 

SPECIAL UPDATE

From Portfolio Managers **Chris Davis and Pierce Crosbie**

Davis Select Financial ETF

To Our Advisors, Clients and Friends,

For more than 50 years, we at Davis Advisors have served as stewards and fiduciaries for our clients' savings. In doing so, our goal is to help them achieve their financial aspirations, whether a comfortable retirement, a child's education, a dream home, or gifts to charity. At this challenging time, our first thoughts are for their safety and well-being.

We also want to make clear that our firm and client portfolios seek to weather any kind of financial storm, including this one. While past performance does not guarantee future results, over the decades, we have withstood countless market dislocations, natural disasters, and other unforeseeable calamities, from the oil embargo and stagflation to the S&L crisis, 9/11, and the Great Recession. Rest assured, we are well-prepared at every level for the storm at hand. Our firm is financially strong and extremely liquid. Davis Select Financial ETF is filled with well-capitalized, durable businesses that we believe have the potential to ride out this period with their franchises and earnings power intact. We have the best research team we have ever had and have been diligently evaluating every individual company across our portfolios. We are in regular contact with the management teams of leading financial firms around the globe. We have a robust and time-tested business-continuity plan and will continue to provide clients and advisors with the first-class support they have come to expect from us, in good times and bad.

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. Year-to-date performance is through 3/31/20. **There is no guarantee that the Fund performance will be positive as equity markets are volatile and an investor may lose money.**

Investment Thoughts

To understand the risks and opportunities we see in the financial services sector at this tumultuous time, investors must place the current environment in the longer-term context of our time-tested investment discipline.

To build generational wealth, successful long-term investors must have the discipline to keep their emotions in check. In normal times, such discipline is not difficult. However, in times of fear, prices gyrate wildly, headlines blare bad news, and panic trumps rationality. In such extreme periods, self-discipline becomes both more difficult and more essential.

Today, with the market, the economy, and country in the grip of panic, rationality and perspective are more important than ever. The purpose of this note is not to make short-term predictions regarding spread of the COVID-19 virus nor on the timing of its containment. Instead, our goal is to provide a longer-term perspective that can serve as a framework for navigating the turbulence and uncertainty of the current environment. Armed with such a framework, investors will be prepared to unemotionally distinguish between the short-term volatility and potential long-term opportunities presented in the current market in general and the financial service sector in particular.

As human beings, we do not welcome times of fear and panic. However, as investors, we welcome the bargain prices such emotions produce. While we are in a volatile period and do not know what the future will look like, today, many durable and resilient financial services firms are on sale. The opportunity to buy such stalwart businesses at bargain prices is both rare and potentially valuable.

After more than 50 years of successful investing as a firm we can think of no better advice for navigating today's market than the timeless words of our founder, Shelby Davis, who famously said, "You make most of your money in a bear market. You just don't realize it at the time." With many high-quality, durable financial leaders trading 30–50% below the prices they traded at just a few months ago, investors have the opportunity to make decisions today that may build wealth tomorrow.

Short-Term Predictions Versus Long-Term Probabilities

Each day, investors are bombarded by a wide range of short-term predictions regarding the course of the current pandemic over the next 3–12 months, though we would suggest that the containment of the virus in countries such as South Korea, Singapore, and China should lead us to question the most extreme predictions, which seem more based on fearmongering and publicity than data and analysis. While the wide range of short-term predictions may be unsettling, longer-term probabilities fall into a much tighter range. Though there is limited knowledge and uncertainty about the impact of the disease, as we get out 12–24 months, it is possible that the virus will have run its course, a vaccine will be available, and, as a result of the lessons learned from this first modern pandemic, we should be far better prepared for future pandemics. In other words, while we don't know the precise timing, we do believe this period of uncertainty will come to an end, infection rates will fall, venues will reopen, businesses restart, and normal life resume. As a result, while there may be a powerful emotional cost, we believe there may be little lasting economic cost.

1. Inception date of Davis Financial Fund is 5/1/91.

Portfolio Update

The three key areas of focus for our portfolio companies remain the same through any environment:

- Companies with durable competitive advantages
- Excellent, experienced, and honest management teams
- Attractive valuations

Regarding our more general funds, an important aspect of defining "durable" is avoiding companies that employ financial leverage to the degree they might be incapable of surviving short-term dislocation. In the financial space, leverage is unavoidable—earning a spread on other people's money *is* the business model. But there are significant differences among the business models of financial firms that affect their durability through financial stress. For example, among the hardest-hit niches (which have been widely written about of late) are commercial mortgage REITs. Their funding structure includes repurchase agreements with banks that are effectively margin loans. With asset prices declining, the REITs must come up with more collateral or sell assets (which in turn drives down the price of their loans further).

In contrast, the regional banks owned in Davis Select Financial ETF (such as U.S. Bancorp, Capital One, Wells Fargo, and PNC Financial) employ almost no short-term wholesale funding; their liabilities consist of customer deposits, long-term debt, and shareholders' equity. They also hold tremendous liquidity in the form of deposits at the Federal Reserve and investment securities (principally U.S. Treasuries and government-backed agency bonds) to support borrowers drawing down their credit lines and any deposit outflows.

In addition to the liquidity these banks possess to carry them through dislocations in the funding market, they are also in a far better capital position than they were before the financial crisis to sustain any credit losses in the looming virus-induced recession. As we wrote you in December, our six largest U.S. bank holdings have increased their collective ratio of tangible common equity to risk-weighted assets from 6.2% to 11.8% since 2007, an improvement of more than 90%. This increased level of conservatism should allow these companies to weather even a severe downturn. For example, as part of the annual stress tests applied to the nation's largest and most important banks, the Federal Reserve models an economic scenario that would arguably be even worse than the financial crisis and Great Recession of 2008–09. This "severely adverse" scenario contemplates high levels of unemployment persisting for more than three years (peaking at 10%), real GDP decline of −8% (also stretched out over time), stocks down −50%, commercial real estate down −35%, and residential real estate down −25%. However, even under this severe scenario, the strong starting capital ratios of the banks we own in Davis Select Financial ETF would allow them to emerge with only a modest impact on shareholders' equity.

So, we have confidence in the durability and resiliency of our portfolio companies, but are the valuations attractive? The S&P Financials Index has declined approximately 30% year-to-date, and the KBW Bank Index by approximately 40%. The question for investors is to consider whether those declines are commensurate with the deterioration in intrinsic value, or if the price decline is an overshoot. Consider Capital One, a major holding for the Fund, which has declined approximately 45% as investors anticipate the worst for credit losses. The bank's financial performance has already been modeled for the Fed's stress tests discussed above. Under this "severely adverse" scenario, projected losses (after-tax) could reduce current book value by approximately 25%. However, at today's discount valuation of only 70% of tangible book value, investors purchasing today would still be buying at less than what the book value would be even *after* going through another Great Recession. While no one can know for sure whether the looming recession couldn't be worse than this scenario, we think there is sound reasoning to expect it might be sharp but not as persistent as this forecast; the Federal government's just signed stimulus package with its enhanced unemployment benefits, one-time payments to households, and grants to small businesses also could favorably alter the linkages between consumer credit and unemployment trends.

Similar analysis across all of the bank holdings in Davis Select Financial ETF also suggest to us that prices have declined faster than intrinsic value. By focusing on facts rather than emotions, rational long-term investors have the potential to build wealth for tomorrow by buying these valuable companies at bargain prices. However, it is important to remember that there is no guarantee these share prices will appreciate in the future.

Conclusion

Over 50 years of successful investing, we at Davis Advisors have weathered many storms and crises by being rational when others were fearful. Whether it was the bear market of the 1970s, early 2000s, or the financial crisis, buying after significant price declines have historically rewarded long-term investors who could keep their emotions in check. Although each period differed in its peculiarities, all share a similar pattern to what we see today. Fearful investors sell after prices have gone down, waiting on the sidelines until 'things feel better.' Rational investors buy after prices have gone down, recognizing that prices have the potential to be higher when 'things feel better.' In every case, fearmongers argued that this time was different and that a recovery would never come. And, in every case, our society, our economy, the market, and our portfolios proved resilient, recovered, and went on to new heights. We believe today is no different. Investors who can keep their emotions in check may once again have the opportunity to buy resilient financial companies at bargain prices and pursue generational wealth over the long term.

Perhaps there is no better indication of the durability of the stalwart companies that we hold in Davis Select Financial ETF than the majority of our holdings have been operating for more than one hundred years. That means that they survived two World Wars, the Great Depression, the Cold War, presidential assassinations and resignations, stagflation, the S&L crisis, 9/11, the financial crisis, and the Great Recession. We are confident they will weather the current storm as well.

As stewards of our clients' savings, our job is to make rational, long-term decisions and remain dispassionate at all times. However, we are also human beings who understand the stress that fear places on our families, friends and communities. While we know that a period of recovery and healing will follow this difficult stretch, we sincerely hope that, until then, you remain safe and healthy. We thank you for the trust you have placed with 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 3/31/20, the top ten holdings of Davis Select Financial ETF were: U.S. Bancorp, 8.67%; Berkshire Hathaway, 8.06%; Capital One Financial, 6.66%; Markel, 6.34%; American Express, 5.99%; Bank of New York Mellon, 5.24%; JPMorgan Chase, 5.16%; PNC Financial Services Group, 4.70%; Bank of America, 4.65%; Wells Fargo, 4.53%.

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, Thomson Financial, 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. The stocks represent large U.S. national money center banks, regional banks, and thrift institutions. 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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