Davis Appreciation and Income Fund

Update from Portfolio Managers

Christopher Davis, Peter J. Sackmann, CFA
and Creston A. King III, CFA

Davis FUNDS

THE EQUITY SPECIALISTS™

Davis Appreciation and Income Fund

Annual Review 2017

Portfolio Results

Davis Appreciation and Income Fund returned 9.20%, outperforming a traditional balanced fund benchmark (60% S&P 500 Index and 40% Barclays Aggregate Bond Index) in 2016.[1]

Our disciplined approach to bottom-up active management has not always been rewarded by the market over shorter periods. However, we believe the durability and growth of the individually selected companies that make up Davis Appreciation and Income Fund strongly position the Portfolio to participate in the U.S. stock market's returns over the years to come while mitigating downside risk with select high-grade fixed income securities and cash. ■

Investment Outlook

Selectivity in both equity and fixed income markets is critical. Avoid overpriced dividend darlings and expensive companies with peak profit margins. Technology and globalization are disrupting industries at an unprecedented rate.

When evaluating the investment landscape, we do not make investment decisions based on short-term forecasts, which history has shown can be unreliable. Instead, we focus on the important and knowable and maintain a long-term perspective.

In today's market, our long-range assumptions include:

- Selectivity is essential for both equity and fixed income securities.
- Opportunities in today's market include global leaders selling at bargain prices, dominant lesser-known businesses in necessary economic niches, blue chips of tomorrow and beneficiaries of short-term misperceptions.[2]
- Risks in today's market include companies with near peak margins and overvalued dividend darlings that are riskier than they appear. The 25 most commonly held stocks in the five largest dividend-focused exchange traded funds are valued at 25 times earnings, a P/E ratio significantly higher than the market.
- Technology and globalization are reconfiguring industries at an unprecedented rate. Many longstanding brands and business moats are being disrupted in unexpected ways. For example, in recent years iconic companies in the newspaper, retailing and media industries have all become obsolete. At the current rate of change, 75% of the S&P 500 Index may be replaced in the coming decade. To succeed, investors should avoid conventional thinking and remain flexible. ■

The average annual total returns for Davis Appreciation and Income Fund's Class A shares for periods ending December 31, 2016, including a maximum 4.75% sales charge, are: 1 year, 4.02%; 5 years, 6.50%; and 10 years, 3.08%. 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 total annual operating expense ratio for Class A shares as of the most recent prospectus was 0.87%. 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 or call 800-279-0279.*

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. **Past performance is not a guarantee of future results. 1.** Class A shares not including a sales charge. **Past performance is not a guarantee of future results.** The Combined Index is a composite blend of 60% of the S&P 500 Index and 40% of the Barclays U.S. Aggregate Bond Index and represents a broad measure of the U.S. stock and bond markets, including market sectors in which the fund may invest. During the time period the Fund underperformed its benchmark, the S&P 500 Index. See endnotes for descriptions of the indices, peer group, and category. **2.** While we research companies subject to such contingencies, we cannot be correct every time, and a company's stock may never recover.

The Portfolio

Global leaders trading at bargain prices. Dominant lesser-known businesses. Blue chips of tomorrow. Beneficiaries of short-term misperceptions.

Davis Appreciation and Income Fund seeks to own durable, well-managed businesses that can be purchased at attractive prices and held for the long term.

The Fund is structured as a traditional balanced portfolio with approximately 65% of assets currently invested in equities and roughly 35% in cash, fixed income securities and other assets. The Fund's equity holdings are structured to grow the value of shareholders' capital by investing in strong businesses at attractive prices. Most of our equity securities also pay dividends or have demonstrated the capacity to do so, which should increase over time. Other, more defensive asset classes round out the Portfolio and are intended to mitigate risk and enhance capital preservation.[3]

Global Leaders Trading at Bargain Prices—The Fund's holdings include some of the strongest and best-known companies in the world. Short-term economic concerns over the past year have reduced the share prices of many global leaders to bargain levels at a time of high valuations for the average company. Buying top-tier businesses at bargain prices should be a goal for long-term investors in any environment.

An example of a global market leader in the Portfolio is Berkshire Hathaway, a diversified holding company with interests in insurance, reinsurance, railroads, utilities, manufacturing, retailing, and a host of other business lines.[4] Under the strong leadership of Warren Buffett and his first-class management team the company has compounded book value at almost 20% per year on average over the last 50 years. During that time Berkshire has quietly evolved from a textile manufacturer to a well-run insurance operation and more recently to a diversified business with almost two-thirds of its earnings generated by nonfinancial operations. We believe Berkshire is a financial powerhouse and well positioned for continued steady growth over the next decade.

Microsoft, another global market leader in the Fund, is one of the world's largest software companies. While many of its products such as Microsoft Word, Excel, Skype, Bing, and Internet Explorer are widely used on a daily basis by individual PC owners, the majority of Microsoft's revenue is generated from the company's solid position serving businesses both large and small. Most Fortune 500 companies, for example, license an array of Microsoft products to help run their corporate, exchange and database servers as well as using software that enhances productivity such as Microsoft Office. This widespread and entrenched use of Microsoft's information technology software by companies provides predictable and recurring revenue streams through licensing fees. In addition to these core businesses, Microsoft has begun expanding its cloud computing capabilities, which we expect will enhance shareholder returns over the long term.

Dominant Lesser-Known Businesses—The Portfolio's investments also include lesser-known businesses that dominate dull but necessary niches in the global economy. Whether these companies participate in unglamorous industries or are headquartered in different countries, the businesses are not household names. As a result, their shares often trade at a discount to better-known companies despite having the same qualities of market dominance and durability as the global leaders described above. These businesses combine the relevance and resilience of blue chip companies with below-average valuations.

A representative business in this category is PPG Industries, a more than century-old business that manufactures and distributes coatings, specialty materials and glass products for the automotive,

3. While Davis Advisors attempts to manage risk, there is no guarantee that an investor will not lose money. Equity markets are volatile and the investment return and principal value of an investment will vary. Diversification does not ensure against loss. **4.** 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 the Fund will vary based on weighting and timing of purchase. This is not a recommendation to buy, sell or hold any specific security. **Past performance is not a guarantee of future results.**

industrial, aerospace, and commercial building industries, among others. PPG benefits from a deep competitive moat and should grow shareholder value over time through both organic growth in the company's traditional end markets and sensible tuck-in acquisitions made for the purpose of merging the business with one of the company's existing divisions.

Blue Chips of Tomorrow—Another theme is fast-moving companies that use innovation to disrupt the economics of larger but less agile competitors. Capitalism is a process of constant change that rewards businesses that can adapt. Over decades, we have seen many examples of today's disrupters emerging as tomorrow's blue chips. Several of Davis Appreciation and Income Fund's core holdings, particularly in the online retailing and social media sectors, currently reflect this theme.

Alphabet, the parent company of Google, globally dominates the business of online search with a market share of more than 65%. The company's Google search engine allows users to search the World Wide Web for free but charges advertisers for placing ads on the search results page. Advertisers gladly pay for this ad placement as their ads are displayed only when searches are relevant to their business. This makes Alphabet a new generation media company in our view with a business model that is exceptionally well positioned to capitalize on the continuing transition from traditional print and television media to internet-based content and advertising.

Amazon.com and Facebook are two additional examples of companies we consider blue chips of tomorrow as both have innovative and disruptive business models that are taking market share in enormous markets.

Beneficiaries of Short-Term Misperceptions— Investors who have a very short-term focus often avoid companies that face any type of controversy or a negative near-term outlook, creating an opportunity for long-term investors willing to look beyond today's headlines. Since oil prices began their steep decline several years ago, investors fled the energy sector in response to the dramatic (and unsustainable) collapse in oil prices. While oil prices are unknowable in the short term, prices must exceed the cost of replacing reserves over time. This simple fact will eventually lead to higher energy prices and should drive future returns for the well-positioned, low-cost producers held in the Portfolio.

Encana, a Canadian-based oil and gas exploration and production company with properties in both Canada and the United States, is a low-cost producer as well as a natural beneficiary of higher energy prices. We expect double-digit production growth in the years ahead, which could potentially generate strong returns for shareholders over a multiyear period—especially if energy prices continue to recover. ■

Conclusion

Building wealth in the coming decade will require equity investors to look beyond the index and be selective, adaptable and flexible. Given the quality and valuations of the companies in Davis Appreciation and Income Fund, we believe we are well positioned to grow shareholder wealth and exceed the performance of the broader market over the long term. ■

This report is authorized for use by existing shareholders. A current Davis Appreciation and Income 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.

Objective and Risks. Davis Appreciation and Income Fund's investment objective is total return through a combination of growth and income. There can be no assurance that the Fund will achieve its objective. The Fund is subject to both equity and debt risk. 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; manager risk: poor security selection may cause the Fund to underperform relevant benchmarks; 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; 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; 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; 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; foreign country risk: foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified. As of December 31, 2016, the Fund had approximately 8.0% of assets invested in foreign companies; depositary receipts risk: depositary receipts may trade at a discount (or premium) to the underlying security and may be less liquid than the underlying securities listed on an exchange; convertible securities risk: convertible securities are often lower-quality debt securities; preferred stock risk: preferred stock is a form of equity security and is generally ranked behind an issuer's debt securities in claims for dividends and assets of an issuer in a liquidation or bankruptcy. An adverse event may have a negative impact on a company and could result in a decline in the price of its preferred stock; bonds and other debt securities risk: Bonds and other debt securities generally are subject to credit risk and interest rate risk; interest rate risk: interest rate increases can cause the price of a debt security to decrease; extension and prepayment risk: the pace at which borrowers prepay affects the yield and the cash flow to holders of securities and the market value of those securities; credit risk: The issuer of a fixed income security (potentially even the U.S. Government) may be unable to make timely payments of interest and principal; changes in debt rating risk: if a rating agency gives a fixed income security a low rating, the value of the security will decline; variable current income risk: the income which the Fund pays to investors is not stable; overburdened issuers risk: issuers of high-yield, high-risk debt securities are unlikely to have a cushion from which to make their payments when their earnings are poor or when the economy in general is in decline; priority risk: issuers of high-yield, high-risk debt securities are likely to have a substantial amount of other debt which it must be current on before it can pay bondholders; difficult to resell risk: many investors do not want high-yield, high-risk debt securities, and others are prohibited from buying them; and fees and expenses risk: the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund. See the prospectus for a complete description of the principal risks.

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.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of December 31, 2016, the top ten holdings, not including cash and equivalents, of Davis Appreciation and Income Fund were: Berkshire Hathaway, Inc., Class B, 5.15%; U.S. Bancorp, 4.39%; Wells Fargo & Co., 3.83%; American Express Co., 3.58%; EQT Midstream Partners LP, 3.46%; Roche Holding AG-Genusschein, 2.99%; Occidental Petroleum Corp., 2.93%; Bank of New York Mellon Corp., 2.85%; United Technologies Corp., 2.67%; Amazon.com, Inc., 2.67%.

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 or call 800-279-0279 for the most current public portfolio holdings information.

Broker-dealers and other financial intermediaries may charge Davis Advisors substantial fees for selling its funds and providing continuing support to clients and shareholders. For example, broker-dealers and other financial intermediaries may charge: sales commissions; distribution and service fees; and record-keeping fees. In addition, payments or reimbursements may be requested for: marketing support concerning Davis Advisors' products; placement on a list of offered products; access to sales meetings, sales representatives and management representatives; and participation in conferences or seminars, sales or training programs for invited registered representatives and other employees, client and investor events, and other dealer-sponsored events. Financial advisors should not consider Davis Advisors' payment(s) to a financial intermediary as a basis for recommending Davis Advisors.

We gather our index data from a combination of reputable sources, including, but not limited to, Thomson Financial, Lipper and index websites.

The Fund can invest in a variety of derivative investments to pursue its investment objective or for hedging purposes. The Adviser and the Fund have claimed exclusions from the definition of the term "commodity pool operator" under the Commodities Exchange Act and, therefore, are not subject to registration or regulation as a pool operator under the Commodities Exchange Act.

Trailing Price/Earnings (P/E) Ratio is the weighted average of the price/earnings ratios of the stocks in a portfolio. The P/E ratio of a stock is calculated by dividing the current price of the stock by its trailing 12 months' earnings per share. Portfolio totals are computed using an inverse harmonic methodology.

The **Combined Balanced Fund Index** reflects an unmanaged portfolio (rebalanced monthly) of 60% of the S&P 500 Index and 40% of the Barclays U.S. Aggregate Bond Index. 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 towards stocks with large market capitalizations and represents approximately two-thirds of the total market value of all domestic common stocks. The **Barclays Capital Aggregate Bond Index** is an index made up of the Barclays Capital Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have a coupon that is fixed or steps according to a predetermined schedule. Investments cannot be made directly in an index.

After April 30, 2017, 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.

Davis Distributors, LLC
2949 East Elvira Road, Suite 101, Tucson, AZ 85756
800-279-0279, davisfunds.com

Item #4775 12/16