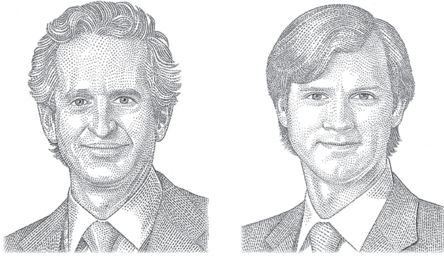
Davis ETFs



Portfolio Manager VIDEO

Update from Portfolio Managers

Chris Davis and Pierce Crosbie

Davis Select Financial ETF (DFNL)

Semi-Annual Review 2022

Overview

Davis Select Financial ETF (DFNL) seeks to invest in durable, well-managed financial services companies at value prices that can be held for the long term. So far in 2022, DFNL returned −15.0%. Although painful in absolute terms they are relatively better compared with the S&P Financials Index at −18.7% and the S&P 500 Index at −20.0%. The price declines among financial stocks was fairly consistent among subsectors, with the notable exceptions of insurance, which held up better and was the primary source of the Fund's relative outperformance. ■

The Current Environment for Financials

The macroeconomic environment has changed dramatically since the start of the year. Discussion has to commence with the re-emergence of inflation, which stood at 8.6% year-over-year as of May 2022.[1] Depending on whom you ask (and your political leanings), the drivers of this inflation are supply chain disruption, expansionary monetary policy, excessive fiscal stimulus, the war in Ukraine and underinvestment in energy production and refining capacity. All of the above seems likely to be the answer to us.

The average annual total returns for Davis Select Financial ETF for period ending June 30, 2022, are: NAV Return, 1 year, –11.43%; 5 years, 5.93%; Inception (1/11/17), 6.78%; Market Price Return, 1 year, –11.58%; 5 years, 5.89%; Inception, 6.78%. 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 discussions within this piece are at NAV and are as of 6/30/22 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.** Source: Bureau of Labor Statistics.

Energy is undoubtedly the epicenter of the price increases. In aggregate, it accounts for approximately 8% of the Consumer Product Index (CPI) and increased by +35% over the past year. Gasoline alone increased +49%, but utility bills for electricity and natural gas are higher by double digits also. Vehicles are another notable source of the observed price inflation, with new and used vehicles up +13% and +16%, respectively. They account for another 8% of the CPI. To a large extent, we would classify these as *relative* price increases, which is to say that they would have occurred even in the absence of general inflationary pressure, due to what our university professors called adverse supply shocks. There is no reason to assume that these goods should see their prices continue to increase *at the same pace*. But it certainly does mean that, all else equal, consumers are poorer as a result, and consequently, there should be a depressing effect on the economy.

But importantly, the observed price inflation is no longer limited to those goods experiencing such supply shocks. Price inflation for all consumer purchases other than energy, food (which also tends to be volatile, has been subject to its own supply constraints, and increased +10% year-over-year) and vehicles has accelerated to approximately 5% compared to less than 3% a year ago,[2] and well above the Federal Reserve's stated target average of 2%. This "across the board" increase in prices is of the pernicious kind that can get built into expectations, potentially leading to a wage/price spiral.

The Federal Reserve, not surprisingly, has responded to the re-emergence of inflation by raising short-term rates more and faster than had been expected at the outset of the year to reign in aggregate demand. The futures contract for fed funds now implies that the effective rate will be around 3.3% by the end of 2022, up approximately 250 basis points since December 31, 2021. The ten-year Treasury yield is up approximately 150 basis points to 3.0%. Such increases in interest rates will be beneficial to banks' revenue. To illustrate the point, JP Morgan Chase disclosed during the quarter that it now expects to exit 2022 with annualized net interest income of $66 billion, up more than $20 billion from 2021, and all else equal, equivalent to approximately 40% of 2021's net earnings.[3] Our view has consistently been that interest rates would *normalize* in time, but we couldn't know when. In that same vein, the impact of higher interest rates on banks' earnings should not be conflated with a change in our estimate of intrinsic values, other than that sooner is better on the margin, but it does illustrate the "coiled spring" that was awaiting release while interest rates were so low, which we felt was not fully captured in banks' valuations going into the year.

However, bank stocks have performed poorly in 2022, with the KBW Bank Index down −22.5% through the first six months. Investors' concern about banks has shifted from the depressing impact of low interest rates on bank profitability to the likelihood of the economy falling into recession and the loan losses that would follow. We aren't

2. CPI inflation excluding food, energy and vehicles is calculated by DSA from the data disclosed by the Bureau of Labor Statistics. **3.** Source: JP Morgan Chase Investor Day on 5/23/21 and DSA analysis. Net earnings in this calculation are adjusted for changes to loan loss reserves.

macro forecasters, but the combination of the above-noted adverse supply shocks and the Federal Reserve's desire to rein in aggregate demand to check inflation does put downward pressure on our economy. A recession in the next year or so is certainly plausible. But more important in our view is that a recession was *always inevitably* going to occur at some point in the future, even when there was no sign of it on the horizon. The question for investors then is, what is priced into valuations?

We think U.S. banks are very well positioned to weather the next recession, whenever it may come. They are holding almost twice as much capital as before the 2008 financial crisis, and their credit underwriting appears to be considerably more disciplined. In the annual stress test just conducted by the Federal Reserve, the eight largest U.S. bank holdings in our portfolio are modeled in aggregate to lose (pre-tax) approximately 12% of their starting common equity capital in a "severely adverse scenario" that envisions unemployment peaking at 10%, a 3.5% decline in real GDP, residential housing down −28.5% and commercial real estate down −40%.[4] Any recession is, by definition, likely to be far more moderate than this scenario, and we think it's quite likely that these banks will actually generate capital over the next couple years, albeit not necessarily in a straight line. This same basket of banks is collectively valued in the market at 1.4x tangible book value, and we think they should earn a mid-teens return on equity on average and over time. It's a powerful combination for investors, particularly if you also factor in even just a modest amount of business growth.

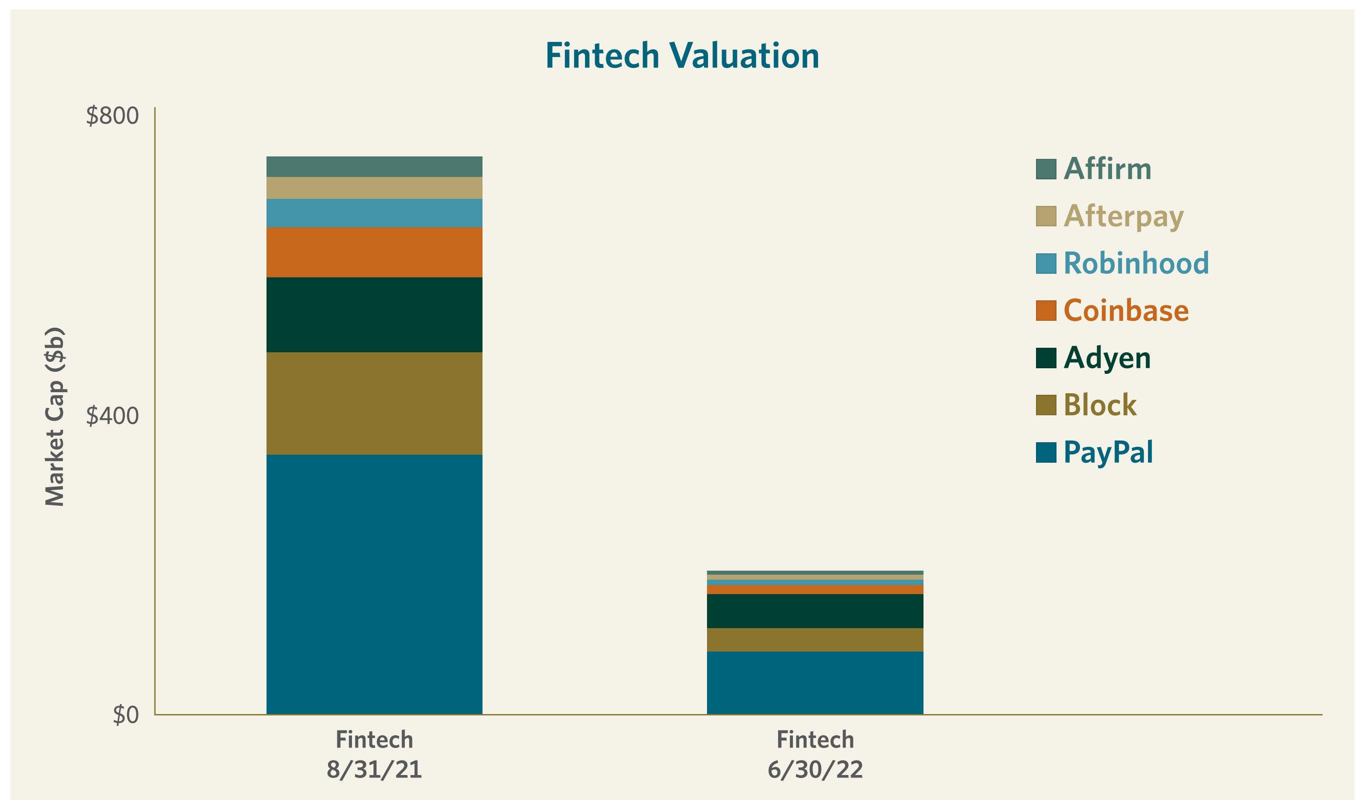
Property and casualty insurance and reinsurance (P&C) stocks performed well on a relative basis in the first half of 2022, with a median return for P&C companies within the S&P 500 Financials Index of +5%. This sector was the primary source of the Fund's relative outperformance of the index in the first half of 2022. The double-digit price increases over the last couple of years are showing through in their attritional underwriting profit margins.[5] While the pace of price increases has slowed, the current outlook seems to call for this improved profitability to be sustained in the medium-term. We have reallocated some of the capital invested in P&C companies as the relative risk/reward has shifted in favor of our bank holdings.

DFNL does not currently own any of the prominent so-called "fintech" companies, though we study them closely. At the right price, they could of course be attractive investments in their own right, but at minimum, we must be aware of the competitive risks they pose to the industry incumbents. Fintech stocks have been on a roller coaster in the last few years, climbing to incredible highs in mid-2021—a group of seven of them were valued then at more than $700 billion.[6] For roughly the same price, an investor could have bought all of JP Morgan Chase, Charles Schwab and American Express. In theory, market prices should be discounting consensus expectations of all future cash flows. The market prices of mid-2021 were certainly implying a very bright future for these disruptive business models. Since then, as the

4. Source: 2022 Federal Reserve Stress Test Results. Basket of banks includes BAC, BK, COF, FITB, JPM, PNC, USB and WFC. Pre-tax losses exclude the modeled trading and counterparty losses attributable to market-making businesses. **5.** Attritional underwriting profit excludes catastrophe losses and adjustments to loss reserves related to prior years. **6.** The fintech "basket" includes PayPal, Block, Adyen, Afterpay (since acquired by Block), Affirm, Robinhood and Coinbase. Aggregate market capitalization cited as of 8/31/21.

chart below shows, the fintech basket has lost 74% of its value. Admittedly, we can't say with certainty whether it's the highs or the lows that are the "right" prices. There is, however, a real-world implication for the abrupt change in valuation: fintech companies' previous high valuations and low cost of capital gave them the resources to invest heavily in their technology and marketing. They no longer have such a blank check.

To sum up, investors' fears of a future recession are weighing on the stock prices of financial companies, notably banks. While such an event certainly could come to pass in the next year or two (indeed an eventual recession is inevitable), we believe banks are far better positioned to withstand it, and their valuations are so low that we think they should generate strong returns over the next decade. ■



Conclusion

Our approach to 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 DFNL. Nothing provides a stronger indication of that than the fact that the Davis Family and colleagues have more than $2 billion invested in our strategies alongside our clients.[7] We are grateful for the trust you have placed in us. ■

7. As of 6/30/22. Davis Advisors, the Davis family and Foundation, our employees, and Fund trustees have more than $2 billion invested alongside clients in our strategies.

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 6/30/22, the top ten holdings of Davis Select Financial ETF were: Capital One Financial, 7.94%; Chubb, 7.75%; Berkshire Hathaway, 6.84%; U.S. Bancorp, 6.50%; Markel, 5.94%; Wells Fargo, 5.08%; Julius Baer Group, 4.91%; Bank of New York Mellon, 4.88%; JP Morgan Chase, 4.71%; and PNC Financial Services Group, 4.66%.

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.

One basis point is 0.01%.

Tangible book value per share is a method by which a company's value is determined on a per-share basis by measuring its equity without the inclusion of any intangible assets. Intangible assets are those that lack physical substance, thus making their valuation a more difficult undertaking than the valuation of tangible assets.

The **Consumer Price Index** (CPI) measures the monthly change in prices paid by U.S. consumers. The U.S. Bureau of Labor Statistics calculates the CPI as a weighted average of prices for a basket of goods and services representative of aggregate U.S. consumer spending.

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 10/31/22, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

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