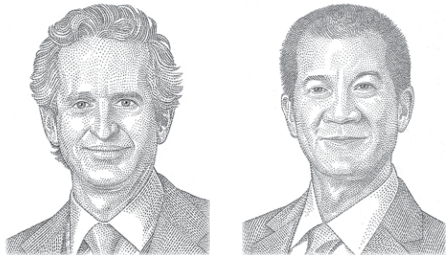
Davis ETFs



Update from Portfolio Managers

Chris Davis and Danton Goei

Davis Select U.S. Equity ETF (DUSA)

Semi-Annual Review 2022

Overview

As we write this review, there is war in Ukraine, a bear market in U.S. stocks, soaring global inflation and implications of a recession.

So why is this a good time for long-term investors?

As anyone who watches the news can see, the struggles that individuals, families and our country face are not to be taken lightly. As citizens, we do not wish for times of fear and suffering. As investors, however, we know that remaining unemotional through turbulent times is a requirement for success.

To understand why, we recognize two simple truths. First, fear lowers prices. Second, lower prices increase future returns. The first is learned from experience and the second from arithmetic. Imagine you had a neighbor who owned a local car wash business that reliably produces $100,000 per year of income. Buying this business for $1 million would give you a 10% future return. If, instead, your neighbor was panicking and offered you the business for $500,000, your return would double to 20%. The same business purchased at a lower price will mathematically produce a higher return. We do not welcome times of fear; rather, we welcome the lower prices that such times produce, a concept succinctly captured in Shelby Cullom Davis' famous observations: "You make most of your money in a bear market, you just don't realize it at the time."

In the pages that follow, we will look backwards at results. More importantly, we will look ahead at how we believe the actions we are taking in today's bear market will affirm this wisdom. Specifically, we will provide a longer-term context for current events, share with you how we have prepared the portfolio for market and economic downturns, outline our thoughts concerning systemically higher inflation, and most importantly, describe the investment opportunities created for long-term investors who can remain rational when fearful sellers race for the exits. ■

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. The Attractive Growth and Undervalued reference in this piece relates to underlying characteristics of the portfolio holdings. There is no guarantee that the Fund performance will be positive as equity markets are volatile and an investor may lose money.**

Results

For the first six months of 2022, Davis Select US Equity ETF (DUSA) returned −19.8%, roughly in line with the S&P 500 Index decline of −20.0%. While unpleasant, this down-market year comes after a decade of strong cumulative market returns. At Davis, after more than five decades of investing, we understand that crises and corrections are painful, but inevitable.

Despite numerous crises, including the Great Depression, World War II, the Korean War, the 1970s oil shock, the dot-com bust, the global financial crisis, the COVID-19 pandemic and the Ukraine War, the market has continued its upward march. If you had invested in the S&P 500 Index at the beginning of 1929 through June 2022 (over 93 years), your return would have been 9.2% a year. A long-term focus and holding period has been and will continue to be the path to building wealth.

The period following DUSA's inception was characterized by an enormous dispersion in which speculative growth companies surged into bubble territory, driving the S&P 500 Index up more than 83% from January 11, 2017 to present and leaving value investors like us with a cumulative return of only 45% trailing way behind. Absolute returns have been on track, but relative returns have lagged substantially.

While this relative performance gap has persisted through the start of the current bear market despite the collapse of some of the risky high flyers, we believe we have set the stage to meaningfully make up this ground. This conviction is driven by the characteristics of the carefully selected companies that make up DUSA.

In addition to the resiliency, durability and ability to prosper in times of inflation (all of which will be discussed below), these high-quality companies have grown earnings per share at almost 23% per year over the last five years, a remarkable 5.3% per year faster than the S&P 500 Index. As shown in the table below, however, despite this outstanding record of growth, these high-quality companies are currently valued at less than 9x earnings, a 47% discount to the S&P 500 Index. Higher growth at lower valuations is a rare combination and one that we believe positions us well for the years and decades ahead. ■

Selective, Attractive Growth, Undervalued

	Fund	Index
Holdings	27	503
EPS Growth (5 Year)	22.9%	17.6%
P/E (Forward)	8.9x	16.7x

The average annual total returns for Davis Select U.S. Equity ETF periods ending June 30, 2022, are: NAV Return, 1 year, −21.42%; 5 years, 6.76%; Inception (1/11/17), 6.97%; Market Price Return, 1 year, −21.57%; 5 years, 6.70%; Inception, 6.98%. 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 0.61%. The total annual operating expense ratio may vary in future years.*

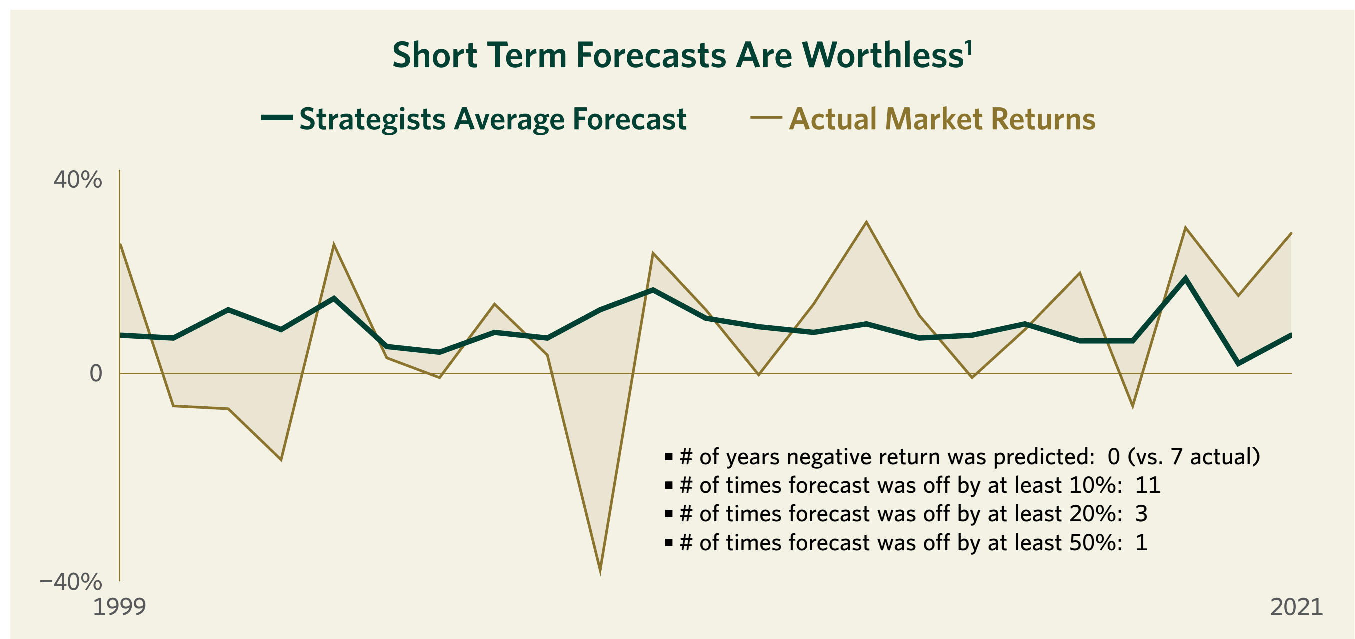
The Futility of Forecasts

Davis Advisor's long record of building generational wealth through so many different economic and political environments does not result from our ability to make economic, monetary or political forecasts, but rather our ability to identify durable, growing and undervalued companies, prepare for uncertainty and adapt to changing times, a discipline that can be distilled to three words: Don't predict. Prepare.

While this may sound obvious, given that none of the crises highlighted on page 2 were predicted by the experts, one need only turn on the news to see the same experts who failed to predict what has already happened boldly predicting what is going to happen next. As John Kenneth Galbraith famously said, "The function of economic [and, we would add, political and market] forecasting is to make astrology look respectable." As can be seen in the graph below, for example, the forecasts of Wall Street's top strategists (shown in green) are essentially uncorrelated to what actually happened. (We could easily show similar charts for political, interest rate and economic forecasts.)

Reacting to such forecasts is a recipe for disaster. Instead of trying to make short-term predictions, we prepare for uncertainty by identifying a select portfolio of high-quality, durable companies that can withstand corrections, recessions and inflation and build generational wealth for shareholders over the long term.

After decades of low inflation, we now face a period of systemically higher inflation. While there is debate about how long this period may last, we are confident that recent increases in wages, the most important contributor to inflation, will not reverse and that other contributors such as supply chain and commodities will take time to come back under control. ■



1. Source: Wall Street Journal Publications. From 1999 through 2005, numbers reflect Dow Jones Industrial Average forecasts. In 2006, the S&P 500 Index was used exclusively. **Past performance is not a guarantee of future results.**

Investing Through Market Corrections

Market corrections like the one we are experiencing are an unpleasant but inevitable part of the investment landscape. As shown in the table below, over the last 100 years of market history, a 10% correction occurs roughly once per year and a 20% bear market roughly every three years.

Although knowing *when* a correction or market shock will occur is unpredictable, knowing *that* one will occur is certain. Because we will certainly be investing through such episodic times of market dislocation, we avoid companies that require short-term access to capital markets. As became clear during the junk bond crisis of the late '80s, the dot-com bust of the early 2000s, the financial crisis and, most recently, in today's downturn, capital markets can be fickle. When the market window is closed, even decent businesses can be forced into a distressed sale and even bankruptcy if they require funding.

In contrast, we prepare for market corrections by focusing on two types of companies. First, we invest the lion's share of the portfolio in companies with strong, liquid balance sheets and little or no short-term funding needs. These companies could be described as resistant or even indifferent to dislocations in capital markets. Examples of such holdings include companies like Applied Materials and many of our internet platform companies that have net cash positions. Second, we invest in a select handful of companies that we would describe as "anti-fragile", a phrase coined by Nassim Taleb to refer to companies that actually *gain* from market disorder. In saying this, we are not predicting that the stock prices of such companies will go up in a bear market, but rather that their business models and strategies are designed to create value when markets are in turmoil. Examples in our portfolio include Berkshire Hathaway and Markel, both of which have a contrarian record of putting money to work when others are panicking.

To this list, we might also give partial credit to companies with trading operations that benefit from market volatility, such as JP Morgan, and companies with the capacity and history of repurchasing their own shares as they fall, a rare characteristic that we particularly value. Because repurchasing shares at lower prices increases return on capital, a number of our tech and financial holdings may also share this valuable anti-fragile characteristic (discussed further below).

Crises and Corrections are Painful, but Inevitable[2]

	Occurrences Since 1928	Frequency of Occurrences
5% Dip	320	≈ 3 per year
10% Correction	99	≈ 1 per year
20% Bear Market	26	≈ every 3 years

2. Source: Ned Davis Research, Inc. As of 2/23/22. Further distribution prohibited without prior permission. All Rights Reserved.

Investing Through Recessions

Though less frequent than market declines, economic recessions are similarly inevitable. However, they present significantly more risk and opportunity for investors.

This larger risk is created by the fact that while market corrections only impact businesses that require access to capital, economic downturns affect virtually all businesses. As the economy contracts, falling revenue can have a magnified impact on a company's bottom line, leading to significant losses and even distress. This is especially true for companies with high fixed costs and leveraged balance sheets. Such highly cyclical companies are especially fragile as they may ultimately be forced to raise capital at distressed prices (see above). Although companies with fixed costs and balance sheets leverage can be rocket ships in good times, we avoid them for the simple reason that recessions are inevitable. As a result, for our portfolio companies, we demand the strength and durability to get through such downturns without jeopardizing long-term earnings power or issuing more shares. That does not mean that the short-term earnings of our companies won't decline, many will, but rather that their long-term earnings power, competitive position and capital structure will weather the storm.

Importantly, when investors are fearful of an impending recession, they tend to be aggressive sellers of all businesses whose earnings are economically sensitive, without discriminating between those that are durable and those that are fragile. While this lack of discrimination is a contributor to our lagging short-term results, it will be an accelerant to returns as the market's perception changes and the durability of our companies becomes apparent. Because these companies may benefit from both recovering earnings *and* multiple expansion, we view their current underperformance like a coiled spring, primed for a future snap back.

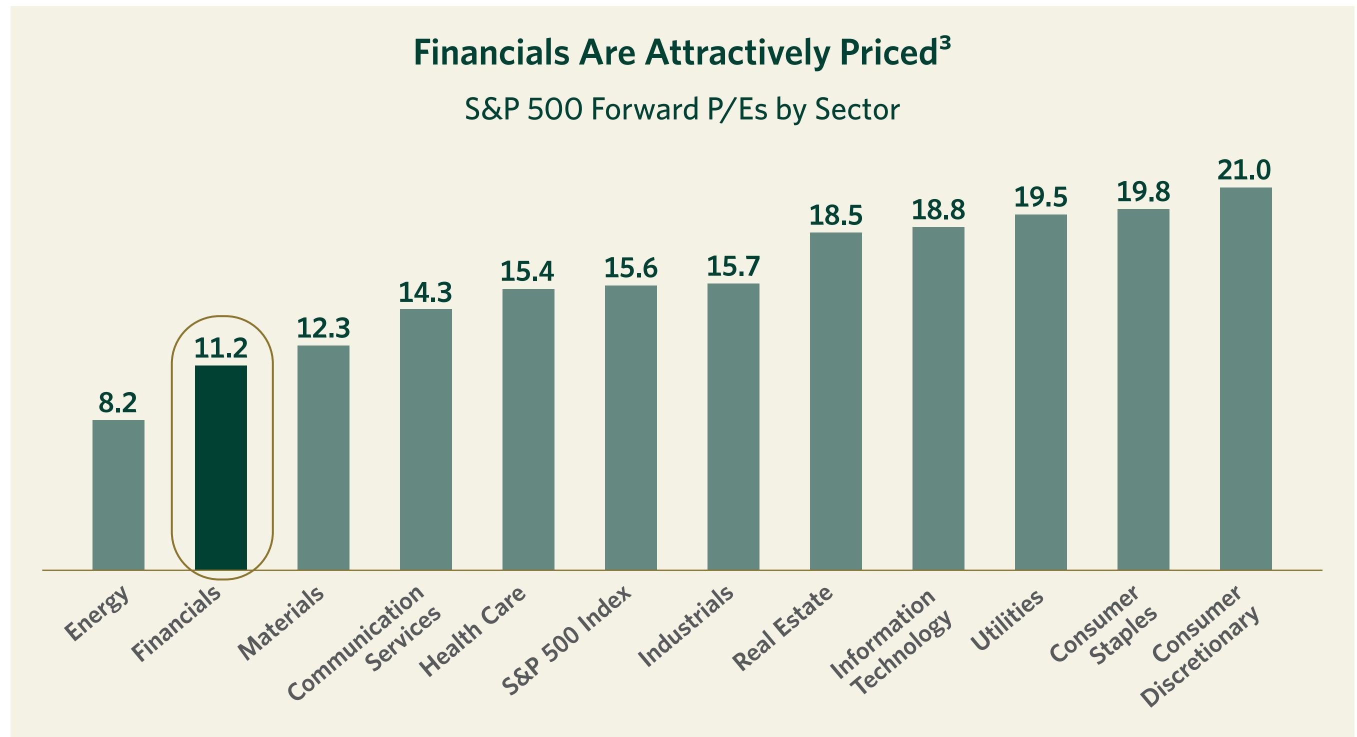
This opportunity is the dominant theme for our investment in select banks like Wells Fargo, Capital One and U.S. Bancorp. The great financial crisis created a once-in-a-generation transformation of the U.S. banking system at all levels. At the regulatory level, banks are now required to hold more capital than any time in their history, making them far more resilient. Beyond increased capital, banks have also been subject to much stricter regulation, including an annual stress test that assures they can weather an economic catastrophe far worse than either COVID or the financial crisis.

At the company level, the financial crisis reinforced the importance of conservatism in lending. While there is unquestionably credit risk in the system, our research indicates that the risk is predominantly outside of the banking system, in areas like high-yield and private credit, rather than on our banks' balance sheets. Finally, at the investor level, the demise of companies like Fannie Mae, Freddie Mac, Countrywide, WAMU, Lehman and Bear Stearns still lingers in investors' minds, making them mistakenly think that banks are fragile when we believe they are in fact better capitalized and less risky than they have ever been. The poor performance of bank shares in the last several months reminds us of the early days of the pandemic when bank shares dramatically underperformed, only to snap back to new highs as investors realized that the sector was well prepared for a recession. Today, banks are trading at or near their lowest relative valuation in history. As the recession unfolds and banks demonstrate their resilience while continuing to pay handsome dividends, we expect our bank holdings to become a powerful driver of future returns.

In contrast to our approach, panicked investors are selling bank holdings and flocking to a small handful of companies and industries that have historically been recession resistant. We consider such a strategy highly risky for two reasons. First, it overvalues short-term earnings prospects over long-term cash generation. Earnings of $2 million this year, zero next year and $2 million the year after are more valuable than earnings of $1 million this year, $1.1 million next and $1.2 million the year after. Second, many companies that have historically been recession resistant may face other challenges that make their futures bleaker than their past. In industries like consumer staples, the erosion of once-dominant consumer brands, when paired with increasingly leveraged balance sheets, may make companies that were once safe havens far riskier in the future.

Putting these two thoughts together, investors who fear a recession will often pay silly prices for smooth earnings from companies with competitively disadvantaged futures, while significantly undervaluing durable and growing businesses, such as our bank holdings, simply because they happen to exhibit more short-term earnings volatility.

As we invest through a time of recession, the enormous valuation discount presented in the chart below should begin to close, creating a double play of rising earnings on rising valuations. In the meantime, high dividends and steady share repurchases make select banks one of the best investment opportunities facing patient investors in today's market. ■



3. Source: Credit Suisse. As of 6/30/22.

Investing Through Inflation

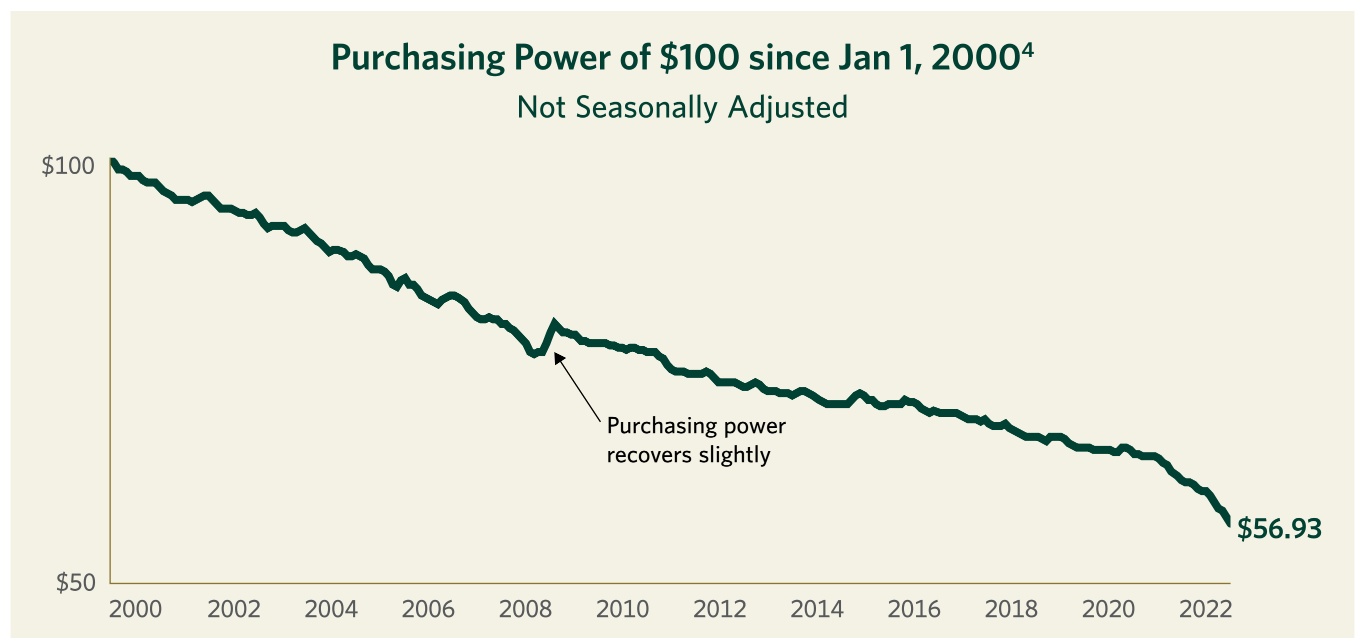
No investor who has been in the profession for less than 40 years has ever seen a period of rising inflation. In this context, we view our firm's long history as an enormous advantage. While many of today's investors consider bonds low-risk investments, legendary investor Shelby Cullom Davis referred to them as "certificates of confiscation."

To understand why we continue to hold this view, we must first recognize that the decision to invest rather than save is really a decision to put off buying something today with the expectation that you will be able to buy more in the future (otherwise, why defer the purchase?). As a result, what matters over time is that an investment increases the holder's purchasing power. Over a long period of time, the erosion of purchasing power can be staggering. For example, over the last 50 years, purchasing power has fallen more than 88%. Even in periods of low inflation, investors are often surprised at the pernicious and relentless impact of price increases. As shown in the graph below, even in the low inflationary period we have enjoyed since 2000, purchasing power has fallen more than 40%.

After decades of low inflation, we now face a period of systemically higher inflation. While there is debate about how long this period may last, we are confident that recent increases in wages, the most important contributor to inflation, will not reverse and that other contributors such as supply chain and commodities will take time to come back under control.

In times of inflation, investors must decide what to avoid as well as what to own. Speaking to the former, many investment classes previously viewed as safe, most notably cash and bonds, are almost certain to decline in value, perhaps substantially, especially when viewed in terms of purchasing power rather than notional price. Real estate investments are a mixed bag in inflationary times, depending on capital structure, lease terms and operating costs, not to mention the impact of work-from-home trends on office values and online shopping on shopping mall owners. Finally, companies with meaningful cost inputs (labor, energy and materials) and/or high required capital spending will see significant margin and return erosion if they are unable to pass along those higher costs to customers. (Given dollar appreciation, this is a particular worry for companies with lower-cost foreign competitors.)

Turning from risk to opportunity, businesses whose revenue and prices go up with inflation faster than their costs can be very resilient. In the 1970s, for example, advertising firms significantly outperformed. Today's equivalent of the Madison Avenue ad giants of that era are the great tech platforms, particularly Alphabet and Meta. Similarly, while Amazon will see some pressure from higher labor costs, its scale gives it a huge leg up



4. Source: https://fred.stlouisfed.org/series/CUUR0000SA0R#0

on traditional retail competitors, while its high margin and inflation-protected advertising and cloud services businesses should continue to grow significantly. Finally, we should mention that the earnings of several of our financial holdings, including Bank of New York Mellon, American Express and our bank holdings, will all benefit from higher interest rates.

Conclusion

The last 12 months have represented a complete change in market fundamentals and sentiment as we moved from a time of record-low interest rates, speculative bubbles and market highs to a period of inflation, recession and a bear market. However, the seeds for this change were planted in the excesses of the last five years. Signs of speculative excess were apparent in so many different aspects of market and economy, from artificially low interest rates to Special Purpose Acquisition Companies (SPACs) to the fact that 73 companies in the S&P 500 Index traded at more than 10 times sales at the beginning of this year!

During that stretch, especially the last five years, our focus on durability, resiliency and valuation left us out of the hottest areas of the market, and though we grew the value of the assets entrusted to our stewardship, we significantly lagged the indices. As fear and pessimism have set in, investors have been selling indiscriminately, with the result that the prices of our companies have declined roughly in line with the market index, and we continue to have ground to make up.

So why are we convinced that now is an excellent time to invest in DUSA? Because, as Warren Buffett famously said, in the short term, the market is a voting machine, and in the long term, it is a weighing machine. Our focus on durability, resilience and valuation has been unpopular and unimportant for most of the last decade, but especially the last five years. While others chased momentum, we prepared our portfolio to weather a bear market, a recession and the return of inflation. While the market has not yet rewarded us for this discipline, the strength, performance and competitive position of the select businesses we own gives us confidence that this is just a matter of time. If a picture is worth a thousand words, the table below says it all. The combination of resiliency and above-average growth along with a valuation at a 47% discount to the S&P 500 Index is a value investor's dream.

Selective, Attractive Growth, Undervalued

	Fund	Index
Holdings	27	503
EPS Growth (5 Year)	22.9%	17.6%
P/E (Forward)	8.9x	16.7x

In short, as the flood waters rise, we have been seeking to build an ark. In the years ahead, we expect our discipline and patience will be rewarded. With more than $2 billion of our own money invested alongside clients, our interests are aligned, and our conviction is more than just words.[5] This alignment is an uncommon advantage, given that 85% of all funds are overseen by managers who have less than $1 million invested alongside their clients. We are well prepared for today's fear and turmoil and grateful for the trust you have placed in us.

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

This report is authorized for use by existing shareholders. A current Davis Select U.S. Equity 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, fees, and expenses before investing. Read the prospectus carefully before you invest or send money.

Shares of DUSA 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 U.S. Equity ETF is long-term capital growth and capital preservation. 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; **focused portfolio risk:** investing in a limited number of companies causes changes in the value of a single security to have a more significant effect on the value of the Fund's total portfolio; **financial services risk; foreign country risk; headline 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;** 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 U.S. Equity ETF were: Alphabet, 9.96%; Berkshire Hathaway, 9.61%; Capital One, 9.28%; Wells Fargo, 6.24%; DBS Group, 5.25%; Amazon.com, 5.17%; U.S. Bancorp, 4.64%; Cigna, 4.45%; Intel, 3.97%; and Markel, 3.85%.

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.

We gather our index data from a combination of reputable sources, including, but not limited to, Lipper, Wilshire, and index websites.

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability. It is common for a company to report EPS that is adjusted for extraordinary items and potential share dilution.

Forward Price/Earnings (Forward P/E) Ratio is a stock's current price divided by the company's forecasted earnings for the following 12 months. The values for the portfolio and index are the weighted average of the P/E ratios of the stocks in the portfolio or index.

Five-Year EPS Growth Rate is the average annualized earning per share growth for a company over the past five years. The values for the portfolio and index are the weighted average of the five-year EPS Growth Rates of the stocks in the portfolio or index.

A **Special Purpose Acquisition Company** (SPAC) is a company without commercial operations and is formed strictly to raise capital through an initial public offering or the purpose of acquiring or merging with an existing company.

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 **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue chip stocks. The Dow Jones is calculated by adding the closing prices of the component stocks and using a divisor that is adjusted for splits and stock dividends equal to 10% or more of the market value of an issue as well as substitutions and mergers. The average is quoted in points, not in dollars. 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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