

# Davis Appreciation and Income Fund

2012 Portfolio Manager Commentary

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AN UPDATE FROM  
**Andrew A. Davis and Keith J. Sabol, CFA**  
**Portfolio Managers**

**Performance Overview**

The Davis Appreciation and Income Fund's Class A shares delivered a total return on net asset value of -7.45% for the one year period ended December 31, 2011 compared with a return of 2.11% for the S&P 500® Index.<sup>1</sup> Over the same period, the average mixed-asset target allocation growth fund tracked by Lipper returned -1.24% and the average aggressive allocation fund tracked by Morningstar returned -3.81%.<sup>2</sup> Because short-term results are less interesting to us than long-term results, we find it more meaningful that over the long term the Fund has generated a somewhat better return than the market with less risk. Since the Fund's inception on May 1, 1992, its Class A shares have generated

an average annual total return on net asset value of 8.01% versus an average annual total return of 7.96% for the S&P 500® Index.<sup>1</sup> At the same time, since May 1992, the Fund has had an annualized standard deviation (a commonly used statistical proxy for risk) of 14.12 versus 15.12 for the S&P 500® Index.<sup>3</sup>

According to a 2011 Morningstar report on the Davis Appreciation and Income Fund, "This aggressive allocation fund takes an atypical approach. While most of its peers invest only in stocks and bonds, this fund's co-managers, Andrew Davis and Keith Sabol, look across a company's capital structure. . . . The managers like convertible bonds because they often capture the

Average Annual Total Returns as of December 31, 2011	1 Year	5 Years	10 Years	Inception (5/1/92)
Davis Appreciation and Income Fund Class A Shares without a sales charge	-7.45%	-0.22%	5.56%	8.01%
with a maximum 4.75% sales charge	-11.85	-1.18	5.04	7.74
S&P 500® Index	2.11	-0.25	2.92	7.96

***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 0.94%. 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](http://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.**

<sup>1</sup>Class A shares, not including a sales charge. **Past performance is not a guarantee of future results.** <sup>2</sup>Mixed-asset target allocation growth funds invest 60%–80% in equity securities with the remainder invested in bonds, cash and cash equivalents. Aggressive allocation funds seek to provide both capital appreciation and income by investing in three major areas: stocks, bond, and cash. <sup>3</sup>Source: Morningstar EnCorr. See endnotes for a definition of standard deviation.

stock market's upside while participating less on the downside. The fund's high-conviction, deep-value strategy also stands out. The managers seek competitively advantaged, well-managed companies trading at a steep discount to their intrinsic values..."<sup>4</sup>

## Our Strategy

Our long-standing investment goal is to capture most of the market's upside performance while participating in less of its downside.<sup>5</sup> We use the Davis Investment Discipline to identify the businesses we wish to own, and then we seek to achieve our goal by investing in convertible bonds, equity, preferred stock, and straight debt of these target companies. We blend securities from these categories, taking into account valuations and other attributes of the particular securities employed. Because of the favorable return profile of many convertible securities, we like to include them when they are available from particular issuers at acceptable prices. In constructing our Portfolio we consider the risk versus reward trade-off at both the issuer and portfolio levels. At purchase, we size the issuer exposure and equity sensitivity of our positions to match our view of that issuer's fundamentals and valuation and our return expectations. These blends are adjusted over time on an event-driven basis to reflect changes in our outlook.

## The Markets

After a strong first half, equity markets languished in the second half of 2011. For the year, the S&P 500<sup>®</sup> Index rose 2.11%, and the Russell 2000<sup>®</sup> Index declined 4.18%. The Merrill Lynch All Total Return Alternatives U.S. Convertibles Index fell 5.60%, pushed down by the relatively weak

performance of convertible securities relative to their underlying stocks. Stocks underlying the convertibles market performed particularly poorly, with an index measuring the performance of the most liquid of these securities falling 8.55%.<sup>6</sup> Fixed income assets performed relatively well due to their comparative safety in a highly risk averse investment environment.

The performance of fixed income markets is relevant to the Fund because those markets directly affect the fixed income component of our convertible bonds, our corporate bonds and our straight preferred stock positions. When bonds perform better than stocks, we expect the Fund to benefit compared with the S&P 500<sup>®</sup> Index and, conversely, when bonds lag, the Fund suffers by comparison. Our portfolio strategy is a balanced one that combines equity and equity-like securities with securities having fixed income characteristics, so we expect the Fund's returns should normally lie between fixed income and equity returns. During 2011, the Fund declined 7.45%, a disappointing showing, particularly given a reasonably strong start through June.<sup>7</sup>

## Understanding Fund Performance

We began the year expecting that the U.S. economy would slowly begin to recover and that the least appreciated risk in the market was the potential for a surge in inflation driven by the liquidity being pumped in to the economy to stimulate recovery. We thought short-term rates were quite low and likely to move higher, a view we believed was reflected in the pricing of options on the investment grade portion of the convertibles market.

<sup>4</sup>Morningstar Quicktake Report, November 3, 2011. <sup>5</sup>While we seek to structure a portfolio that will increase in value when the S&P 500<sup>®</sup> Index increases in value and that will provide downside protection when the S&P 500<sup>®</sup> Index decreases in value, there can be no assurance that the portfolio will perform in line with our expectations. <sup>6</sup>Markit iBoxx Liquid USD Delta-Hedging Stock Index is the index that measures the performance of the liquid stocks underlying the convertible bond market. <sup>7</sup>Class A shares without a sales charge. **Past performance is not a guarantee of future results.**

What we failed to appreciate was the degree to which fears of an economic collapse in Europe would affect assets in the United States. Despite the rating agencies' downgrade of the United States, the dollar was still widely viewed as the safest investment in the world and risk-averse traders drove yields down. At the same time, worries about deteriorating economic conditions in Europe dampened the outlook for many businesses.

Consistent with our view that inflation was a significant risk, we positioned the Portfolio to benefit from owning high quality companies in industries that are historically considered hedges against inflation and thus might help protect our purchasing power.<sup>8</sup> These companies include Devon Energy Corporation (DVN), an oil and gas exploration and production company; Freeport-McMoRan Copper & Gold Inc. (FCX); United States Steel Corporation (X); and Allegheny Technologies Incorporated (ATI), a specialty metals manufacturer. Anticipating a recession, investors sold these cyclical companies, driving their stock prices down 20% to 40% between June 30th and year-end. Over the same time period, our internal estimate for intermediate-term inflation expectations dropped from 3.25% to 2.65%.

In the midst of this turmoil, we took steps to capitalize on the opportunities the market presented. In February, for example, after the stock of United Rentals, Inc. (URI) had appreciated approximately 36% we sold a portion of our equity-sensitive convertible bond position.<sup>9</sup> The company's operating trends remained favorable, but management's focus on reinvesting in its rental equipment implied that while earnings before interest, taxes, depreciation, and amortization (EBITDA) were likely to grow, free

cash flow would not. Like many companies operating in cyclical businesses in 2011, United Rentals' stock subsequently declined sharply, falling 57% between the date of our sale (February 9th) and the 22nd of August.

With the market declining in August seemingly in expectation of a recession, we reacquired much of the United Rentals' position we had sold earlier in the year. As a leader in a highly fragmented market, United Rentals enjoys significant opportunity for growth through acquisitions in our view. The company again confirmed this view in mid-December when it made a significant friendly acquisition of RSC Equipment Rental, Inc. (RRR). Both companies have long shared similar operating philosophies, and a larger presence will enable the merged entity to offer even better coverage to national accounts as well as realize operational synergies by reevaluating rental locations and adjusting equipment inventories. These synergies should allow United Rentals to continue to grow its cash flow even in the event of an economic slowdown.

However, not all of the additions we made to existing Fund positions worked so well. We added to our bond positions in U.S. Steel and Allegheny Technologies relatively early in the summer sell-off and both of those additions exacerbated our third quarter downside. Ultimately the ATI bonds recovered, but the U.S. Steel purchase contributed to our disappointing performance in 2011.

In what was perhaps the most frustrating sale of the year, between August 5th and August 9th we liquidated our holdings of Avon Products Inc. (AVP). Avon's stock had seemed inexpensive for several years and we believed the experience that

<sup>8</sup>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. <sup>9</sup>The return of a security may not be the same as its return to the Fund because of weighting and timing of purchase. **Past performance is not a guarantee of future results.**

interim CFO Chuck Cramb brought from his long career at Gillette, now part of Procter & Gamble, would drive a renaissance at Avon. For a time operational improvements seemed steady but by late summer signs of difficulties became apparent. Increased spending on advertising floundered; changes in reporting procedures suggested the potential for further deterioration in operating profits; and the company stumbled in Brazil, one of its best markets, suggesting that competition there may be taking its toll on Avon. With the company seemingly adrift and lacking confidence in the management team, we eliminated our position in Avon. On January 31st of this year, we learned Avon had dismissed Mr. Cramb, reinforcing our conviction that our sale in early August 2011 was the right course of action.

No one relishes a bankruptcy filing by a Portfolio company but it can provide valuable lessons. As an example, in 2009, one of the Fund's holdings, Thornburg Mortgage, filed for bankruptcy protection and we have served on the creditors' committee since. While the Thornburg bankruptcy was a costly drag on Fund performance, our experience there helped preserve shareholder capital in 2011 when the Fund's investment in Kodak convertible bonds faltered. When we bought the Kodak bonds in 2009, investors had committed new capital; the company was licensing some of its intellectual property; and Kodak's printer business, though small, was growing rapidly. These facts made the bond's 7% coupon seem attractive. By September of 2011, however, rising silver prices had become an increasing drag on Kodak's film business, general economic malaise further impaired the prospects of its other businesses and a key patent infringement decision was delayed by the

retirement of an administrative judge. (A history of previous favorable judgments had helped Kodak secure key licensing agreements that provided a cash flow lifeline to the company.)

Despite indications from Kodak that the seasonally strong second half of the year would be its best cash flow period, that Kodak would generate adequate cash to continue its efforts to revitalize the company and that the sale of a large patent portfolio was pending, the company caught investors off guard by drawing down a credit line. From our experience with the Thornburg bankruptcy, we recognized this as the act of a desperate management team. The credit line draw down strongly suggested the odds of Kodak running out of cash before the patent portfolio could be sold were quite high. Further, we knew prospective buyers of the patent portfolio would worry about possible fraudulent conveyance claims debt holders could make in a bankruptcy proceeding. Even in a best case scenario, the sale of the portfolio would come at a distressed price, and that might not be adequate to guarantee Kodak's survival. As a result, we immediately sold our position, avoiding a 20 point drop in the bonds over those several days.<sup>10</sup>

## Looking Ahead

The high correlation between the euro and the U.S. stock market is well reported in the financial press. That the stock market moves in the same direction as the euro is an indication investors continue to worry about how, or even if, the eurozone crisis will be resolved. The number of separate European governments involved adds a layer of complexity that makes the outcome largely unknowable.

<sup>10</sup>Period discussed is from 9/26/11 to 9/30/11.

What we do know is interest rates in the United States are extremely low, with mortgage rates at their lowest levels since the 1950s. While not everyone will be able to refinance, the current wave of refinancing is large enough that brokers and lenders are extending closing dates to accommodate the demand. In many cases homeowners can reduce their payments 15% or more by refinancing. While rising food and energy costs may absorb much of that savings, the extra money will at least provide an offset.

Just as low interest rates are a boon to homeowners and buyers, they are great for companies too. Low rates enable companies to take on additional projects, buy other businesses and buy back shares. All of these activities should buoy the stock market.

On the other hand, low rates can be a serious problem for people living on fixed incomes. Not only are yields on retirement assets low, but risk to principal is higher. As of this writing, the yield on 30 year Treasury bonds is about 2.9%. While that yield could stay low, the concern is what if it does not? If the yield on 30 year Treasuries moves up to just 3.9%, which is where it was in August, holders of these bonds would lose about 14% of their principal.

In fairness, judging by the implied forward yield curve, the market is not anticipating such a move in long-term bond yields anytime soon. (The implied forward yield curve reflects current market expectations for interest rates at various points in the future.) Currently, the projected yield for 30 year Treasury bonds in 2022 is 3.6%.<sup>11</sup> This suggests the market is expecting another decade of lethargic economic growth on top of the one we just experienced. That is a dreary outlook. Today the dividend yield on the S&P 500® Index is higher than the yield to maturity on 10 year Treasury bonds and dividends on S&P 500® stocks can grow while bond coupons will not. Predicting the future is hard, if not impossible, but the hurdle for stocks to outperform 10 year Treasury bonds does not seem too high.<sup>12</sup>

Market turmoil presents both pitfalls and opportunities. As shareholders in the Fund along with you, we thank you for your support as we continue to work diligently to uncover those investments that will create value for all of us over time. ■

<sup>11</sup>Source: Bloomberg. <sup>12</sup>Stocks and U.S. Treasuries represent different asset classes subject to different risks and rewards. Unlike U.S. Treasuries, the Fund does not offer a fixed rate of return if held to maturity, and the Fund has risks not associated with holding a Treasury bond. Treasury bonds are considered to have less risk than equities. Future economic events may favor one asset class over another.

*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; under \$10 billion market capitalization risk: small- and mid-size companies typically involve more risk than larger, more mature 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; fees and expenses risk: the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; 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 may be unable to make timely payments of interest and principal; interest rate sensitivity risk: interest rates may have a powerful influence on the value of fixed income securities; 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 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, 2011, the Fund had approximately 3.1% of assets invested in foreign companies. 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, 2011, Davis Appreciation and Income Fund had invested the following percentages of its assets in the companies listed: Allegheny Technologies Incorporated (ATI), 4.34%; Devon Energy Corporation (DVN), 3.26%; Freeport-McMoRan Copper & Gold Inc. (FCX), 1.91%; Thornburg Mortgage, 0.33%; United Rentals, Inc. (URI), 3.07%; United States Steel Corporation (X), 3.97%.

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](http://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.

Standard Deviation is a measure of the average deviations of a return series from its mean; often used as a risk measure. A large standard deviation implies that there have been large swings or volatility in the manager's return series.

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

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 **Russell 2000® Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Index is value weighted and includes only common stocks belonging to corporations domiciled in the U.S. and its territories. The **Merrill Lynch All Total Return Alternatives Index** was created by Merrill Lynch's research department to serve as an "All Total Return Alternative U.S. Convertibles Index." To be included in the Index an issue must meet a variety of criteria, including: having an aggregate market value of at least \$50 million, being denominated in U.S. dollars, be traded in U.S. markets, and the issuing company must meet minimum revenue criteria and not currently be involved in bankruptcy. The **Markit iBoxx Liquid USD Delta-Hedging Stock Index** is a series of indices each of which is expected to initially consist of one hundred (100) Stock Components determined in accordance with these Index Specifications. Each Index Series shall represent the aggregate total return, including the effective reinvestment of dividends, that a Hypothetical Holder of the relevant Number of Shares of each Stock Component would receive, without taking into account applicable taxes of any kind whatsoever. Investments cannot be made directly in an index.

After April 30, 2012, 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.**

