

Davis New York Venture Fund

An Update from Christopher C. Davis and Kenneth Charles Feinberg
Portfolio Managers



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Semi-Annual Review 2010

The chart below summarizes results through June 30, 2010 for the Davis New York Venture Fund compared with the S&P 500® Index against which my co-manager Ken Charles Feinberg, our colleagues and I judge ourselves. Our goal is to outperform this Index after fees over the long term as we have done in every rolling 10 year period since our inception in 1969.¹ Over the last decade, our results have exceeded the benchmark by 2.5% per year after fees.¹ Although this is a more than satisfactory relative result, the Fund's absolute return of only 0.91% per year is a grim reminder that for more than a decade, investors have been mired in one of the worst bear markets since the Great Depression.¹ In fact, a hypothetical \$10,000 invested in an S&P 500® Index fund or exchange-traded fund (ETF) 10 years ago would now be worth only about \$8,500 after fees. The same \$10,000 invested in the Davis New York Venture Fund would now be worth almost \$11,000.¹

Over the last five years, Fund results were only marginally positive on a relative basis and somewhat worse on an absolute basis. Specifically, the S&P 500®

Index declined 0.79% per year and the Davis New York Venture Fund declined 0.77% per year, essentially matching the market.¹ Given that trailing five year returns are a key metric in the incentive compensation plans for your portfolio managers and our research team, we consider an advantage of two one-hundredths of one percent as too close for comfort. On top of this relative hurdle, the fact that we are also large investors in the funds we manage means that we also bear the consequences of poor absolute returns. While no system is perfect, shareholders should know that our incentives are aligned with our goal of generating satisfactory absolute *and* relative returns over long periods of time.

Finally, though we tend not to focus on shorter term results, we consider our one year return of 14.79% satisfactory on an absolute basis and marginally acceptable on a relative basis compared to the 14.43% market return.¹

In this report, we will try to put these results in context as well as share our perspective on the

Total Returns as of June 30, 2010	1 Year	5 Years	10 Years	Inception (2/17/69)
Davis New York Venture Fund Class A Shares <i>without a sales charge</i>	14.79%	-0.77%	0.91%	11.52%
<i>with a maximum 4.75% sales charge</i>	9.35	-1.74	0.42	11.39
S&P 500® Index	14.43	-0.79	-1.59	9.14

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 0.92%. 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.**

¹As of June 30, 2010. Class A shares, not including a sales charge. Rolling returns are from 2/17/69-12/31/09 and would be lower in some periods if a sales charge were included. See endnotes for a description of our rolling 10 year performance and a definition of the S&P 500® Index. **Past performance is not a guarantee of future results.**

investment environment and our Portfolio companies. As usual, we have structured the report as a series of responses to the questions we are most frequently asked by shareholders. We have organized them from the general to the specific and, as always, will include a review of our mistakes as well as our successes.

Q: Will the economy and/or the stock market “double dip”?

A: We receive more questions about the short-term outlook for the market and the economy than on any other topic. Unfortunately, each time we are asked, we must give the same answer, “We don’t know.”

While such an answer is unsatisfying, it is the only truthful one we or any other investor can give. Since the dawn of history, people have wanted to predict the future. But wanting to and being able to are not the same thing. The following two charts clearly show that predictions by investment strategists and economists about the stock market (chart one below) and the economy (chart two on the following page) are essentially uncorrelated with what actually happens.

If this data is not convincing, consider the following admission from none other than Alan Greenspan who said, “I was telling my colleagues the other day...I’d been dealing with these big mathematical models for forecasting the economy...and I say, ‘Y’know, if I could figure out a way to determine whether or not people are more fearful, or changing to euphoric...I could forecast the economy better than any way that I know.’ The trouble is, we can’t figure that out. I’ve been in the forecasting business for 50 years, and I’m no better than I ever was, and nobody else is either.”²

The futility of forecasting does not mean that investors should ignore the economic environment. On the contrary, it is essential that investors factor economic risks and uncertainties into all portfolio decisions. In recent reports, we have written about some of the most important of these risks, including both the short-term impediments to a robust recovery as the painful process of reducing consumer debt and government deficits continues, as well as the long-

Six Month Average Forecasted Direction vs. Actual Direction of Interest Rates

The Wall Street Journal Survey of Economists (12/82–12/09)

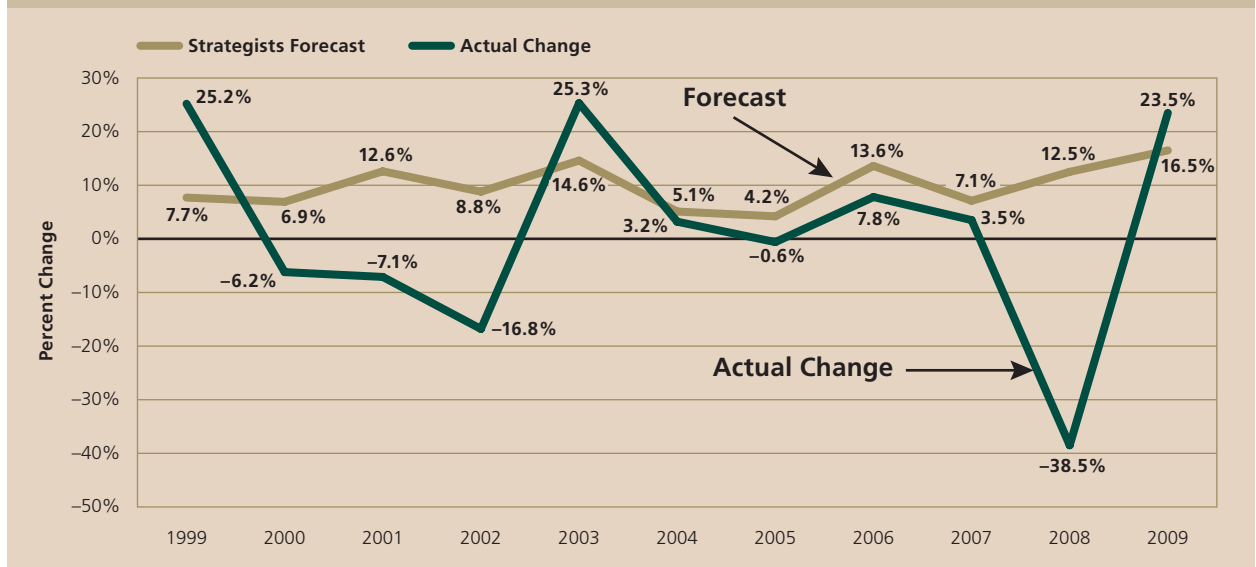
Date	Forecast	Actual	Result	Date	Forecast	Actual	Result	Date	Forecast	Actual	Result
12/82	▼	▼	Right	6/92	▼	▲	Wrong	6/01	▼	▲	Wrong
6/83	▼	▲	Wrong	12/92	▼	▼	Right	12/01	▼	▼	Right
12/83	▼	▲	Wrong	6/93	▲	▼	Wrong	6/02*	▲	▲	Right
6/84	▼	▲	Wrong	12/93	▲	▼	Wrong	12/02	▲	▼	Wrong
12/84	▲	▼	Wrong	6/94	▼	▲	Wrong	6/03	▲	▼	Wrong
6/85	▲	▼	Wrong	12/94	▼	▲	Wrong	12/03	▲	▲	Right
12/85	▲	▼	Wrong	6/95	▲	▼	Wrong	6/04	▲	▲	Right
6/86	▲	▼	Wrong	12/95	▼	▼	Right	12/04	▲	▼	Wrong
12/86	▲	▲	Right	6/96	▲	▲	Right	6/05	▲	▼	Wrong
6/87	▼	▲	Wrong	12/96	▼	▼	Right	12/05	▲	▲	Right
12/87	▼	▲	Wrong	6/97	▼	▲	Wrong	6/06	▲	▲	Right
6/88	▼	▼	Right	12/97	▲	▼	Wrong	12/06	▲	▼	Wrong
12/88	▲	▲	Right	6/98	▲	▼	Wrong	6/07	▼	▲	Wrong
6/89	▲	▼	Wrong	12/98	▲	▼	Wrong	12/07	▲	▼	Wrong
12/89	▲	▼	Wrong	6/99	▼	▲	Wrong	6/08	▲	▼	Wrong
6/90	▼	▲	Wrong	12/99	▼	▲	Wrong	12/08	▲	▼	Wrong
12/90	▼	▼	Right	6/00	▼	▼	Right	6/09	▲	▲	Right
6/91	▼	▲	Wrong	12/00	▲	▼	Wrong	12/09	▲	▲	Right
12/91	▼	▼	Right								

Source: Legg Mason and *The Wall Street Journal* Survey of Economists. This is a semi-annual survey by *The Wall Street Journal* last updated December 31, 2009. *Benchmark changed from 30 Year Treasury to 10 Year Treasury. **Past performance is not a guarantee of future results.**

²“Jon Stewart and Alan Greenspan: Best Interview Ever” (September 19, 2007). <http://dummyspots.com/2007/09/jon-stewart-and-alan-greenspan-best-interview-ever/> (July 24, 2010).

Strategists Average Forecasted Market Change vs. Actual Market Change

(1999–2009)



Source: *Barron's*. From 1999 through 2005, numbers reflect Dow Jones Industrial Average forecasts. In 2006, *Barron's* began using the S&P 500® Index exclusively. Investments cannot be made directly in an index. **Past performance is not a guarantee of future results.**

term risks of substantial inflation given the government's incentive to deflate the cost of its debts by inflating the amount of money it prints. We continue to view these as grave risks and have left our earlier discussion of them on our website for your review. (Please see our Annual Review 2009 in the "Portfolio Manager Commentaries" section of davisfunds.com.) These twin risks of short-term deflation followed by long-term inflation are troubling and although neither can be predicted with certainty, such risks are a vital consideration when making investment decisions. As we have often written, the fact that we cannot predict does not mean we cannot prepare.

One way to begin this preparation is to learn from the legendary banker J.P. Morgan who, when asked his prediction for the stock market, famously declared, "It will fluctuate." Although at first such an answer sounds flip, there is a relevant truth hidden in it. Specifically, although the timing of ups and downs cannot be predicted, the fact that there will be ups and downs is a certainty. Furthermore, because of our long holding period, it is likely that we will own any company we purchase for the Davis New York Venture Fund through both the ups and downs—

through periods of economic expansion and recession, rising interest rates and falling interest rates, and bull markets and bear markets. As a result, when we are evaluating potential investments, we must consider how each business might perform under a range of different economic scenarios. For example, rather than try to forecast the timing of economic downturns, we try to incorporate their inevitability into our business appraisals. Specifically, we ask ourselves, Are the businesses that we own at today's prices likely to produce satisfactory long-term returns for patient investors even if we go through periods of recession? In our view, the companies that make up the Davis New York Venture Fund pass this threshold test. Importantly, this test does not mean that a company's share price and its earnings will not decline during a recession, but rather that its long-term earnings power and competitive position will not be permanently impaired.³ So instead of trying to predict the timing of ups and downs, we seek to invest in those companies that should have the ability to endure and adapt to whatever the future holds. This is especially true today when the risks are so large and many predictions contradictory.

³There is no guarantee that the holdings in the Fund will increase in value over the short term or the long term.

Q: What characteristics give businesses the ability to endure and adapt?

A: Assessing a business's durability and adaptability is the foundation of our investment research process at Davis Advisors. These assessments are complex and not based on rules or certainties but rather tendencies and probabilities. As in many complex problems, it is often useful to begin by first inverting the question, in this case by asking, What characteristics tend to lead to business failure or impairment? When asked in this inverted fashion, a number of answers seem immediately obvious. Generally, businesses fail or become impaired due to some combination of debt, low returns on capital, competition, obsolescence, over-concentration (by geography or product), 'diworsification' (a wonderful term coined by legendary portfolio manager Peter Lynch to describe foolish acquisitions), and hubris. If such characteristics are most often associated with failure or impairment, then we can turn back to the original question and conclude that those businesses without these traits will tend to be more durable and more adaptable. Therefore, in the face of inherent uncertainty, investors should look for businesses with strong balance sheets, satisfactory returns, sustainable competitive advantages, products with low risk of obsolescence, geographic and/or product diversification, a skeptical view of mergers and acquisitions, and a healthy fear of arrogance and complacency.

Q: How does Davis Advisors identify these companies?

A: While making a list of such traits is straightforward, identifying these characteristics in real businesses is not so simple. To start with many of these traits are subjective or qualitative. Even those that are quantitative such as balance sheet strength and returns on capital often require some context or adjustment. Furthermore, even if a company has embodied these traits in the past, there is no certainty that it will do so in the future. However, while there are no certainties, there are probabilities. For more than four decades, identifying these characteristics and assessing the probability they will continue has been the foundation of our research process. This process includes such steps as a detailed review of each company's financial and regulatory documents,

extensive management interviews, competitive benchmarking and comparisons, and so forth. While inexact, our focus on identifying those businesses with the characteristics that make them more likely to endure and adapt has been an important contributor to our long-term results.

Q: Are such companies always good investments?

A: If identifying businesses with such attractive characteristics is the foundation of our investment process, buying them at the right price is the capstone. Because the stock market works like a pari-mutuel system, those businesses that are most admired tend to trade at the highest valuations, which in turn can make them poor investments. To understand why valuation is such an integral part of investment return, consider a simple example of a small, durable business that reliably generates \$70,000 per year of income. If this business is purchased for \$1 million, the investor will receive a 7% return. If the same business is purchased for \$2 million, the investor's return drops to only 3.5%.

For decades, the most durable companies—those with strong balance sheets, satisfactory returns, sustainable competitive advantages, products with low risk of obsolescence, geographic and/or product diversification, and so forth—have traded at significant premiums to the averages. While such a premium may be warranted, it decreases the likelihood investors will earn an excess return. In general, investors who have wanted the safety and security of owning some of the world's most durable businesses have had to give up some return by paying a higher than average valuation. Such valuations reached bubble levels in the Nifty Fifty era of the early 1970s and again in the late 1990s when many such global leaders had dividend yields of less than 1% and traded at more than 30 times earnings.

Q: How do such companies compare to other alternatives today?⁴

A: Because of the enormous risks in today's economy, characteristics such as durability and adaptability should be especially highly valued. But despite these risks, shares in many global leaders are trading at or

⁴Common stocks, cash and bonds represent different asset classes subject to different risks and rewards. Bonds and cash are considered to have less risk than equities. Future economic events may favor one asset class over another.

near their lowest absolute and relative valuations in decades, creating a significant opportunity for long-term investors. The best way to understand this opportunity is to take a moment to consider the alternatives. For example, money market funds now yield close to zero and in some cases actually have surcharges that result in a negative yield. That means money market investors today are simply accepting a zero percent return as their best case. But when (not if) we enter a period of inflation, real returns on money market funds will be negative and holders will suffer real losses in purchasing power.

Turning to intermediate and long-term U.S. government bonds, these have done so well for so long, investors feel safe owning them. However, as is usually the case, those asset classes that investors feel are the least risky are often those that are in a bubble. For example, in the years leading up to the worst real estate decline on record, people could hardly imagine losing the equity in their home. In fact, the higher prices went, the more real estate seemed like a low-risk sure thing and the more comfortable people were increasing their leverage. Today the same is true of intermediate and long-term government bonds. A 10 year U.S. Treasury bond, for example, currently yields less than 3%. Because interest rates have fallen steadily for almost 30 years, few bond investors can recall more than a temporary period when bonds declined in value. Investors who know history, however, realize that the last time interest rates were at today's levels, bonds went on to decline in value for more than 20 years. What's more, on an inflation-adjusted basis, investors in U.S. Treasuries lost more in those 20 years than stock investors did during the Great Depression!⁵ It is striking today that the dividend yield alone on many high quality and durable companies is higher than the coupon on a 10 year government bond. In addition, this dividend generally represents a payout of less than half of earnings. This means investors in these equities are currently receiving an earnings yield more than twice the yield on bonds and a dividend yield that roughly matches. Furthermore, because such businesses maintain a certain amount of pricing power,

these earnings and dividends should be somewhat inflation protected compared to bonds whose real yields erode in times of inflation.

While the inflation risks described above also apply to municipal and corporate bonds, each of these categories has additional areas of concern that should be considered. Before mentioning these general concerns, it must be noted that both the municipal and corporate debt sectors are large and include issuers of vastly different quality and soundness. Even if the overall sectors do poorly, expert investors may be able to find specific issues that do well. That said, some general concerns should be kept in mind. For municipals, one need only pick up the newspaper to realize that the financial condition of many municipalities makes the federal government look like a paragon of prudence. Unfortunately, if you limit investments only to those issuers whose finances or prospects are sound, these currently trade at such low rates that, as with Treasuries, investors are not compensated for the inflation risk they are assuming. The same is true in the corporate debt world. The debt of strong and sound companies currently yields a paltry 3% to 4%. As for lower quality corporate debt, one doesn't need a long memory to realize that should the economy slow again, the financial condition of many highly leveraged companies could quickly become strained.

Turning to equity alternatives, in the domestic equity markets many investors have shunned shares in large and durable companies in favor of small- and mid-sized companies. Stocks of small- and mid-sized companies have outperformed large capitalization companies over the last decade and, as is often the case, investors want to get in *after* such periods of outperformance.⁶ While this category is too diverse for sweeping statements to apply, it is generally true smaller companies tend to be more concentrated by product or geography. While such concentration is not bad in itself, it can increase a company's vulnerability to global competition or obsolescence. Outside of small- and mid-capitalization stocks, investors have also flocked to international and emerging

⁵Source: Morningstar. Bond prices and yields are represented by a constant maturity U.S. government bond. Results assume an investor purchases a U.S. government bond at the beginning of every year, sells it at the end and rolls the proceeds and the interest received into another U.S. government bond. Results are adjusted for inflation. **Past performance is not a guarantee of future results.**

⁶Small- and mid-size companies typically have more limited product lines, markets and financial resources than larger companies, and their securities may trade less frequently and in more limited volume than those of larger, more mature companies.

market stocks, mutual funds and ETFs.⁷ In many cases, these investments are made without regard to valuation but simply because of the widely held view that emerging markets are growing faster than the United States. Such “story” investing can often lead to trouble as it did during the Internet mania. While we would agree that it is likely that many emerging markets will grow faster than the United States, there may be ways to capitalize on this trend that involve less risk than blindly buying some foreign index. For example, in our view, where a company earns its money is more important than where its stock is listed. Although the S&P 500[®] Index is considered a domestic stock index, the companies that make up the Index earn roughly half of their profits outside the United States. In other words, although companies like Procter & Gamble, Coca-Cola and others are truly global companies, they often trade at a discount to foreign companies with similar growth prospects because they are wrongly perceived as domestic companies. As a result, they offer investors a good combination of exposure to higher growth economies such as China and India at a lower valuation and with better diversification, governance, liquidity, and financial transparency.

In sum, while stocks of durable, world-class companies seem attractive based on their current valuations and prospects, they seem fantastic compared with all of the other major alternatives. As we look over the investment landscape today in full knowledge of the risks and uncertainties that range from Japanese-style deflation to Latin American-style hyperinflation, we believe that large capitalization, durable businesses have never looked better.

Q: How is the Portfolio constructed?⁸

A: In past reports, we have divided the Portfolio into four categories with the caveat that these labels are somewhat imprecise. As could be inferred from the discussion above, the largest category is made up of those companies that we consider world leaders or stalwarts. At today’s prices, we continue to add to companies in this category. Holdings include Merck,

Johnson & Johnson, Procter & Gamble, Hewlett-Packard, Diageo (the world’s largest spirits company), Heineken, Coca-Cola, Microsoft, Philip Morris, Walt Disney, and Becton, Dickinson. These companies share virtually all of the characteristics we associate with durability and adaptability, including balance sheet strength, competitive advantages, decent returns on capital, reasonable pricing power, low risk of obsolescence, and geographic diversity. Yet despite these strengths, these companies on average trade at discounts to the market. Specifically, on average, these companies are generating an earnings yield of about 8% while paying a dividend yield of approximately 3%. Such valuations seem particularly attractive when compared with the 5% to 7% earnings yield and 2% dividend yield of the average company in the S&P 500[®] Index and wonderful when compared with bonds.⁹ Just to add an exclamation point to this last observation, it is hard to believe that the seven year debt of Johnson & Johnson currently yields 2.8% while its dividend, which represents less than half of its earnings, yields 3.8%.

A second category of investments includes our holdings in energy and other so-called commodities. In making these investments, we combine several top-down themes with bottom-up stock selection. From a top-down perspective, we have long believed that the combination of growth in the emerging markets, higher replacement costs and the high cost of alternative energy sources make long-term declines in the price of energy and other vital commodities unlikely. It is striking, for example, that in 2009 China overtook the United States as the world’s largest consumer of energy. But there are two important risks in owning commodities. First, if we go through a period of deflation, commodity prices can plummet. Second, even if prices stay high, most commodity companies will still generate a poor return on capital over the long term. This low return results from a lack of capital discipline that leads most commodity companies to increase capital spending after commodity prices have already risen, often spending the vast majority of their windfall profits to simply

⁷Foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified, foreign political systems may not be as stable and foreign financial reporting standards may not be as rigorous as they are in the United States. ⁸Individual 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 or sell any specific security. **Past performance is not a guarantee of future results.** ⁹Stocks and bonds represent different asset classes subject to different risks and rewards. Future economic events may favor one asset class over another.

replace what they just sold. In short, for most commodity companies capital spending increases at roughly the same rate as commodity prices and earnings. Because of these two concerns, we couple our top-down view with bottom-up stock selection. Specifically, when evaluating companies in industries such as energy and agriculture, we consider how the companies fared in different parts of the commodity price cycle, paying particular attention to their performance when prices were low. We also focus on their record of generating satisfactory returns on *incremental* capital investments. It is gratifying that our largest holdings in these sectors—including Occidental Petroleum, EOG Resources, Devon Energy, Canadian Natural Resources, Monsanto, Sino-Forest, and OGX Petroleo—share the rare distinction of having generated, or having the prospect of generating, satisfactory returns on reinvested capital over the very long term. We think the managements of these companies are among the best in their sectors. When we turn to our mistakes below, we will contrast the results of these companies with the performance of ConocoPhillips, which we have since sold.

A third category is made up of our holdings in financial companies, though we consider this label so broad as to be unhelpful. In fact, we can think of no other sector in which John Train's expression "Investing is the art of the specific" is truer. To begin with, this sector includes companies that are in fundamentally different businesses. What sense can it make to put a car insurer like Progressive in the same category as a global securities processing firm like Bank of New York Mellon? This is like lumping together Tiffany and Caterpillar because they both sell things made out of metal. In addition to including companies with vastly different business models, the financial sector also includes companies of vastly different quality and durability. It is our view while the headlines of the last several years have been filled with financial companies that went bankrupt or were taken over, there are also a select few financial firms that embody those characteristics we associate with durability—strong balance sheets; satisfactory returns; sustainable competitive advantages; products with low risk of obsolescence, geographic and/or product diversification; a skeptical view of mergers and acquisitions; and a healthy fear of arrogance and

complacency. Companies like American Express and Wells Fargo & Company have been in business for more than a century. But even they are relative newcomers compared with Bank of New York Mellon, which was founded by Alexander Hamilton more than 200 years ago. It is not a coincidence that these three proven companies make up the lion's share of our holdings in the financial sector.¹⁰

Furthermore, as with many of the global leaders mentioned earlier, financial services firms are trading today at very low valuations. For example, the three companies mentioned above trade at average P/E multiples of 12 to 15 times our estimated range of their 2010 earnings. This discount may become even wider as these companies benefit from industry consolidation, the collapse of the shadow banking sector and reductions in bad credit costs. In fact, over the next three to five years, earnings at these companies could increase 50% to 100% even with some of the positives being offset by a more hostile political, regulatory and fiscal environment.

A final category of Portfolio investments is a catchall made up of companies that do not fit into a category. Some like Berkshire Hathaway and Loews are quasi-holding companies with investments in a range of industries. While their strong balance sheets and conservative positioning may make these dull investments in good times, they each have wonderful records of building value during times of panic or chaos. Others like CVS Caremark and Express Scripts are neither retail companies nor drug companies but rather a type of distribution channel that should benefit from the aging of America and growth in generic drugs. Companies such as Sealed Air, the maker of bubble wrap, and Iron Mountain, a document storage company, are so unusual as to be almost unique. Even companies like Costco, Harley-Davidson and Bed Bath & Beyond are difficult to lump together with others in their industry as each company uniquely dominates a narrow subcategory of its particular industry. As a result, while we often describe the Portfolio in terms of categories, the fact that so many holdings defy easy categorization is a reminder that the Portfolio is still built stock by stock from the bottom up.

¹⁰There is no guarantee that these companies will continue to perform in the future how they have performed in the past.

Q: What were your biggest mistakes and the lessons learned?

A: As always, we must begin a discussion of mistakes with some definitions. Most important, we do not label an investment a mistake simply because it trades below our purchase price. In fact, it is probable that every company we buy will trade below our purchase price at some point, simply as a result of the unpredictability and vagaries of short-term results. Furthermore, it is the nature of markets that value and price often diverge for long periods of time. In euphoric times, such as during the Internet bubble, the stock prices of many companies exceed their value. In times of panic and dislocation, the value of many companies exceeds their prices. In such periods, the poor performance of an individual stock or even the Portfolio as a whole may indicate deferred returns rather than permanent losses. For example, a company purchased at \$10 per share that has an intrinsic value of \$20 is a good investment even if its stock price falls to \$5 for some period of time. However, in other cases falling stock prices reflect substantial declines in the value of the underlying business. In these cases, we were mistaken in our business appraisals.

Over the past five years, our largest mistake by far was our investment in AIG. This investment detracted approximately 5% from our returns and was almost two and a half times more costly than our next largest mistake, which was Merrill Lynch. We have written extensively about these two mistakes in past reports and because these companies remain the largest detractors from our five year results, we have left these reports on our website and commend them to your attention. (Please see the "Portfolio Manager Commentaries" section of davisfunds.com to read these reports.) The lessons learned from these mistakes have been pounded into your investment managers and while we will make mistakes in the future, we do not expect to repeat these. The most important lessons learned are worth reiterating. First, the chief executive officer of any large financial institution must have the skills, experience and discipline to also serve as the chief risk officer. Both AIG and Merrill Lynch were run for a number of years by executives who clearly failed this important test. Second, because of leverage, stupidity in even a relatively small part of a financial firm can bring down the entire enterprise. AIG's global insurance operations and Merrill Lynch's outstanding network

of financial advisors were both the largest and most profitable parts of their respective firms. However, the steady profits of these huge and well-run operations were swamped by the losses at what were essentially small proprietary trading desks. In other words, the idiocy of a tiny minority overwhelmed the competence of the vast majority. Finally, both mistakes reinforced the importance of liquidity. Net worth and earnings power may be valuable, but in times of crisis only cash matters. Both companies faced calls on cash that was simply not available. Worse, their attempts to raise the cash by selling assets during a time of panic simply added fuel to the fire by driving down asset prices further. As Warren Buffett has rightly said, it is dangerous "to count on the kindness of strangers in order to meet tomorrow's obligations."

In our last report, we also highlighted the fact that often the largest mistakes we make will never show up in our financial statements. This is not because we are glossing over them but rather because they were mistakes of omission. For example, our costliest mistakes during this financial crisis may well be the investments we failed to make when others were panicking. Wells Fargo, for example, traded roughly as low as \$8 per share and American Express as low as \$10. Had we added approximately 1.5% of the Fund to each of these positions at those low prices, we would have more than made up the cumulative losses we suffered in AIG and Merrill Lynch.

Finally, in our earlier discussion of energy companies, we highlighted the critical importance of capital discipline. ConocoPhillips, which was one of our largest holdings in the energy sector, failed this important test and was a meaningful detractor from our returns, particularly over the last three years. Management's lack of discipline becomes evident when contrasted with one of our other large energy holdings, EOG. For example, from 2003 to 2009, it cost ConocoPhillips roughly 60% more than EOG to replace each barrel of oil (or oil equivalent) it sold. As a result, despite spending \$111 billion, ConocoPhillips only managed to grow its reserves per share (debt adjusted) 2%. During the same period, EOG grew its reserves per share almost 80%. Over time, the combination of reinvesting huge amounts in low-returning projects as well as an ill-timed acquisition binge during which the company issued its

relatively undervalued shares in exchange for over-priced acquisitions destroyed an enormous amount of shareholder value. As a result, over the last five years, ConocoPhillips' share price declined while EOG's appreciated almost 80%. In fact, ConocoPhillips' stock price trailed our other four holdings by an average of 12% per year. Despite our mis-assessment of management, we were bailed out by the rising price of oil during our holding period and were able to sell the shares at a respectable profit. Furthermore, because the shares are strikingly cheap on the basis of reserves, we continue to monitor the company and would be open to repurchasing the shares should the board and management team become more disciplined.

Looking Ahead

Having spent much of this report highlighting risks and uncertainties, we should spend a moment on real reasons for optimism, though such optimism may sound out of place in today's world. Coming through one of the worst decades ever for stock investors, commentators and the public are more pessimistic than ever. The term "black swan" was recently popularized by author Nassim Taleb to describe the rare, high-impact and hard-to-predict events that roiled financial markets in the last decade. But black swans are nothing new. The future has always been full of unpredictable but significant events.

What is new today is the assumption that black swans must necessarily be negative. While recent history is full of many negative surprises, investors and commentators have forgotten that many high-impact, hard-to-predict events are enormously positive for society as a whole and capitalism in particular. For example, over the last several decades biotech and pharmaceutical companies (like Johnson & Johnson, Merck, Pfizer, and Roche) have produced almost miraculous cures to diseases that have plagued humanity for centuries. Is it possible in the years ahead that they will find a cure for costly and horrifying diseases like Alzheimer's, Parkinson's and diabetes and in doing so produce huge unexpected savings for our health care system? How about

energy? Over the last several years, innovative companies (like Devon and EOG) developed a new technology that allows them to tap vast reserves of cheap, clean natural gas trapped in domestic shale formations. Is it possible in the years ahead there could be breakthroughs in solar or even nuclear technology as well as in energy transmission and storage that could dramatically reduce the economic, political and environmental costs of energy? How about education? In the face of decades of poor results in our community college system, innovative for-profit education companies like Kaplan,¹¹ Apollo and Strayer have grown into some of the nation's largest universities. Is it possible in the future that their innovative use of the Internet and other technologies could help improve outcomes and reduce costs throughout our nation's school systems?

We give these examples not to be Pollyannas but as reminders that the march of progress has not come to a stop because real estate prices have declined and stocks are mired in a bear market. Future events have always been unpredictable, filled with both negative and positive surprises. In building the Davis New York Venture Fund, we have sought companies with the durability and resilience to weather the bad times but also the intelligence, innovation and adaptability to capitalize on the good times.

Concluding Thoughts

Ken and I have now worked together more than 15 years. Because my name happens to be on the door, I routinely receive credit that is owed to him. Ken is an outstanding analyst, portfolio manager and colleague who has quietly and tirelessly made an enormous contribution to shareholder returns over the years.

Finally, we have never worked with a better team of analysts, not just in terms of intelligence and dedication but also in terms of character and humanity. It is a pleasure and privilege to have such colleagues.

On behalf of all of us at Davis Advisors, we thank you for your continued trust. ■

¹¹Chris Davis serves as a Director for the Washington Post Company (a publishing company which owns Kaplan).

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The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of June 30, 2010, Davis New York Venture Fund had invested the following percentages of its assets in the companies listed: American Express, 4.31%; Bank of New York Mellon, 3.53%; Becton, Dickinson, 0.92%; Bed Bath & Beyond, 1.54%; Berkshire Hathaway, 4.49%; Canadian Natural Resources, 2.49%; Coca-Cola, 1.74%; ConocoPhillips, 0.09%; Costco Wholesale, 3.73%; CVS Caremark, 2.96%; Devon Energy, 2.91%; Diageo, 1.31%; EOG Resources, 3.76%; Express Scripts, 1.93%; Harley-Davidson, 1.55%; Heineken, 1.09%; Hewlett-Packard, 1.40%; Iron Mountain, 1.45%; Johnson & Johnson, 2.46%; Loews, 2.79%; Merck, 2.89%; Microsoft, 1.27%; Monsanto, 0.64%; Occidental Petroleum, 3.41%; OGX Petroleum, 0.59%; Pfizer, 1.64%; Philip Morris, 0.94%; Procter & Gamble, 1.89%; Progressive, 2.45%; Sealed Air, 2.18%; Sino-Forest, 1.18%; Walt Disney, 0.82%; Wells Fargo, 4.12%.

Davis Funds has adopted a Portfolio Holdings Disclosure policy that governs the release of non-public portfolio holding information. This policy is described in detail in the prospectus. Visit davisfunds.com or call 800-279-0279 for the most current public portfolio holdings information.

Rolling 10 Year Returns. Davis New York Venture Fund's average annual total returns for Class A shares were compared against the returns earned by the S&P 500® Index as of December 31 of each year for all 10 year time periods from 1969 through 2009. The Fund's returns assume an investment in Class A shares on January 1 of each year with all dividends and capital gain distributions reinvested for a 10 year period. The returns are not adjusted for any sales charge that may be imposed. If a sales charge were imposed, the reported figures would be lower. The figures shown reflect past results; past performance is not a guarantee of future results. There can be no guarantee that the Fund will continue to deliver consistent investment performance. The performance presented includes periods of bear markets when performance was negative. Equity markets are volatile and an investor may lose money. Returns for other share classes will vary.

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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 **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue chip stocks. The Dow Jones is calculated by adding the closing prices of the component stocks and using a divisor that is adjusted for splits and stock dividends equal to 10% or more of the market value of an issue as well as substitutions and mergers. The average is quoted in points, not in dollars. Investments cannot be made directly in an index.

After October 31, 2010, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

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