Davis Advisors
Winter 2009 Review

Portfolio Positioning[1]

While market conditions vary, the core tenets of the Davis investment discipline and approach remain the same. We start with the premise that stocks represent fractional ownership in real businesses. We seek to purchase durable businesses at value prices and hold them for the long term. We believe that owning shares of well-managed businesses with attractive reinvestment rates, purchased at reasonable valuations and held for years to allow the power of compounding to work, is a reliable method for building capital over long investment horizons.

By definition, owning shares of companies for years or even decades means that some, perhaps all, of our investments will traverse rough patches along the way, whether they are specific to a company, an industry or the broader market. We know in advance that we are going to own businesses in periods of rising interest rates, falling interest rates, inflation, disinflation, a weak dollar, a strong dollar, and so forth. Therefore, when we think about purchasing shares of a company, we have to weigh carefully up front whether we think the business can withstand inevitable shocks like the present financial crisis in addition to considering the likelihood the business can grow earnings power (and therefore intrinsic worth) over full cycles. Then company by company we set out to build a durable, all-weather portfolio of businesses that can compound over the long term.

Our Masters' Select Equity Portfolio holds three primary categories of investments:

- Market leaders with strong balance sheets
- "Out-of-the-spotlight" businesses
- Headline risk or contrarian investments

Market leaders with strong balance sheets— In many cases these are global companies with universally known brands, earnings that are well-diversified from the standpoint of product line and geography, and fortress balance sheets. They constitute the majority of the Portfolio, providing a core foundation of stability and offering a high probability of long-term sustainable returns through capital appreciation and dividends, in our opinion.

Costco Wholesale, is a representative holding in the market leader category. It operates membership- based wholesale warehouses in multiple countries. Costco is a low-cost, customer-oriented retailer whose primary competitive advantages stem from its membership model, which is difficult to replicate; its purchasing clout, which increases with size; and its frugal, results-oriented culture. Customers consistently save money by shopping at Costco and it is extremely difficult for competitors to match Costco on price and still make an acceptable return. This strategy offers a compelling value proposition for members as evidenced by their 86% renewal rate and the fact that Costco's approximately 50 million customers pay a total of *$1.5 billion* annually in membership fees for the privilege of accessing Costco's discounts. Interestingly, while Costco members are true value shoppers, they tend on average to be upscale households and small businesses with high levels of everyday spending. In the fiscal year ending in August 2008 Costco generated $72 billion in sales with just 544 stores, meaning the company's average annual sales per store exceeded $130 million. With that type of critical mass, Costco enjoys superior economies of scale and returns on capital relative to

[1] Individual securities are discussed in this piece. 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. The return of a security to a portfolio will vary based on weighting and timing of purchase. This is not a recommendation to buy or sell any specific security. **Past performance is not a guarantee of future results.**

most of its retail competitors. And significantly in these challenging times, Costco has a fortress balance sheet with more than $900 million of net cash.

Other examples of market leaders with strong balance sheets in the Portfolio include Berkshire Hathaway (diversified holding company with major insurance and reinsurance businesses), Microsoft (technology) and Procter & Gamble (consumer products).

Out-of-the-spotlight businesses—After market leaders, the next major category of investments in the Portfolio is out-of-the-spotlight businesses. These are lesser known companies with attractive economics that in our opinion should eventually command higher valuations. Their appeal may take time to gain recognition, often because these businesses are smaller, headquartered in other countries[2] or operate in a mundane non-consumer-oriented industry. Given the right leadership and attractive reinvestment rates, these low-profile holdings can provide the opportunity for the "double play" of expanding multiples on expanding earnings, which can turn a company with a solid earnings growth rate into a stellar investment. EOG Resources, an oil and natural gas exploration and production company, and Transatlantic Holdings, a reinsurer, are current examples of out-of-the-spotlight holdings in the Masters Select portfolio.

Headline risk or contrarian investments[3]— On a very selective basis we make contrarian investments. These often involve controversial situations where the market is discounting a company's share price to reflect a perception of risk that we think is greater than the probable economic risk to the business's long-term fundamentals. Typically a minor portion of our portfolios in percentage terms, headline risk investments can sometimes be difficult for clients to understand because they beg the question, "Don't you read the papers?" But it is precisely because so many other investors automatically sell companies with near-term challenges, however surmountable, that the potential for high returns exists in many such instances. Our job is to ferret out opportunities that represent favorable risk/reward trade-offs and do our best to avoid the value traps. We will not get every investment right. However, overall this distinctly contrarian element of our investment discipline can be an effective and repeatable way to capitalize on herd mentality in the market.

The Bank of New York Mellon is a current example of a headline risk investment in the sense that its share price declined in 2008 along with financials in general. Share price declines are not the same as declines in intrinsic worth. The Bank of New York Mellon is engaged in such mundane but profitable business activities as global custody, securities processing and asset management and is a leader in almost all of its business lines. Operating in 34 countries, the bank is one of four primary global custodians with more than $23 trillion in custody assets and more than $1 trillion in assets under management. We believe the company is well positioned to be a long-term beneficiary of growth in global custody and asset management. Taking into account cost synergies from the merger of The Bank of New York and Mellon Financial in 2007, the combined company is trading at roughly 10 times owner earnings.

Performance Review

To put 2008's performance into some meaningful context it is necessary to distinguish between *security prices* and intrinsic *business values*. Security prices reflect what a buyer is willing to pay for a given business today, and those prices declined substantially last year. Incorporated in those prices, among other factors, is the market's prevailing sentiment, which can vacillate from extreme optimism to extreme pessimism. In the dot-com bubble of the late 1990s investors were willing to pay euphoric prices for businesses with no profits. Today we are living through a time of such fear that indiscriminate selling is

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[2] *Companies operating, incorporated or principally traded in foreign countries may have more fluctuation as foreign economies may not be as strong or diversified, foreign political systems may not be as stable and foreign financial reporting standards may not be as rigorous as they are in the United States.*

[3] *While we research companies subject to such contingencies, we cannot be correct every time, and a company's stock may never recover.*

driving down prices for companies that have strong balance sheets, generate annual profits in the billions of dollars and enjoy favorable long-term growth prospects.

Does the fact that share prices have declined necessarily mean that businesses have become permanently less valuable? The answer is it depends on the situation. A business's intrinsic worth is equal to the sum of *all* future cash flows. Typically, business values tend to change much more gradually than security prices because a single quarter's or year's earnings represents only one portion of a going concern's cumulative earnings power. Therefore, the key question for investors to ask in the current environment is whether security price changes accurately reflect changes in long-term earnings power and, by extension, intrinsic business values. With the vast majority of our holdings we do not believe they do, although we are prepared to acknowledge certain instances where a dramatic and permanent impairment of earnings power has in fact occurred.

On the plus side, JPMorgan Chase and Berkshire Hathaway are two formidable financial services giants that are likely to get stronger in the current environment precisely because so many of their competitors have left the playing field. JPMorgan Chase took over Bear Stearns and Washington Mutual at deeply distressed prices in 2008 and has the balance sheet strength to consolidate more of the industry if further opportunities arise. Berkshire Hathaway recently made capital infusions into General Electric and Goldman Sachs at what we consider highly favorable terms. Despite these facts, the share prices for both JPMorgan Chase and Berkshire

Hathaway declined by double-digit percentages in 2008. In our view, there is a marked disconnect between price and value in these and similar instances, which supports Ben Graham's description of the stock market as a voting machine in the short term, measuring how people feel. In contrast Graham notes that in the long term the market is more like a weighing machine, valuing businesses according to their earnings power. We are confident that the market should eventually reward businesses whose profits are on a long-term growth trajectory, arguably even more so starting from such modest valuation levels.

We have sought to position the Portfolio conservatively in high-quality, durable businesses using bottom-up stock selection and to maintain prudent diversification.[4] As the financial crisis unfolded, our selective approach helped us avoid a number of ill-fated businesses that appeared dangerously leveraged according to our research. For instance, when the mortgage crisis hit, we had consciously steered clear of Countrywide and Washington Mutual. As the crisis spread, we had intentionally avoided Bear Stearns, Lehman Brothers, Fannie Mae, and Freddie Mac.

Despite some notable successes of omission, we had our share of disappointments in 2008 as well. The most significant of these were American International Group (AIG) and Merrill Lynch, both of which suffered in its own fashion from the spreading crisis in the capital markets. AIG, the Portfolio's biggest loss, assumed a large degree of hidden leverage in its financial products unit in recent years that ultimately led this company, which generates $100 billion in annual revenues, to seek the safety of a government-orchestrated bailout that, among other things, gave the U.S. government 80% ownership of the company. The massive dilution of that transaction alone means AIG has become dramatically less valuable to shareholders as a business. Merrill Lynch was forced into a shotgun marriage with Bank of America. We believe the combined entities make economic sense but recognize that Merrill as a standalone business would have declined markedly in intrinsic worth.

Our experience with these companies reinforces a cold hard reality about investing: It is a process involving probabilities, not certainties, to the extent that even deep fundamental research has its limitations. We are in a business where getting two out of three investments right can yield exceptional results but where some mistakes are inevitable as well. Hence, while we expect the overall Portfolio to produce satisfactory risk-adjusted returns over the long term, we know that this result, if realized, will doubtlessly be the byproduct of

[4] Diversification does not ensure against loss.

some clear investment successes, some marginal successes and mistakes, and some outright mistakes. To the best of our ability we seek to research companies thoroughly; to be a learning organization that admits, analyzes and learns from its mistakes–indeed, we maintain a “mistake wall” in our research department–and to weight the Portfolio in favor of our highest conviction investments.

Maintaining a Long-Term Perspective

Building long-term wealth with a portfolio of businesses is like driving an automobile. If investors focus too narrowly on the stretch of road a few feet ahead, they run the risk of making unnecessary adjustments and oversteering. Only by lifting our eyes to see the road further ahead are we likely to reach our ultimate destination. While returns in any given year can be poor, the long-term outlook for equities remains attractive in our opinion, more so in fact starting from today’s lower level of valuations and expectations.

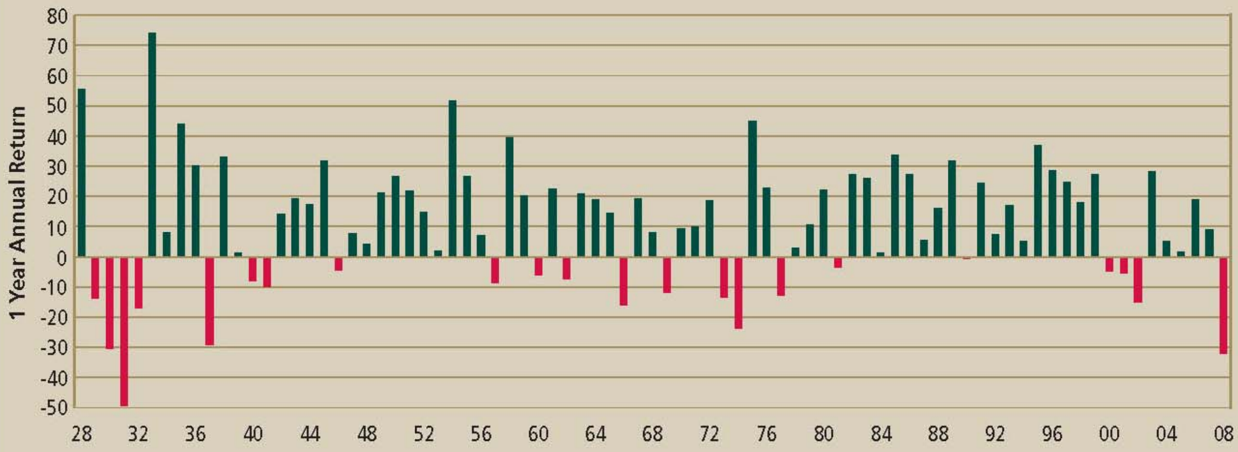
It is important to bear in mind that 2008 was extraordinary in many respects. The norm over multiyear periods generally favors growth and positive equity returns. Moreover, historical data suggest that the probability of achieving positive returns on equities increases *the longer one’s investment horizon*, which is a strong endorsement for being patient and staying the course.

The chart below illustrates this point by showing the percentage of time from 1928 through the end of 2008 the Dow Jones Industrial Average produced positive returns over one year and five year holding periods. Extending one’s horizon from one to five years increased the historical chances of realizing a positive return in the market from 73% to 92%. In weathering challenging periods like the present, it is useful to remain focused on the long term since stocks have generally rewarded patient investors.

Dow Jones Industrial Average Performance (1928–2008)

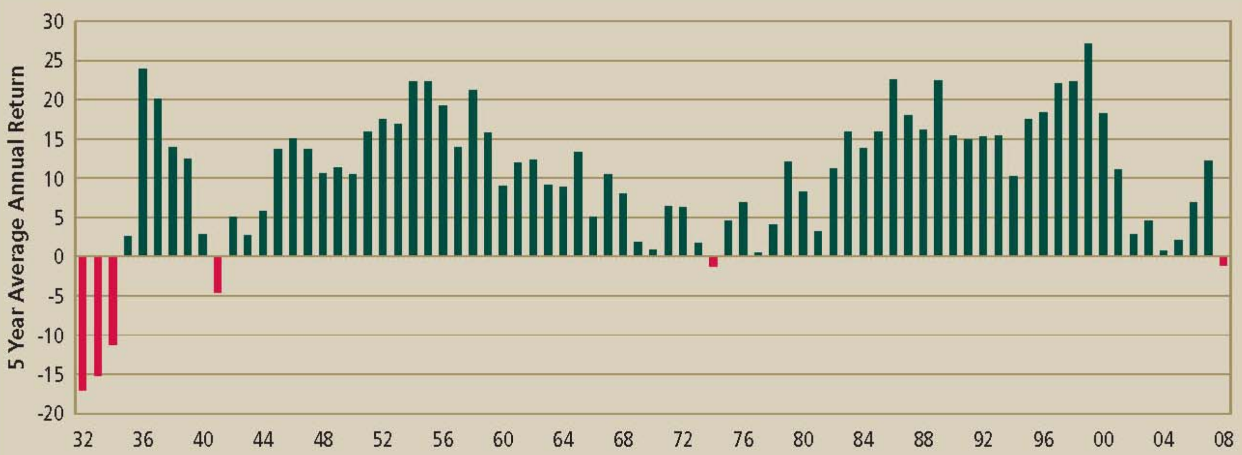
Holding Period	Percent of Time the DJIA Generated Positive Results
One Year	73%
Five Year	92%

One Year Returns for the Dow Jones Industrial Average (1928–2008)



In 59 out of 81 One Year Periods (73% of the Time), the Market Delivered a Positive Return

Five Year Returns for the Dow Jones Industrial Average (1932–2008)



In 71 out of 77 Five Year Periods (92% of the Time), the Market Delivered a Positive Return

Source: The performance was obtained from a combination of sources, including, but not limited to, Thomson Financial, Lipper and index websites. Returns are annualized total returns. **Past performance is not a guarantee of future results.**

The charts represent data from January 1, 1928 through December 31, 2008.

Concluding Thoughts

As long-term investors we seek to be realists, not optimists or pessimists, so that we set proper expectations and are capable of making rational decisions through inevitable market and economic cycles. One realistic perspective is that the principles of value investing hold even in markets when returns are poor. Second, a rational approach of investing in well-managed, durable businesses with attractive reinvestment rates has historically proven an effective method for compounding capital over long holding periods, and that fact has not changed in spite of bear markets, extreme price volatility, credit crunches, recessions, and so forth. Lastly, as Warren Buffett has famously said, the key to success in investing is to be “fearful when others are greedy and greedy when others are fearful.” We are now in a time of great fear and we know that purchasing shares of compounding machines at lower prices should, all other things being equal, *improve* the risk/reward trade-off for investors–a fact that prompted investor Shelby Cullom Davis to remark, “You make most of your money in a bear market, you just don’t realize it at the time.”