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Update from Portfolio Managers

Chris Davis and Pierce Crosbie

# Davis Select Financial ETF (DFNL)

Annual Review 2023

## 2022 Results and Outlook

The year 2022 has been difficult for many asset classes. Not only were investors confronted with a decline in their stock portfolios, with the S&P 500 Index falling −18.11% but their investments in bonds also suffered double-digit declines driven by the increase in interest rates.[1]

Financial stocks performed better than the broader S&P 500 Index this year, nonetheless the S&P Financials Index still declined −10.53%, while the KBW Nasdaq Bank Index declined −21.40%. Many financial services companies—and banks in particular—stood to benefit from the rise in interest rates as the spread they earn on their customers' deposits and insurance premiums widens.

In general, they certainly are experiencing meaningful improvement to their interest income, which is dropping to the bottom line. However, the why behind this year's change in the interest rate environment—an unexpected and significant increase in the inflation rate, which demanded a response from the Federal Reserve to slow the economy—shifted bank stock investors' concerns toward recession and credit cycles.

Davis Select Financial ETF (DFNL) declined −8.24% in 2022, outperforming the S&P 500 Financials Index. Primary contributors to relative performance were our investments in property and casualty (P&C) insurance, foreign banks and Berkshire Hathaway. Primary detractors were our U.S. bank and consumer-lending holdings.

***The average annual total returns for Davis Select Financial ETF for periods ending December 31, 2022, are: NAV Return, 1 year, −8.24%; 5 years, 5.18%; Inception (1/11/17), 7.56%; Market Price Return, 1 year, −8.43%; 5 years, 5.09%; Inception, 7.55%. 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 0.62%. The total annual operating expense ratio may vary in future years.*

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 discussed within this piece are at NAV and are as of 12/31/22 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. There is no guarantee that the Fund performance will be positive as equity markets are volatile and an investor may lose money. 1.** The Bloomberg US Aggregate Bond Index declined −13.01% in 2022.

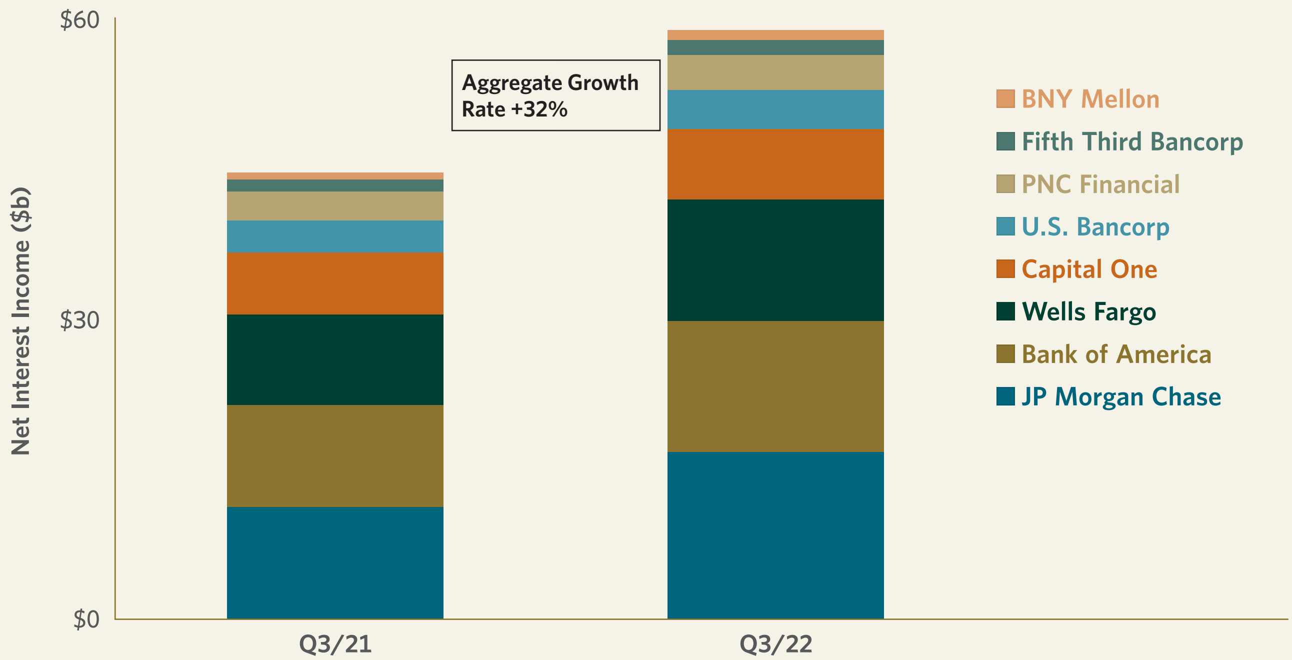
Since its inception, Davis Select Financial ETF (DFNL) has invested in durable, well-managed financial services companies at value prices, which the fund could hold for the long term. Shelby Cullom Davis's quip that financial services companies can be "growth companies in disguise" remains a bedrock 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 may generate shareholder value. By focusing on economic reality rather than investor sentiment, DFNL has compounded shareholder wealth at 7.56% since its inception.

With rising fear that the U.S. (and global) economy may enter a recession in the coming year driven by inflation, central bank tightening and geopolitical risk, we believe the stage is set once again for select financial companies to generate strong relative and absolute returns over the next decade. We base this belief on the companies' combination of durable business models, robust balance sheets, decent return on equity, disciplined capital allocation and low valuations. ■

## Environment for Bank Stocks

In prior letters we've frequently observed that banks were under-earning because of the impact of low interest rates on the spreads that banks can earn on their customers' deposits. We described this situation as being like a coiled spring waiting for a more favorable interest rate environment to be released. We also offered hypothetical illustrations of how sensitive banks' earnings should be to an increase in interest rates. We no longer need to hypothesize: Because the short-term Fed Funds rate increased by 425 basis points in 2022, the net interest income generated by the largest U.S. bank holdings in the fund[2] increased 32% year-over-year in the third quarter as shown in Figure 1. While at this writing we're awaiting

Fig. 1: **Interest Income at U.S. Banks[3]**
Q3 2021–Q3 2022




**2.** Includes Capital One, Wells Fargo, JPMorgan Chase, Bank of America, U.S. Bancorp, PNC Financial, BNY Mellon and Fifth Third Bancorp. **3.** Source: company filings and Davis Advisors' analysis.

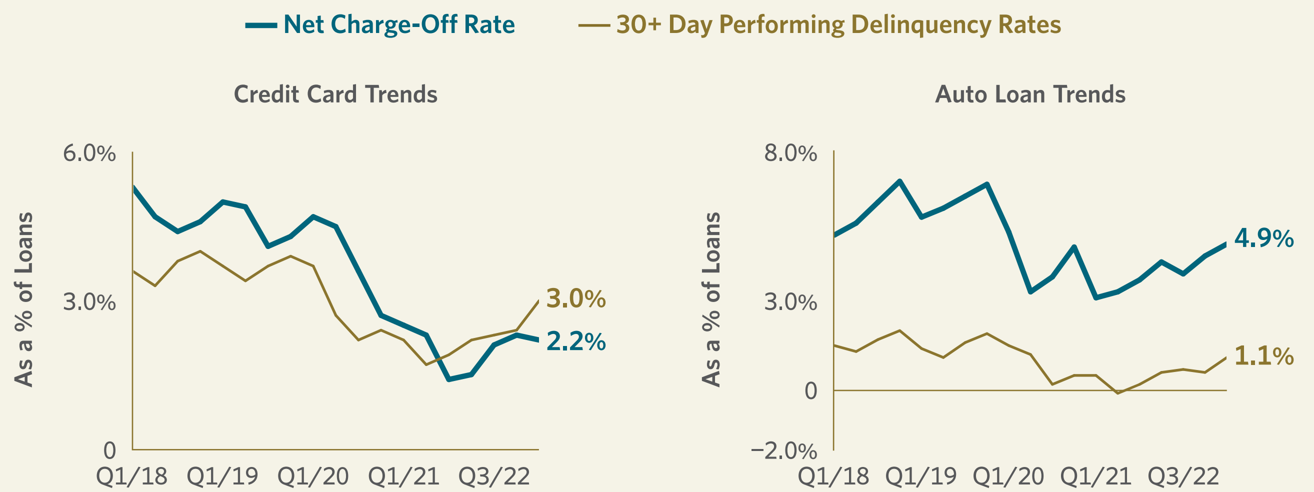
fourth-quarter results, it's widely expected that banks' interest income will increase further still—though from there, the pace should slow considerably given that the cost of customers' deposits tends to reprice on a lag. The vast majority of this tailwind to revenue does drop to banks' bottom-line profitability. As result, this same basket of banks generated an attractive 17% return on tangible common equity in the third quarter.[4]

Despite the improvement in financial performance among U.S. banks this year, their stock prices have declined. In fairness, we have posited that companies should be valued on their *average* (or so-called "normalized") earnings power. So, this change in net interest income driven by the increase in interest rates doesn't cause a dramatic shift in our assessment of banks' intrinsic value. But in our view, this group of stocks was attractively priced even at the start of the year, and with the decline in share prices (combined with the capital generated in 2022) it is now priced at 1.5 times tangible book value. We believe this basket of banks should earn a good return on equity *on average and over time*. We believe this is a very powerful combination for investors.

The weight on bank stock valuations seems to be credit concerns. Credit trends have been exceptionally good through and coming out of the COVID-19 pandemic. There is no dispute that credit will eventually "normalize" from this low run-rate of charge-offs. But, in our view, we are very far away from an economic scenario in which bank capital is impaired.

Let's consider one of our largest holdings in DFNL, Capital One. The company's two main consumer-facing lending businesses are credit cards and autos. Credit quality trends in both lines have followed a similar path, as seen in Figure 2. Delinquencies and charge-offs declined in 2020–2021 relative to pre-COVID-19 levels, but more recently they've started to experience an uptick in delinquencies (which naturally would precede any increase in charge-offs). So, the trajectory does suggest that the credit environment is deteriorating from what it was, but the absolute level of the trend remains favorable relative to the longer-term past. As Capital One's CEO Rich Fairbank recently noted, "It would be very abnormal if we were not seeing normalization."

Fig. 2: **Capital One Credit Card and Auto Loan Trends[5]**
Q1 2018–Q3 2022




**4.** Source: company filings and Davis Advisors' analysis. Earnings adjusted for changes to the allowance for credit losses, intangible amortization and one-time items. Tangible common equity deducts goodwill and other acquisition-related intangible assets, and adjusts for accumulated other comprehensive income related to available-for-sale securities. **5.** Source: company filings.

We try to avoid making forecasts about macroeconomic variables, though given the Federal Reserve's desire to rein in inflation through tighter monetary policy, a recession within the next year or so remains the most plausible scenario, in our view. Regardless of exactly how the next six- to-eighteen months play out we've always assumed that our companies would need to live through a recession at some point during our holding period.

The important question is, how well prepared are the companies to get through it? Their first line of defense is the allowance for loan losses that has already been booked. Accounting rules require a company to make a "life of loan" estimate of total credit losses, so their existing allowance already reflects a consensus economic outlook that calls for a slowing economy and a gradual rise in the unemployment rate. The actual path taken by the economy can of course veer adversely from the current outlook, but the point is that banks' reserves already incorporate a down payment on reversion to the mean of economic trends.

The second line of defense is the considerable amount of pre-provision earnings generated by the business, which at Capital One is currently running at slightly more than $15 billion annualized. That's sufficient to cover charge-offs equivalent to, say, 8% on their credit card loan portfolio, 4% on their auto loans, and 2% on their commercial loans—levels that are nearly on par with Capital One's experience in the Great Financial Crisis of 2008–2009, when the unemployment rate reached 10%. By definition, a "typical" recession would be far less painful. The final line of defense against any future recession is the bank's capital. And all U.S. banks, including Capital One, are holding materially more capital against their credit, markets and operating risks than they were leading up to the financial crisis.

That the economy may enter a recession in the coming year or two is hardly news to us. Recessions are an unpleasant but inevitable feature of the economic landscape for long-term investors. The question then is, as always, what is priced into valuations? At today's stock prices, we believe these risks are being overly discounted by investors whose memory of the financial crisis remains vivid. A recession could very well put pressure on banks' earnings in the coming year, but they should bounce back in subsequent periods. It's interesting to note that Capital One has never once in its history experienced a four-year period in which it did not earn at least a 13% return on tangible common equity. It's a great illustration of Warren Buffett's quip from his 1996 Berkshire Hathaway letter, "I would much rather earn a lumpy fifteen percent over time than a smooth twelve percent." ■

## Property and Casualty Insurance Sector

DFNL leaned into investments in property and casualty insurance[6] in 2020–2021. As we wrote to you last year, the industry had been pushing through substantial price increases across most commercial lines, driven by elevated catastrophe-related losses, "social inflation" in the size of litigation settlements and awards, and the (then) low level of interest rates. We felt that the market wasn't recognizing the improvement in the profitability of commercial P&C insurers. In 2022 that sentiment has begun to shift, as P&C insurance stocks performed well on a relative basis, with the median return for P&C companies within the S&P 500 Financials Index of +18%. This was the fund's primary source of relative outperformance in the year, given our 19% position in the sector at the outset.[7]

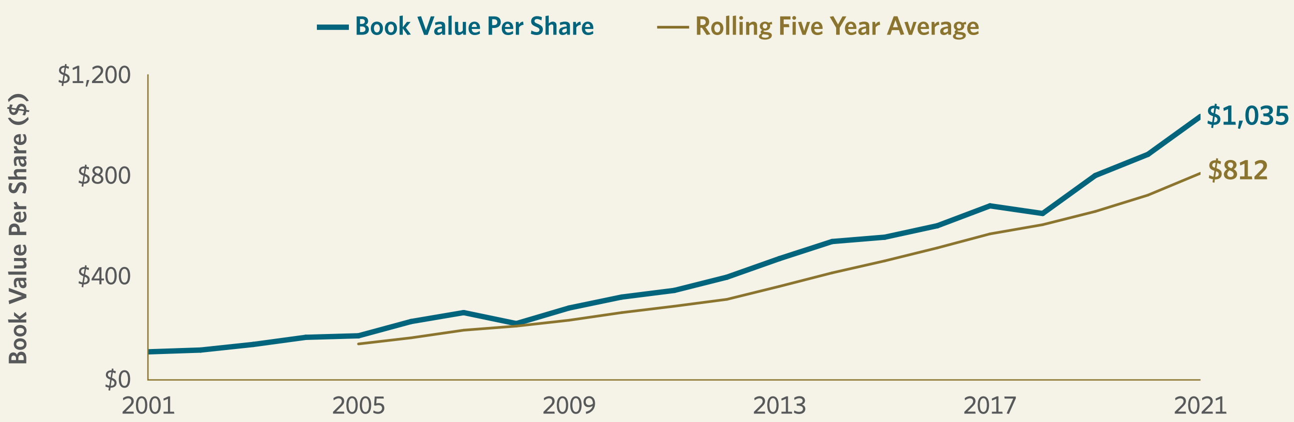
**6.** References to property and casualty insurance ("P&C") include both primary insurance and reinsurance. **7.** Excluding the 6.4% position in Berkshire Hathaway, which also has a sizeable insurance operation.

As the relative risk/reward trade-off has shifted back toward our bank holdings, the fund has reallocated some capital away from P&C insurance, though it still remains a meaningful position at 18%. A closer look at one of those holdings, Markel Corporation, illustrates why. Referred to by some as a "mini-Berkshire Hathaway," Markel allocates its capital between writing P&C insurance, investing in publicly traded stocks, purchasing controlling interest in private companies and repurchasing its own stock. Such flexibility conveys an advantage over those who limit themselves to one or two of those options. It also complicates the analysis of the company by investors, and despite its $18 billion market capitalization, Markel is covered by relatively few brokerage analysts. Insurance companies in general earn two streams of profits: the profit (loss) from underwriting clients' risks, and the investment income generated from assets financed with the float provided by their customers (and their own capital). Markel has a demonstrated record as a highly competent underwriter, illustrated by management's targeted underwriting margin of 10% in the medium-term, an outcome that would translate into an attractive mid-teens return on equity if it were conventionally structured.

But Markel is not conventional: It carries far more equity capital than its insurance operations need on a standalone basis, and that excess is allocated to stocks and owned private companies. The underlying companies in that portfolio—which include Berkshire Hathaway, Deere & Co., Home Depot and Alphabet, among others—earn perhaps $350 million more than they pay out in dividends.[8] Moreover, these companies are reinvesting much of that into their own businesses at attractive rates of return, which over time will materialize into stock price appreciation. Adjusting Markel's reported earnings for these retained earnings would decrease its 2023 valuation multiple. Furthermore, the contribution to this adjusted measure of earnings from these stocks and from the approximate $2 billion invested in private companies is roughly 45% of the total. These are non-financial businesses that generally command higher valuation multiples than typical financial companies.[9]

Figure 3 shows the growth in Markel's book value. Markel's rolling five-year compound growth rate in book value per share has ranged from a low of 7% to a high of 20% over the preceding 20 years, and has averaged 12% during that entire period.[10]

Fig. 3: **Markel Book Value Per Share**[11]
2001–2021




**8.** Source: Company filings, Bloomberg, and Davis Advisors' analysis. **9.** E.g., the S&P 500 Index is currently priced at 17.8 times 2023 earnings. **10.** Source: Markel 2021 Annual Report. Over 10-year periods, the range of book value per share compound annual growth rate (CAGR) narrows to 10–17%. **11.** Source: company filings and Davis Advisors' analysis.

This is a reasonable (though arguably understated) proxy for the growth in intrinsic value, and reflects the quality of Markel's underwriting business combined with their discipline in investing capital into equities and private companies. Market and intrinsic values will of course diverge at times but ultimately the former follows the latter. The path may not always look like a smooth one, but Markel has demonstrated its ability to compound intrinsic value at a steady pace over time. ■

## Rocket Companies: A Contrarian Investment

We first purchased a small position in residential mortgage lender, Rocket Companies, on its initial public offering in the summer of 2020. The country was in the middle of a massive refinancing boom, and as the leading mortgage originator, Rocket was earning approximately $3 billion per quarter (pre-tax). While the then-high level of profitability certainly influenced the math of valuation, by no means was it the whole story, as it was anticipated that origination volumes would be cyclical. Rocket, which continues to be controlled by its founder Dan Gilbert, had built a digitally driven platform in an otherwise labor-intensive industry, which we believe is an enduring source of competitive advantage.

As long-term interest rates began to rise in late 2021, the wave of refinancing volumes began to slow, and in 2022 they fell off a cliff. Rocket will earn little if any money in 2022, and profits in 2023 likely will again be meager. But the company's stock price declined by more than half over this period. To us this seems like a case where everyone knows that the sector is facing challenges, but not everyone acknowledges what is priced into the stock. DFNL nearly doubled its position in Rocket Companies in 2022 at much lower prices. Yes, the flow of mortgage originations has dried up for now, but the stock of mortgages outstanding has increased by 18% to $12 trillion in the past three years.[12] And the value of homes increased by an even greater rate, meaning that loan-to-value ratios have actually fallen. People do eventually move homes, or they will look to tap into their home equity for myriad purposes, and Rocket will be there to help them finance those transactions.

Over the long run, we prefer a lumpy 15% return to a smooth 12% return. ■

## 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 management 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—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 P&C insurance.

**12.** Source: Federal Reserve's Financial Accounts of the United States as of 9/30/22.

Currently, investors' fears of a future recession are weighing on stock prices of financial companies, notably banks. While a recession is quite plausible in the next year or two, we believe banks are well positioned to withstand it. Although 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 are excited by the investment prospects for the companies in Davis Select Financial ETF. We believe nothing provides a stronger indication of our belief in the future than the fact that the Davis family and colleagues have a meaningful investment in the fund alongside our clients.[13] We are grateful for the trust you have placed in us. ■

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- Viewing volatility as a cost of admission to building wealth
- Saving like a pessimist, but investing like an optimist

**13.** As of 12/31/22.

*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.** 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; **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 12/31/22, the top ten holdings of Davis Select Financial ETF were: Berkshire Hathaway, 6.97%; Capital One Financial, 6.78%; Chubb, 6.09%; U.S. Bancorp, 5.90%; Markel, 5.80%; Julius Baer Group, 5.59%; JPMorgan Chase, 5.36%; Wells Fargo, 5.13%; Bank of New York Mellon, 5.10%; and DBS Group Holdings, 4.87%.

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.

**Contrarian investing** refers to an investing strategy that looks for profit opportunities in trades that go against current market sentiment.

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 **Bloomberg Barclays US Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).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. Investments cannot be made directly in an index.

After 4/30/23, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

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