

Winter 2012 Review

Since our founding more than 40 years ago in 1969, Davis Advisors' mission as a firm has been to serve our shareholders and to do so with high integrity. Mindful of the enormous responsibility that comes with serving as a steward of others' capital, we are firmly committed to:

- Investment excellence
- Sharing wisdom and perspectives about investor behavior
- Open and honest communications

As a sign of our commitment to and alignment with all those who have entrusted their capital to us, the Davis family, Davis Advisors, employees, and directors have more than \$2 billion of their own money invested side by side with fellow shareholders in the various mutual funds our firm manages.¹

Market Perspectives

During 2011, international equity indexes traded in a broad range and ended the period in negative territory. The MSCI ACWI® (All Country World Index) ex US returned -13.71%. Interestingly, global markets today are behaving in similar fashion to what we observed several years ago. Then, as now, equity markets inflicted declines on businesses around the world, in both developed and developing economies and across sectors and industries, with companies in emerging markets experiencing particularly steep declines.

Yet, most of the businesses we own are battle-tested on balance and in many instances have stronger fundamentals and stronger balance sheets than at any time in their recent history. Consequently, while their stock prices have declined to varying degrees, we believe many of these businesses are actually worth more today on an intrinsic value basis than at any time in recent memory and represent compelling opportunities for compounding capital from these levels.

Over our four decades as an investment firm, we have navigated many different market environments. *Significantly, periods when we have seen such wide disparities between stock prices and underlying business values (what we call the price-to-value gap) have generally been the moments of greatest opportunity for investors with a long investment horizon.* This dynamic rests on strong logic: When prices overly discount business values, quality businesses can be purchased at reasonable, even cheap, valuations, offering risk-conscious investors the opportunity to trade up in quality at lower prices. In addition, where investors have disproportionately punished stocks as is the case in emerging markets today, many well-managed, durable businesses with exposure to faster growing economies can be purchased at single-digit to low double-digit multiples. As a result, low prices often set the stage for higher future returns, a fact that deserves attention in our view but that appears largely ignored in current market debates.

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.**

¹As of December 31, 2011.

Portfolio Positioning²

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

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

Market leaders with strong balance sheets—

In many cases these are global companies with universally known brands, earnings that are well diversified from the standpoint of product line

and geography, and fortress balance sheets. These businesses span a broad range of global industries from consumer products to financial services to technology to industrials, among others. They provide a core foundation of stability within the Portfolio and offer in our view the possibility of long-term sustainable returns through capital appreciation and dividends.

A representative market leader in the Portfolio is Heineken, one of the world's largest brewers. Founded in 1864 and today operating in more than 70 countries, this Dutch-based company has created a truly global premium brand in virtually every major market worldwide offering approximately 200 international, regional and local beers. Long a dominant force in developed markets, in recent years Heineken has systematically broadened its product offerings while expanding its reach to include many developing countries in Central and Eastern Europe, Africa and the Asia-Pacific region. In our view the company is well positioned to compound capital for many years to come.

Swiss-based Nestlé with its large, strong and durable global franchise is also an excellent example of a market leader in the Portfolio. Its brands, mostly serving the global food and beverage market segments, include Gerber baby food products, Poland Spring water and Purina pet food, among many others. Nestlé sales show broad geographic diversification with revenues spread almost evenly among the United States, Europe and emerging economies. The company has a long history of disciplined capital allocation and regularly returns cash to shareholders through share buybacks and annual dividends.

²Individual 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.**

We believe market leaders like Heineken and Nestlé that possess strong competitive positions, proven management and strong balance sheets are well positioned to create significant value for long-term shareholders.

Out-of-the-spotlight businesses—After market leaders, the next major category of investments in the Portfolio is “out-of-the-spotlight” businesses. These are lesser known companies with attractive economics that in our opinion should eventually command higher valuations. Their appeal may take time to gain recognition, often because these businesses are smaller or operate in a mundane non-consumer-oriented industry. Given the right leadership and attractive reinvestment rates, these low-profile holdings can provide the opportunity for the “double play” of expanding multiples on expanding earnings, which can turn a company with a solid earnings growth rate into a stellar investment. As a general rule, out-of-the-spotlight holdings tend to be boring but have the potential to compound returns over time.

BHP Billiton, based in Australia, is an example of an out-of-the-spotlight holding in the Portfolio. It is one of the world’s largest natural resource companies producing coal, oil, natural gas, various base metals, and even silver and diamonds. The company’s mines, oil and gas wells, and other facilities are spread globally among 25 countries. While demand for its products is cyclical, BHP Billiton has customers on six continents and can take advantage of world growth wherever it occurs. Over the long term, we believe the world’s increasing population combined with the continued growth of the middle class should drive demand for the company’s products.

Another example of an out-of-the-spotlight holding in the Portfolio is Grupo Televisa, the world’s leading Spanish-language media company. Headquartered in Mexico, this media conglomerate’s operations include broadcast TV, cable services, satellite services, programming, and publishing among others. It dominates television broadcasting in its home market with a market share of nearly 70% and exports its programming to more than 50 countries. Grupo Televisa has a strong balance sheet with modest net debt and steady, ample cash flow. Moreover, the company is still controlled by its founding family, which provides strong alignment with shareholder interests.

China Merchants Bank, listed in Hong Kong, is the sixth largest bank in China and another example of an out-of-the-spotlight holding in the Portfolio. Through its growing branch network, which is mostly located in more economically developed areas of China, it offers individuals and businesses traditional commercial banking services such as deposits, loans and credit cards. We believe China Merchants Bank is among the top tier Chinese banks and well positioned to capitalize on the growth of the Chinese economy for many years to come.

Headline risk or contrarian investments³—

On a very selective basis we make contrarian investments. These often involve controversial situations where the market is discounting a company’s share price to reflect a perception of risk we think is greater than the probable economic risk to the business’s long-term fundamentals. Typically a minor portion of our Portfolios in percentage terms, headline risk investments can sometimes be difficult for clients

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

to understand because they beg the question, “Don’t you read the papers?” But it is precisely because so many other investors automatically sell companies with near-term challenges, however surmountable, that the potential for high returns exists in many such instances. Our job is to ferret out opportunities that represent favorable risk/reward trade-offs and do our best to avoid the value traps. We will not get every investment right. However, overall this distinctly contrarian element of our investment discipline has been an important contributor to our long-term success and may be an effective way to capitalize on herd mentality in the market.

Overall, the investments we have made in the three categories described above combine to create a Portfolio that we believe is well diversified and can produce satisfactory compound returns over full market cycles.⁴

Portfolio Review

During 2011, the MSCI ACWI® (All Country World Index) ex US returned –13.71%. The Davis International Fund underperformed the Index over that time period. The Fund’s underperformance was primarily due to our exposure to emerging markets and our position in Sino-Forest. Sino-Forest is a Canadian-based company that acquires standing timber and leases long-term land usage rights to harvest, sell and replant timber on land owned by provincial cooperatives throughout a number of different provinces in mainland China. As of this writing, it is unclear what developments will unfold at Sino-Forest, and we have explored a range of scenarios. As the full story has not yet been written, we will comment further on Sino-Forest in subsequent communications.⁵

Notable contributors in the period included Roche Holding, Essilor and Nielsen Holdings. Detractors included Sino-Forest, Kuehne & Nagel and Schneider Electric. In addition to company-specific performance drivers, our positioning with respect to countries and regions has played a meaningful role in the Portfolio’s performance in 2011. Emerging markets, which constitute a significant portion of the total Portfolio and which in our view represent higher growth economies in the long run, were among the worst performing markets in 2011.⁶

We have retested all of our holdings from the standpoint of balance sheet strength, liquidity, competitive position, and other key criteria. Our stress tests suggest that with the possible exception of Sino-Forest, we are holding durable businesses with favorable long-term prospects on balance. *What has changed is that the price-to-value gap has widened to a point where we now see unusually attractive valuations, ranging from mid single-digit earnings multiples to low double-digit multiples. Therefore, we are more inclined to be buyers than sellers in the current market, except when we exit a position because we have the opportunity to trade up in quality or growth potential at a lower price or the underlying investment thesis changes.*

Where We Are Finding Opportunities

Looking ahead with a very long-term perspective, our confidence in our investment approach rests to a large degree on what we view as favorable prospects for the businesses we own. The Portfolio is essentially a group of business models we have researched and view as attractive vehicles that may compound capital over the long term based on their management quality, business durability

⁴While 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. Equity markets are volatile and an investor may lose money. Diversification does not ensure against loss. ⁵Sino-Forest shares have been suspended from trading by the Ontario Securities Commission. ⁶Foreign investments, particularly those in emerging markets, involve greater risk than U.S. investments. Some of these risks are foreign country risk, currency risk, market risk, and emerging market risk. See endnotes for a complete description of these risks.

and competitive advantages, coupled with relatively attractive valuations. In our view the keys to outperforming the market over the next decade are to:

- Think long term and not get caught up in short-term cycles,
- Continue to exercise a highly selective and disciplined approach with respect to business quality, valuation and risk, and
- Remain focused on in-depth, bottom-up research.

Today we are finding compelling values in many areas of the market that in our view represent attractive avenues for compounding shareholders' capital over the next decade. Most of these opportunities fit within the following long-term themes:

Globally dominant world leaders—These industry leaders are characterized by strong pricing power, diversified earnings, healthy balance sheets, strong competitive moats, and durable business models. Because these businesses produce excess cash, they are not generally dependent on external funding.

Beneficiaries of crisis—The business model, capital position and management discipline of certain companies allow them to take advantage of dislocations in their industry, the economy or the capital markets. Given strong free cash flow and a conservative balance sheet, these companies may be able to use distressed prices to make investments, arrange acquisitions or buy back their shares at accretive prices. Other companies may significantly decrease their costs allowing for potentially increased returns as revenues return to more normal levels.

Select financial companies—Although the future is always uncertain, we believe the financial services industry has much growth ahead of it, especially on a global basis, and its products carry little risk of obsolescence. People will always need basic banking services, insurance products, investment management advice, and other such services. Nonetheless, it is necessary to differentiate between strong and weak players in order to invest successfully in this area of the market.

Energy, commodities and agricultural businesses—Well-managed companies in these areas are positioned to benefit from the inexorable long-term growth of a global middle class, which will result in increasing demand and potentially higher prices for most natural resources. We seek businesses with a history of smart capital allocation that have mostly avoided the pitfalls of rapid expansion and costly acquisitions during periods of relatively high commodity prices. Investing in companies that can grow the intrinsic value of their business through economic cycles may create the opportunity for long-term growth that is not solely dependent on the pricing of the underlying commodity and also provide the potential for even greater growth should rapid commodity price inflation occur in the future.

Select special situations—From time to time we may invest in highly opportunistic companies in diverse industries with unique or not well understood characteristics that may make them compelling long-term investments in our view.

The sum total of our holdings creates what we believe is a broadly diversified Portfolio with a conscious blend of both offensive and defensive components.⁷ The common thread running through

⁷Diversification does not ensure against loss.

the Portfolio is each holding has been selected according to the Davis Investment Discipline with an emphasis on management quality, business model strength, durable competitive advantages, and appropriate valuations. The result in our view is a Portfolio that affords our clients the potential to generate satisfactory compound returns over the course of many years.

All of us at Davis Advisors thank you for investing with us. We take our responsibilities to our clients seriously and appreciate your confidence. We look forward to continuing our investment journey together. ■

This report is authorized for use by existing shareholders. A current Davis International 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 International Fund's investment objective is long-term growth of capital. There can be no assurance that the Fund will achieve its objective. 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; foreign country risk: foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified; foreign currency risk: the change in value of a foreign currency against the U.S. dollar will result in a change in the U.S. dollar value of securities denominated in that foreign currency; emerging market risk: securities of issuers in emerging and developing markets may present risks not found in more mature markets; trading markets and depositary receipts risk: depositary receipts involve higher expenses and may trade at a discount (or premium) to the underlying security; 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; and fees and expenses risk: the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund. As of December 31, 2011, the Fund had approximately 37.0% of assets invested in securities from emerging markets. See the prospectus for a complete description of the principal risks.

The Fund is subject to a 2% short-term redemption fee for shares held for fewer than 30 days.

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 International Fund had invested the following percentages of its assets in the companies listed: BHP Billiton, 1.37%; China Merchants Bank, 3.24%; Essilor, 3.25%; Grupo Televisa, 2.32%; Heineken, 4.74%; Kuehne & Nagel, 5.91%; Nestlé, 3.72%; Nielsen Holdings, 3.08%; Roche Holding, 7.58%; Schneider Electric, 4.31%; Sino-Forest, 0.26%.

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.

During the period from inception (December 29, 2006) through December 30, 2009, only the directors, officers and employees of the Fund or its investment adviser and sub-adviser (and the investment adviser itself and affiliated companies) were eligible to purchase Fund shares. Since inception, the Fund's investment strategies and operations have remained substantially the same.

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 **MSCI ACWI® (All Country World Index) ex US** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the United States. The Index includes reinvestment of dividends, net of foreign withholding taxes. Investments cannot be made directly in an index.

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.

