



## Davis International Fund

Update from Portfolio Manager  
Danton Goei



THE EQUITY SPECIALISTS

# Davis International Fund

Annual Review 2021

**Please provide an update on the long-term performance and more recent results for Davis International Fund. Discuss the current positioning:**

For the year 2020, Davis International Fund returned 22.69%, compared with a 10.65% rise in the MSCI ACWI (All Country World Index) ex US, an outperformance of 12.04%. In the first half of 2020, the Fund was down -3.26%, though it still outperformed the index by 7.74%. This weak market environment in the first half was followed by a very strong rebound in the second half, when the Fund returned 26.83% for the six months, compared to the market return of 24.33%.

In the first half of 2020, the rapid spread of the COVID-19 pandemic led to a wide range of reasonable disaster scenario forecasts, given the novel nature of the SARS-CoV-2 virus. Included in this range of outcomes was a replay of the Great Influenza Pandemic of 1918, when an estimated 2% of the world population perished. A similar 2% death rate would have resulted in a devastating toll of 150 million casualties today. However, as spring turned into summer in the Northern Hemisphere, countries in Asia, Europe and North America

were able, through a mix of lockdowns, social distancing and wearing masks, to significantly lower transmission rates.

We also learned that while the novel virus was highly transmissible, exacerbated by asymptomatic carriers, the mortality rate was lower than initially feared. As overwhelmed hospitals recovered, record high unemployment levels fell, and the Federal Reserve further eased monetary policy, equity markets recovered, looking ahead to the end of the pandemic.

The beginning of the end was on November 9, when Pfizer and its partner, German biotech firm BioNTech, announced the results of their Phase 3 interim analysis, showing vaccine efficacy of over 90%. This stunning level of efficacy, achieved in less than 10 months after the genetic sequence of the novel virus was first shared globally on January 11, was astounding. It was particularly impressive given the Pfizer/BioNTech vaccine will be the first ever approved using the messenger RNA (mRNA) approach. The Pfizer vaccine was approved for emergency use by the U.S. FDA on December 11, and a similar mRNA vaccine by Moderna was approved on December 18. As colder winter

**The average annual total returns for Davis International Fund's Class A shares for periods ending December 31, 2020, including a maximum 4.75% sales charge, are: 1 year, 16.86%; 5 years, 10.21%; and 10 years, 5.76%.**

**The performance presented represents past performance and is not a guarantee of future results.** Total return assumes reinvestment of dividends and capital gain distributions. 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. The Fund is subject to a 2% short-term redemption fee for shares held for fewer than 30 days. The total annual operating expense ratio for Class A shares as of the most recent prospectus was 0.99%. The total annual operating expense ratio may vary in future years. Returns and expenses for other classes of shares will vary. Current performance may be higher or lower than the performance quoted. For most recent month-end performance, visit [davisfunds.com](http://davisfunds.com) or call 800-279-0279. The Fund's performance benefited from an IPO purchase in 2014. After purchase, the IPO rapidly increased in value. Davis Advisors purchases shares intending to benefit from long-term growth of the underlying company; the rapid appreciation of the IPO was an unusual occurrence. The Fund recently experienced significant negative short-term performance due to market volatility associated with the COVID-19 pandemic.

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. All fund performance discussions within this piece refer to Class A shares without a sales charge and are as of 12/31/20 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.**

weather exacerbates the spread of a second wave of the pandemic across many regions, including North America and Europe, it is clear that over the coming months, challenges remain; nonetheless, it also appears that the end of the pandemic is in sight.

Among the drivers of outperformance were holdings in China, which predominantly focus on the Chinese consumer, such as JD.com, Meituan and New Oriental Education & Tech. They had strong results as they too experienced increased demand for food delivery, e-commerce and online education, coupled with the strength of the Chinese economic rebound, as virus transmission was largely brought under control. Resilient cyclicals such as Schneider Electric and Ferguson have since rebounded, while at first negatively impacted by the recession, as G20-area GDP fell by 9.1% year-over-year in the second quarter of 2020, and some even have benefited from certain aspects of the pandemic world. Ferguson, for example, the leading distributor of plumbing and heating products in the U.S., has benefited from strong residential demand as people spend more time at home.

Detractors to performance relative to the index include financial services holdings such as DNB, Development Bank of Singapore, Bank of Butterfield and Metro Bank. While banks in general have suffered due to the recession and experienced credit losses, Metro Bank has also suffered from operational missteps. It is our expectation, however, that our bank holdings in general will benefit from stronger economic growth as the pandemic recedes. Energy holdings in Ovintiv and Seven Generations also experienced detracted performance, as oil demand collapsed due to the pandemic. With approximately 70% of oil demand used for transportation, the decline in miles driven (i.e., U.S. miles driven are down 11% in 2020) and the far bigger 60–70% decline in global air passenger traffic led to a dramatic drop in oil prices.

It is our expectation that oil demand will remain weak for the foreseeable future, as flying and driving slowly recover, and that over the long

term, electric vehicles and renewable energy will also decrease demand for fossil fuels. As a result, we sold out of our energy positions in 2020. We redeployed the assets in other sectors such as financial services that also saw falling stock prices, but where we had stronger conviction that the long-term health of their business was strong.

### **Please provide your current perspective on global markets during COVID-19:**

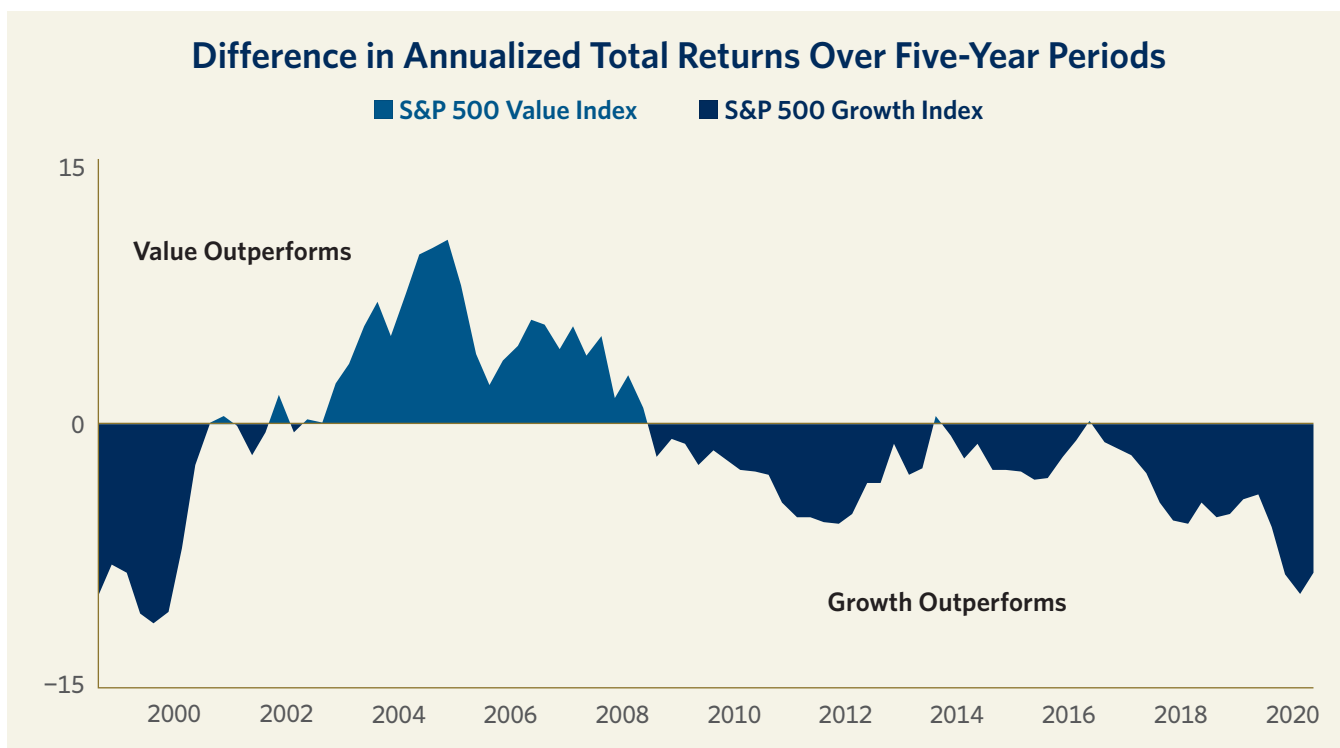
The year 2020 has been a difficult year in the United States like for much of the world. The over 20 million U.S. confirmed infections and 350,000 deaths from the COVID-19 pandemic have been the largest health crisis in over a century. The economic disruption has also been significant, as U.S. GDP in 2020 is forecast to fall by 3.6% and unemployment peaked in April at the highest level since the Great Depression at 14.7%. Large corporation earnings were heavily impacted, as S&P 500 Index earnings for 2020 are expected to drop by 14%, and small- and medium-sized businesses have been especially hard hit, with an excess of 100,000 businesses permanently closed.

So why, might one ask, did the S&P 500 Index return 18.40% in 2020? The two “Feds”—the Federal Reserve and the Federal government—were key reasons why asset prices, including equity values, were boosted in 2020. Since March, the Federal Reserve has cut the Federal funds rate by 150 basis points (bps) to a range of 0% to 0.25%—basically near zero. The Fed also resumed purchasing a massive amount of securities, including Treasuries and mortgage-backed securities, a tool known as quantitative easing, to improve market liquidity and further lower interest rates. From mid-March to year-end, the Fed’s portfolio of securities owned grew from \$3.9 trillion to \$6.6 trillion, up \$2.7 trillion. In addition to lowering the Fed funds rate and pursuing quantitative easing, the Fed undertook a number of programs to support the smooth functioning of capital markets and the banking system.

The Federal government, led by Congress and the President, also responded from mid-March to mid-April by passing four coronavirus relief bills providing \$3 trillion in fiscal stimulus to individuals, small and large businesses, hospitals, and state and local governments and to fund testing. By November, the unemployment rate had fallen to 6.7%, and the economy resumed growth in the third quarter, albeit at a tepid pace. At the end of December, Congress passed a fifth stimulus bill totaling \$892 billion to further support the economy. The lower interest rates decreased the cost of capital for businesses and made equities more attractive relative to fixed income, and the fiscal stimulus replaced much of the income lost during the recession that supported individuals, businesses and the banking system during the downturn. The long-term effects of the unprecedented size and scope of the two Feds' responses are unknown and something we will be monitoring closely going forward. It is clear, though, that without the monetary and fiscal stimulus provided, the recession of 2020 would have been much deeper and longer and provides the basis for some optimism for an economic recovery in the coming periods.

Though the S&P 500 Index was up 18.40% in 2020, returns have been very unevenly distributed. For example, the S&P 500 Growth Index has returned 33.47% year-to-date, compared to a 1.36% return for the S&P 500 Value Index, yielding a 32.11% difference. The chart below shows the cyclical nature of S&P 500 Value and Growth Indices' relative performance. Historically, large outperformances of one style versus the other have resulted in a reversion to the mean in subsequent periods.

Such a difference in returns over just a 12-month period has also driven a big disparity in valuations, with the S&P 500 Value Index trading at a 41% discount to the S&P 500 Growth Index on a price-to-earnings multiple basis. At Davis, we believe such a wide dispersion in returns and valuations within the index bodes well for selective active stock pickers to generate strong returns, while lowering risk relative to the market. We believe taking advantage of the bargains available in the S&P 500 Value Index, while avoiding the overvalued holdings in the S&P 500 Growth Index, will increase the probability of outperforming the market over time.



Source: Morningstar. As of 12/31/78 through 12/30/20.

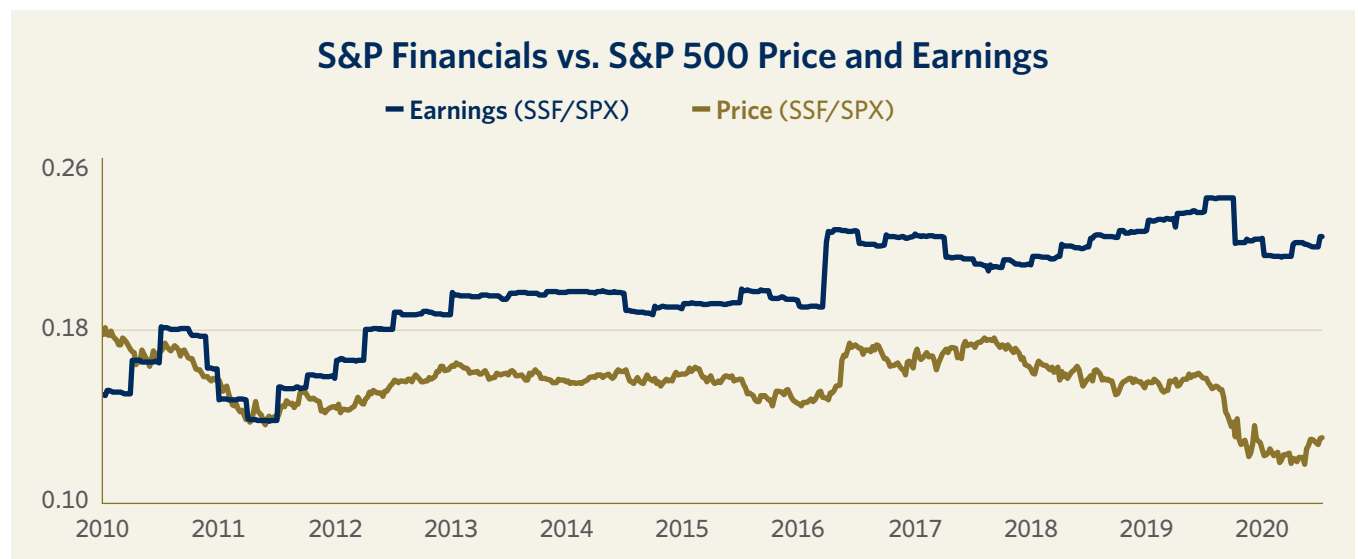
One of the biggest sector disparities that illustrates well the opportunity available to active stock pickers is in the financials sector. The chart below shows that over the last decade, when financials' earnings grew from 15% to more than 20% of the index, their prices have fallen from roughly 18% to a record low 12% of the index.

As the banks emerge on the other side of this current crisis with their balance sheets and earnings power intact, we anticipate that attitudes towards the sector could improve significantly, leading to a powerful increase in their relative valuation and a sharp closing of this enormous gap. In the meantime, we are delighted to be buying durable institutions that are, in our opinion, well-prepared for this turmoil, at distressed prices, as in doing so, we are sowing the seeds for future performance.

Asia is but one of the world's seven continents, but accounts for 60% of the world's population, and this year, Asia's GDP will overtake the GDP of the rest of the world combined. Over the next decade, the region is forecast to contribute 60% of the world's economic growth, in large part because 90% of the 2.4 billion new members of the global middle class will be from Asia.

China is the largest economy in Asia and the second largest in the world, accounting for 18% of world GDP. In the first quarter this year, China's economy was severely disrupted by the pandemic and a national lockdown, as the GDP shrank by 6.8% year-over-year. In subsequent quarters, however, the Chinese economy rebounded, as lockdowns and strict measures were generally effective, so that in 2020, China is expected to be the only large economy to grow. In fact, 2020 will be the 16th year in a row that China is the largest contributor to global growth.

There are good reasons to believe that the next decade will be a continuation of the trend of above-average growth in China seen over the past four decades. While, for example, the urbanization rate has tripled since economic reforms were started in 1978, China is still only at 61%, compared to the U.S. at 82% and Japan at 91%. Rising urbanization not only drives a growing middle class, but a burgeoning affluent class is also moving up the income scale. Over the decade from 2012 to a forecast of 2022, China's upper middle class is expected to grow from 14% to 54% of urban households, and the affluent class is expected to triple from 3% to 9%. As of 2018, China was actually first in the world in number of billionaires at 658 and second in millionaires at 3.5 million.



China has become the world's largest luxury goods market in the world. By 2025, it is expected to account for 40% of the entire global luxury market. In August 2020, China also surpassed the U.S. for having the most companies in the Fortune Global 500 with 124 companies, up from 46 in 2010 and only 10 in 2000.

China's rapid growth and size as the world's second largest economy, however, is creating increasing friction with its trading partners in the U.S., Europe and Asia. Relations with the U.S. in particular have become strained over the past two-to-three years, resulting in a number of import tariffs, technology trade restrictions and heated rhetoric. As a new U.S. administration takes over in 2021, even if there is change in the level of rhetoric and more multilateral solutions are sought, a continuation of the policy of competition with China should be expected, as it has broad bipartisan support.

However, as the geopolitical relationship evolves over time, the incentives to the Chinese government to promote economic growth remain strong. Over two million workers migrate from the countryside to cities every year, and the number of migrant workers has ballooned to 291 million, one-third of the entire working population. Moreover, an additional 550 million Chinese still live in rural regions at per capita incomes roughly a third of those in urban areas. Economic growth and rising employment are crucial to satisfy desires for a better life in a country that still has per capita incomes of only one-sixth of U.S. levels.

Importantly, the companies in China that we invest in—ones that focus on domestic consumption, such as New Oriental Education & Tech, Alibaba, JD.com and Meituan—are only marginally impacted by geopolitics and global trade friction. While, in the short term, their stock prices can be affected, over the long term, their businesses are driven by the growing Chinese middle class' growth in consumption. For example, in the second half of 2018, when fears of the growing U.S.-China

trade conflict swept across the market, these four holdings fell on average by 38%. Knowing, however, that these companies are not export-oriented and sell to domestic Chinese consumers, we held on and even added to our positions in 2018 and 2019.

So how did these businesses fare? Well, over the five quarters from the third quarter of 2018 to the fourth quarter of 2019, the revenues of these companies rose on average by 39% year-over-year. So there was very little, if any, impact from the trade conflict. As investors started refocusing on company results, rather than the media headlines, the stock prices from the end of 2018 to mid-2020 rose by an average of 169%, helping to drive our outperformance over the period.

That is not to say that challenges do not exist for our holdings in China. In China, like other markets, understanding the regulatory environment is crucial. Historically, the Chinese government has focused on market reforms in one or two sectors, which can be disruptive in the short term. In the past, government regulations have focused on sectors such as live video streaming in 2016, for-profit education in 2018 and video games and online video in 2019. It was disruptive when New Oriental Education & Tech had to ensure 100% of its after-school teachers had teaching degrees and when Tencent was unable to launch new video games for almost a year due to new laws covering minors' access to video games.

But these reforms had little impact on these businesses' long-term value, and in the end, it created a more sustainable business environment. The current focus of the Chinese government is on e-commerce and consumer finance, impacting companies such as e-commerce leader Alibaba, resulting in the delay of the ANT Group IPO. Our expectation is that while a company like Alibaba will have to eliminate business practices such as exclusive supplier arrangements, it will maintain its leading position in the thriving Chinese e-commerce sector due to its brand, scale, network effects and ability to innovate.

In addition to the business outlook for our holdings in China, valuations matter tremendously for determining what future returns will be. Encouragingly, the MSCI China Index trades at a 28.1% discount to the S&P 500 Index, and Hong Kong's Hang Seng Index is at a dramatic 41.5% discount to the S&P 500 Index on a P/E basis. We believe that lingering geopolitical and regulatory concerns are creating a valuation discount, despite these businesses' proven and profitable models, with promising long-term outlooks.

In contrast, the European Union's GDP dropped by a record 13.9% in the second quarter, and while third-quarter results showed improvement, it was still 4.2% below the GDP a year ago. The forecast for full-year 2020 GDP growth is for a decline of 7.4%, which is worse than the 3.6% decline forecast for the U.S. and the 2% growth anticipated in China. However, looking at our three large European financials holdings, DNB in Norway, Danske Bank in Denmark and Julius Baer in Switzerland, we can see our selectivity has paid off. Not only are these three world-class financial institutions, but they are also located in conservatively-run economies with strong fundamentals.

For the full year 2020, Norway's GDP is forecast to decline by 3.5%, Denmark's GDP to fall by 3.9% and Switzerland's economy to shrink by 3%. While all three countries were still impacted by the pandemic, they all achieved far superior economic growth than the European Union as a whole, which is forecast to decline by 7.4%. Results for all three financial institutions were satisfactory in 2020, and we expect them to recover quite well in 2021.

### **Discuss some of the businesses Davis International Fund owns and any notable changes during this period:**

One of our larger international holdings is DNB ASA (DNB), Norway's leading financial institution. With the number one national market share ranging from 20–40% across the spectrum of financial services, DNB enjoys meaningful economies of

scale and scope, with the next-largest competitor only a tenth of DNB's balance sheet. Norway is one of the most financially digitized countries of the world, with cash/GDP only around 1%, a fraction of the rest of the developed world. DNB plays its part by being a leading innovator and serving the dispersed population of just over five million with only around 50 branches. This allows DNB to maintain an attractive and enviable cost-efficiency ratio of about 40%. DNB also enjoys long-term structural advantages by being domiciled in Norway, one of the few AAA-rated countries with one of the more fiscally sound balance sheets globally. The Norwegian oil fund has assets exceeding \$200,000 per citizen of Norway, and that provides an important backstop for situations like the current COVID pandemic. The Norwegian government has been able to extend relief to individuals and businesses and bring back unemployment to near pre-pandemic levels without overextending its fiscal liabilities. An extension of the sovereign wealth fund also owns a third of DNB, effectively giving the bank the backing of a strong sovereign wealth fund.

DNB currently trades at just under 12x forward earnings and at 1.1x tangible book value for 10–12% return on tangible equity. It has historically offered consistent, low double-digit returns over time, comprising of an attractive 5–6% dividend yield, low single-digit share buybacks and mid-single-digit book value growth.

Hollysys Automation (HOLI) has been a long-term holding in Davis International Fund, but is still unfamiliar to most investors. Hollysys is a Chinese manufacturer of automation equipment for power plants, petrochemical facilities and factories, as well as safety and control systems for high-speed rail and subway cars. The company has attractive growth prospects in a handful of industrial automation niches, where it has built a loyal customer base over the years, as well as in the rapidly-growing high-speed rail market in China. While Hollysys has seen some order delays during the pandemic, it is a provider of essential equipment to keep the Chinese

economy running and should resume growing once order cycles return to their normal cadence. HOLI is one of the cheapest stocks in the Fund, currently trading for 8–9x owner earnings, and if one takes into account the roughly \$0.6 billion of net cash the company has on its balance sheet (equal to well over half of the company's market cap), HOLI is trading under 5x owner earnings.

So why is it so cheap? Part of Hollysys' challenge is that while it is one of the top industrial automation firms in China, it is still relatively unknown to the investing public in the U.S., where HOLI is listed. The recent push to de-list U.S.-traded Chinese companies has led to worries that it could have an adverse impact on HOLI's trading liquidity and even force a de-listing in three years, if regulators do not find a compromise. This could make for a bumpy ride in the capital markets and force the company to seek out a more receptive trading venue (i.e., one closer to its end market of China), but we believe there is underlying value in Hollysys that will eventually be more fully recognized, regardless of where the stock trades. The value is being driven by the earnings of the business, rather than the exchange it is being traded on.

### **Looking ahead, what is your outlook for Davis International Fund:**

The COVID-19 pandemic has taken an enormous toll, with over 1.7 million deaths worldwide and a global recession, with an expectation that GDP will fall 4.2% in 2020. At Davis, our thoughts go out to everyone who has been affected, and unfortunately we know the pandemic effects will continue into 2021. As we look into the new year, however, there is reason for optimism, given the efficacy and safety of the vaccines being currently administered and the expectation that several other vaccines will be available during the year. Diseases such as polio, tetanus, measles and many others have proven that global health emergencies can be addressed with the help of vaccines.

As we look back at how the Davis International Fund portfolio of companies performed in the midst of a global pandemic and recession, we can see that our focus on business durability and financial strength has served us well—whether it was New Oriental Education & Tech's foresight in investing over \$100 million annually in building an online service that enabled them to teach their two million students online when all the schools were closed in February; or e-commerce leaders Alibaba and JD.com's ability to operate in the midst of a pandemic and deliver the goods consumers needed when they could not leave their homes; or the balance sheet strength of banks such as Development Bank of Singapore, Danske Bank and DNB that enabled them to navigate the recession without needing to raise capital. The business results these holdings produced in such difficult conditions show that the Davis discipline of investing in companies built to survive the inevitable challenges faced over a long investment horizon served the portfolio well in 2020.

We understand that in uncertain times such as these, it is more important than ever to be able to entrust your savings to an experienced and reliable investment manager with a strong long-term record. Over the 50 years since the firm's founding, the Davis investment discipline has demonstrated an ability to generate above-average returns, based on in-depth fundamental analysis, a long-term investment horizon and a strong value discipline. While the times have changed, these fundamental principles are timeless and proven. We thank you for your continued trust and interest in Davis International Fund.



*This report is authorized for use by existing shareholders. A current Davis International Fund 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.*

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 International Fund's investment objective 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:** stock markets have periods of rising prices and periods of falling prices, including sharp declines; **common stock risk:** an adverse event may have a negative impact on a company and could result in a decline in the price of its common stock; **foreign country risk:** foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified; **headline risk:** the Fund may invest in a company when the company becomes the center of controversy. The company's stock may never recover or may become worthless; **depository receipts risk:** depository receipts involve higher expenses and may trade at a discount (or premium) to the underlying security; **foreign currency risk:** the change in value of a foreign currency against the U.S. dollar will result in a change in the U.S. dollar value of securities denominated in that foreign currency; **exposure to industry or sector risk:** significant exposure to a particular industry or sector may cause the Fund to be more impacted by risks relating to and developments affecting the industry or sector; **emerging market risk:** securities of issuers in emerging and developing markets may present risks not found in more mature markets. As of 12/31/20, the Fund had approximately 49.5% of net assets invested in securities from emerging markets; **large-capitalization companies risk:** companies with \$10 billion or

more in market capitalization generally experience slower rates of growth in earnings per share than do mid- and small-capitalization companies; **manager risk:** poor security selection may cause the Fund to underperform relevant benchmarks; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; and **mid- and small-capitalization companies risk:** companies with less than \$10 billion in market capitalization typically have more limited product lines, markets and financial resources than larger companies, and may trade less frequently and in more limited volume; See the prospectus for a complete description of the principal risks.

The Fund is subject to a 2% short-term redemption fee for shares held for fewer than 30 days.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of 12/31/20, the top ten holdings of Davis International Fund were: New Oriental Education & Technology, 11.07%; JD.com, 9.05%; Alibaba Group Holding, 6.18%; DNB ASA, 5.16%; DBS Group Holdings, 4.86%; AIA Group, 4.69%; Danske Bank, 4.53%; Naspers, 4.48%; Schneider Electric, 4.33%; and Ferguson, 3.89%.

Davis Funds 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 [davisfunds.com](http://davisfunds.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 **MSCI ACWI (All Country World Index) ex US** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the United States. The index includes reinvestment of dividends, net of foreign withholding taxes. The **S&P 500 Value Index** represents the value companies of the S&P 500 Index. The **S&P 500 Growth Index** represents the growth companies of the S&P 500 Index. Investments cannot be made directly in an index.

After 4/30/21, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

**Shares of the Davis Funds 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.**