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Davis Research Methodology

Davis Advisors is an independent investment management firm founded in 1969. We are specialists in equities and manage more than \$30 billion on behalf of both individual and institutional investors worldwide.¹ We have more than \$2 billion invested in Davis strategies, therefore our interests are aligned.*

The Davis Investment Discipline

The Davis Investment Discipline seeks durable, well-managed businesses at value prices that can be held for the long term to allow the power of compounding to work. Our initial premise is that stocks are not pieces of paper like lottery tickets or speculative instruments but ownership interests in real businesses which we expect to hold for at least three to five years. Our entire investment process focuses on two basic questions: "What kind of businesses do we want to own over the long term?" and "How much should we pay for those businesses?"

Finding the Right Business

Financial Strength. Competitive Advantages. Superior Management.

The first step in our investment process is to identify businesses that possess characteristics which foster the creation of value over long periods of time. We evaluate prospective investments according to a list of time-tested criteria that, in our minds, describe durable businesses with attractive growth prospects. These can be grouped into three categories: financial strength, competitive advantages and superior management.

Financial Strength—Beginning with the balance sheet, financial strength is very important to the survival and the earnings power of a business. Because we hold investments for a long period of time, we must feel confident that the companies we buy can withstand an industry and/or economic downturn. A strong balance sheet allows some companies to survive, and even expand, when others cannot.

Durability of cash flows is another important consideration. We favor businesses with strong recurring cash flows and attractive growth potential.

Next, we want to invest in companies that can generate high returns on capital over a cycle. The reinvestment rate of cash flows will play a significant role in determining a business's earnings growth rate and intrinsic value—and by extension an investor's return on that business.

Finally, our financial analysis would not be complete without comparing individual companies against peers on the basis of revenues, margins, capital structure, and other factors.

Competitive Advantages—The next category of business characteristics that we study closely is competitive advantages, or what Warren Buffett has

referred to as the “moat” around a business. In other words, does the company have brand? Does it have scale? Does it have distribution? Does the company have a cost structure advantage? Does it have intellectual property? At the heart of these questions is the desire to know what allows one company to generate a superior return on capital compared to its competitors and how sustainable are the advantages. Through our research we seek not only to understand a company’s current competitive advantages but also to assess whether that competitive moat is growing or shrinking.

Superior Management—Management can make a defining difference in the long-term success of any business.

We evaluate management based on the following criteria:

First, we need to understand management’s long-range strategic vision for their company and to gauge if management has the ability—based on a proven record of execution—to achieve those goals.

Second, we believe that management’s most important day-to-day job is to allocate capital. We want to understand the thought process behind decisions such as how much and where to reinvest capital within the business, how much capital can be returned to shareholders through dividends or share buybacks and under what circumstances mergers and acquisitions make sense.

Third, we like to see that the management’s interests are aligned with those of the shareholders. We look for owner-operators who deal honestly with shareholders.

Evaluating management is an iterative process that requires a great deal of time and patience. As such, we typically study companies not for a matter of days or weeks, but over quarters and years.

Beyond financial strength, competitive advantages and company management, we complete our research by interviewing competitors, vendors, suppliers, customers, and employees.

How to Value a Business

Enterprise Value. Owner Earnings. Owner Earnings Yield.

After determining which businesses are attractive on the basis of financial strength and qualitative factors, we must also develop an estimate of true worth for each business. Our purchase price will be an important component of our investment return.

In our valuation methodology, we depart somewhat from Wall Street by dispensing with the accounting shorthand that other managers tend to favor, such as the price to earnings (P/E) ratio.

There are fundamental problems with the P/E. First, the “P” only represents the per-share equity of a business, but excludes any debt the business might require to produce its earnings. It also ignores important adjustments that a sophisticated investor should make to determine an appropriate price for a company, such as marking to market certain balance sheet items carried at cost or taking into account off-balance sheet liabilities. Enterprise Value, which takes into account all of these on- and off-balance sheet adjustments is a more conservative and more accurate figure for determining how much one would theoretically have to pay to own a business free and clear.

The “E” in the P/E multiple, which represents the per-share net income of a company, also poses problems. Above all, it is subject to discretionary accounting choices. We wish to understand the true earnings power of a business which requires adjusting reported earnings so as to arrive at a cash-based, not an accounting-based, measure of earnings which we refer to as “Owner Earnings.”

After establishing Enterprise Value and Owner Earnings we can calculate an “owner earnings yield” which is defined as Owner Earnings divided by Enterprise Value. This represents our hypothetical first year’s return on investment based on the current earnings of the business and the price we would have paid to own the entire company. (For example, a business trading at 10x owner earnings would translate into an owner earnings yield of 10%.)

By valuing each prospective business on a yield or “bond equivalent” basis we are able to compare the relative attractiveness of each investment against the risk-free rate, which is always the alternative for investors. A compelling value investment in our view is a business that can be purchased at a significantly higher owner earnings yield than the prevailing risk-free rate and which possesses characteristics that foster the creation of value over the long term such as competitive advantages, high returns on capital and skilled management. Our ideal investment in a business is analogous to a hypothetical bond that offers an attractive current yield followed by a growing, not a fixed, stream of coupons into the future.

Sell Discipline

We sell investments on the basis of valuation, deteriorating fundamentals, a loss of confidence in management or because better opportunities exist elsewhere. Our sell discipline centers around the same set of criteria as our buy discipline, which is to say that we evaluate businesses on the basis of their financial strength, competitive advantages and management

quality, and we compare the intrinsic value of each company in our portfolio to the current market price. While we intend to own businesses over long horizons, it is critical to sell investments when circumstances warrant. Portfolio turnover is about 20–30% annually in most environments.

Distinguishing Davis Advisors

Our patient, time-tested investment approach makes us different as a money management organization in our industry, but there are other ways in which we distinguish ourselves from our industry peers as well.

Since our firm’s inception in 1969, we have practiced the same patient investment discipline of seeking durable, well-managed businesses that can be purchased at value prices and held for the long term. The Davis Investment Discipline has proven successful for decades and through vastly different economic environments. It is the same investment discipline that has guided the Davis family for more than 65 years and three generations. Very few organizations on Wall Street have experienced such continuity with respect to people, philosophy and process.

Finally, we take our role as stewards of capital seriously and always maintain a strong alignment of interests with our clients. Davis Advisors, Davis family and Foundation, and our employees have more than \$2 billion invested in similarly managed accounts and strategies. As such, we take the same risks and reap the same rewards as our clients.

This material may be shared with existing and potential clients to provide information concerning market conditions and the investment strategies and techniques used by Davis Advisors to manage its client accounts. Please refer to Davis Advisors Form ADV Part 2 for more information regarding investment strategies, risks, fees, and expenses. Clients should also review other relevant material, including a schedule of investments listing securities held in their account.

The investment strategies described herein are those of Davis Advisors. These materials are being provided for illustrative and informational purposes only. The information contained herein is obtained from multiple sources that are believed to be reliable. However, such information has not been verified, and may be different from the information included in documents and materials created by the sponsor firm in whose investment program a client participates. Some sponsor firms may

require that these materials are preceded or accompanied by investment profiles or other documents or materials prepared by such sponsor firms, which will be provided upon a client's request. For additional information, documents and/or materials, please speak to your Financial Advisor.

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 material. 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.

Owner earnings yield is Davis Advisors' estimate of the amount of cash which a purchaser of an entire company could withdraw from a company while still investing to maintain current operations. It is not the same as the return which a minority investor purchasing shares in the same company would realize. Estimated owner earnings yield represents a single data point about a company. No such data point can, by itself, guide an investor as to what securities should be bought or sold or when to buy and sell them. We caution our shareholders not to give this calculation undue weight.