Davis FUNDS

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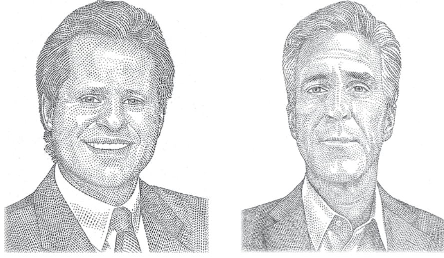

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Update from Portfolio Managers

Andrew A. Davis and Chandler Spears

Davis Real Estate Fund

Annual Review 2025

Key Takeaways

- In 2024 Davis Real Estate Fund (DREF) returned 4.89% compared to 9.15% for the Wilshire U.S. Real Estate Securities Index.
- We regard 2024 as the year in which, among other developments, our thesis on office real estate was vindicated. The bad press plaguing the sector gave way to a growing realization that the best office assets in the best markets would thrive. We believe office is in the early stages of a multiyear recovery.
- The year ahead presents a broad front of opportunity. Interest rate volatility will likely continue, favoring ownership of properties with shorter lease terms and lower leverage. A recovery is due for the Sunbelt apartment group. Data centers remain in steep growth mode, with digital REITs and tower infrastructure companies both positioned to be beneficiaries of AI's long tail.

Davis Real Estate Fund's Class A shares provided a total return on net asset value of 4.89% for the year ended December 31, 2024. Over the same time period, the Wilshire U.S. Real Estate Securities Index returned 9.15%. During the most recent one-, five- and 10-year periods, a $10,000 investment in Davis Real Estate Fund would have returned $10,489, $11,158 and $16,142, respectively. ■

The average annual total returns for Davis Real Estate Fund's Class A shares for periods ending December 31, 2024, including a maximum 4.75% sales charge, are: 1 year, –0.09%; 5 years, 1.23%; and 10 years, 4.40%. 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. For most recent month-end performance, visit davisfunds.com or call 800-279-0279. Current performance may be lower or higher than the performance quoted. The total annual operating expense ratio for Class A shares as of the most recent prospectus was 1.00%. The total annual operating expense ratio may vary in future years. Returns and expenses for other classes of shares will vary.*

This material 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. All fund performance discussed within this material refers to Class A shares without a sales charge and are as of 12/31/24, unless otherwise noted. This is not a recommendation to buy, sell or hold any specific security. **Past performance is not a guarantee of future results. There is no guarantee that the Fund performance will be positive as equity markets are volatile and an investor may lose money.**

Being Right and Wrong

It is not the first time Davis Real Estate Fund (DREF) has been in this position, but it has been a long time since we've dealt with the paradox of being frequently right and wrong on so many investment themes during the same year. So it was with our performance during 2024, when absolute return was positive but relative performance lagged our benchmark. Underlying that performance was ownership of some stocks that did exceedingly well while, conversely, several performed poorly for various idiosyncratic reasons, and one had the dubious distinction of losing over half its value during the year. There are other crosscurrents that help explain 2024 performance, many of which we will get to in a moment, but being mired between very right on the one hand and profoundly wrong on the other is a decidedly undesirable outcome.

If anything, this past year will be remembered as one during which our thesis on office real estate was finally vindicated. The endless litany of bad press that has plagued the sector since the pandemic gave way to increasing realization that the best office assets in the best markets would thrive. That's exactly what has come to pass and no company better represents that than Cousins Properties. The obvious answer to why it performed so well in 2024 is easy—it was far too cheap to begin with. The more informed answer is the company has built a business that despite the pandemic never stopped growing. It is the one U.S. office REIT in our investment universe whose cash market rents haven't declined since 2013. Once it became clear that its lifestyle office properties were not destined for the waste bin, the stock recovered meaningfully. The same can be said for two of the fund's other office holdings, BXP Inc. and Highwoods Properties, both of which had a great year.

"San Francisco hobbled Hudson's ability to generate meaningful traction with leasing. To boot, the company's studio and sound stage properties were essentially idled during two entertainment industry strikes."

Even though we've won the battle against office naysayers, we lost the performance war in 2024 and the primary reason for that was our ownership of Hudson Pacific Properties, a West Coast-based office REIT. Our stance with Hudson was that its markets would recover just like other office markets in the U.S., though with a lag. That didn't happen the way we envisioned. San Francisco has been a persistent laggard and it hobbled Hudson's ability to generate any meaningful traction with its leasing efforts. To boot, the company has a considerable investment in studio and sound stage properties that were essentially idled during two sequential entertainment industry union strikes. The confluence of those events pushed Hudson's valuation down to levels we rarely see for going-concern companies. Selling out might have been the correct call had it been made in early 2024, but we wanted to avoid compounding that mistake with a second mistake of selling too low. Hudson's current valuation is discounting outcomes we consider highly remote, such as a material debt default, and we maintain our small position in the business. If things turn out as we hope that small position could make a meaningful contribution to future performance. ■

Interest Rate Myopia

As we mentioned in our midyear shareholder letter, the direction and magnitude of interest rates had become an exhausting narrative which exerted too much influence on the fate of public real estate securities. Our hope at that time was that the myopia would soon lose its luster as the Federal Reserve began to loosen monetary policy. In positioning for that possibility we began to lighten the fund's holdings in coastal apartment REITs where valuations more fully reflected solid growth prospects. Proceeds from those sales we recycled into storage REITs, which tend to benefit when for-sale housing trends improve.

The Fed's lowering of rates should have led to an improvement in lending rates, fueling home sales. For a while that looked to be the case, but then macroeconomic data released over the second half of the year threw into question the magnitude and timing of additional Fed rate cuts. While we, along with almost all other investors, were correct in assuming rates would drop, they haven't dropped enough to spur the sort of home-buying activity that would bolster self-storage fundamentals. That short-circuited any hope of recovery in self-storage fundamentals and hindered performance of the fund's storage holdings, Public Storage and Extra Space Storage.

"When we say 'elevated supply' we are talking about unprecedented additions to the standing stock of apartments. Surprisingly, demand in those markets remained robust enough to stem meaningful rent drops."

Where we were wrong with our storage call, higher rates flattered the fund's holdings in apartments as demand in the sector held firm. In fairness, our investment in apartments was never based solely on an interest rate call. Rather, the fund's apartment holdings are durable businesses that have proved to be excellent long-term investments. Even so, we will take the fortuitous outcome.

The most surprising thing about the apartment sector's performance in 2024 is that it was managed in an environment of significantly elevated supply. Two of the fund's holdings, Camden Property Trust and Mid-America Apartment Communities, operate in Sunbelt markets with the highest rates of inventory growth during 2024. It shouldn't be missed that when we say "elevated supply" we are talking about unprecedented additions to the standing stock of apartments. Surprisingly, demand in those markets remained robust enough to stem meaningful rent drops. A combination of sustained job growth, immigration into those areas and persistently high mortgage rates served as strong support to the apartment sector. If we had been in an environment where any of those forces had worked in the opposite direction, vacancy would surely have increased and market rents dropped significantly. As a result, we count Camden and Mid-America among our best performers in 2024. ■

AI's Long Tail

The balance between being right and being wrong extends to the fund's ownership of data centers and infrastructure. While many contend the two are distinct from one another, we believe investors are underestimating how much they may be related. Digital Realty, the fund's largest data center

investment, had a stellar year. Not only was it well-positioned to take advantage of AI-fueled demand growth but a series of successful capital events significantly bolstered the company's balance sheet, and this has set the stage for accelerating growth in the years ahead. The company's backlog is as big as it's ever been and the only constraint on growth, we believe, is going to be access to electric power. Even though the stock's valuation is full, we are taking a tolerant approach given that growth seems to be consistently outpacing expectations. As a reminder, this stance is identical to the one we communicated to you in our midyear letter.

In that same letter we noted how the tower companies—and American Tower in particular—are set to be second-order beneficiaries of the AI revolution. That view is predicated on our belief, shared by American Tower's management, among others, that as low-latency inferencing applications begin to surface, the amount of data being exchanged over towers will increase dramatically. We believe this will eventually happen, but it's not a necessary precondition to seeing growth accelerate for the tower REITs. Technology continues to advance, necessitating constant improvement of radio towers, and with a growing population, cell densities need to increase. Those are natural tailwinds for tower demand even if AI demand is slow in coming for the tower companies.

Unfortunately, those merits were lost on an investing public in 2024. Investors seemed to treat the tower companies as little more than a bond proxy. It's an understandable position for some to take. Tower leases are long-term in nature, sometimes extending beyond 10 years. While they usually have handsome embedded rent bumps, that's not enough during periods when interest rates are volatile. Nevertheless, we like the long-term prospects for American Tower, including its wholly owned data center subsidiary, Coresite, even though we expect interest rates to remain choppy during the early part of 2025. The business is trading near historic lows on a relative basis and has an above-average and growing dividend, which compensates us for being patient. ■

Post-Pandemic Sprinters

Healthcare has been another area where we've been both wrong and right, though with a skew to the former. We were early believers that senior housing was set for recovery once the pandemic passed. To say that happened is an understatement as growth returned far sooner and with greater vigor than we expected. As a consequence the fund's senior housing REITs, Ventas Inc. and Welltower Inc., performed exceptionally well. With the resulting improvement in their cost of capital throughout the year both were able to pursue very large accretive acquisitions in a fragmented senior housing market and grow earnings at a solid clip. Ultimately, however, all of this became increasingly discounted into rich valuations.

In response, the fund used much of its position in Welltower to rotate into more attractive value, but maintained its position in Ventas, which offered better relative value though is certainly not cheap. We were too early in selling, unfortunately. Welltower in particular is a very large constituent of the fund's benchmark and being significantly underweight as the stock continued to outperform proved costly for the fund's relative performance.

"A closer look at competitive supply, meaning the space a tenant might consider as an alternative, indicates the situation is not as dire as the market narrative or Alexandria's valuation suggests."

Complicating matters is our preference for value that had us overweight in life science REIT Alexandria Real Estate for the whole of the year. Despite being one of our highest conviction ideas with fantastic long-term prospects, it is performing poorly under the weight of a narrative focused on the supply of life science property being delivered over the next couple of years. While that is true in absolute terms it misses a subtlety that we've always cared about—submarkets and sponsorship matter. Some of Alexandria's life science markets are saturated with new product. We have no doubt this will act as a governor of market rents over the near term.

A closer look at competitive supply, meaning the space a tenant might consider as an alternative to space offered by Alexandria, suggests the situation is not as dire as the market narrative or Alexandria's valuation suggests. Take for example the Sorrento Mesa submarket in San Diego. Life science space availability in that market is over 25% with more than one million square feet of new space under construction. Alexandria's development in that market is 70% pre-leased ahead of a late-2025 delivery. Competitive new construction in the market is only 8% leased. The implication is that tenants prefer Alexandria's offering in the submarket. While Sorrento Mesa's life science fundamentals are likely to be challenged near-term, Alexandria's stock valuation is being disproportionately penalized for the reality of what is likely to unfold over the longer term in that submarket. However, Alexandria's properties are very likely to perform much better than other lab options in the area, and we can say substantially similar things about its other submarkets across the U.S. We continue to believe the stock belongs among our top holdings. ■

Outlook:
Return of the Generalist

As we think about what 2025 may hold for public real estate securities, several things come to mind that on balance give us cautious optimism. We say this while believing that a Trump presidency and Republican mandate in Washington will be inflationary. This is likely to reinvigorate interest rate volatility, but we believe it will influence short-term stock movements far more than it will the fundamentals of the fund's holdings. With that in mind and further assuming there is no material slump in the labor market, fund positioning in 2025 favors ownership of property with shorter lease terms and lower leverage, and property that benefits from employment growth.

We remain steadfast in our belief that office is in the early stages of a multiyear recovery. Fundamentals have turned for most markets in the country—only San Francisco lags behind but we think 2025 will see its inflection. Even if interest rates remain higher for longer, which has been a pea beneath the office mattress for a long time, strong business profits and growing employment should matter more. Cousins Properties remains our favorite office holding and it, along with BXP, will continue to anchor the fund's office exposure. We have also been adding to our positions in two London-based office companies, Great Portland Estates and Derwent London. Valuations for both remain compelling and the setup for office fundamentals in their markets is, to our eye, better than in New York City, which is the best office market in the U.S., according to most.

Those sectors battling supply are presenting some interesting opportunities. We've mentioned life science, but there is also ample opportunity in the industrial sectors. As a reminder, the fund's positions in industrial previously led to several years of outperformance before elevated valuations faced slowing growth rates and fears of over-supply in certain markets. We've taken the opportunity to add to our position in Rexford Industrial given its very attractive relative and absolute valuation. The valuation is discounting flagging growth rates, which we consider remote, and we believe its southern California submarkets will prove more robust than market-wide statistics suggest.

"We are in uncharted territory with data center demand. With each passing quarter the total addressable market seems to grow and company backlogs to set sequential records."

Similarly we like the prospects for a late-2025 to early-2026 recovery in Sunbelt apartments. Historic levels of inventory additions in many markets across the south are already beginning to crest. Rents overall have remained remarkably strong (though are down in some markets), suggesting to us that migration and a lack of reasonable for-sale options are buoying fundamentals. A higher-for-longer interest rate regime will likely support preference for apartments over for-sale housing even in relatively affordable markets, and we believe strong employment growth in the Sunbelt will continue to be a tailwind for apartments. Mid-America Apartment Communities and, to a slightly lesser extent, UDR Inc. remain our preferred ways to capture improving Sunbelt apartment fundamentals.

We think data centers should continue to perform well. Capital investment into the AI sector is accelerating and the only thing likely to curtail growth at the data center REITs is access to electric power. As we noted in our midyear letter we are remaining tolerant of lofty valuations—this was a correct call at the time and hopefully is this time too. Our stance is based on a willingness to accept that we are in uncharted territory with data center demand. With each passing quarter the total addressable market seems to grow and company backlogs to set sequential records. Digital Realty remains our preferred way to make a direct investment in AI-demand given its strong relationship with hyperscalers such as Amazon, Google and Meta, but we believe tower infrastructure companies like American Tower offer a better value even though they are second-order beneficiaries.

Lastly, the stage is set for a return of generalist investors to the real estate sector. While we wouldn't posit it as a definite outcome, there is no question in our mind that real estate presents a solid relative value versus the broader market's best-performing stocks. It would make perfect sense for generalists to crystalize some gains and reinvest in better relative value. Real estate is as worthy of consideration as any sector, particularly if interest rate expectations begin to discount lower rates.

For more than 50 years we have navigated a constantly changing investment landscape guided by one North Star: to grow the value of the funds entrusted to us. We are pleased to have achieved strong results thus far and look forward to the decades ahead. With more than $2 billion of our own money invested in our portfolios, we stand shoulder to shoulder with our clients on this long journey.[1] We are grateful for your trust and are well-positioned for the future. ■

1. As of 12/31/24, Davis Advisors, the Davis family and Foundation, our employees, and Fund directors have more than $2 billion invested alongside clients in similarly managed accounts and strategies.

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Objective and Risks. The investment objective of Davis Real Estate Fund is total return through a combination of growth and income. 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; **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; **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; **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; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; **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; 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.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of 12/31/24, the top ten holdings of Davis Real Estate Fund were: Prologis, 5.77%; Equinix, 5.50%; American Tower, 4.89%; Digital Realty Trust, 4.75%; Cousins Properties, 4.65%; Ventas, 4.54%; Public Storage, 4.28%; Alexandria Real Estate, 4.22%; Simon Property, 4.22%; and Brixmor Property, 4.20%.

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 Statement of Additional Information. Holding percentages are subject to change. Visit davisfunds.com or call 800-279-0279 for the most current public portfolio holdings information.

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After 4/30/25, this material must be accompanied by a supplement containing performance data for the most recent quarter end.

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