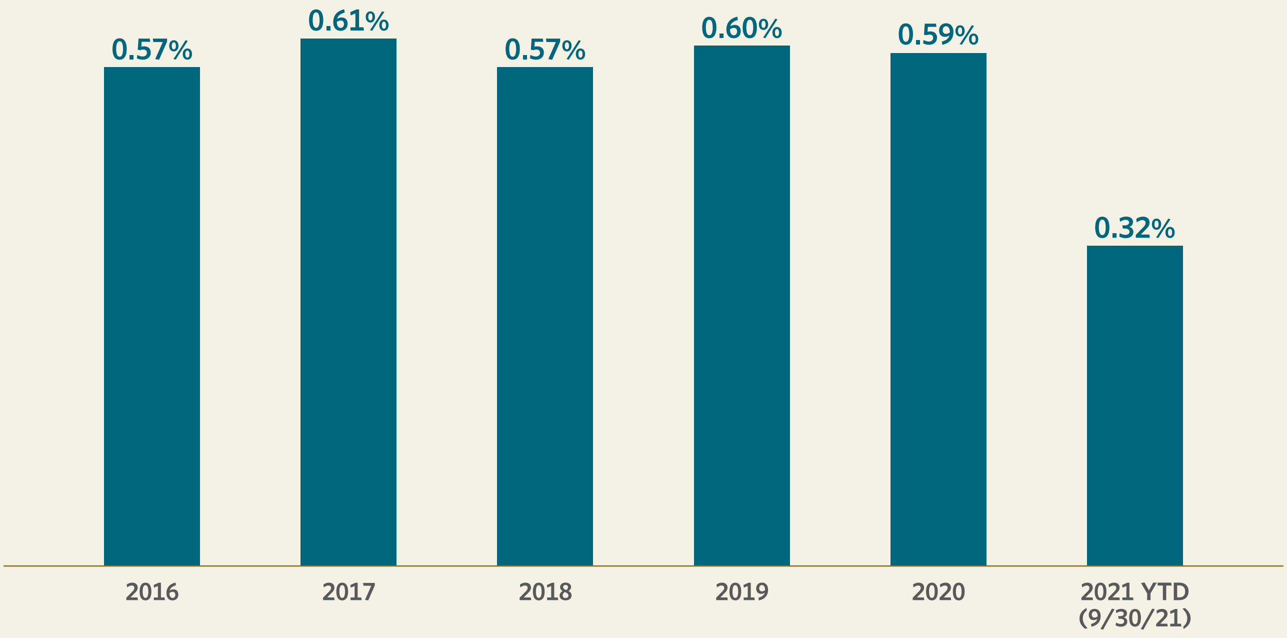
**Personal Income** (Annualized)[2]




**1.** Bureau of Labor Statistics. As of 12/31/21. **2.** Bureau of Economic Analysis. As of 9/30/21.

Banks, not surprisingly, continued to recognize loan charge-offs at very low levels—lower even than pre-COVID rates; our largest U.S. bank and consumer lending holdings in aggregate incurred charge-offs in 2021 at 0.32%, a rate only just over half the pace of the prior five years.[3] (See chart below.) With the improved outlook for credit, banks were able to further unwind the loss reserves that were provided for in the first half of 2020. While such reserve releases are not a "repeatable" source of earnings, they do contribute real capital back to the balance sheet that is available to support growth or distributions to shareholders. Our largest U.S. bank holdings released $35 billion of loan loss reserves through the first nine months of 2021—equivalent to about 5% of their common equity capital at the start of the year. Consequently, they are on track to earn a return on their tangible common equity this year of 19% in aggregate and 12% on their starting market value.[4] When we make assessments of intrinsic value at our companies, we always assume that credit losses will revert to "normal"—i.e., we do not capitalize the benefit to current earnings from such low charge-offs. But for the near-term at least, given the favorable credit backdrop, we believe U.S. banks should continue to compound capital at an attractive rate.

## U.S. Banks Aggregate Charge-Off Rate[5]




Aggregate Includes: Capital One, JPMorgan Chase, Wells Fargo, U.S. Bancorp, Bank of America, PNC Financial, BNY Mellon, American Express

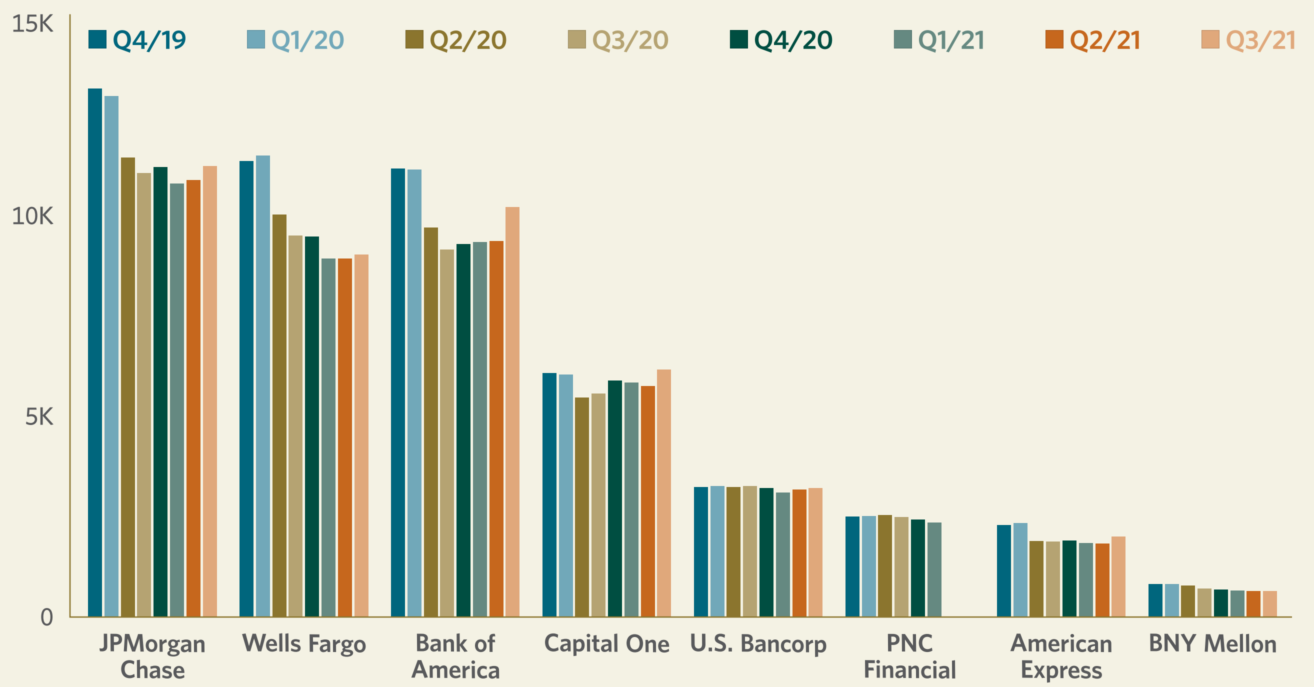
**3.** Includes Capital One, JPMorgan Chase, Wells Fargo, U.S. Bancorp, Bank of America, PNC Financial, BNY Mellon and American Express. As of 9/30/21. **4.** Calculated using actual earnings through 9/30/21 (adjusted for certain items) and consensus earnings for Q4 2021 from Bloomberg. **5.** Source: Company SEC filings and Davis Advisors analysis. As of 9/30/21.

Regarding interest rates, while banks' reported earnings continue to face headwinds from tightening spreads, the sentiment on the timing and magnitude of expected interest rate increases improved significantly in 2021. At our largest U.S. bank holdings previously mentioned, interest income has declined –11% in aggregate since the last quarter of 2019. (See chart below.) This reflects both the tightening of spreads in the low interest rate environment and softness in loan demand (particularly credit cards and commercial lending). But these banks have also seen an enormous inflow of customer deposits related to stimulus bills and monetary policy. Not all of those funds will stay with the banks in a higher interest rate environment, but a meaningful portion is likely to.

There is a "coiled spring" here waiting to be released. Based on the companies' required disclosures of interest rate sensitivity, we calculate that a relatively modest increase of 100 basis points (bps) would drive a +20% earnings increase in the first year alone.[6]

That was true a year ago as well, and as discussed above with respect to credit losses, we already were making our assessments of intrinsic value, based on *average* earnings power. What has changed is the market's expectations around the timing of increasing interest rates. The 10-year U.S. Treasury yield increased 60bps to 1.5% as of year-end, and while the Federal Funds Rate range remains at 0.00 to 0.25%, market participants have accelerated the expected timing for rate increases to start in 2022.

## U.S. Bank Interest Income by Quarter[7]

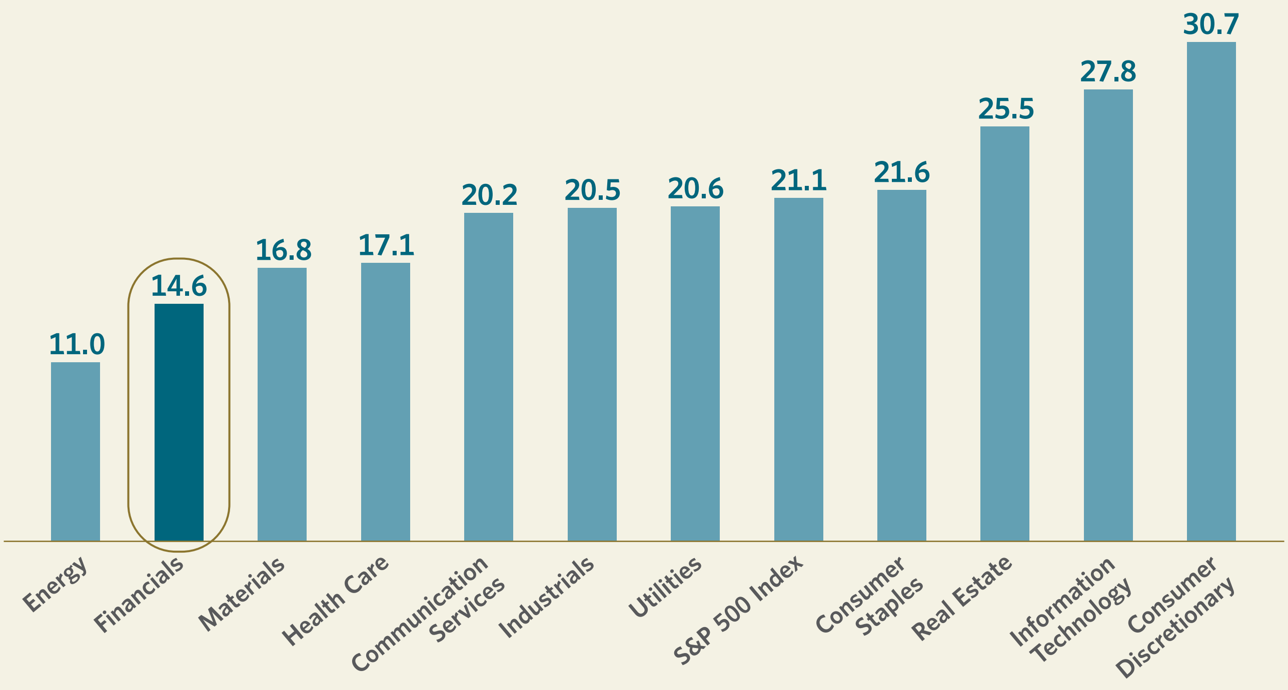



**6.** Company SEC filings and Davis Advisors analysis. **7.** Source: Company SEC filings and Davis Advisors analysis. As of 9/30/21.

Regarding capital, which had built up in 2020 as a result of the Fed's COVID-related restrictions, U.S. banks were given a freer hand to return it to shareholders this year. The Fund's largest U.S. bank holdings have deployed in aggregate about $84 billion in buybacks (net of stock compensation), dividends and cash acquisitions through the first nine months of the year, equivalent to an approximate 80% payout ratio and an annualized 10% of their starting market capitalization. Furthermore, this group remains comfortably overcapitalized at an 11.8% common equity capital ratio relative to risk-weighted assets; this is about 20% in excess of its required minimums and an improvement of more than 90% since 2007.[8] Excess capital will be a driver of *per share* earnings growth for quite some time as it continues to get worked down.

With the strong stock performance this past year, U.S. banks are naturally more richly valued than they were a year ago. Our group of U.S. banks has seen its aggregate tangible book value multiple increase from 1.7x to 2.1x. Within the context of the broader market, we think these banks nonetheless remain attractively valued. This group is expected to earn a mid/high-teens return on tangible equity next year, for a price/earnings valuation of 13–14x, which is a steep discount to the broader S&P 500 Index at approximately 20x next year's earnings. We believe today's leading financial companies are far stronger, more cautious and better positioned than any other time in memory. ■

## S&P 500 Index P/E Multiple by Sector[9]




**8.** Source: Company filings, DSA analysis. Required minimum as per the Federal Reserve's stress capital buffer. **9.** Source: Credit Suisse. As of 12/31/21.

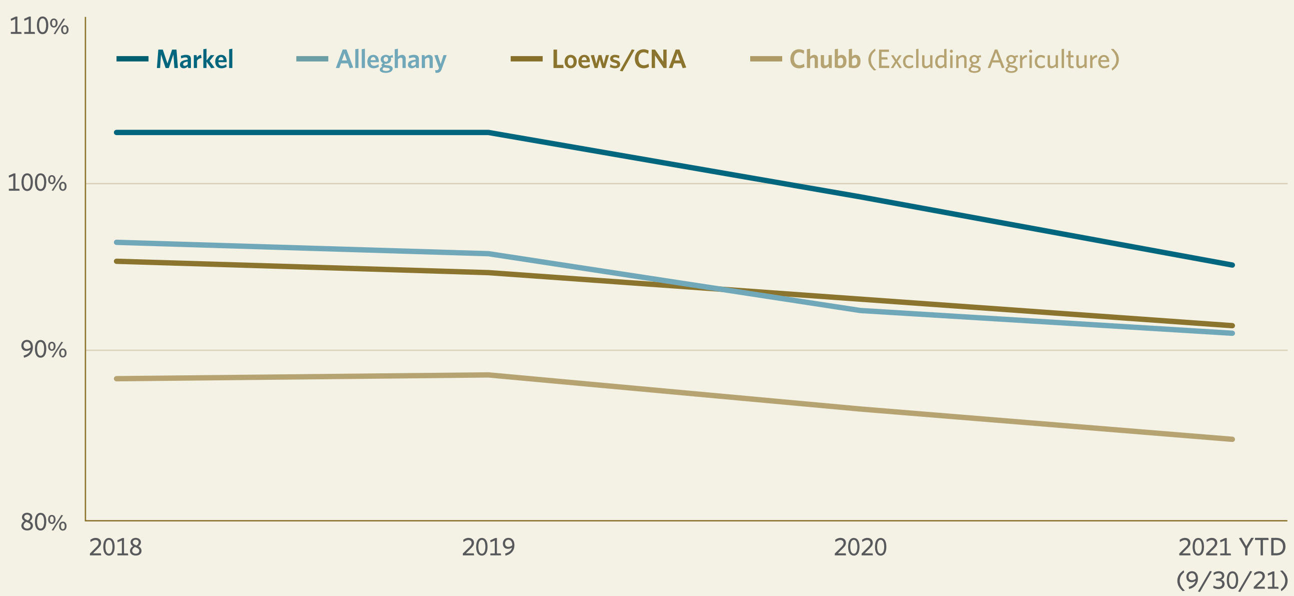
## Trends in Property and Casualty Insurance[10]

Stocks in the property and casualty insurance industry lagged the broader S&P Financials Index in 2021, with the median return among insurers within the index returning 27% vs. 35% for the index and compounding the soft investment returns of 2020 (the two-year median return is 19% vs. 33% for the index). Even before COVID, the industry had been beset by a string of years with above-average catastrophe losses, so-called "social inflation" in the size of litigation awards and settlements and low long-term interest rates. The lockdowns imposed by governments around the world in response to COVID-19 then led to insureds making claims for event cancellation and business interruption losses. While some insurance policies are explicitly intended to cover viruses, the insurance industry maintains that the bulk of business interruption policies do not, and for the most part, courts in the U.S. have upheld that view.

The property and casualty insurance industry had begun increasing prices across most lines of business even prior to COVID. Since then, momentum has only built. Most commercial lines insurers have pushed through double-digit price increases for more than two years running, and while the annual year-over-year rate of change may be slowing now, it still remains positive. We believe recognition of pricing increases in Generally Accepted Accounting Principles (GAAP) income tends to lag, but will inevitably emerge in time (all else equal).

The graph below shows the trend in accident year combined ratios, excluding catastrophe losses, for our four largest P&C insurance positions. This measure of underwriting profitability before factoring in changes to reserve estimates for prior years and catastrophe losses (which are certainly to be expected over time, but are quite volatile from period to period) has shown steady improvement over 2020–2021 of between 4–8 points as a percentage of premiums earned. We believe these companies are poised to perform financially much better over the coming years than they did in the recent prior years.

### P&C Insurance Accident Year Combined Ratio Excluding Catastrophes[11]




**10.** References to property and casualty insurance include both primary insurance and reinsurance. **11**. Source: Company SEC filings and Davis Advisors analysis. As of 9/30/21.

We already added to our property and casualty insurance investments in the second half of 2020 because we felt there was a growing mispricing opportunity. We leaned in a little further in 2021 as the stock prices continued to diverge. Total capital in DFNL allocated to these insurers stands at 19.5%,[12] and we continue to be excited about the prospects for these companies in the coming years. ■

## Conclusion

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

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 more than $60 million invested in DFNL alongside our clients.[13] We are grateful for the trust you have placed is us. ■

**12.** Excluding the 6.4% position in Berkshire Hathaway, which also has a sizeable insurance operation. **13.** As of 12/31/21.

*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; 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 12/31/21, the top ten holdings of Davis Select Financial ETF were: Capital One Financial, 9.10%; U.S. Bancorp, 6.89%; Chubb, 6.47%; Berkshire Hathaway, 6.37%; Wells Fargo, 5.81%; Bank of America, 4.98%; PNC Financial Services, 4.95%; Markel, 4.81%; Bank of New York Mellon, 4.66%; and JPMorgan Chase, 4.47%.

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.

**Bps** stands for Basis Points. One basis point = 0.01%.

**Federal Funds Rate** refers to the target interest rate set by the Federal Open Market Committee (FOMC). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight. The FOMC, which is the policymaking body of the Federal Reserve System, meets eight times a year to set the target federal funds rate, which is part of its monetary policy. This is used to help promote economic growth.

**Generally Accepted Accounting Principles** (GAAP) refer to a common set of accounting principles, standards, and procedures issued by the Financial Accounting Standards Board (FASB). Public companies in the U.S. must follow GAAP when their accountants compile their financial statements.

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 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 04/30/22, 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.**

**Distributor, Foreside Fund Services, LLC**
**800-279-0279, davisetfs.com**

**Item #6318 12/21**