DFNL ANNUAL REVIEW 2019

# Davis Select Financial ETF

Update from Portfolio Manager

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Davis ETFs

The Equity Specialists

# Davis Select Financial ETF (DFNL)

Annual Review 2019

## Executive Summary

Despite outperforming the S&P 500 Financials Index by more than 2.1 percentage points in 2018, the Davis Select Financial ETF generated a negative return for the year as investor fears of an economic downturn led to a sharp sell-off in financial stocks late in the year.[1] With memories of the 2007–2008 financial crisis still vivid in many investors' minds, the fear a future recession will lead to substantial and permanent destruction of value in financial stocks is understandable but we feel misplaced. Unlike 2007, today's leading financial companies are far stronger, more cautious and better positioned than any other time in memory. As a result, the recent sell-off has created what we believe to be an opportunity for investors to take advantage of this misperception.

Given today's low prices, we believe the carefully selected companies that comprise the Davis Select Financial ETF will generate strong relative and absolute returns over the next decade for the simple reason they combine extremely durable business models, the strongest balance sheets in half a century, resilient earnings, good returns on equity, rising dividends, falling share counts, and low valuations.[2] With our own money invested alongside clients, our primary concern is making smart investment decisions rather than reacting to short-term investor perceptions.[3] ■

| **Average Annual Total Returns as of December 31, 2018** | 1 Year | Inception 2/17/17 |
|---|---|---|
| Davis Select Financial ETF NAV Price | –10.80% | 3.53% |
| Davis Select Financial ETF Market Price | –11.12 | 3.45 |
| S&P 500 Financials Index | –13.03 | 2.44 |

***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. Returns of less than one year are not annualized. 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 davisetfs.com. The total annual operating expense ratio as of the most recent prospectus was 0.65%. The Adviser is contractually committed through one year from the date of the Prospectus to waive fees and/or reimburse the Fund's expenses to the extent necessary to cap total annual fund operating expenses at 0.76%. The expense ratio before the cap was 0.68%. The total annual operating expense ratio may vary in future years. Current performance may be higher or lower than the performance quoted.*

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. This is not a recommendation to buy, sell or hold any specific security. **Past performance is not a guarantee of future results. 1. Past performance is not a guarantee of future results. 2.** While very few companies have all of these characteristics, we search for those possessing several of these characteristics, or an appropriate combination of these characteristics. **3.** This includes Davis Advisors, the Davis family, our employees, and Fund Directors. As of 12/31/18.

## Results and Outlook

In 2018, despite strong earnings and improved balance sheets of most financial companies, investors became nervous about the economy and drove down share prices of financial companies more than 20% on average from their midyear highs and roughly 13% for the year 2018. While Davis Select Financial ETF declined somewhat less than the S&P 500 Financials Index, the Fund still generated a negative one-year return of –10.8%.[4]

While short-term price changes rarely mean much, often information can be gleaned by examining the underlying market dynamics during such periods. In this case, our analysis is reassuring. For reasons we will discuss, our analysis indicates the recent price declines in the face of strong fundamentals have created an enormous opportunity for long-term investors. In fact, financial stocks are now priced at their most attractive level in many years especially relative to some of the overpriced market darlings. As a result, we believe shares of select financial companies are poised for a prolonged period of strong relative and absolute returns in the years ahead.

Beginning around August of last year, a series of political and economic developments ranging from trade tariffs to rising interest rates led to a sharp increase in investor fear and uncertainty. As a result, investors flocked to so-called low-volatility stocks such as consumer goods companies and utilities that have historically been safe havens while selling companies that historically have been more volatile, especially banks, which were hurt so badly during the financial crisis. The key word here, however, is "historically." As Warren Buffett once said, "If history books were the key to riches, the Forbes 400 would consist of librarians."

Although companies in historically less volatile sectors such as consumer products, health care and utilities seem safe looking backward because of their long history of dividend payments and stable results, our analysis indicates many of these companies are significantly overpriced and, in many cases, may face the prospect of future dividend cuts and falling profits. For example, over the last five years, the top 10 holdings of the S&P 500 Low Volatility Index increased their total debt almost 50% while revenue increased only 1.3% per year. Amazingly, the market currently values this toxic combination of no growth and high leverage at a rich 24 times estimated earnings, a 30% premium to the overall market and more than double the valuation of select high-quality financial companies. This data makes clear where investors feel safe they are often taking risk.

In contrast, investors have been dumping shares of banks and other financial companies they perceive as risky for the simple reason shares in such companies declined a great deal in the last recession. Importantly, this perception is based on the past not the present or the future. What many investors are forgetting is the companies we own not only survived the financial crisis, but also took advantage of the demise of many of their competitors to expand their market share significantly and broaden their competitive advantages. Today's financial leaders are not only more dominant, they are also stronger and better capitalized than at any time in the last 50 years. As a result, the selling pressure that

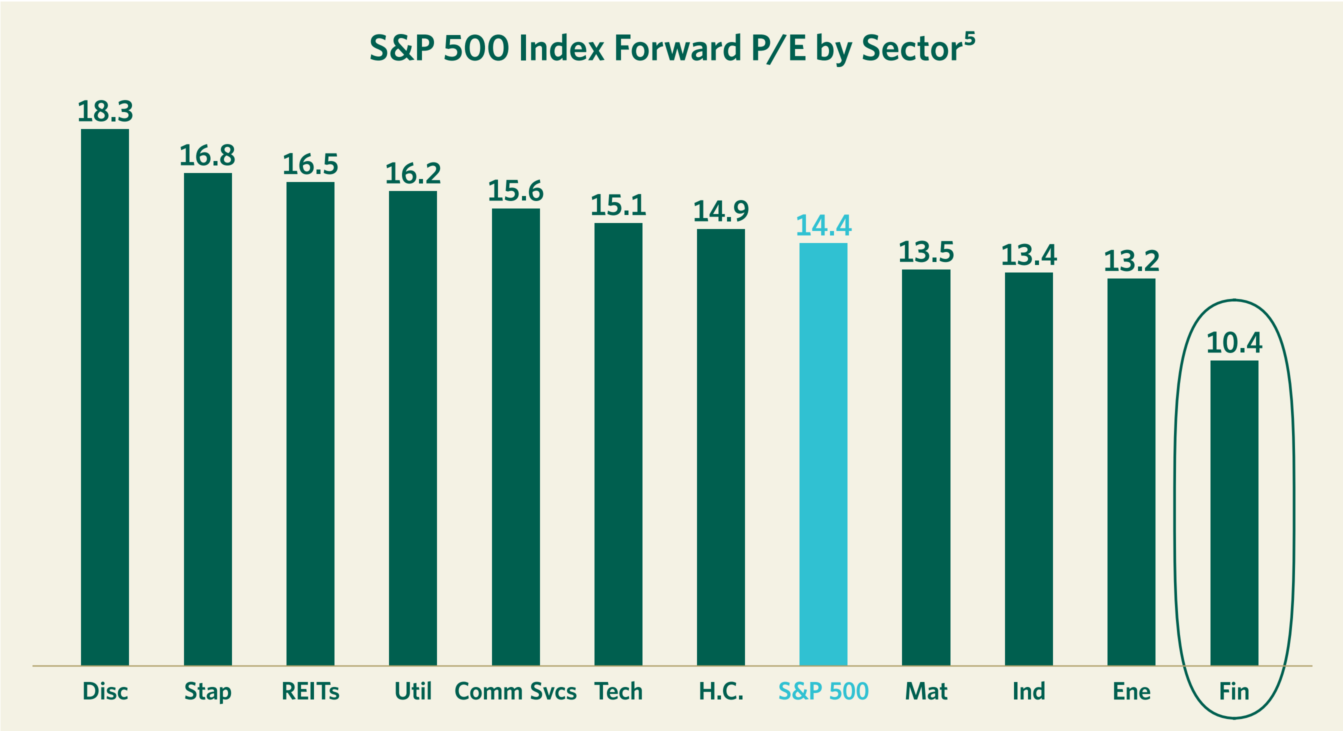
**4. Past performance is not a guarantee of future results.**

has driven down the prices of select, high-quality financial stocks to the point where they are trading at almost half the valuation of the low-volatility stocks mentioned has created an enormous buying opportunity as the chart below shows.

While investors fear calamity, we expect steadily rising dividends, increasing share repurchases and reliable earnings to gradually change investor perceptions so that high-quality financial holdings could be revalued upward and take the place of today's richly valued dividend darlings. More important, while so-called safe haven stocks have been increasing their debt, the vast majority of Davis Select Financial ETF's holdings have strengthened their balances sheets, reduced their share counts and raised their dividends. Moreover, we have every reason to believe these dividend increases and share count reductions will continue for years to come as capital ratios remain at all-time highs and dividend payout ratios near all-time lows. We believe the chance to own such companies at a steep discount to the market averages should pay off handsomely in the years ahead.

In short, if yesterday's safe havens represent tomorrow's risks, our carefully selected Portfolio of high-quality financial companies should be tomorrow's wealth builders.

As always, our confidence includes the realistic recognition financial stocks can be volatile and selectivity remains critical. In particular, because most financial services companies employ leverage, investors must pay scrupulous attention to the risk management culture at each company. In good times a favorable tide lifts all the boats, making our disciplined focus on risk management seem




**5.** Note: NTM P/E. Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse. The Forward P/E ratio is the aggregate of the Forward P/E ratios of the S&P 500 Index's holdings. The ratio is not a forecast of performance and is calculated for each security by dividing the current ending price of the stock by a forecast of its projected Earnings Per Share (EPS).

overly cautious as aggressive companies quickly expand and gain investor attention. But when bad times inevitably come, these companies tend to flounder, wiping out years of gains and leaving an open field for those companies that maintained their underwriting discipline. In the future as in the past, we believe our success will be achieved as much by avoiding the big losers as by picking the big winners.[6]

Our selectivity and focus on risk management stand in stark contrast to passive exchange-traded funds (ETFs). For example, we are amazed more than 40% of the largest and most popular ETF, the Financial Select Sector SPDR ETF (XLF)[7], is invested in only five stocks, four of which are mega-cap banks, including two that devastated shareholders with huge losses and permanent dilution during the financial crisis. We consider our flexibility and diversification an enormous advantage and important contributor to our long-term success versus financial stock indexes.

Keeping this note of caution in mind, the current environment offers significant opportunities within the financial sector. With memories of the 2007–2008 financial crisis still vivid, investors and market commentators remain leery of financial stocks in general and bank stocks in particular. They assume long-term returns have been poor and consider business models highly risky. While true for many financial companies, we don't believe this to be true for the companies that make up Davis Select Financial ETF. In fact, seven of our top 10 holdings were founded more than 100 years ago, a strong indication of their extraordinary durability and resilience.[8] ■

## Portfolio Manager Update

More than a decade ago, Pierce Crosbie joined Davis Advisors as a member of our financial stock research team. In the years since, his talent, work ethic and intelligence have made him a valuable research analyst and his character, ethics and commitment have made him a trusted partner. As a result, I am delighted he has agreed to join me as co-manager of the Davis Select Financial ETF.[9] His promotion is as deserved as it is overdue. Pierce and I look forward to reporting to you as co-managers in the years and decades ahead. ■

## Conclusion

We are convinced last year's sell-off in financial stocks has created a rare opportunity to buy durable, well-managed businesses at bargain prices. At the very time many of these companies are reporting record profits with the strongest balance sheets they have ever had, their share prices are trading at significant discounts to the market averages. Our investment case is simple: over the long term, economic reality trumps market sentiment. As a result, business value and stock prices eventually converge.

Nothing provides a stronger indication of our confidence in Davis Select Financial ETF than the fact my family and colleagues have invested in the Fund side by side with our clients.

As fellow shareholders, we are excited about the opportunity we see in financial companies today. We remain grateful for the trust you have placed in us and mindful of our responsibility. Thank you. ■

**6.** There is no guarantee Davis Selected Advisers, L.P. will continue to achieve positive returns. Davis Selected Advisers, L.P. was founded in 1969. **Past performance is not a guarantee of future results. 7.** Not a solicitation for XLF, which is offered under a separate prospectus and is not affiliated with Davis Selected Advisers, L.P. or Davis Select Financial ETF. See the endnotes for a description of some of the material differences between traditional mutual funds and ETFs, and for a description of the material differences between the Fund and XLF. **8.** Holdings are subject to change. **9.** Pierce Crosbie became a portfolio manager for Davis Select Financial ETF effective 12/31/18.

*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.*

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.

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.

**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; common stock risk; credit risk; cybersecurity risk; depositary receipts risk; exchange-traded fund risk; fees and expenses risk; financial services risk; focused portfolio risk; foreign country risk:** As of December 31, 2018, the Fund had approximately 15.3% of assets invested in foreign companies; **foreign currency risk; headline risk; interest rate sensitivity risk; intraday indicative value risk; large-capitalization companies risk; manager risk; market trading risk; mid- and small-capitalization companies risk;** and **stock market 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 December 31, 2018, the top ten holdings of Davis Select Financial ETF were: Berkshire Hathaway Inc., Class B, 7.79%; U.S. Bancorp, 7.43%; American Express Co., 6.47%; Capital One Financial Corp., 6.09%; Markel Corp., 5.94%; Bank of New York Mellon Corp., 5.25%; Wells Fargo & Co., 4.88%; JPMorgan Chase & Co., 4.69%; Chubb Ltd., 4.63%; Loews Corp., 4.12%.

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 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 **S&P 500 Low Volatility Index** measures performance of the 100 least volatile stocks in the S&P 500 Index. The index benchmarks low volatility or low variance strategies for the U.S. stock market. Constituents are weighted relative to the inverse of their corresponding volatility, with the least volatile stocks receiving the highest weights. Investments cannot be made directly in an index.

**Forward P/E ratio:** Forward price to earnings (forward P/E) is a measure of the price-to earnings (PE) ratio using forecasted earnings for the PE calculation. Davis does not offer an opinion as to the accuracy of, and does not guarantee, the forecasted numbers.

**Davis Select Financial ETF ("Fund") and Financial Select Sector SPDR Fund ("XLF").** The Fund 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. The Fund's expense ratio is 0.98% and that of XLF is 0.13%. As of 12/31/18, the Fund had 28 holdings, while XLF had 68 holdings.

After April 30, 2019, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

**Shares of the Davis ETFs 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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**Item #6318 12/18**