Davis FUNDS

Update from Portfolio Managers

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Davis Appreciation and Income Fund

Semi-Annual Review 2019

Investment Results

The Davis Appreciation and Income Fund seeks to generate total returns through a combination of capital appreciation and income with a degree of downside protection.[1] We regard the Fund as an all-in-one solution for growing shareholders' purchasing power over the long term.

In the year-to-date period, the Fund returned 11.1%, building further on our long-term record of growing wealth for our clients. The Fund typically holds a majority of its assets in well-researched equities with balance representing high-grade fixed income securities as well as other assets. Our investment approach seeks to add value over multi-year holding periods.

Historically, the longer clients have remained invested in the Fund the more likely they have realized positive wealth building. In the year-to-date period, the 60% S&P 500/40% Barclays Aggregate Index returned 13.5% while the Endowment Index returned 12.8%, by comparison. ■

Portfolio Review

The Fund is consciously positioned in 27 high-conviction equity holdings as well as a portfolio of high grade fixed income securities.

Our performance this year, led by our equity positions, has been strongly influenced by our conscious positioning, which reflects our assessment of where true value resides in the broader market, and by where we feel risks have increased and should be avoided (the so-called "dividend darlings" being the notable example in our view).

On the first question of where we are positioned, we currently hold 27 high-conviction equity positions in durable businesses that have delivered earnings-per-share growth of more than 16.5% per year over the last five years. They are trading at only 14.0 times forward earnings, despite this compelling and attractive growth rate.

The average annual total returns for Davis Appreciation & Income Fund's Class A shares for periods ending June 30, 2019, including a maximum 4.75% sales charge, are: 1 year, −3.96%; 5 years, 1.71%; and 10 years, 8.59%. 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 1.01%. 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. All fund performance discussions within this piece refer to Class A shares without a sales charge and are as of 6/30/19 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.** Total returns are not annualized for periods of less than one year. **1.** While we seek to structure a portfolio that will increase in value when the S&P 500 Index increases and that will provide downside protection when the S&P 500 Index declines in value there can be no assurance that the portfolio will perform in line with our expectations.

The S&P 500 Index, by comparison, holds 505 securities with an approximate average position size of 0.20% which we believe is overly-diversified and not focused enough on a set of best ideas. The index has grown earnings per share at a rate of about 16.4% over the trailing five years, but its underlying securities trade at a much higher valuation of 17.9 times forward earnings than our stock positions, whose average valuation is only a multiple of 14.0.

It is worth noting that many of the market's leading performers have relatively high valuations and should be avoided at this time, in our opinion. The corollary to this is that elsewhere in the market, stocks have lagged the broader average. It has come to the point where we believe the market is now presenting stockpickers with a rare opportunity to buy extremely robust earnings growth at discounted prices. Furthermore, most of our holdings have what we feel are fortress balance sheets, and we always seek discernible competitive advantages—both of which are important buffers against many different types of risks.

We believe this market setup is ideally suited for our approach of buying durable, growing businesses at value prices and holding them for the long term; we believe this may provide a powerful springboard from which to generate attractive future returns.

Given the broad opportunity set today to purchase durable growth at discounted prices, we are finding the most value in the following areas:

- **Financials—**a natural core of the Fund, based on cash earnings generation, soundness of balance sheets, attractive returns on equity, and very cheap valuations, with many of our top holdings trading at 9–11 times owner earnings. Much of our thesis for financials is predicated on the belief that return of capital through rapidly rising dividends and large share buybacks will constitute a large portion, and in some instances the majority, of our expected total return. One of our top bank holdings, Wells Fargo, for instance, has a 3.8% dividend yield, earns more than $27 billion pre-tax, and returned more than $24 billion to shareholders in 2018 alone. Meanwhile, its multiple is roughly 10 times earnings. Other financial businesses in the Fund, including JPMorgan Chase and Bank of America, share similar attributes.

- **Consumer businesses—**companies that can benefit from strong consumption trends, both in the U.S. and internationally. The growth of the online dominant players is explained in no small part by the growing penetration of online versus offline businesses around the world. Taking retail as an example, within the U.S., only 10% of retail volume is online today, and this secular trend is still in its infancy. Globally, that share is even smaller but is growing at double-digit rates. In other words, the online theme has a long runway for stockpickers searching for selective companies that are natural beneficiaries of Internet-enabled business models; these opportunities touch multiple geographies and are creating disruption (and opportunities) in consumer-related industries ranging from retail to media to video gaming.

- **Technology—**With more than 50 years of history investing in technology, we are very comfortable owning many different segments of the sector. We hold positions in semiconductor-related businesses, where we believe valuations are low, even on trough earnings. Intel and Applied Materials are two such examples. Other technology businesses in the Fund include Microsoft and Alphabet. Overall, our technology holdings in aggregate provide exposure to strong cloud businesses, enterprise software cash cow businesses, leadership positions in artificial intelligence, dominant online retail and video services.

- **Industrials—**Our interest in this sector lies primarily in the aerospace industry, as evidenced by our positions in companies like United Technologies, a leader in the manufacturing and service of jet engines. Our thesis is based on the fact that the world supply of passenger and cargo jets is woefully behind demand. This is because global expansion of air travel linkages is running into a bottleneck on the assembly lines of Boeing and Airbus. The backlog of orders for both is measured in years, not months. As such, we feel the manufacturers such as United Technologies who make the engines and provide high-margin maintenance parts and services over the life of planes are exceptionally well-positioned to grow with aerospace around the world.

- **Energy—**Our interest lies primarily in North American shale players today. There is a select list of companies with excellent, high-productivity acreage that should, within the very near future, begin producing oil and natural gas at increasing rates. Our observation is that the performance of this group has reflected widespread capitulation among investors in this sector, driving down valuations to bargain prices. We understand the contrarian posture this represents. We are invested in this sector because we do not believe the market's price accurately reflects the growth potential of our names, on the one hand; on the other hand, we believe the market under-appreciates the companies' staying power—as expressed in balance sheet liquidity. In addition, we own relatively mid-size companies such as Encana and Apache; hence, we believe there are two ways to win—organically or by acquisition. Either way, we see real value in this extremely beaten-down sector.

On the fixed income side of the ledger, we have invested about a quarter of the Fund in high-grade corporate bonds and government securities (including agencies). Given our high bar and conservative posture for fixed income investments, our fixed income allocation has an effective duration of under two years.

However markets behave for a time, we must at all times remain singularly focused on pursuing investments that, at the business and industry level, represent acceptable and attractive long-term opportunities to us and our clients. The longer clients have invested with us, the more wealth we have built for them. We believe that an ability to look through the current market gyrations and recognize the confidence we have in businesses we own is critical to staying the course. For suitable clients, this may also be an attractive time to add further capital, given the opportunity set.

Overall, we believe we are well-positioned with respect to our goal of providing an all-in-one solution that seeks capital appreciation, rising income (over a multi-year period), and a degree of downside protection for shareholders. ■

Conclusion

The following summarizes our views relative to today's markets and the Fund:

- Selectivity, earnings growth and value are a powerful combination that is possible to achieve in our equities holdings today, all while owning a high credit quality portfolio of select fixed income securities that can provide a degree of income and downside protection.

- Current events such as the U.S.-China trade dispute, while a headwind to the market's advance, should eventually de-escalate, which we believe would be bullish for equities—and the market has successfully proven its resilience during much more serious tensions over the course of history.

- Economic and business fundamentals as well as current credit conditions remain generally healthy in the U.S.

- The current market conditions are favorable to active stockpickers, in our view.

At Davis Advisors, we seek to purchase durable, growing businesses at value prices and hold them for the long term. Since our firm's inception 50 years ago, we have adhered to the same, time-tested investment philosophy and rigorous research process of buying durable businesses at attractive prices and holding them for the long term. The more than $2 billion Davis Advisors, the Davis family and Foundation, our employees, and Fund directors have invested in similarly managed accounts and strategies remains a true sign of our commitment to and conviction in this enduring philosophy.[2] ■

2. As of 6/30/19.

This report is authorized for use by existing shareholders. A current Davis Appreciation and Income 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.

Objective and Risks. Davis Appreciation and Income 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. The Fund is subject to both equity and debt risk. Some important risks of an investment in the Fund are: **bonds and other debt securities risk:** bonds and other debt securities generally are subject to credit risk and interest rate risk; **changes in debt rating risk:** if a rating agency gives a fixed income security a low rating, the value of the security will decline; **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; **convertible securities risk:** convertible securities are often lower-quality debt securities; **credit risk:** the issuer of a fixed income security (potentially even the U.S. Government) may be unable to make timely payments of interest and principal; **depositary receipts risk:** depositary receipts may trade at a discount (or premium) to the underlying security and may be less liquid than the underlying securities listed on an exchange; **difficult to resell risk:** many investors do not want high-yield, high-risk debt securities, and others are prohibited from buying them; **extension and prepayment risk:** the pace at which borrowers prepay affects the yield and the cash flow to holders of securities and the market value of those securities; **fees and expenses risk:** the Fund may not earn enough through income and capital appreciation to offset the operating expenses of the Fund; **foreign country risk:** foreign companies may be subject to greater risk as foreign economies may not be as strong or diversified. As of 6/30/19, the Fund had approximately 10.2% of assets invested in foreign companies; **headline risk:** the Fund may invest in a company when the company becomes the center of controversy. The company's stock may never recover or may become worthless; **high-yield, high-risk debt securities risk:** issuers of these debt securities are unlikely to have a cushion from which to make their payments when their earnings are poor or when the economy in general is in decline. These issuers are likely to have a substantial amount of other debt, which will be senior to the high-yield, high-risk debt securities. An issuer must be current on its senior obligations before it can pay bondholders; **interest rate risk:** interest rate increases can cause the price of a debt security to decrease; **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; **overburdened issuers risk:** issuers of high-yield, high-risk debt securities are unlikely to have a cushion from which to make their payments when their earnings are poor or when the economy in general is in decline; **preferred stock risk:** preferred stock is a form of equity security and is generally ranked behind an issuer's debt securities in claims for dividends and assets of an issuer in a liquidation or bankruptcy. An adverse event may have a negative impact on a company and could result in a decline in the price of its preferred stock; **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. These comments may also include the expression of opinions that are speculative in nature and should not be relied on as statements of fact. 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 6/30/19, the top ten holdings of Davis Appreciation and Income were: Berkshire Hathaway Inc., 5.54%; Wells Fargo & Co., 4.17%; United Technologies Corp., 3.87%; U.S. Bancorp, 3.74%; Capital One Financial Corp., 3.65%; Applied Materials, Inc., 3.62%; Apache Corp., 3.53%; Amazon.com, Inc., 3.39%; Microsoft Corp., 3.07%; Alphabet Inc., 2.95%.

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.

The **Forward P/E ratio** is the aggregate of the Forward P/E ratios of the holdings. The ratio is not a forecast of performance and is calculated for each security by dividing the current ending price of the stock by a forecast of its projected Earnings Per Share (EPS). **Historical 5 Year EPS Growth** represents the annualized rate of net-income-per-share growth over the trailing five-year period for the stocks held by the Portfolio.

The attractive growth reference in this piece relates to underlying characteristics of the portfolio holdings. There is no guarantee that the Fund performance will be positive as equity markets are volatile and an investor may lose money.

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 Endowment Index is an objective benchmark for investors who manage a portfolio incorporating three dimensions: global equities, global fixed income, and alternative investments. The **Endowment Index** has been co-created by Endowment Wealth Management, Inc. and ETF Model Solutions, LLC. The **60% S&P 500/40% Barclays Aggregate Index** performance is calculated using 60% Standard & Poor's 500 Index and 40% Bloomberg Barclays U.S. Aggregate Bond Index. The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index that is widely regarded as a standard for measuring U.S. investment grade bond market performance. Investments cannot be made directly in an index.

After 10/31/19, 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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