

Investing in Today's Global Economy

By Shelby M.C. Davis
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Introduction

Looking back at my long career on Wall Street beginning in the 1950s I can offer certain key lessons that helped make me a more successful investor and that I believe have perennial applicability. Chief among these is that successful investing starts with the discipline of being a *realist*, basing one's view on facts, data and research, and not staking out overly simplistic positions like blind optimism or stubborn pessimism. Optimism is dangerous if it leads to thinking that risks are either highly improbable or worse, not present at all. The Internet bubble of the late 1990s and the valuations many paid to own shares of Internet-related companies—some of which generated no profits—showed a degree of complacency toward risk that bordered on suspension of disbelief on a mass scale. That, like other bubbles before it, ended in a painful correction once reality set in. Even in less frothy times, businesses do battle to maintain their earnings power in the face of ongoing risks such as competition, disruptive technologies or both. The Big Three automakers have become shells of their former selves due to competition from abroad. Eastman Kodak, a former giant in the world of film, has had to adapt to the digital age or face extinction. AOL, which just 10 years ago was the dominant player among Internet service providers, now struggles to remain relevant to consumers who can obtain high-speed Internet service from any number of providers. As long as the world keeps changing, there is risk.

Conversely all significant periods of stock market history have come with their fair share of big

opportunities to make money as well.¹ Even periods marked by severe economic, social and political strife have offered fortunes to enterprising investors with the nimbleness and independence of mind to adapt to the circumstances. The decade of the 1970s comes to mind with stagflation, the OPEC oil embargo, the Vietnam War, and the hostage crisis. While many of the headlines at the time were negative, stock pickers who looked hard enough could make money. For instance, Davis Advisors owned many energy and natural resource-related businesses at the time that vastly outperformed the broader market.¹ The savings and loan (S&L) crisis of the late 1980s is another case in point. In the depths of turmoil, more than a thousand undisciplined lenders went bankrupt under the weight of bad loans, yet banks like Wells Fargo and S&L Golden West Financial (now part of Wachovia Corp.) that had built up good balance sheets and maintained strong underwriting disciplines not only survived, but thrived by taking market share. So opportunity resides even in the harshest of market environments, a fact that once prompted my father, Shelby Cullom Davis, to remark, "You make most of your money in a bear market, you just don't realize it at the time."

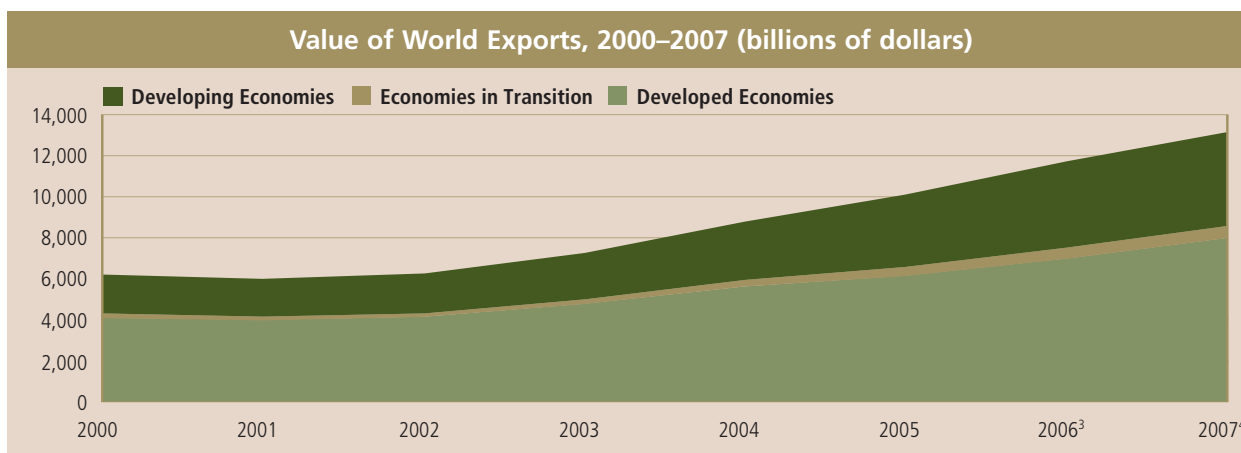
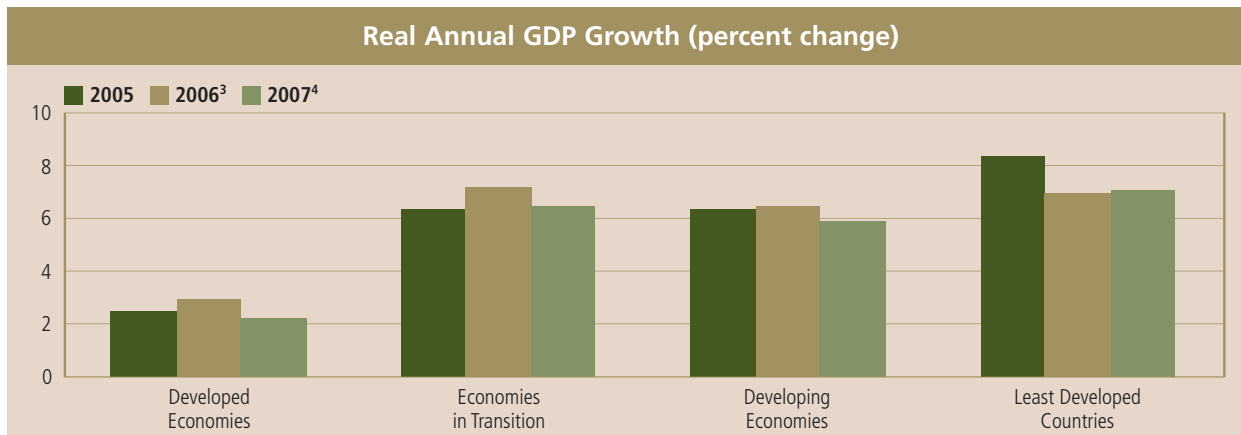
In short, both opportunity and risk are ever present in a realist's world. Our job as investors is to handpick situations where we feel the facts and the data suggest the risk/reward trade-off is strongly tilted in our favor. By owning enough of these investments and continually looking for more, Davis Advisors' aim is to maximize the likelihood that our clients will enjoy the substantial rewards of consistent long-term compounding.

¹Past performance is not a guarantee of future results.

Today's Global Economy

Each decade is different, so we need to be in touch with business realities as they are *in our time* and to think critically about what they mean for the future. When my father started his investment career in the late 1940s, he saw a big opportunity to invest in insurance companies whose future profits would soar as a result of millions of GIs returning from the Second World War, starting families and buying homes, cars and other insurable property. His approach, which we still practice at Davis Advisors, was to own well-managed companies led by “doers” (not “bluffers”) that he could accumulate when the companies were underappreciated by the market. Over the course of his career he amassed a fortune of more than \$800 million in such opportunities starting with only \$100,000.²

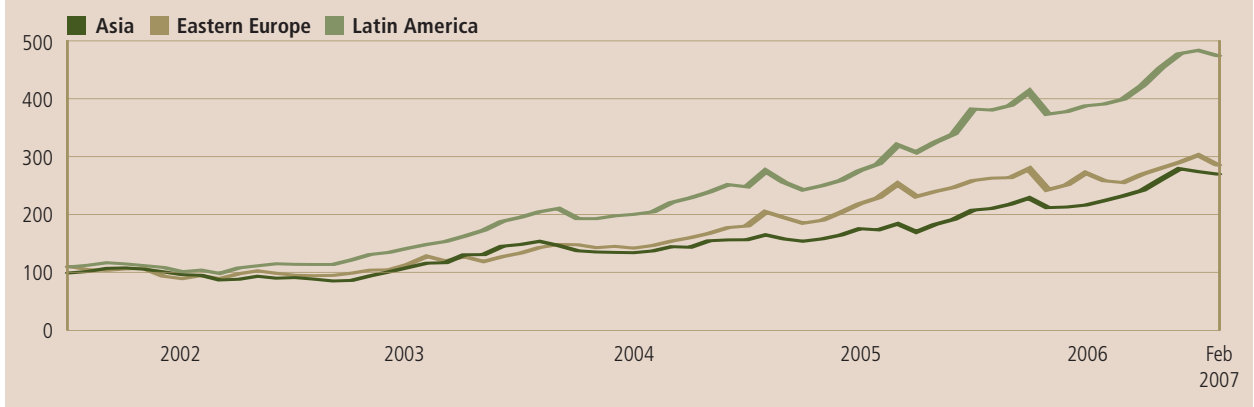
The world today presents a very different picture than when my father started in the investment business. For one we are operating in a truly global economy and may be witnessing a unique moment in history in that never before have so many countries been as fiscally healthy, oriented toward free market capitalism and open to cross-border flows of capital, goods, services, technology, and ideas as they are now. These tailwinds have combined to create a massive wave of growth whose effects can be seen in the growth of real GDP and world exports. Within this broader theme of globalization is the noteworthy subtheme of fast-developing countries in the Far East, Latin America, Central and Eastern Europe, and the Middle East playing a larger role in the world economy.



Source: United Nations World Economic Situation and Prospects, 2007.

²Shelby Cullom Davis borrowed \$100,000 in 1947 and turned it into an \$800 million fortune by the year 1994. While Shelby Cullom Davis' success forms the basis of the Davis investment discipline, this was an extraordinary achievement and other investors may not enjoy the same success. ³Partly estimated. ⁴Forecast.

Emerging Equity Markets (2001 = 100; national currency)



Source: International Monetary Fund, World Economic Outlook: Spillovers and Cycles in the Global Economy (April 2007).

The implications of a global economy are far-reaching and are likely to manifest themselves in phases. Over the past decade much of the impetus for corporations seeking out partners in the developing world had to do with moving production offshore to countries that possess a comparative advantage in low-cost labor. China has become a de facto manufacturing base for much of the developed world. The major story in the decades ahead may be one of transition, where so-called developing countries take their place on the world stage alongside developed economies and move beyond being just convenient trade partners to become deep markets unto themselves for global consumers, businesses and investors. To the extent that major regional stock exchanges become deeper and more integrated, global custody becomes more prevalent and information technology reduces the distance, so to speak, between different parts of the world, investment opportunities should abound.⁵

Globalization, however, ushers in a new set of risks as well. Lower barriers to competition mean that capitalism's force of creative destruction will flow from market to market causing dislocations along the way. From developing countries will spring a new generation of global

competitors, some of which will doubtlessly be savvy enough to imitate and innovate on the models of well-established businesses. The cell phone market is a good example of how quickly competitive positions can change. In the late 1990s Motorola, based in the United States, and Nokia, headquartered in Finland, dominated the market for mobile phones globally, each with approximately a 30% market share, dwarfing the next closest competitors. Since that time Nokia's market share has risen while Motorola's has eroded, not only because of better execution on Nokia's part but also as a result of new competition from Samsung and LG, two South Korean companies that were virtually unknown outside of their home country as recently as 2000. Today Samsung's market share in handsets rivals that of Motorola and this growing South Korean industrial conglomerate could realistically surpass a longtime American icon.

In addition to the competitive risks that globalization introduces, integrated capital markets coupled with lightning speed communications mean that freely flowing capital could exert a greater influence over the pricing of assets, interest rates and currencies than was the case in decades past. The 1997–1998 Asian crisis gave

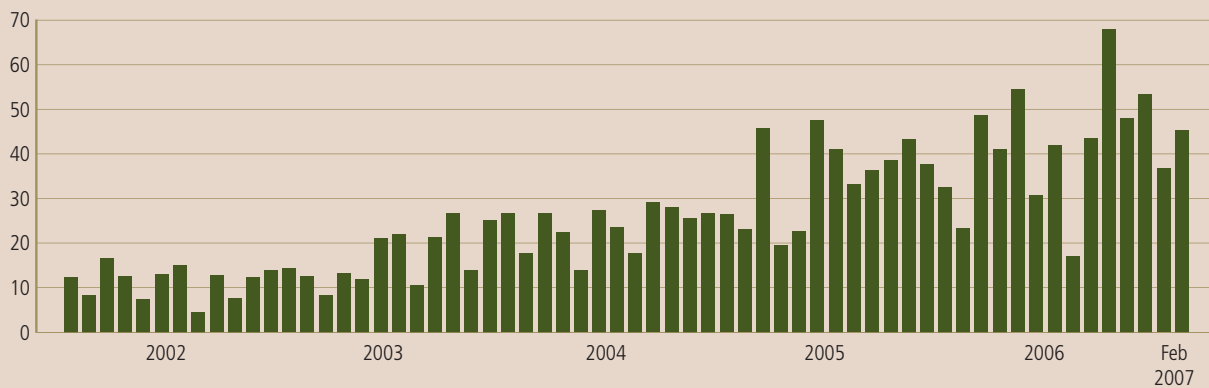
⁵Investing in foreign securities is subject to certain risks not associated with domestic investing, such as currency fluctuations and changes in political and economic conditions.

us an early glimpse of the brutal force with which capital flows can impose fiscal discipline on countries whose balance sheets become too leveraged, causing deep recessions in some cases. That particular episode culminated in the Russian government's bond default and the disintegration of Long-Term Capital Management. Since last summer we have seen how a slowing residential housing market in the United States can destabilize unsuspecting financial institutions in Europe through the asset-backed securitization and collateralized debt obligation markets. The long-term trajectory of cross-border capital flows has been up, but not without punctuated bursts of turbulence. As investors we need to

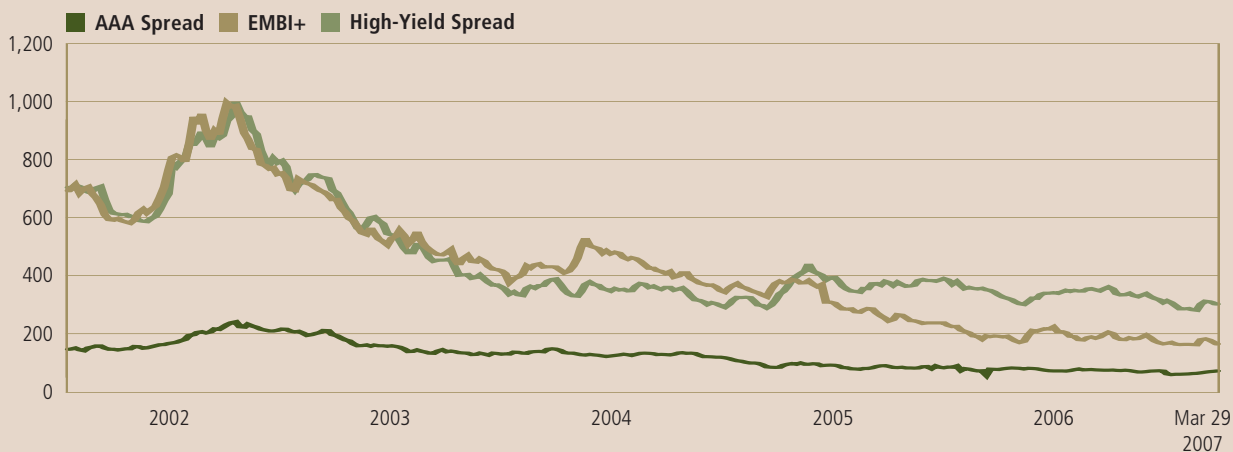
factor this into our thinking and make sure the companies we choose to own are built to last.

Last but not least, rapid growth in developing countries means that many countries will be competing for raw materials like oil and metals and natural resources like food and water. While the world has vast reserves of these things, supply is not infinite and ramping up production to meet demand growth is not something that happens overnight. Depending on how things develop, pockets of inflation could form as we saw in the 1970s and corporate profit margins could become vulnerable to higher cost inputs.

Emerging Market Financing (billions of U.S. dollars)

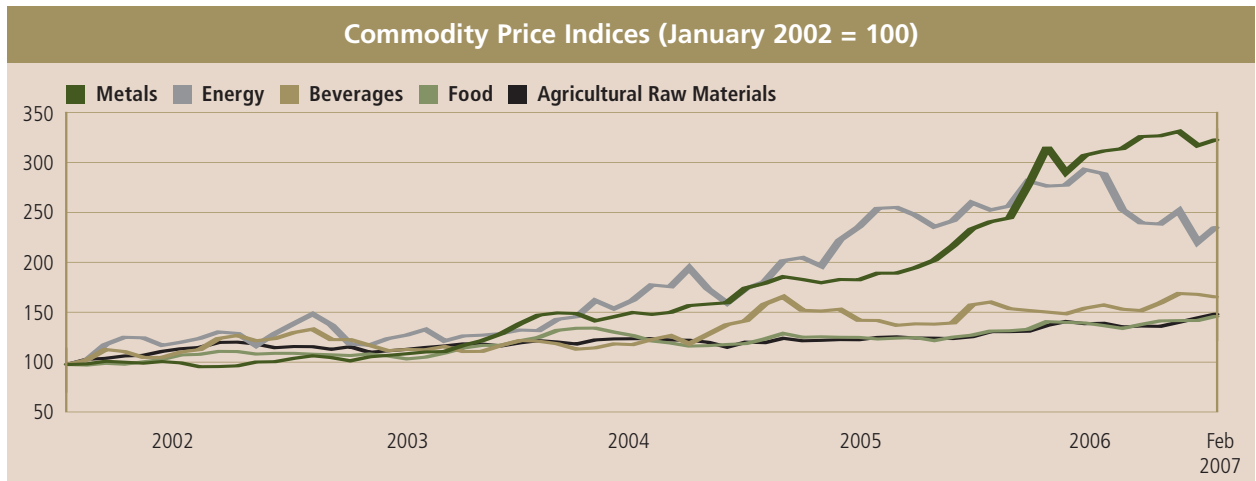


Interest Rate Spreads (basis points)



Source: International Monetary Fund, World Economic Outlook: Spillovers and Cycles in the Global Economy (April 2007).

(charts continued on next page)



Source: International Monetary Fund, World Economic Outlook: Spillovers and Cycles in the Global Economy (April 2007).

A Global Framework for Investing

There are two primary ways to navigate these relatively uncharted waters as long-term equity investors in our opinion. The first is to own well-managed global multinationals that have the size and breadth to participate in the world's long-term growth and also have the durability to withstand inevitable shocks and setbacks, whether they relate to volatility in the capital markets, terrorism, supply disruptions, natural disasters, or war. We believe multinationals with strong balance sheets (which can allow them to raise capital through various market environments) that show an ability to adapt, have the stability of diversified earnings sources and manage locally but think and position themselves globally are the model for the next generation of global leaders and deserve a premium valuation. Right now the market is not rewarding big cap multinationals with a premium on balance. Indeed the group as a whole has lagged other areas of the market in recent years, but there is a silver lining in this fact:

Reasonable valuations generally mean we are starting from a point of relatively modest expectations, which in turn can mean better risk/reward ratios as well as the potential for the double play of expanding multiples on expanding earnings.

Some of the finest multinationals with strong overseas operations are U.S.-based. Today nearly 45% of the sales of S&P 500® Index companies come from outside U.S. borders. Given this fact it would be a mistake in our opinion to limit research only to a company's U.S. operations since a significant (and in many cases growing) part of the franchise's value may depend on how those businesses fare in other parts of the world. For this reason our research effort at Davis Advisors is global in scope and takes into account the reality that countries outside the United States, which represent the other 96% of the world's population, will play an increasingly important role even for U.S.-based multinationals.

U.S. Companies with Overseas Revenue

Company	Industry	Estimated % Revenue from Outside U.S.
Intel	Semiconductors	79.0
Coca-Cola	Beverage Manufacturing	72.3
ExxonMobil	Oil and Gas	69.0
Schlumberger	Oil and Gas Services	67.0
McDonald's	Restaurants	65.5
Hewlett-Packard	Computer Equipment	65.0
3M Company	Diversified	61.4
United Technologies	Diversified	60.0
E.I. du Pont de Nemours	Chemicals	60.0
Altria Group	Tobacco	58.0
Procter & Gamble	Household and Personal Products	57.0
IBM	Computer Equipment	57.0
Caterpillar	Construction Machinery	53.0
Aon	Insurance (General)	53.0
FPL Group	Electric Utilities	52.0
American International Group	Insurance (Property)	49.0
Oracle	Business Applications	48.0
Praxair	Chemicals	48.0
Google	Business/Online Services	47.0
Abbott Laboratories	Drugs	47.0
American Express	Finance	47.0
News Corporation	Media Conglomerates	47.0
General Motors	Auto Makers	47.0
Symantec	Systems and Security	47.0
Pfizer	Drugs	46.6
General Electric	Electric Equipment	46.0
Bristol-Myers Squibb	Drugs	46.0
Cisco Systems	Data Networking	45.0
Johnson & Johnson	Drugs	45.0
Eli Lilly & Company	Drugs	45.0
eBay	Online Retail	43.0
Yum Brands	Restaurants	43.0
Apple Computer	Computer Equipment	40.0
Merck & Co.	Drugs	39.0
Boeing Co.	Aerospace and Defense	38.0
PepsiCo	Beverage Manufacturing	37.0
Merrill Lynch	Securities	37.0
Medtronic	Medical Equipment	36.0
Dell	Computer Equipment	35.0
Microsoft	Business Applications	34.0
Kraft Foods	Food Manufacturing	33.0

Source: Morningstar.

While many of the finest multinationals are headquartered and listed in the United States, quite a few are not. All major global multinationals irrespective of country of origin should be on our list of potential investment candidates. What matters most when investing is the ability to make informed judgments about management quality, durability of business models (including where and how a business earns its money), sustainability of competitive advantages, and valuation.

Nestlé is a Swiss company in terms of country of listing but it can hardly be called a proxy for the Swiss economy considering it generates \$80 billion of annual revenues, employs a workforce of more than 265,000 and has operations in virtually every inhabited country in the world. Procter & Gamble owns 23 “billion dollar” global brands in its product portfolio and generates roughly half of its sales outside the United States, with as much as 40% of the company’s

incremental sales growth coming from fast-growing developing countries. American International Group, a global leader in property, casualty and life insurance as well as annuities and other financial services, is based in New York but operates in more than 130 different countries. WPP Group, one of the best-run global media, market research and advertising conglomerates in the world, has offices in every major region. It is one of only four companies with the scale and breadth of resources capable of serving multinationals seeking to promote their brands in a consistent and effective fashion around the globe. Headquartered in the United Kingdom, WPP is an important partner for large corporations in developed markets and developing markets alike. The company derives about 20% of its business from emerging markets—which it intends to grow to one-third—and has become the number one advertising firm in China, India, Brazil, and Indonesia. It is on track to become number one in Russia.

Global Fortune 50

Rank	Company	Revenues (\$ millions)	Rank	Company	Revenues (\$ millions)
1	Wal-Mart	351,139.0	26	ENI	109,014.2
2	ExxonMobil	347,254.0	27	UBS	107,834.8
3	Royal Dutch Shell	318,845.0	28	Siemens	107,341.7
4	BP	274,316.0	29	State Grid	107,185.5
5	General Motors	207,349.0	30	Assicurazioni Generali	101,810.7
6	Toyota Motor	204,746.4	31	JPMorgan Chase	99,973.0
7	Chevron	200,567.0	32	Carrefour	99,014.7
8	DaimlerChrysler	190,191.4	33	Berkshire Hathaway	98,539.0
9	ConocoPhillips	172,451.0	34	Pemex	97,469.3
10	Total	168,356.7	35	Deutsche Bank	96,151.5
11	General Electric	168,307.0	36	Dexia Group	95,846.6
12	Ford Motor	160,126.0	37	Honda Motor	94,790.5
13	ING Group	158,274.3	38	McKesson	93,574.0
14	Citigroup	146,777.0	39	Verizon Communications	93,221.0
15	AXA	139,738.1	40	Nippon Telegraph & Telephone	91,998.3
16	Volkswagen	132,323.1	41	Hewlett-Packard	91,658.0
17	Sinopec	131,636.0	42	IBM	91,424.0
18	Crédit Agricole	128,481.3	43	Valero Energy	91,051.0
19	Allianz	125,346.0	44	Home Depot	90,837.0
20	Fortis	121,201.8	45	Nissan Motor	89,502.1
21	Bank of America	117,017.0	46	Samsung Electronics	89,476.2
22	HSBC Holdings	115,361.0	47	Credit Suisse	89,354.4
23	American International Group	113,194.0	48	Hitachi	87,615.4
24	China National Petroleum	110,520.2	49	Société Générale	84,485.7
25	BNP Paribas	109,213.6	50	Aviva	83,487.0

Source: *Fortune* Magazine, July 23, 2007. The original list as published included the Global Fortune 100, which we have abbreviated to the Global Fortune 50. These are not recommendations to purchase or sell any securities and are presented for illustrative purposes only.

In our view multinationals represent a logical core for a portfolio that seeks to participate in world growth in a sensible, risk-adjusted way. It is not the only way to invest in today's global economy, however. Thanks to advances in technology, market exchanges and communications, investors based in New York, London, Tokyo, Toronto, Hong Kong, Sydney, Dubai, or any number of other locations can now own shares of foreign companies that may be more specialized, either in terms of their regional focus or in the particular products and services they offer. Banks, port operators, satellite television companies, logistics providers, capital equipment makers, and real estate developers are just a few examples of opportunities our research team has uncovered in different parts of the globe. Some of these are by definition more specialized investments and should offer potentially higher returns given a somewhat higher risk profile, but they can have a place in a well-diversified portfolio. Once the privilege of large institutional investors, investing across borders is now possible for people on Main Street through ownership of mutual funds that specialize in global or regional markets.

In short, the business world today is already a global reality. In the investment world it may take some time before perception catches up to reality and many investors—even sophisticated institutions—may continue to apply out-of-date labels like country of listing for a time. At Davis Advisors we believe such distinctions will eventually fade.

Creating Generations of "Internationalists"

As a side note, a global economy poses new challenges that go well beyond the scope of investing. Social, political and economic forces will shape the future of nations in ways that few people in any one country can predict. I feel strongly about preparing generations to come

for the new challenges they will face, so much so that I established a philanthropic organization known as the Davis United World College Scholars Program to promote international diversity and to foster greater understanding among the world's future decision makers—Americans and citizens of other nations. The program provides scholarships to students from both the United States and other countries who have proven themselves by completing their last two years of high school at a group of international schools called the United World Colleges (UWC).

The UWC schools now have campuses in the United States, Bosnia, Canada, Costa Rica, Hong Kong, India, Italy, Norway, Singapore, Swaziland, the United Kingdom, and Venezuela. Since the founding of the first UWC in 1962 at the height of the Cold War, UWC schools have provided opportunities to students from some 175 countries representing all regions of the world. In recent years we expanded the program to provide needs-based support to UWC scholars who gain acceptance to and matriculate at more than 75 leading colleges and universities in the United States. The legacy of this philanthropic effort—which has grown to become the largest international scholarship program of its kind—is twofold: It helps American students gain a global perspective by offering them the chance to learn side by side with citizens from around the world while at the same time providing students from other countries access to the caliber of higher education available in this country. Currently approximately 1,500 students are enrolled in the program. At the rate we are going, in my lifetime I will have probably helped 40,000 to 50,000 students and spent more than a billion dollars doing it. Those are staggering figures to imagine, yet only a drop in the bucket in a world of more than six billion people. Nonetheless we have to start somewhere. (For more information please visit <http://www.davisuwcscholars.org>.)

Closing Remarks

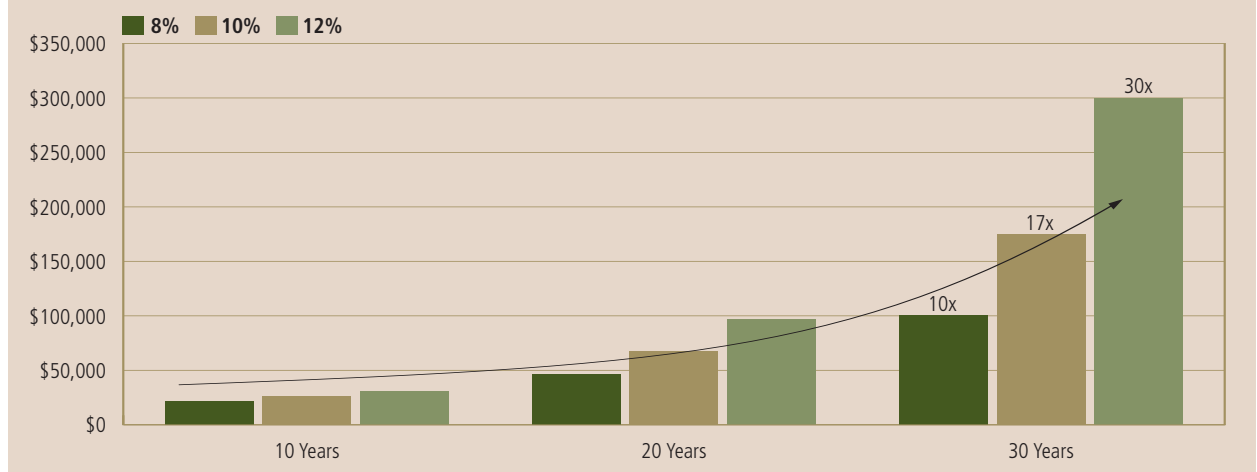
As noted earlier, our job as long-term investors is to chart a prudent course that strikes a favorable balance between the available opportunities and the ever-present risks. Looking at today's world we are by all measures living in very interesting times. Globalization has arrived in earnest and will open many doors for fortunes to be made but it will also introduce new competitive and systemic risks. As realists we need to take both into consideration at all times.

Although conditions may change from time to time, the mission of Davis Advisors will always remain the same. We aim to give our clients the benefits of compounding over long time horizons. Our approach, which we have honed and refined over the course of decades, is to purchase

durable businesses at value prices and hold them for the long term. If we compound our clients' money at an 8% average rate of return, their initial investment will increase tenfold over the next 30 years, all other things being equal. A 10% average return would result in a 17-fold increase and a 12% average return a 30-fold increase.⁶ Given the enormity of these possible rewards, we at Davis Advisors focus every day on seeking out long-tailed opportunities wherever they may lie in today's global market, all while taking precautions to manage risk judiciously.

On behalf of our entire organization, I thank you for your support and look forward to continuing our long journey together as investors. ■

Growth of a Hypothetical \$10,000 Investment at Various Annualized Rates of Return (and multiples of initial investment)



⁶The graph above represents hypothetical investments and hypothetical returns. Equity markets are volatile and an investor may lose money. This graph is not intended to predict or project any investments results.



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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 regarding the investment prospects of our portfolio holdings and the market in general include "forward looking statements" which may or may not be accurate over the long term. 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. These opinions are current as of the date of this report but are subject to change.

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Some of the important risks of an investment in a Selected Fund may be: market risk: the market value of shares of common stock can change rapidly and unpredictably as a result of political or economic events having little or nothing to do with the performance of the companies we invest in; company risk: the market values of a common stock vary with the success or failure of the company issuing the stock. As a result, the success of the companies in which the Fund invests largely determines the Fund's long-term performance; small and medium-capitalization risk: smaller companies typically have more limited product lines, markets and financial resources than larger companies, and their securities may trade less frequently and in more limited volume than those of larger, more mature companies; financial services risk: investing a significant portion of assets in the financial services sector may cause a fund to be more volatile. Securities within the financial services sector are more prone to regulatory action in the financial services industry, more sensitive to interest rate fluctuations and are the target of increased competition; foreign country risk: foreign investing may involve more volatility as the foreign economies may not be as strong or diversified, political systems may not be as stable and the foreign capital markets may not be as well developed; headline risk: the Funds may invest in a company when it becomes the center of controversy after receiving adverse media attention or when the company is involved in litigation. While we research these companies, their stock may never recover. Not every fund is subject to these risks. Each fund may be subject to other risks not mentioned. See the prospectus for a complete listing of the principal risks.

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 toward stocks with large-market capitalizations and represents approximately two-thirds of the total market value of all domestic common stocks. Investments cannot be made directly in the S&P 500® Index.

Shares of the Selected 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.