Where the Davis Funds is Finding Great Opportunities
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by Robert Huebscher

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I interviewed Chris on October 17.

To listen to this interview as a podcast, go here.

Your firm uses the Davis Investment Discipline. What is that?

As a manager of our own and our clients’ money, we have a single goal, which is generational wealth building. One of the things that we recognized when my grandfather started investing in the late 1940s was that if you want to build wealth over the long term, you need to be an owner of rather than a lender to businesses. He looked at the prospect of bonds back in 1948 and called them “certificates of confiscation.” He said that every year your purchasing power declines. To build wealth, you need to compound faster than your purchasing power declines.

I think of purchasing power as more than just inflation. But even if we just think of it in terms of inflation, it's amazing to think that in my lifetime the purchasing power of a dollar is down 88%, based on the so-called risk-free dollar. I put a dollar in the mattress, I take it out 50 years later, and it's only got 12 cents worth of purchasing power. My grandfather’s fundamental belief, and that of our firm, was that to build wealth over the long term you need to be an equity holder rather than a creditor or a bond investor.

From our beginning we’ve been equity specialists. Our investment process boils down to the idea that our return will be driven by the return of the underlying business. We perform research on the businesses that we consider for investment as if we were going to buy the entire business and our return would be driven by the cash that that business generates.

Suppose you bought an apartment building for $10 million. In the first year, it generates $700,000 of income. What would your return be? Of course, you'd say, "7%." You wouldn't think of your return by asking, "What would somebody buy this building from me tomorrow or the next day or the day after or the month from now." You wouldn't be pricing the building every day; you'd be looking at the earnings that the building generates as your return.

If, in 10 years, that building was generating $2 million of income, you'd say we're getting 20% on our $10 million investment. If you look at that over 10 years that would imply an 11% return, starting at seven and rising to 20%. That is the underlying philosophy that we bring to bear.

Our investment process boils down to the idea of identifying businesses we want to buy and determining how much we want to pay for them. If we’re buying businesses rather than renting stocks, we’re not thinking about what somebody would pay us in a month or two from now.

How does that translate into the types of businesses you own and the prices you pay for them?

Let's look at each of those questions separately. Which business? A business is, in a sense, is assets and people. Let's first think of the assets part – the characteristics of the underlying business. If you had to invest your entire family’s net worth and buy a business in your local neighborhood, you'd think of the same sorts of characteristics that you would think about when you’re buying a business for the long term – durability, adaptability, resiliency. We're evaluating businesses based on their competitive advantages. A business is durable because of its business model, the strength of its balance sheet, its return on equity and its free-cash–flow generation.
As for the people, we look at the characteristics of who we've entrusted the management of this business to. There's subjectivity, but there's also a lot of data. We look at the record of their decisions, compensation practices, accounting choices, capital-allocation decisions and an alignment of interests. We're among the largest investors in every fund that we manage. That creates an alignment. In fact, we're shocked that only 12% of all funds are managed by individuals who have more than $1 million invested in the funds that they oversee. We don't have a single investment where the management team doesn't have at least a million dollars invested.

The second part is how much we pay for it – the valuation. We have a deep valuation discipline. We look for businesses where the underlying returns will drive our return at an attractive rate. We're looking at valuations that go beyond GAAP accounting. We're looking at the enterprise value; we're marking the balance sheet to market; and we're calculating a concept that we call "owner earnings." To understand that, consider that a business has its tax books that it reports to the tax authorities. Often management makes rational choices for its accounting policies to minimize current reportable income. That reduces the taxes. It accelerates depreciation and expenses things it might defer.

But, if you were to report the economics of the same business to a potential buyer, management might choose policies that make the business look better than the tax basis. It straight lines depreciation, accelerates revenue, capitalizes things that it ought to expense and so on.

We are trying to get at owner earnings, which is usually between those two. We look at the amount of cash we could take out of the business each year after reinvesting enough to maintain its current competitive position. We aren't doing anything as simplistic as a P/E or price-to-book ratio. We're trying to look as if we were buying the whole company and the amount of cash the business generates relative to the price we pay for it, after adjusting for debt, underfunded pensions and off-balance sheet assets and liabilities. We're looking at earnings in a rational, owner-oriented way.

That is a very long answer, but when people talk about their investment process, they often oversimplify it. We want people to understand the rigor that is behind the words and the discipline that's behind the statement of process.

Where are you finding investment opportunities today?

We are looking for businesses that have that qualities that I mentioned – durability, adaptability, resiliency, good management and are selling at attractive prices. That opportunity set will be wherever people feel the most uncomfortable. If you have a good business and everybody agrees it's a wonderful business, it will tend to trade at a high price. We can't check that last box of finding that business at an attractive valuation. We're looking for good businesses in out-of-favor areas.

Where do we see those areas? Let's start with financials. Investors have memories of the financial crisis still seared into their minds. Every time there's a whiff of recession, bank stocks get hit. What they're forgetting is that in the 10 years since the financial crisis, the structure of the financial service industry has transformed. Capital ratios have doubled. You have companies with more capital, less leverage and far less risk. They have greater market share and less competition. The bigger banks have a greater market share. They have tighter regulation, which many view as a curse. But it also has raised the barrier to entry. Banks have much higher credit and underwriting standards than they had before the financial crisis.

Banks trade at some of the lowest relative valuations in a long, long time – despite having decent returns on equity, record profits, higher capital ratios.

Financials are priced as if they are highly risky. But we view them as incredibly durable. Four of our top five financial holdings are in their second century of life as corporations. One of them is in its third century. That speaks to the enormous durability of their business models and yet they are priced at nine to 11 times earnings – as if they're going out of business.

Where else are there bad headlines?

The opportunities outside the U.S are amazing. Based on the growth rates of many non-U.S. economies, they are priced on sale. Within that category, we like developing markets that have very powerful, dominant businesses with great economics and proven management. We like companies that are addressing and servicing the growing global middle class. That includes Chinese commerce companies like Ali Baba, video game companies like Tencent, and education companies that cater to the desires of newly wealthy parents to educate their children. We like some tutoring companies in China. In global air travel, we like a developing market like India as well as the dominant global aircraft engine business, which has had wonderful growth for decades.

The third category is durable industrial companies. Those companies often also get cheap when investors
are worried about a recession. People overvalue the durability of some businesses and industries in this environment. They tend to undervalue companies that aren't household names. Take United Technologies. It is one of the largest manufacturers of aircraft engines, air conditioning systems and elevator systems; it owns OTIS, Pratt and Whitney, and Carrier. Those are wonderful, industrial franchises. But they trade as if they are cyclical.

Where do you see some of the biggest risks?

I've been running a financial fund for most of the last 28 years. It's a fund I started, the Davis Financial Fund. There is always something to worry about in financial stocks - like if there'll be a recession, the yield curve flattens or interest rates continue to stay low. Those are normal risks and part of the investment landscape in financials. Too much money is lost trying to time those things. You lose the opportunity to own real compounding machines. That's especially true now. Those risks are overblown.

Investors in financial services have to be careful - not about normal, cyclical risks, which are priced in. That's why those capital ratios that I talked about earlier are so important. But investors want to be careful about any disruption. We've seen what happened to retail, media and record labels. Those business models were carved in stone. Think of Kodak, Polaroid and Avon. They were disrupted by technology. If you're invested in financial services, you have far greater than average durability. But in the long run, you want to be careful to see are those businesses are using and taking advantage of technology to widen their moat. In the current environment, that moat has gotten wider.

The largest banks, like JP Morgan, Wells Fargo, Bank of America and Capital One, have been aggressive users of technology. They've used their scale to make investments to create a great internet experience and peer-to-peer payment systems, like Zelle. They compete with Venmo. They have been surprisingly nimble and able to take technological risks and incorporate them into their business models.

You have managed the Davis Financial fund for 28 years. Financial stocks, and banks in particular, fared poorly during the last recession. Many analysts are predicting a recession in the next 12 to 18 months, yet you have major positions in, for example, US Bancorp, Capital One and JP Morgan. What's your outlook for financials in the current market environment?

As an investor, you want to be cognizant of cyclical risks. You do not want panic; you want to watch thoughtfully. Avoid companies that are taking undue credit risk. When credit losses are the lowest, companies often do irresponsible things. Be a specialist and don't own an index; look at the companies that have proven credit cultures – or in the case of insurance, proven underwriting cultures. We want companies that have a history of managing the normal risks of interest-rate and economic cycles. Those are the ones that have been and will continue to be able to compound generationally.

The companies we own all made money throughout the financial crisis. All of them gained market share. Many of them were able to acquire, at bargain prices, their irrational competitors who went out of business. Even if a crisis happens, the stocks of the companies we own may perform badly, but the underlying businesses have greatly accreted their value.

In the last recession, banks went in over-levered and with lousy credit portfolios. We're in a very different scenario now. Most banks have more than twice the capital they had before the last recession with much higher lending standards. In fact, there's some sloppy credit in the financial sector, but most of it is not in the banking system. It is in high-yield funds, where there seems to be a lack of discipline. Some may be in municipal finances. But the loan books of many of the banks that we look at are disciplined, well-managed and have high capital ratios.

Although bank stocks tend to trade down with fear of a recession, if one were to happen, investors will see that the businesses will perform much better. But if the stocks do go down, you'll see a significant acceleration in the percentage of the company that's being repurposed each year. Many of the companies that we own are repurchasing 5% to 6% of their shares per year. If the stocks go down 20%, the amount that they repurchase goes up.

We focus on whether the underlying businesses are in a threat of a recession. We feel strongly the answer is no. There's too many fundamental differences between now and the conditions that prevailed before the financial crisis.

How does a flat or possibly inverted yield curve figure in to how you value the financial companies you own?

The fundamental model of banking is based on a spread between short- and long-term rates. That spread does not exist at all points in a cycle. If we have an inverted yield curve, it will not be the first or last time. It is a normal occurrence. But you can imagine a scenario where the yield curve stayed inverted for a very
long time, which would be bad for bank profits.

Is that the natural state of affairs? Let’s look at it at the micro level.

If I want to borrow money for 30 years to buy a house, what rate would a bank charge me versus if I give them the option to reprice that interest rate every year in an adjustable-rate loan? You would expect the rate on the longer loan to be higher because the lender is taking more risk. They’re locking in that interest rate. The natural shape of the yield curve is positively sloped because of the underlying nature of lending money short versus long. That basic rule of common-sense economics won’t be repealed.

But an inverted yield curve happens when people are worried about a recession. They’re anticipating short rates coming down and the long end of the curve discounts or anticipates that change. But the idea of a yield curve being inverted for a very long period of time is very unlikely.

When we invest in a financial company, we do so with the expectation that we will own that company in a recession. We will own it in periods of rising and falling rates, and steep, flat and even of inverted yield curves. When we model our returns buying those businesses, we incorporate those scenarios into our analysis.

**One of the more stunning developments in the last couple of weeks has been the elimination of commissions by major on-line brokerage firms. Do you see this as part of a broader trend to commoditize and cheapen the value of financial services?**

There are commodity aspects to financial services. The custody business at the Bank of New York, for example, is a wonderful business that keeps assets safe and secure. The net charge for that is less than a basis point. People are getting a great bargain. But there’s not much room for it to go down.

The idea of offering free commissions as part of a full relationship with a financial advisor isn’t revolutionary. I went through the “big bang,” when commissions were 12 to 15 cents a share for institutions. Now they’re a penny a share. The difference between a penny and zero is not that much. The question is what is the value of the relationship that Schwab has with its clients? To me, the answer is very high because of all of the other services that it offers.

Parenthetically, offering free commissions facilitates stupid client behavior. Clients and the general public would be better served with commissions that were a dollar a share than free. People would recognize that over time, trading detracts value. It benefits those trying to make money with short-term trading strategies, which tends to be a loser’s game. Any type of changes in the pricing system that encourages more trading does not to accrue to the benefit of the end investor.

The cost of trading securities was already so low that the difference between so low and free will be a rounding error in terms of total return to investors, measured in basis points. It’s a curious phenomenon. But the commoditization of certain aspects of financial services has been and is ongoing. There many services that start out with fees and then they become part of the value of the relationship that you have with your financial institution.

Financial service institutions in aggregate are reporting record profits. They created the mortgage backed bond, the money market fund, internet banks, credit card specialists. All challenged the banking system over the last several decades. It’s amazing how many of those have been incorporated into the landscape of services we take for granted.

It’s a headline rather than a real threat. It reflects the ongoing trend of how to add value for our clients and how do we get paid for that value added.

**As an active portfolio manager, what do you see as the role and utility of the financial advisor?**

I had my annual physical last week. When I see my doctor, he takes a certain number of tests – he draws blood and so on. But if he did nothing else but modify my behavior that would result in a better patient outcomes. If your doctor can convince you to exercise regularly, sleep well, significantly improve your diet, not smoke and not drink in excess, his patients will have way better health outcomes than any other service he or she could provide. Above the expertise and diagnostics, behavior modification is the most important influence that a medical practitioner has on a patient.

Similarly, a financial advisor has an enormous amount of expertise, including planning platforms, technology and so on. But the most important role that a financial advisor can play is behavior modification. It is convincing clients to save more than they spend, to live responsibly, to invest for the long term, not to chase what’s hot, not to get excited when prices are going up and not to get panicked when prices are going
To take the analogy to robo advising, I could wear a Fitbit on my wrist. It might modify my behavior a bit. It might tell me to take a few more steps or so on. But it's not a mystery what we need to do to improve our health. The difficulty is getting people to do it. Similarly in investing, there's no mystery about what will improve clients' financial health in the long run. The question is how are you able to get them to do it.

Robo advising doesn't commoditize and doesn't address the most important aspect of a financial advisor, which is how they modify and influence their clients to get them to behave in a financially more healthy way. Robo advising can be a tool that's very helpful to advisors, with tasks such as rebalancing. But a relatively small percentage of the population is ignorant about what they ought to be doing. A relatively large percentage of the population has trouble doing it. A person-to-person relationship has the greatest potential to add value.

Our firm distributes a study from time to time that was created by DALBAR. It looks at the cost of investor behavior. In the most recent 20-year period, it's was approximately 250 basis points per year. People invest more when prices are high and when the market is outperforming; they get out when they're underperforming and when prices are low. The timing and selection penalty is hundreds of basis points a year. That is where the advisors add enormous value and why they should hold their heads up and recognize the impact on the end client. It's difficult to measure the value when you kept a client from selling and getting out in the financial crisis or when you kept clients out of the internet bubble. There's nowhere on the statement that shows that value, but that it is real and enormous. Likewise, when advisors create a college plan for a kid when he or she is born instead of when they are 15, enormous value is created.

Advisors don't have anything to worry about for the foreseeable future if they build their practice around reducing the behavioral penalty.

Over the past three or four years, flows to passive funds have been strong, while active funds have suffered. What guidance do you give to advisors who are choosing between an active fund, such as yours, and a passive fund?

Well, this is an area where there's a lot of orthodoxy and religiously held, extreme views. Both extreme views are wrong.

Passive investing has a lot of advantages for many clients. Most dramatically, it has very low cost. It is appropriate if you have a client who is terrified of being invested with a manager who will go through periods of underperformance. The data is overwhelming that managers who add value over the long term go through periods of underperformance.

Passive, at its heart, is a momentum strategy that defies common sense in the long run. It automatically puts more money into something that goes up in price and then puts more money into it at a higher price and so on.

On the other hand, there are pluses and minuses to active management. The most powerful minuses are that most active managers have high fees, high turnover, a lack of alignment of interests between the managers and the clients, and they look a lot like the indexes. There's not a lot to be said for the average active manager.

However, the data is very strong that managers who have certain characteristics have added value over time. Active and passive have tended to move in cycles with the passive outperforming in a strong bull market and active outperforming when the market is choppy. We've been in a cycle when active management has underperformed. I don't expect that cycle to persist; it hasn't in the past. There are cyclical patterns and periods of time where even the average active manager has outperformed passive for a five-year stretch.

But you don't need to own the average active manager. If you only look at active managers that have below average cost, a high alignment of interest (they invest in their own funds), high active share and don't look like their benchmarks, that universe has had a significant record of outperforming over the vast majority of rolling five- and 10-year periods.

In our case, we've outperformed in more than 85% of all rolling 10-year periods. But there doesn't need to be a religious debate about this. There's no such thing as "active is always bad" or "passive is always good." We're in a world where it's easier to write the headline and oversimplify than recognize the underlying complexity. The consensus view that active always underperforms is so pervasive that the pure contrarian in me thinks that we should reserve a place in portfolios for true active management. Given that the consensus is so strong, now is a good starting point for active management.
Davis Advisors was one of the first investment managers to offer true active management in a traditional ETF, providing tax efficiency, liquidity and daily portfolio transparency. Tell us about these ETFs and why you saw a need for them. Under what circumstances should advisors choose an active ETF over a traditional, open-end mutual fund?

The idea for our active ETFs came from advisors. We built our business over five decades in partnership with advisors in serving that end client. In a sense, they manage the client; we manage the portfolio. An advisor came to us and said, “I have a lot of clients for whom an ETF is a helpful structure – the ease, transparency, marketability and tax efficiency. Could you offer your services as an ETF?”

I was reminded of how, in 1968, we were exclusively institutional money managers for endowments and corporate pension plans. A consultant who was a financial advisor came and said, "You know, I've used you for some of my endowment clients but I have a number of individual clients and it would be wonderful if you could offer your services as a mutual fund." My father said, "Don't you need to go to a mutual fund company for that? We're institutional advisors. That's different."

Fortunately he thought about it and he said, “It's not different. It's serving a different client with the same investment discipline. Why can't we offer that in a different vehicle that serves the needs of that client in the same way that we're trying to serve the needs of an endowment or an institution or a pension plan?” That was how we launched mutual funds 50 years ago.

Similarly, when this advisor came with this idea, our first reaction was, “Aren't ETFs passive?” When you look at a lot of these so-called passive indexes, they have higher turnover than we have, often by a long shot. There are shifts every quarter among companies going into and out of value and growth indexes.

We realized we could do it. We have low turnover, low fees, a culture of transparency and advisors who have clients for whom this is a useful vehicle. We launched them as true ETFs in the investment areas where we saw the most opportunity in the current environment. We launched them by putting our own money on the line, by being the core and seed investors.

We launched them for international (DINT), global (DWLD), financial (DFNL) and a concentrated U.S. (DUSA), which is large-cap equity. We've been pleased with how they've rolled out. Traditional mutual fund advisors who are curious about ETFs have been pleased and able to access our services in an ETF format for clients where that tax efficiency and so on matters.

We've also had traditional ETF advisors who have been all passive. They look at the data and say, "I still believe in passive. But I recognize that there are many multi-year periods where active outperforms passive. They tend to happen after the indexes have had a huge run. I'd like to reserve a place in my portfolio for true active management. I'm an ETF advisor and there's almost nobody else as far as I know, really doing this." We offer proven, old-fashioned, long-term active equity management in a fully transparent, fully liquid ETF.

That was the history and they're doing quite well. We think that they will play a real part in the ETF universe.

We've generally had turnover between 10% and 30%. That's lower than many indexes. That works very well in the ETF space, given that we're large-cap investors.

This year Davis celebrated its 50th anniversary helping clients build long-term wealth. What have been the biggest changes and challenges, at least over the 30 years you've been at the firm?

Over the long term, the biggest challenge is trying to reinforce the fundamental importance of things like stewardship. We're in a world where shorter and shorter investment time horizons lead to confusion between price and value, in terms of the market as a whole as well as the focus on fees. Fiduciary duty has something to do with fees. But it is more than that. Yet there's no way to measure exactly what people mean by fiduciary duty, so fees become a short hand. That leads to a race to the bottom in terms of fees.

We often talk about risk and volatility. Risk means the probability of a permanent and substantial loss of capital or of an investment degrading your purchasing power over time. You can't measure that in a purely quantitative way. You can measure volatility. Volatility has something to do with risk, but it's not the same as risk. Yet, volatility is equated with risk. One of the big challenges is recognizing that just because something can be measured, that isn't necessarily what's important. We touched on that topic with ESG versus what I would call "common sense judgment." I would say the same about risk; there are measurements for risk and then there's common sense judgment. The same applies to stewardship and fiduciary duty – there are measurements and then there's common sense judgment.
The biggest challenge over time has been the confusion between what can be measured and what's really important. There are many things that people complain about that we see as very positive, like the growth in passive investing. It is positive because the more money is automatically being invested based on market cap. Fewer people are valuing individual companies, so the more opportunity we have.

One of our portfolio characteristics is that we're highly selective. We own approximately 50 companies in our large-cap funds versus 500 in the index. Our international fund owns 40 companies versus 2,000 in the index. Imagine if you're running a university or a business and you have the opportunity to interview 10 people for each one person who you accept. You have the opportunity to be selective and that should serve very well. That selectivity allows us to build a portfolio with above average growth at below average prices.

People complain about the growth in passive investing. But for our long-term returns, it's positive. It might be bad for our business but it's good for our returns and that's what really matters. When you entrust your money to an investor like us, a good question to ask is this: “If you had to choose between an investment that compounds at 12% and the market compounds at 14%, or you compound at 3% and the market compounds at 2%, which would you choose?”

Almost every investment manager would choose B. They would rather compound at 3% and have the market compound at two because that would be good for their business. But every client would choose A. They would rather build wealth over a long period of time. We would choose A because we have $2 billion of our own money invested in our funds.

We make a lot more money from 10% better performance than 10% more assets under management.

There is a confusion between the business and the profession, between trying to build what people do in the asset management industry versus serving clients. That’s an important distinction that advisors must keep in mind. Most clients define risk as having to change their lifestyle, become dependent on somebody else or to outspend their savings. Those are the risks that people need to be thinking about, not what is their performance relative to a benchmark risk over any one-, two- or three-year period.

If there is one thing you’d like our readers to take away when it comes to the Davis Funds and how it serves its investors, what would that be?

Our goal is to build generational wealth alongside our clients. The rarest thing in investing is conviction and trust. Investors chase the “hot dot,” the new system or the new algorithm. But over time, conviction and trust are the most important things in this business. We work to earn the trust of our clients every year. We have for five decades and we’re here alongside our clients to build their wealth over a long period of time. The characteristics in our portfolio – high selectivity, attractive growth and undervaluation – should build on our record over the last 50 years and serve our clients over the next 50 years.