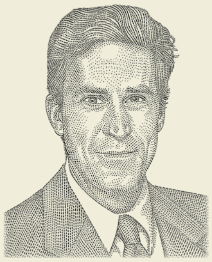
DREF ANNUAL REVIEW 2017



Davis Real Estate Fund

Update from Portfolio Managers

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Davis Funds

The Equity Specialists™

Davis Real Estate Fund

Annual Review 2017

The heart of the Davis Investment Discipline is investing in durable businesses trading at value prices and holding them over the long term to allow the power of compounding to work. Among the more important aspects of achieving that objective is how much we pay for a given stock. To a great extent our methods assume that over long-term cycles valuations will reflect management quality, sustainable competitive advantages and smart capital allocation, among other factors. During the early history of Davis Real Estate Fund, our methods worked well. However, from 2004 through 2006, the investment climate changed and investor interest in real estate funds, particularly real estate investment trust (REIT) funds, grew dramatically. Performance of Davis Real Estate Fund was below our expectations and as a result we examined our investment tactics.

The flow of money into U.S. real estate funds was unprecedented during that time period. Even more impressive was the growth in Japan's nascent global REIT fund business, where U.S. REITs were pitched as a yield substitute. That strategy worked well in a country where interest rates had been near zero for years. However, unlike funds flowing into actively managed domestic real estate funds, money from Japan needed to be invested in stocks with a higher than average yield. After all, the funds were paying a dividend in Japan that far exceeded the earnings yield on the underlying investments. That presented investment managers with a difficult proposition: How to invest in a manner that ensured adequate cash flow to meet heady dividend requirements?

The answer was clear: invest in U.S. REITs offering higher than average yields even if that compromised valuation principles. Such an approach is contrary to our thinking, but the fact remains that over that three year period stocks we considered too richly priced outpaced the dividend-compounding stocks we prefer and Davis Real Estate Fund's performance lagged. Our opinion was then—and still is today—that funds flow from Japan posed a significant risk to the rational pricing of real estate stocks and we were unwilling to chase performance.[1]

All of these factors came together in 2007 as a significant amount of private equity capital coupled with even greater amounts of debt capital sent the U.S. commercial real estate market into a tailspin. By the following year the entire country was embroiled in a credit crisis that most investors still vividly remember. During 2007 and 2008 investors rushed from the sector and money from Japan ground to a halt. Our belief then was that the high-yield REIT funds marketed in Japan had had their day and the sheer pressure of money outflows would significantly reduce valuations.

Hindsight suggests we should have spent more time considering funds flow. In the nine years that have passed since 2008 money has flowed into real estate securities at levels that dwarf the amount prior to 2007. Money from Japan flooded the market, originating from the same sort of high yield funds that fueled stock price advances prior to the credit crisis. Consider these numbers: From 2009 through 2011 money from Japan on average accounted for more than 80% of the total flow of capital into real estate funds. In 2015 and 2016 the amount invested from Japan was actually greater than 100% of total flows given that actively managed accounts experienced significant redemptions.

Not surprisingly history did repeat itself and the best-performing real estate stocks during that period were REITs with higher than average yields, which also tended to be large-capitalization stocks benefiting from the robust liquidity. While we tried our best to be tolerant of valuations that continued to set records, by virtue of our being a real estate fund and not restricted in our definition of real estate, we looked for other real estate opportunities.

In most cases these were businesses that either were not set up as REITs or were too small or illiquid to gain much investor attention, but nevertheless represented attractive value investments in a field crowded with high price stocks. Unfortunately those stocks did not perform as well as high-yielding REITs.

To put this all in perspective, over the last decade Davis Real Estate Fund has tended to underperform during periods when funds flow is huge. Our unconstrained view on real estate means we do not need to follow the crowd even though an argument could be made that is exactly the strategy that worked best. For our investors, the important question to ask is what could change that relationship. This is a question we think about every day. While we have said for years that interest rates must eventually go up, that eventuality has been slow in coming. Now we may finally be at the beginning of a different interest rate environment. President-elect Trump's mandate in Congress will most likely allow for a strong pro-business and pro-growth agenda, both of which will almost certainly entail higher interest rates. Since the election, the 10-year Treasury yield has jumped almost 100 basis points and the flows of money into real estate funds from all sources over the last four weeks has turned decidedly negative. Excluding money from Japan, which for all of 2016 accounted for inflow of more than $22 billion, money flowing into actively managed funds and exchange-traded funds (ETFs) was significantly negative. Even money from Japan has reversed direction over the past month.

The last decade has taught Fund managers many lessons and the idea that stocks can behave irrationally in response to huge funds flow is definitely a lesson we have learned. However, while we recognize that sticking to our investment beliefs may invite periods of underperformance when funds flow moves dramatically, we are willing to take that risk. As long-term investors, we recognize that looking different is often the right move. Fund performance this year suggests value investing eventually leads to attractive risk-adjusted returns. Nevertheless, the relationship between Fund performance and funds flow presents a dilemma: Do we incorporate an explicit forecast of funds flow into our investment approach? The answer is no, we do not. As noted earlier, during periods of fund inflows we tend to be more tolerant of richly valued stocks in the Fund. However, when selecting new investments, no matter the environment, we hold true to our investment roots.

An important attribute of the Davis Investment Discipline is focusing on businesses with a durable, financially strong business model that thrives in good times and also weathers more challenging environments. With funds flow reversing, core growth slowing and interest rates increasing, tougher times for commercial real estate may be in the offing. A case can be made that increasing interest rates could signal better growth in the future and real estate should benefit as a result, albeit with a lag. Even if we accept that argument, valuations would surely need to adjust. To some extent this adjustment has happened since the election in early November with some notable changes in sector leadership as investors try to get ahead of potential policy changes. We have not taken any significant action in response to the election, but have slowly positioned the Fund to weather weaker fundamentals and higher interest rates, which means we are focusing on sectors whose tenants have shorter average leases.

One company that has suffered from slowing funds flow and weakening underlying fundamentals is Public Storage (PSA), a large-capitalization personal storage business.[2] On a relative basis the company's valuation has dropped significantly since midyear primarily because growth, while still significantly positive, is not as strong as a year ago. We can see this concern affecting many other sectors, but storage companies have borne the brunt of the selling. We have not often invested much in the self-storage sector, but freely admit we should have done so in the past. The business has proven remarkably durable and benefits tremendously from one of the lowest structural capital expenditure burdens in the entire real estate universe. Our hurdle in the past was that these companies commanded extremely

2. 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.**

high valuation. Recent price declines and a shorter average lease duration counted in months means the storage sector may be one of our biggest non-consensus investment moves for the next few years.

Even shorter lease durations can be found in the timber sector, where lease duration is not really a relevant measure. Timber is perhaps the one sector where we can find deep value and considerable operating leverage if single-family housing demand grows even modestly. For-sale housing has been a notable laggard since 2008 even though interest rates have been incredibly low and job growth strong, largely the result of a lending environment skewed to favor the most creditworthy. Complicating timber pricing has been the steady supply of timber coming from Canada. Historically, that supply has been governed by a trade agreement, but for the past year the supply of timber has been unchecked as the United States prepared a new trade proposal. That proposal has now been presented, meaning we will likely soon have a new trade agreement that one way or another limits Canada's ability to supply timber to the United States. While predicting how the new agreement will affect prices is difficult, we believe combining steady pricing with any pickup in demand means accelerated earnings growth is likely for timber companies.

CatchMark Timber Trust, Inc. (CTT) remains our favorite company in the timber sector. The company should benefit from any improvement in timber pricing or sales volume and remains particularly attractive to us as the shares trade at a significant discount to fair value. At an implied value of roughly $1,500 per acre, CatchMark trades 25% below private market alternatives. Further, management is deeply aligned with shareholders and continues to make prudent capital allocations decisions. Even though these factors alone justify our investment, the most intriguing aspect of timber is that it grows. In other words, the simple passage of time makes every stand of timber forest more valuable because a larger tree yields more lumber.

Another sector with short lease durations is apartments. The Fund has significant investments in two apartment REITs, AvalonBay Communities, Inc. (AVB) and Essex Property Trust, Inc. (ESS). Neither performed well during 2016 due to slowing growth and concerns that the supply of apartments in several U.S. locations will outstrip demand. Our research corroborates this expected slowing growth, but also suggests growth could reaccelerate in late 2017 given the forecast for a stronger job market and, possibly, improving disposable income.

As of this writing, Davis Real Estate Fund has more than half of its assets invested in companies with short to medium lease durations. Despite our current preference for companies with shorter duration leases, we are still keenly focused on investing in great companies, irrespective of sector and lease duration. Consider the case of data centers, a sector that added significantly to Fund performance in 2016 and continues to offer superior growth prospects. As we enter 2017, the Fund has significant investments in two data center companies with medium-term lease durations, CyrusOne Inc. (CONE) and Interxion Holding NV (INXN). The Fund also has a materially overweighted position in DuPont Fabros Technology, Inc. (DFT), a data center REIT with a long average lease duration. We have always been believers in the demand for data storage and we recognize that facilitating storage of data is not a commodity business. As a result, each of our data center investments focuses on a unique aspect of data storage and Internet communication. Common to all, however, is the ability to deliver new storage capacity to a sector where demand is growing faster than any other sector in our investment universe.

Finally, because we believe the cost of capital will rise over the next several years, we have systematically reduced the Fund's exposure to companies with higher than average leverage and companies with debt that comes due over the short term. We are still willing to make limited investments in companies with higher debt burdens, but the company's valuation must compensate for the added risk. As we move through 2017, we will keep a keen eye on the capital markets to ensure Davis Real Estate Fund is appropriately positioned for an environment of high interest rates.

As fellow shareholders in the Fund, we sincerely appreciate your continued support as we work to build wealth for us all over time. ■

This report is authorized for use by existing shareholders. A current Davis Real Estate 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 Real Estate 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. Under normal circumstances the Fund invests at least 80% of its net assets, plus any borrowing for investment purposes, in equity, convertible, and debt securities issued by companies principally engaged in the real estate industry. 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; real estate risk: real estate securities are susceptible to the many risks associated with the direct ownership of real estate, such as declines in property values and increases in property taxes; focused portfolio risk: investing in a limited number of companies causes changes in the value of a single security to have a more significant effect on the value of the Fund's total portfolio; variable current income risk: the income which the Fund pays to investors is not stable; 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 of Davis Real Estate Fund were: Simon Property Group, Inc., 5.63%; Public Storage, Inc., 3.84%; Terreno Realty Corp., 3.76%; AvalonBay Communities, Inc., 3.53%; Catchmark Timber Trust Inc.,–A, 3.43%; Mid-America Apartment Communities, Inc., 3.26%; American Campus Communities, Inc., 3.25%; Acadia Realty Trust, 3.23%; Prologis, Inc., 3.21%; Equity Residential, 3.02%.

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.

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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