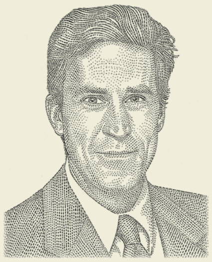
DREF SEMI-ANNUAL REVIEW 2017



# Davis Real Estate Fund

Update from Portfolio Managers

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Davis FUNDS

THE EQUITY SPECIALISTS™

# Davis Real Estate Fund

Semi-Annual Review 2017

## Investment Results

Davis Real Estate Fund's Class A shares provided a total return on net asset value for the six month period ended June 30, 2017 of 2.81%. Over the same time period the Wilshire U.S. Real Estate Securities Index returned 2.42%. Over the latest three and five year periods, a $10,000 investment in Davis Real Estate Fund has grown to $12,678 and $14,741, respectively.[1] ■

## Investment Overview

Is this time different? This question is often asked in many circles, but perhaps used most frequently in terms of investing. On many occasions since the inception of Davis Real Estate Fund we have asked if the real estate industry has changed so much as to require a new approach. After 9/11 most real estate stocks tumbled, especially hotel companies. At that time, with hotel stocks trading at a fraction of replacement cost, we decided valuation more than offset risk and our investment in a few hotel stocks in the fall of 2001 led to attractive returns as the hotel sector recovered.[1]

A similar situation developed in the two years leading up to the credit crisis of 2008. Propelled by low interest rates and the exuberance of less seasoned companies committing to more office space than they could possibly use, investors of all stripes pushed valuations of office real estate investment trusts (REITs) to levels we had never seen. We were unwilling to commit shareholder capital in that volatile environment and because the office REIT sector continued to outperform, culminating in the privatization of Equity Office Properties Trust in 2007, the Fund's relative performance suffered.[2] While we could be accused of failing to recognize the investment climate had changed, we note those who subsequently acquired Equity Office Properties' assets ended up suffering mightily when the credit crisis hit in 2008. So in essence, while we were correct the times had not changed, unfortunately we had nothing to show for our foresight.

Today real estate investors are presented with another puzzling question: Is the future of retail real estate structurally compromised by rapidly changing consumer behavior? Consumers increasingly purchase goods online which is causing many retailers to rethink their real estate strategy. In no area is the change more evident than with conventional department stores such as Macy's and JCPenney. These businesses have too many stores and are greatly dependent on softline goods such as apparel and linen products produced by vendors unable to respond quickly to fast-changing consumer preferences. Already this year department stores have announced more than 200 store closures. We expect more to come.

***The average annual total returns for Davis Real Estate Fund's Class A shares for periods ending June 30, 2017, including a maximum 4.75% sales charge, are: 1 year, −5.56%; 5 years, 7.02%; and 10 years, 2.83%. 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 0.93%. 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. 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.**

Department stores are not the only businesses affected. Inline retailers located in close proximity to department stores are also reeling. Almost 1,500 inline retail locations will be closed by retailers such as The Limited, Wet Seal and American Apparel. And, as with department stores, we expect many more closures. All of this naturally raises the question: Is this time really different? Everything we read in newspapers and hear from industry pundits suggests investing in retail real estate is little more than folly. While we believe some real changes are afoot in consumer behavior, we do not foresee the demise of all retail real estate. In fact, we see pockets of opportunity where the best retail real estate will not only survive but actually thrive based on these structural changes.

What is often lost in headlines that suggest the U.S. has too many retail stores are two facts that for us are the real story. First, the retail business is volatile. Owners of retail real estate have always had to deal with shifting consumer tastes. The risk this time is there might not be retail tenants to fill the void created by the stores that are put out of business by growing e-commerce deliveries. However, for retail real estate in the best locations stores once occupied by those sorts of tenants are being filled by new retailers not threatened by e-commerce. For example, fitness centers, health care providers and experiential retailers such as restaurants, movie theaters and other activity-based companies are opening stores in retail centers that by virtue of location have significant walk-in traffic. While trite, the phrase "location, location, location" has become the driving factor behind our investment in retail real estate.

In addition to concentrating on the best retail locations, we are strongly focused on tenants in those locations. Enclosed malls have always relied heavily on department stores to draw consumers to adjacent mall space where most of the profits can be earned. The types of tenants in those spaces varied somewhat, but the majority of space was leased to softline retailers that sell exactly the same types of goods sold by most department stores. It is no coincidence the word "fashion" appears in many mall names. The trouble is softline retailing has become an increasingly tough business. Fast fashion retailers that can adapt quickly to changing consumer tastes plus the rapid proliferation of e-commerce softline retailers such as Amazon are driving many of the retailers upon which retail landlords rely to the brink of bankruptcy. As a result, we prefer to invest in retail properties that have significantly reduced their reliance on softline retailers and instead focus on goods and services not easily disrupted by e-commerce. ■

## Portfolio Positioning

Davis Real Estate Fund is underweighted in the retail sector compared to our benchmark, we have significant overweighted positions in certain retail real estate companies whose assets and tenant base we consider largely immune to the impact of e-commerce. One example is Acadia Realty Trust (AKR) whose assets are located in dense urban submarkets in the nation's largest cities. Another example is Retail Opportunity Investments Corp. (ROIC) whose assets include grocers located in some of the most expensive real estate markets along the West Coast. (Amazon's recently announced intention to purchase Whole Foods Market Inc. does not materially change our investment outlook for Retail Opportunity Investments.) In addition, while underweighted relative to our benchmark, the Fund's single largest holding is Simon Property Group (SPG). We believe the company's class–A enclosed malls are sure to be survivors in a subsector that will shrink significantly over the next decade in our view. That these companies trade at a significant discount to our estimate of fair value gives us a great deal of latitude if we are incorrect in gauging how long it will take for businesses to adapt to changes in the retail industry. We believe that changes will take place sooner rather than later and that the ensuing recovery will favor our selective overweight investments.

Being underweighted in the entire sector has been a good call, but all of the Fund's retail holdings hampered performance over the past year. However, given Fund investments in other areas, overall performance has been good as we did not approach changing consumer behavior from a single angle, but considered the issue more broadly.

For several years the Fund has heavily invested in two areas that benefit from e-commerce and therefore have contributed meaningful outperformance. Industrial space, long our favored property type, has experienced significant fundamental growth over the past five years. While a number of reasons account for this development, the most notable are a much more disciplined lending environment, functional obsolescence of existing properties, and a dearth of supply in certain areas of the country. The critical factor in keeping supply balanced is the nature of e-commerce distribution, which requires three times the amount of space per dollar of sales to satisfy fulfillment versus conventional retail delivery. That factor has proven to be a powerful tailwind, keeping fundamentals on an upward trajectory even though supply is increasing significantly in many markets across the United States.

While Fund performance benefited from ownership of DCT Industrial Trust Inc. (DCT) and Prologis, Inc. (PLD), both owners of large distribution centers in great markets, the Fund achieved even better performance from Terreno Realty Corporation (TRO) and Rexford Industrial Realty, Inc. (REXR). While these two companies own assets that might appear inadequate for storage on a massive scale, which they are, their location in dense urban areas overcomes that potential weakness. A race is underway among e-commerce and third-party logistics companies to build a network sufficient to optimize delivery economics and eventually make same-day delivery a common occurrence. Rents for this type of property have exploded and, given the impediments to new supply, we do not expect growth to slow over the near term. As a result, Terreno and Rexford have benefitted from sector-leading free cash flow growth and stock returns. Perhaps the only negative currently confronting industrial property companies is their high valuations. While we have taken some gains, we continue to overweight the sector believing growth will be sufficient to compensate for those valuations.

Data centers are also beneficiaries of growth in e-commerce. Every click made by a consumer on an electronic device flows through a communication network that is supported by some sort of data center. While each targets a different type of data center, Fund investments in CyrusOne (CONE), DuPont Fabros Technology, Inc. (DFT) and Interxion (INXN) have contributed meaningfully to performance during 2017 and since the beginning of 2016. We believe growth in this sector will continue to significantly outpace all other sectors and, given that valuations are still attractive, the Fund continues its overweight position in the sector.

Even though we remain generally optimistic about the prospects for commercial real estate, we recognize two risk factors might weigh down property stocks for a while. First, except for data centers and some industrial properties, fundamentals in most sectors are reaching a peak or have started to ebb. Second, funds flow into real estate property funds has slowed significantly. In the past we have noted a great deal of money has flowed into property stocks, sometimes with little regard for valuation. To date investors have not withdrawn money at a clip fast enough to seriously disrupt prices, but that could change. However, even if such a development occurs, we believe the Fund is well positioned to provide excellent risk-adjusted returns over the long-term.

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: **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; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; **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; **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; **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; **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; **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 June 30, 2017, the top ten holdings of Davis Real Estate Fund were: Simon Property Group, Inc., 5.50%; AvalonBay Communities, Inc., 4.10%; Public Storage, Inc., 3.84%; Terreno Realty Corp., 3.72%; Interxion Holding N.V., 3.63%; Catchmark Timber Trust Inc.,–A, 3.46%; Essex Property Trust, Inc., 3.41%; Mid-America Apartment Communities, Inc., 3.37%; Welltower Inc., 3.26%; CyrusOne Inc., 3.11%.

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 Wilshire U.S. Real Estate Securities Index® is a broad measure of the performance of publicly traded real estate securities, such as Real Estate Investment Trusts (REITs) and Real Estate Operating Companies (REOCs). The Index is capitalization-weighted. The beginning date was January 1, 1978, and the Index is rebalanced monthly and returns are calculated on a buy and hold basis. Investments cannot be made directly in an index.

After October 31, 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.**

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