Davis Select Financial ETF (DFNL)

Interview with Christopher Davis, Portfolio Manager

Chris Davis has successfully managed financial stock portfolios for nearly 30 years. He shares his most recent thoughts on why to invest in financial stocks, why active management can add significant value in this vast inefficient sector and why investing in financial stocks offers a unique opportunity today.

"Many financials offer above-average long-term growth prospects, deep competitive advantages, experienced management and disciplined capital allocation, yet trade at below-average P/E multiples.

Separating the winners from the losers in this vast, inefficient sector requires selectivity, flexibility and experienced active management."

Chris Davis
Portfolio Manager, Davis Select Financial ETF (DFNL)

Executive Summary

- Currently, financial stocks are underappreciated and out of favor with investors, offering an attractive long-term investment opportunity.
- Selectivity and active management are the keys to outperformance in the vast, inefficient financial sector. Investing in stronger companies and avoiding weaker ones can make a significant difference in investor returns.
- Davis Select Financial ETF (DFNL) holdings include: Markel, Chubb, Berkshire Hathaway, JPMorgan Chase, BNY Mellon, Visa, American Express and Capital One Financial.

Davis has successfully invested in financial stocks for almost six decades. Why should investors consider this sector now?

In 1947, my grandfather, Shelby Cullom Davis, began investing in financial stocks. Known as the "Dean of Insurance Stocks," he compounded a $100,000 investment into $800 million over his career, largely by investing in financials.[1]

The characteristics my grandfather looked for in financial companies included competitive advantages, experienced management and disciplined capital allocation. We use these same criteria to select all our investments as an equity research boutique. What is interesting and more specific to financials is we can find companies within the sector that have above-average long-term growth prospects but that trade at below-average price/earnings (P/E) multiples. This is the reason my grandfather called financials "growth stocks in disguise."

More recently, investors have tended to consider financial companies inextricably linked to the 2008 financial crisis, resulting in a lingering aversion to this out of favor group. However, our research shows certain high quality financial companies remained profitable during the worst financial crisis since the Great Depression, are currently trading at close to a 30% discount to the market and, most important, we believe they are less risky today as they have doubled their capital ratios. In addition, a significant percentage of the assets on these companies' balance sheets have been added since the financial crisis. Moreover, because of limited competition and extremely tight credit standards, these businesses have record earnings. Now, some

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. **Past performance is not a guarantee of future results.** **1.** While Shelby Cullom Davis' success forms the basis of the Davis Investment Discipline, this was an extraordinary achievement and other investors may not enjoy the same success.

financial companies are in a position to distribute an increasing percentage of their earnings. Lastly, should interest rates rise as a function of strong economic growth, select financials may be net beneficiaries as net interest margins expand. Put together, these developments are creating a cyclical opportunity in financial stocks in our view.

In addition to the current cyclical opportunity, we believe a strong case can be made that the right financial company is by its nature a long-term cash-compounding machine. Such a business generates strong current earnings that can be reinvested as well as providing the potential for excellent long-term growth because the industry is so vast and fragmented, and the products and services offered by financial institutions are as long lasting as they are ubiquitous. Almost everyone is a customer of at least one, two or three financial companies.

In brief, financial companies offer products that generally do not become obsolete.

Why do you believe financial stocks are one of the few areas that can perform well even if we are in a low growth environment as many believe?

We have good reason to believe select financial businesses can deliver satisfactory returns to shareholders in a slower growth environment. Suppose a bank grows its net income only 3% per year and trades at a price-earnings multiple of 12. Then assume the bank has to retain 20% of its earnings because of the need to increase capital ratios or strengthen its balance sheet. Further assume the bank's remaining earnings are distributed half as dividends and half as share repurchases. Given this scenario, what is the five year annualized total return to shareholders?

We believe the answer should be 9.9%, because despite a somewhat modest growth rate, the number of shares outstanding would decrease due to the share buybacks while earnings per share and dividends per share would rise. Thus, in this scenario, 3% growth in net income growth should result in a highly satisfactory average annual total shareholder return of 9.9%.[2]

Of course, if economic growth strengthens, select financial businesses should benefit even more.

Why is selectivity and active management particularly important when investing in the financial sector?

Investing in stronger companies and avoiding weaker ones can make a significant difference over time. Because the returns of financial stocks are widely dispersed, selectivity is key. In fact, since 2005, the average difference between the best and worst performing financial stock in the S&P 500 Financials Index has been about 133%.[3] What accounts for these wide differences in outcomes?

A critical factor to recognize when researching financial companies is they are first and foremost human capital businesses. As a result, management judgment, underwriting practices, and management and employee incentives play a central role in determining which financial companies should perform well through an entire business cycle versus those that might be structured to perform well in a specific environment but not necessarily to endure over time. As bottom-up active managers, we have flexibility to invest more capital in those businesses we believe are best positioned to build long-term wealth while avoiding those with less attractive prospects.

2. This hypothetical example is for illustrative purposes only and does not represent the performance of any particular investment. Actual results will vary. The return of a stock is based on a number of factors in addition to those discussed. Equity markets are volatile and there is no guarantee that these assumptions will prove to be correct. **3.** As of 12/31/17. Source: Davis Advisors and Wilshire Atlas.

Contrast our carefully considered approach with many passively managed strategies that indiscriminately allocate the most capital to stocks with the largest market capitalizations.

This approach can subject investors to the risk of concentration in the most vulnerable areas of the sector. For instance, many investors may not know XLF has tremendous industry concentration as four of its top five holdings are banks and account for 33% of its assets.[4]

We build our Portfolio one company at a time. The Portfolio includes best-of-breed commercial banks, investment banks, insurance companies, wealth management firms, asset managers, credit card companies, diversified financial conglomerates, and rating agencies.

What are some of the perceived risks with financial stocks today?

One of the perceived risks with financials has to do with leverage within the banking sector. Leverage ratios are at historic lows, reflecting both a conservative posture by financial institutions themselves as well as stricter regulations on leverage that were instituted following the crisis. It is worth noting that all major U.S. banks now undergo annual stress tests which more or less control the degree of leverage they are willing or able to take on, implying that they should continue to operate with far lower overall risk and greater durability than in the pre-crisis period. In short, balance sheets for major financial institutions today look very strong.

A second question that relates to financials today is the prospect of higher credit costs than what we witnessed in recent years when the credit environment was particularly benign. Credit costs are an income statement expense and are the rule, not the exception, over any economic cycle. What was unusual in recent years was the near absence of credit losses, but that meant among other things that lending remained rather muted.

Now, with a stronger economy and relatively full employment, demand for loans has risen and credit costs are normalizing which is to be expected. We believe the credit environment remains both very manageable and quite favorable.

A final concern about financial stocks for some investors is financial institutions could become so highly regulated they become safe, boring investments that trade like utilities. Although highly unlikely in our view, such a development should mean a 50%–60% increase in these stocks' multiples, which would be a good problem to have.

With all the positives, why is the opportunity in financial stocks underappreciated and not recognized by the market?

The biggest hurdles to investing in financials in this environment are psychological and emotional as investors still remember the aftermath of the 2008 financial crisis. While the overall market has more than doubled since then, financial stocks have not appreciated as much—even though select financial companies are delivering record earnings and have the strongest balance sheets in decades.

As always, investor fear is correlated with prices. When stock prices go down, people feel more fear and are less interested in buying, and when prices go up they feel reassured. This tends to result in an undesirable outcome.

We take the opposite approach. We search for companies with stock prices that have lagged the companies' true business value. We like to look in unloved or overlooked areas of the market where prices do not reflect true value. In today's environment, the financial sector offers the opportunity we seek.

4. XLF is the Financial Select Sector SPDR Fund. Its inception is 12/16/1998. See the endnotes for a description of the material differences between the Fund and XLF.

Davis Select Financial ETF (DFNL) Representative Holdings[5]	
MARKEL	Markel, a specialty property and casualty insurer, has generated excellent investment results for decades and grown book value per share more than 13% annually over the last 20 years.
VISA	Visa, the largest payments processing company, benefits from a hard-to-replicate business model that includes a secure payments network, trusted brand, large merchant base, and powerful technology.
CHUBB	Chubb is a global insurance leader specializing in property and casualty insurance, reinsurance and Asia-focused life insurance. It has a well-regarded management team, strong balance sheet and disciplined underwriting culture.
BNY MELLON	BNY Mellon, the world's largest custodian bank with more than $32 trillion of assets under custody, is a durable franchise that benefits from economies of scale.
Berkshire Hathaway Inc.	Berkshire Hathaway is a collection of outstanding, profitable businesses. Exceptional world-class capital allocation.

5. The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. Holding percentages are subject to change.

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.

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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: **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; **common stock 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; **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; **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; **fees and expenses risk; financial services risk; focused portfolio risk; foreign country risk; foreign currency risk; headline risk; interest rate sensitivity risk:** interest rates may have a powerful influence on the earnings of financial institutions; **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; **large-capitalization companies risk; manager 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; mid- and small-capitalization companies risk;** and **stock market risk.** See the prospectus for a complete description of the principal risks.

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.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of December 31, 2017, the top ten holdings of Davis Select Financial ETF were: Capital One Financial Corp., 6.94%; Berkshire Hathaway Inc., Class B, 6.54%; American Express Co., 6.52%; Markel Corp., 6.20%; Visa Inc., Class A, 5.33%; Loews Corp., 4.91%; U.S. Bancorp, 4.71%; Wells Fargo & Co., 4.71%; JPMorgan Chase & Co., 4.68%; and Chubb Ltd., 4.51%.

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.

Davis Select Financial ETF ("DFNL") and Financial Select Sector SPDR Fund ("XLF"). DFNL seeks long-term growth of capital while XLF seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of publicly traded equity securities of companies in the Financial Select Sector Index. DFNL and XLF can only be purchased on an exchange with no sales charge but may incur transaction costs (e.g., customary brokerage commissions). DFNL's expense ratio is 0.76% which is capped at 0.65% until March 1, 2019. The expense ratio of XLF is 0.13%. Shares of DFNL and XLF can only be bought and sold on an exchange at the current market price. Shares cannot be individually redeemed. Capital gains tax on DFNL and XLF is incurred only upon the sale of the shares.

Trailing Price/Earnings (P/E) Ratio is the weighted average of the price/earnings ratios of the stocks in a portfolio. The P/E ratio of a stock is calculated by dividing the current price of the stock by its trailing 12 months' earnings per share. Portfolio totals are computed using an inverse harmonic methodology.

We gather our index data from a combination of reputable sources, including, but not limited to, Thomson Financial, Lipper 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. Investments cannot be made directly in an index.

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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