
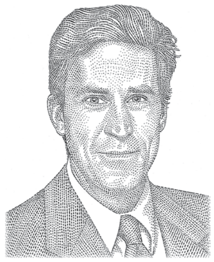

Update from Portfolio Managers

Andrew A. Davis and Chandler Spears

Davis Real Estate Fund

Annual Review 2020

Investment Results

Davis Real Estate Fund's Class A shares provided a total return on net asset value for the year ended December 31, 2019 of 25.4%. Over the same time period, the Wilshire U.S. Real Estate Securities Index returned 25.8%. Over the most recent one-, five- and ten-year periods, a $10,000 investment in Davis Real Estate Fund grew to $12,539, $14,466 and $27,955, respectively. ■

Investment Overview

What might be remembered most about 2019 is not how well real estate securities performed, but rather how such a strong performance could be had when literally no one was expecting it. We certainly did not anticipate that a 25% overall return was a likely outcome for 2019, and we wager that no one who made a forecast in late 2018 suggested such excellence. While we are here to earn index-beating, risk-adjusted returns for our shareholders, we believe investors prefer absolute returns over relative returns. With that in mind, we can say that 2019 was a successful year indeed: the Davis Real Estate Fund is happy to report that we delivered a significant absolute return while also in line with the Index in 2019.

Another remarkable aspect of the real estate securities story in 2019 is the degree to which sector valuations diverged. It is unprecedented in some instances. Certainly there is always a lagging sector or subset of companies that fail to muster any sort of decent performance, even when prices appreciate as much as they did last year. What is different this time is that entire sectors saw their valuations washed away in a storm of concern over changes that could prove persistent and, in every sense of the word, structural. Other sectors saw their fortunes swing the exact opposite way, achieving valuations dearer than we've ever seen.

The average annual total returns for Davis Real Estate Fund's Class A shares for periods ending December 31, 2019, including a maximum 4.75% sales charge are 1 year: 19.43%; 5 years: 6.62%; and 10 years, 10.29%. 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 0.97%. 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 12/31/19 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.**

We have spoken about enclosed malls in prior shareholder letters, but it is safe to say that 2019 represents a crescendo of concern for the sector. Not a single publicly traded mall REIT managed a positive return for the year, and those owning malls in secondary and tertiary locations have been relegated to the waste bin. A couple of companies are literally trading at one or two times cash flow. Even sector stalwart Simon Property Group (SPG) is trading at a meager 12x cash flow despite having one of the strongest balance sheets of any company in our investment universe. These valuations are reminiscent of the Great Credit Crisis of 2008. Whether these valuations are right or proper is not really the point. The point is that there remains within the sector great uncertainty as to what sort of mall real estate is viable and what the cost will be to make it sustainable. Consensus has coalesced around the notion that far-flung enclosed malls have no future.

For some mall companies, we agree that the current downtrodden valuations are likely close to reality. For one company, however, we think the market has it wrong. We have slowly been adding to the Fund's investment in Simon Property Group. They are making tremendous headway in proving that their malls have the potential to be reimagined and grow cash flow. We believe Simon's most promising attributes, beyond historically low valuation, are the quality of their locations and the flexibility to adapt those properties to changing demand. Where there was once just a well-located mall, now there is retail, entertainment, office space or even a hotel. A fortress balance sheet and better than $250M of free cash flow every year (after re-tenanting costs and dividends) gives Simon the opportunity to adapt their real estate to maximize value. For certain, we think they will continue to fight frictional vacancy as the retailing landscape changes to accommodate an omni-channel world, but we believe that surviving retailers as well as digitally-native retailers will seek Simon's properties as homes for their physical stores. All of these reasons explain why we count Simon among our favorite contrarian calls for 2020, despite lingering questions about the viability of mall real estate. In the spirit of Newton's third law of motion, if enclosed malls are performing poorly, surely there must be equal but opposite performance elsewhere. We think industrial real estate is it. Again, we've spoken about this in the past, but the duration of excellent performance by industrial REITs has truly impressed. The year 2019 will represent the fifth successive year of outperformance and underlying fundamentals suggest earnings growth is likely to continue. Yet history would suggest that after so many years of industry-leading performance, we might have reached a point where growth slows. We've seen "second derivative" issues hit high-multiple stocks in the past, and that usually translates into slowing share price gains. Indeed, we do see growth slowing in some interior U.S. industrial markets such as Dallas and Chicago. Conversely, in some dense urban markets such as Los Angeles, rents continue to grow for small-to-medium format distribution sheds. They don't even need to have state-of-the-art functionality such as 36-feet clear heights and expansive floor space. Rather, these infill properties are more likely to be relatively small in size, say around 100,000 square feet, and benefit from locations where new supply growth is virtually impossible to build. The real selling point is that these distribution facilities are indispensable to retailers of all stripes who are attempting to achieve their goals of next-day or even same-day delivery.

None of this has been lost on investors. Multiples have expanded, leaving almost all public industrial REITs trading at peak multiples. For several years running, industrial property investment has buoyed Fund performance, and we've been careful not to sell too early. However, with valuations at all-time highs and some signs of supply pressure in certain interior markets of the U.S., it is not time to be overweight, in our opinion. Throughout 2019, we slowly winnowed the Fund's investment in industrial. We did that by a modest selling of companies that own industrial properties in interior U.S. locations and investing new Fund inflows in other sectors. Noteworthy within the industrial sector are companies we have not materially changed our positions in, Terreno Realty Corporation (TRNO) and Rexford Industrial Realty, Inc. (REXR), where we remain significantly overweight relative to our benchmark. These two companies represent a focused play on seemingly unfettered growth in last-mile logistics. We think their urban infill industrial properties will continue to see growing rent, which is necessary since peak multiples can't coexist long with slowing earnings growth. If the lopsided tug-of-war between industrial and malls isn't challenging enough, there are other areas of commercial real estate dealing with potentially life-changing factors. ■

Fund Positioning

In late 2018, the failed repeal of the Costa-Hawkins Rental Housing Act in California was a shot across the bow for apartment REITs operating in California. Repeal of Costa-Hawkins had the potential to place a regulatory cap on rental rate increases in many of the most profitable apartment markets in the country. The guns have not remained silent. Since then, a number of rent control measures have passed in other states with high housing costs. Thankfully the measures put in place are, in substance, anti-gouging measures and not true rent caps. Further, we believe that most voters and government officials recognize that rent control is not the antidote to expensive housing. A loosening of development restrictions that increases supply is a better solution. Even so, fund management must take into account scenarios that could stall market rent growth. While truly onerous rent control has not come into play, and there has not been a huge increase in new supply, we have started to reduce our long-term growth rate assumptions for apartment companies under our coverage. Even though the apartment business is a very good one, we do expect that slowing rent growth could manifest itself over the next few years as anti-gouging measures take effect and new supply emerges.

While we will monitor all of these factors carefully and adjust our investments in the apartment sector as needed, we remain committed to the sector. Why? Everyone needs a home. Sure, preferences for apartments ebb and flow if for-sale housing represents a relative bargain, but the fact remains that we all need a bed. A nation that continues to benefit from full employment means most apartment companies should continue to see outsized demand for their properties, especially in markets benefiting from growth in technology and life science. The Fund's apartment holdings are concentrated in these sorts of markets, and we expect healthy returns to continue in 2020.

Office too has become fertile hunting ground for value. That might strike some long-time investors as a bit odd because office real estate is a costly sector that we've never really liked. Margins tend to be lower than in other sectors, and the frictional cost of re-tenanting properties is extraordinarily high. Blind adherence to this thinking might compel us to dismiss all office real estate out of hand simply because it is not a good business. In this instance, however, digging deeper into the sector pays dividends. We've concluded that one way to earn good risk-adjusted returns in the office sector is to build new product or redevelop existing product in the right locations. For example, Hudson Pacific Properties (HPP) is not developing splashy high-rise properties of the sort you'd see in Manhattan, but it does have a remarkable set of redevelopment opportunities. Many of those include elements of new construction that supplement refurbishing of existing structures. Further, they are located in vibrant submarkets in Los Angeles, Silicon Valley and Seattle, among a few others. As a result, Hudson's projects are already almost 90% pre-leased. We expect that under the stewardship of an exceptional management team, Hudson will be able to grow owner earnings faster than almost all other companies in our investment universe. We therefore count Hudson as one of our largest overweight investments heading into 2020.

While selling down industrial to buy out-of-favor malls and office might seem risky or bold, our approach remains conservative and thoughtful. The Fund will remain deeply invested in fast-growing industrial real estate with the brightest future. Similarly, the Fund's increased emphasis on malls and office will continue to be extremely selective, focusing on the mall locations best suited for use expansion and office developments with the highest level of pre-leasing.

Speaking more generally, during 2019, we continued to buttress the Fund's ability to withstand less accommodative credit markets. Don't get us wrong, we are not calling for a negative credit event nor predicting interest rates. However, we believe that credit conditions can't get any better than they were in 2019, and it therefore makes little sense to stretch for earnings growth with excessive leverage. The Fund's holdings have very low balance sheet risk and tremendous flexibility with their properties. That is important because it is very difficult to sell an asset to fund other investment opportunities if the property to be sold is encumbered with excessive debt, is cross-collateralized, or has some other impediment that compromises attainment of full value. We'd rather sacrifice a bit of growth to sit in a protected position relative to markets, especially credit markets. Given the number of unsettled macroeconomic issues afoot, a defensive approach is prudent.

Potentially disruptive structural changes as well as the daily onslaught of new information definitely keep the job of securities analyst interesting. Our job, however, is not simply about explaining the problematic issues. Rather, the challenge lies in analyzing those issues, formulating a plan, and putting it to work. When we factor into our analysis the structural headwinds discussed above and combine that information with our other research, we enter 2020 with a sense that value might be the way to achieve excess performance over our benchmark. This is pushing us into measured investment in out-of-favor sectors with a concomitant reduction in expensive sectors that have worked so well over the past few years and are now in decline.

We are gratified that the Fund performed well in 2019 and we will strive to achieve the best possible outcome for shareholders of the Fund in 2020. As fellow shareholders in the Fund, we thank you for your trust and support. ■

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 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; **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 Funds 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 may 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.

Owner Earnings are the excess cash a business generates after reinvesting enough to maintain current capacity and competitive advantages but before investing for growth.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of 12/31/19, the top ten holdings of Davis Real Estate Fund were: Simon Property Group, 6.04%; Prologis, 5.56%; AvalonBay Communities, 5.29%; Alexandria Real Estate Equities, 3.61%; Equinix, 3.57%; Public Storage, 3.54%; Essex Property Trust, 3.36%; Camden Property Trust, 3.26%; American Campus Communities, 3.10%; Hudson Pacific Properties, 3.08%.

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.

Broker-dealers and other financial intermediaries may charge Davis Advisors and/or Davis Distributors, LLC 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; 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' and/or Davis Distributors, LLC's payment(s) to a financial intermediary as a basis for recommending the Fund.

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 1/1/78, 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 4/30/20, 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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