 

Update from Portfolio Managers

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# Davis Select Financial ETF (DFNL)

Semi-Annual Review 2020

### Please provide your perspective on financials in the current environment:

The S&P Financials Index declined −24% in the first half of 2020, and the KBW Bank Index fell even further at −33%, underperforming the broad market indices. The industry has suffered from a one-two punch of anticipated credit losses resulting from the COVID-19-induced recession and declining interest rate expectations that pose a headwind to its primary source of revenue, interest income.

While this recession will weigh on banks' earnings for a time, we feel that the market's reaction has overdiscounted the magnitude of the impact. In times of fear, it is a challenge for investors to keep their emotions in check. Whether it was the bear market of the 1970s and early 2000s or the financial crisis, buying after significant price declines have historically rewarded long-term investors who could do so.

### Discuss why you are optimistic about financials:

We wrote to you in December that investors remained leery of financial stocks—banks in particular—with memories of the financial crisis still vivid. The lockdowns around the world and associated economic decline have exacerbated investors' fears. But banks are in a very different position than before the financial crisis.

***The average annual total returns for Davis Select Financial ETF for period ending June 30, 2020 are: NAV Return, 1 Year, −18.15%; Inception (1/11/17), −0.37%; Market Price Return, 1 Year, −18.16%; Inception, −0.36%. 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 bid/ask midpoint 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.*

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. Equity markets are volatile and an investor may lose money. All fund performance discussions within this piece are as of 6/30/20 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.**

First, banks are starting from a much stronger capital position. Their levels of common equity are roughly double what they were in 2007. The Federal Reserve's just-released annual stress test for 2020 revealed that U.S. banks collectively were holding greater than 15% more capital going into this crisis than required to meet the "stress capital buffer"—i.e., the threshold that in theory permits them to distribute capital to shareholders as they see fit.[1] However, out of an abundance of caution, for the third quarter, the Fed has asked U.S. banks to refrain from buybacks, and it superimposed a cap on dividends relative to trailing earnings that will impact a few banks despite their excess capital positions. Most U.S. banks are poised to continue paying dividends at the current level. Concerning our European holdings, regulators have demanded or encouraged banks to suspend or delay their dividends without distinguishing between those that can afford to maintain them and those that cannot. All else being equal, we would, of course, prefer their dividends to be continued (and buybacks too where appropriate), but we're consoled by the fact that this retained capital does not disappear, and all of our European holdings are continuing to generate capital at adequate rates.

Second, bank loans have been underwritten to much higher credit standards than in the buildup to the financial crisis. In contrast to other recessions, this one is not the bust that inevitably follows an economic and financial boom. Our U.S. banks increased their reserves by 0.5% of loans in the first quarter of 2020 and seem poised to repeat a similar increase in the second quarter.[2] These are indisputably large credit loss provisions (though in aggregate, our holdings still made money in the first quarter). There was, however, a critical accounting change made at the start of this year to adopt "life-of-loan" loss reserving. The rule means just what it says—you must reserve for all the losses you ever expect to take on a loan. As a consequence, banks will absorb most of the pain of a recession all at once as the economic outlook deteriorates. While it is always possible that the already grim outlook could deteriorate further (and therefore require additional loss reserves), at some point we believe it will stabilize, and that point almost surely will come long before the economy actually starts improving. Bank managements will know considerably more about the state of the economy at the end of the second quarter than they did after the first, so we think it's reasonably likely that this will mark the low point for loan loss reserves.

The deterioration in the interest rate environment will result in pressure on banks' revenue, and it will continue for several quarters as maturing fixed-rate assets roll over at lower reinvestment yields. On the funding side, most banks can only decrease their deposit costs by 50 bps or so before hitting the 0% floor, which won't fully offset the 1.5 point decline in the Fed funds rate or the approximately 1 point decline in the 10-year Treasury yield. In practice, loan yields do not decline one-for-one with their underlying benchmark yields due to LIBOR floors, hedging strategies and credit spreads that seem to widen when rates are so low. Still, an eventual approximate 15% decline in interest income relative to the Q1 2020 run-rate wouldn't be unreasonable.

So why are we optimistic about financials today? Because the market has already priced in these adverse trends in credit and interest rates, and in our view, it is actually overdiscounting them. The intrinsic value of companies reflect their cumulative earnings over many years into the future, not just the next couple. We don't forecast the economy or interest rates, but we are confident that in time, our economy will recover, and interest rates will revert to levels sufficiently above zero, thereby restoring banks' earnings power. Looking ahead, we believe the returns to investors at today's prices should be quite attractive.

**1.** Source: Dodd-Frank Act Stress Test 2020 and DSA analysis. **2.** Source: Company filings and DSA analysis.

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

Through the first six months of 2020, DFNL declined −27%, exceeding the decline in the S&P Financials Index by approximately 4 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. Despite near-term results, we have high conviction in our portfolio positioning. 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:**

Our approach in assembling our portfolio has remained consistent 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.

Our portfolio, by some measures, is rather concentrated in our favorite investment ideas. The S&P Financials Index is quite concentrated as well, with two names sized above 10% and five names comprising about 40% of the fund (four of which are money-center banks), but of course, those position sizes are determined by solely market cap. On occasion, those large companies might coincidentally be the "right" stocks to concentrate in; they certainly weren't in 2008.

**Discuss some of the businesses Davis Select Financial ETF owns and any notable changes during this period:**

Capital One is among our largest holdings and one we leaned into during the first half of 2020, as loan loss concerns weighed on its share price. At the end of the first quarter, Capital One had already reserved for losses on its credit card book equal to 11% of loans outstanding, after adding approximately 2.3 points to its reserves in the quarter.[3] While we expect the company will add additional reserves in the second quarter, we also observe that management has earned a reputation for recognizing bad news early. Admittedly the economy is experiencing unemployment rates unlike anything since the Depression, but with the bulk of the federal government's stimulus bill geared toward the replacement of wages (e.g., enhanced unemployment benefits, stimulus checks, the Paycheck Protection Program loans), consumers largely have the means to honor their financial obligations (at least through the first few months of this recession, and Congress may do more in the coming weeks). Capital One should soon be able to put reserve-building behind, is capable of earning returns on capital in the mid-to-low-teens over time and is valued at only 0.8x tangible book value.

Bank of NY Mellon acts as a custodian to asset managers and owners, is the trustee for bond issuances and depository receipts and operates a clearing business for brokers, dealers and RIAs. It incurs little credit risk for a "bank" of its size—

**3.** Source: Company SEC filings. Figures are inclusive of losses shared with retailer partners.

a trait well-illustrated in Bank of NY Mellon's supervisory stress test where the Federal Reserve officials modeled that it would *earn* more than $4 billion in pre-tax profits in the "severely adverse" scenario. The majority of its revenues are fee-based, but it also earns approximately one-fifth of its revenue from interest income on the approximately $250 billion of client deposits that these businesses attract. The decline in interest rates erodes that revenue stream and does so relatively quickly, given the short duration of its assets. It's valued today at 10x current year earnings, which already reflects most of the impact from lower interest rates. The earnings upside from an eventual rise in interest rates could be 20–30%.

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

Investors' fears of the credit losses that could be incurred during the COVID-driven recession, 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 had been before 2008, and their valuations are so low that we think they should generate strong 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 6/30/20, the top ten holdings of Davis Select Financial ETF were: U.S. Bancorp, 8.4%; Capital One Financial, 7.8%; Berkshire Hathaway, 6.7%; American Express, 6.0%; Markel, 5.7%; Bank of New York Mellon, 5.3%; JPMorgan Chase & Co., 4.8%; PNC Financial Services Group, 4.6%; Bank of America, 4.6%; and Wells Fargo & Co., 4.5%.

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 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 10/31/20, 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.**

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