Davis Appreciation and Income Fund

Update from Portfolio Managers

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Davis FUNDS

THE EQUITY SPECIALISTS

Davis Appreciation and Income Fund

Annual Review 2018

Market Perspectives

Davis Appreciation and Income Fund returned 16.4% in 2017, outperforming a traditional balanced fund benchmark.[1] Selectivity in both equity and fixed income markets is critical today.

In 2017 the S&P 500 returned 21.8% and the Barclay's Aggregate Bond Index returned 3.5%. The progress of the equity and bond markets occurred against a relatively favorable economic backdrop. The U.S. economy grew gross domestic product (GDP) at an annualized rate of approximately 3% with relatively full employment while interest rates and inflation remain muted.

Davis Appreciation and Income Fund delivered strong results during the year, returning 16.4% and outperforming a traditional balanced portfolio with a 60% equities allocation and a 40% fixed income allocation. Our outperformance was driven by a relatively higher weighting in equities of nearly 72% with the balance of the Fund invested in high-grade fixed income and preferred securities and cash, as well as by certain individual holdings. In other words, both asset allocation and security selection mattered. The net result is the Fund grew the wealth and savings of our shareholders at a double-digit rate through what we feel is a reliable time-tested, long-term investment approach with relatively low volatility.

As for the capital markets overall, we see reasons for optimism about many businesses today, but not all securities in the U.S. stock and bond markets represent equally good value. Stock picking, in our view, is the most sensible way to navigate the current equities market as certain pockets of opportunity offer a better risk/reward trade-off than others in our estimation. This is pertinent not just in the current environment but is a perennial approach to investing that has grown the wealth and savings of Davis shareholders over the long term. Similarly, in bond markets we believe selectivity is crucial as fixed income investors navigate the transition from an accommodative monetary policy from the Federal Reserve toward a tightening policy for the first time in more than a decade. In the context of fixed income securities, we believe capital preservation should take precedence over income yield if reaching for yield means compromising on underlying credit quality. ■

The average annual total returns for Davis Appreciation and Income Fund's Class A shares for periods ending December 31, 2017, including a maximum 4.75% sales charge, are: 1 year, 10.82%; 5 years, 8.01%; and 10 years, 4.52%. 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 0.91%. 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 without 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.

Portfolio Review

Dominant market leaders. Out-of-the-spotlight businesses. Contrarian investments.

The equities portion of Davis Appreciation and Income Fund consists predominantly of large, well-capitalized businesses with the potential to compound capital consistently over full market cycles, based on our independent, research-based analysis.

The Fund holds three categories of businesses in the equities portion of the Portfolio, including in order of proportion:

- Dominant market leaders
- Lesser-known, "out-of-the-spotlight" businesses
- Contrarian investments[2]

Among the Fund's market leaders are Berkshire Hathaway, JP Morgan Chase, United Technologies and Alphabet.[3]

Berkshire Hathaway, a representative market leader in the Portfolio, is a diversified holding company with interests in insurance, reinsurance, railroads, utilities, manufacturing, retailing, and a host of other business lines. Under the strong leadership of Warren Buffett and team the company has compounded book value at almost 20% per year on average over the last 50 years. During that time Berkshire Hathaway 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 Hathaway is a financial powerhouse and well positioned for continued steady growth, although at a somewhat slower pace given its already large size.

Another market leader is JPMorgan Chase. With more than $2.5 trillion in assets, JPMorgan Chase's diversified operations include one of the top private banks in the country, one of the largest investment banks, the largest U.S. credit card company as measured by loans outstanding, and a retail bank ranked in the top three based on deposits. This well-diversified business mix provides some stability for the company's cash flow through various economic cycles.

United Technologies, a third market leader, is a U.S.-based industrial conglomerate with strong business lines primarily in aerospace and building services including aircraft engine company Pratt & Whitney, Otis Elevator and Carrier among other subsidiaries. United Technologies has strong competitive moats and the potential to deliver steady growth in the years ahead, driven particularly by strong demand for its aerospace products.

Alphabet Inc., another example of a market leader in the Portfolio, is an innovative global technology holding company that dominates the business of online search. By establishing a first mover advantage, the company has positioned itself as a prime beneficiary of the shift of advertising spending from traditional media channels to search-based, online advertising, a secular shift that is happening worldwide. In addition to its global core search business, the company owns YouTube, is quickly building a high operating margin cloud computing business and is a leader in artificial intelligence, which has implications not only for advertising and market research but also for other industries such as autonomous or self-driving cars. Financially strong, Alphabet is a cash flow machine with no net debt and enormous global markets for the company's current and prospective business lines.

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

In addition to market leaders, the Fund owns a number of out-of-the-spotlight businesses. Capital One Financial, a representative holding in this category, is a top 10 U.S. bank based on deposits with branches located primarily in the New York to Washington, D.C. corridor as well as in Texas and Louisiana. In addition to providing a full range of banking services, the company is best known for its competitive credit card offerings and is among the top 10 issuers of MasterCard and Visa cards. In our view, Capital One has a strong balance sheet, dramatically undervalued earnings power and a history of returning vast amounts of distributable earnings to shareholders through dividends and share buybacks. Valued at less than 12 times our estimate of owner earnings, we believe Capital One is trading at a highly attractive multiple given its potential earnings growth and offers investors a favorable risk/reward trade-off at today's prices.

Our contrarian investments include a number of businesses in the out-of-favor energy sector. Occidental Petroleum, a current representative contrarian investment, is a well-managed, U.S.-based energy exploration and production company with an excellent management team, a strong balance sheet and top-notch properties, especially its fields in the productive Permian Basin in southeastern New Mexico and western Texas.

The fixed income portion of the Portfolio is largely invested in a diversified array of capital preservation oriented and income-generating securities including high-grade corporate bonds, mortgages and preferred issues.

Overall, we believe the durable balance sheets and long-term earnings power of the companies that make up Davis Appreciation and Income Fund strongly position us to continue building shareholder wealth over time by combining the appreciation potential of equities with a degree of downside protection provided by fixed income investments.

Since our firm's inception nearly 50 years ago, we have adhered to the same, time-tested investment philosophy and rigorous research process of buying durable businesses at attractive prices and holding them for the long term. The fact that we are significant investors side by side with our clients' savings in the funds we manage remains a true sign of our commitment to and conviction in this enduring philosophy. ■

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: **bonds and other debt securities risk:** Bonds and other debt securities generally are subject to credit risk and interest rate risk; **changes in debt rating risk:** if a rating agency gives a fixed income security a low rating, the value of the security will decline; **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; **convertible securities risk:** convertible securities are often lower-quality debt 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; **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; **difficult to resell risk:** many investors do not want high-yield, high-risk debt securities, and others are prohibited from buying them; **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; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; **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, 2017, the Fund had approximately 13.22% of assets invested in foreign companies; **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; **interest rate risk:** interest rate increases can cause the price of a debt security to decrease; **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; **manager risk:** poor security selection may cause the Fund to underperform relevant benchmarks; **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; **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; **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; **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; **stock market risk:** stock markets have periods of rising prices and periods of falling prices, including sharp declines; and **variable current income risk:** the income which the Fund pays to investors is not stable. 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, 2017, the top ten holdings, not including cash and equivalents, of Davis Appreciation and Income Fund were: Berkshire Hathaway Inc., Class B, 4.85%; Capital One Financial Corp., 3.82%; American Express Co., 3.71%; United Technologies Corp., 3.57%; Safran S.A., 3.57%; Occidental Petroleum Corp., 3.34%, Wells Fargo & Co., 3.34%; LafargeHolcim Ltd., 3.28%; Amazon.com, Inc., 3.27%; Bank of New York Mellon Corp., 3.24%.

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.

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.

The **Combined 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, 2018, 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.

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Item #4775 12/17