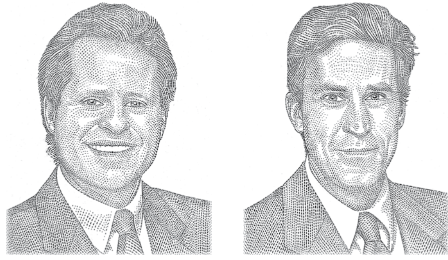

Update from Portfolio Managers
Andrew A. Davis and Chandler Spears

Davis Real Estate Fund

Fall Review 2021

Davis Real Estate Fund's Class A shares provided a total return on net asset value for the year-to-date period ended July 31, 2021 of 27.51%. Over the same time period, the Wilshire U.S. Real Estate Securities Index returned 28.95%. Over the most recent one-, five- and 10-year periods, a $10,000 investment in Davis Real Estate Fund would have returned $13,916, $14,102 and $24,437, respectively.

There is a great quote from Nassim Taleb's latest book, *Skin in the Game*, which we will paraphrase, that captures the most important aspect of the Davis Investment Discipline: Don't be so enamored with the grand scale and opulence of the theater that you overlook the size of the exit door. Said a bit differently and in terms we have often used in the past: the capital stack always matters. No matter how compelling the business opportunity, if the balance sheet cannot weather the bad times, the business will suffer (or fail) when those bad times materialize. And they always do. In fact, the frequency of highly disruptive exogenous market shocks has become a persistent and consistent reality. During our management's 21-year tenure together, the U.S. economy has weathered the dot.com market collapse, terrorist attacks, a financial crisis of historic proportions and a global pandemic, to name only the largest black swans. It is simply unreasonable to suggest that we are permanently out of the exogenous shock woods.

In some respects, investors can pat themselves on the back, because despite all of those events, the U.S. economy is performing fairly well. If stock market values were the only source of information, one would have trouble discerning that anything has happened. While Davis Real Estate Fund has enjoyed a good record through those periods, including through the first seven months of 2021, we spend our time focusing on prior mistakes in

The average annual total returns for Davis Real Estate Fund's Class A shares for periods ending June 30, 2021, including a maximum 4.75% sales charge, are: 1 year, 31.57%; 5 years, 6.02%; and 10 years, 8.51%. 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 lower or higher 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 discussed within this piece refers to Class A shares without a sales charge and are as of 7/31/21 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.**

an attempt to improve future performance. Long-time investors know that we value those scars as memorials to the best teaching moments.

The most important lesson we have learned over the past two decades is that growth is not fungible. Impressive growth rates are often created by high leverage. As a result, part of our research seeks to place investment options on a level playing field by forcing leverage parity. The specifics of how we do that are beyond the scope of this review, but suffice it to say that we try to determine who is buying their growth with extra leverage. In essence, we juxtapose great growth prospects with the size of the exit door. During periods when interest rates are low, which has been the case for well over a decade, our conservatism might mean we are underweighted in some fast-growing real estate businesses. However, because return is never risk-free, debt-fueled growth over long durations can result in bad outcomes when financial times get tough.

When the economy shut down last year to curb the spread of COVID-19, the size of the exit door belatedly became the focus again, and there were indeed some bad outcomes. In the span of roughly a single month, companies with higher operating leverage, such as hotels, went from cash flow generators to cash consumers. Likewise, many retail formats highly dependent on foot traffic also succumbed as tenants could not make rent payments. When this sort of high operating leverage intersects with high financial leverage, failure becomes a clear and present danger. That is why our research focuses so heavily on all forms of leverage.

As we stand at what we hope to be the far edge of the pandemic abyss, you might wonder: if things were so bad in commercial real estate, why didn't more real estate companies fail? The answer is quite simple: most public real estate companies were (and continue to be) well-financed. Said a bit differently, had the pandemic struck in 2008 instead of the financial crisis, failures would have been plentiful. From that standpoint, we can applaud the universe of publicly traded real estate companies for avoiding institutional amnesia and not lapsing into the poor financial management practices that made 2008 so painful.

Nevertheless, there is a distinction we want to make. While the pandemic has resulted in very few casualties among public real estate companies, simply surviving is not sufficient to make a business a good investment. A good investment grows effectively. It doesn't spend years tending to old wounds. From our perspective, no long-lived business maintains a weak balance sheet, at least not for long. That focus means that our investments didn't incur permanent economic damage from the pandemic. No doubt some of our holdings suffered a dramatic drop in share price, but it was transitory. To be clear, those were anxious days, and there was no shortage of hand-wringing over various going-concern issues for several of our holdings, but Fund performance held up well. Beyond our pervasive commitment to balance sheet strength, performance was buoyed by a few factors deserving of explanation.

As frightening as the pandemic became in early 2020, our first action was to evaluate calmly. We did not panic-sell holdings simply because they were in a property sector that was thrust into going-concern conversations. Most of the commercial real estate issues you read about or heard parroted from media commentators were not new trends at all. Consider that work-from-home, the changing landscape of retail consumption and geographic migration shifts are structural changes that have been taking shape for decades now. The pandemic simply accelerated and magnified the process. Because Davis Real Estate Fund has for years been positioned for those changes, we did not need to make dramatic portfolio adjustments.

That stance has been effective, given the significant recovery in several sectors thought to be permanent casualties of the pandemic, particularly shopping centers. We have long held

that the evolution of retail consumption would favor e-commerce and industrial distribution at the expense of shopping malls. Early in 2020, we extended our thinking to other retail formats and found a preference for grocery-anchored shopping centers. Well before the pandemic struck, we believed that prices of certain grocery and necessity-based retailers were being unduly punished. When Amazon purchased Whole Foods, endorsing the importance of bricks-and-mortar retail, we expected shopping center valuations to improve. That didn't happen right away. The accelerated and magnified recognition of grocery store importance occurred during the early days of the pandemic when people were relying heavily on grocery delivery. The realization was that those making the delivery still needed a fulfillment center; it was called the grocery store. Further, with restaurants shuttered, some of the demand for dining out shifted to grocery. Grocery stores became an essential property type. Even when the pandemic started to ease late in 2020 and people returned to shopping in person, grocery-anchored centers improved their customer focus with services such as buy-online-pickup-in-store (BOPIS) and buy-online-pickup-curbside (BOPUC). In a counterintuitive way, grocery-anchored centers have shown themselves to be somewhat internet- and virus-resistant, far more so than their pricing at our time of purchase. Davis Real Estate Fund's holdings in the shopping center sector have performed exceptionally well over the past year, and we expect that to continue, given current, favorable valuations.

Our next action was to search through the debris to find great businesses whose valuations had become disconnected with a post-pandemic world. What made this exercise so difficult was the number of issues surrounding legal rent payments, the politics surrounding them, and in the case of rent arrears, collectability. Several states and government agencies promulgated temporary prohibitions against evictions. While the intent of those measures has merit, they robbed landlords of a legitimate business tool to protect their interests.

It is understandable that apartment renters might need some protection, but as is often the case, there are bad actors. In California, emergency orders allowed some perfectly healthy commercial tenants to simply stop paying rent, often without the courtesy of notice to the landlord. That set up a day of reckoning that is now fast approaching. Those orders will likely expire at some point this year, and rent will ultimately be repaid, terms renegotiated or the tenant evicted. The uncertainty surrounding how this process will unfold has created significant headwinds for companies and investors.

Take Douglas Emmett (DEI), for example. It owns office and apartment properties in several Los Angeles submarkets with a few similar holdings in Honolulu. Importantly, the company has amenity retail space in most of its office properties and numerous parking garages, almost all of which ceased to generate cash when California entered lockdown. Most of the office tenants continued to pay rent. Some of the retail tenants also continued to pay rent, but some could not. Some bad actors stopped paying rent despite their wherewithal to do so without giving any notice to Douglas Emmett as to why or when they might resume rent payment. Investors punished their valuation, given an inability to confidently answer a number of questions. For those not paying rent, when do they begin again? Do they make good on past due amounts? And when do parking garages become necessary again, if ever?

We don't claim to have perfect answers to these questions, but part of our job means making decisions under conditions of uncertainty. We believe the issues surrounding Douglas Emmett are mostly transitory, as the company has been adapting to the changing model prior to COVID. Many workers will return to the office with some portion (yet to be determined) of work from home. Further, given the desirability of their properties, holdout tenants should eventually come to some accord with rent arrearage. Where space is returned to the company, we believe demand will eventually surface to backfill that space. Not everyone agrees.

Douglas Emmett's valuation was punished early last year, and while it has recovered some since, it still remains deeply discounted. We like the company's prospects, and it remains one of the Fund's top office holdings.

We wouldn't be true to our valuation roots if we ignored the carnage in the hotel sector. While it was fairly easy to foresee the demand for leisure travel returning, there is still vociferous debate over the future of business travel demand. We believe that hotel demand in all forms will eventually return; the question is the timing. What separates hotels from every other real estate sector is its massive operating leverage. This heightened risk is unique to hotels because they need to refill their rooms each day.

Think of it as a sector with single day leases for each room. Hotels need to be open to generate cash, and that is not at all possible during a shutdown. Adding to the complexity: hotels are capital-intensive. It is not just the initial cost of acquisition or development that comes into play here, but also the investment dollars necessary to maintain properties even if they aren't open. That's why the majority of public hotel owners are very well-capitalized, with leverage levels far lower than other sectors.

Even so, they weren't designed to weather a complete shutdown lasting over a year. The only way to weather such an arrest of business activity is to have the financial wherewithal to outlast it. Of all the hotel owners we follow, only two had sufficient capital to fund quarterly cash shortfalls for an extended period: Host Hotels & Resorts, Inc. (HST) and Sunstone Hotel Investors (SHO). Based on our detailed analysis in April of this year we determined that both companies could fund operating cash deficits for more than two years. Still, to invest, we needed much more than just survival.

While well-timed investment in survivors can yield great returns, we prefer to make long-term investments. Currently that means finding the survivors that can thrive over the long term. In our view, having a stellar balance sheet is a necessary precondition to thriving. But the business itself needs to have a moat. Host and Sunstone have considerable moats. Both companies own irreplaceable U.S.-based assets that slant heavily in favor of properties catering to the leisure traveler. That is important because the prolonged sequestering of the entire population was setting the stage for what we believe will be a summer of "revenge travel." After all, humans are social animals who enjoy travel experiences.

Initially, we doubt it will be international travel (even if legally permitted). Rather, more likely, we expect trips that involve car travel or domestic flights, the sweet spot for the assets owned by Host and Sunstone. In fact, demand is returning so quickly that both Host and Sunstone anticipate achieving break-even cash flow later this year. That is far quicker than anticipated. Further, because both companies had enough cash on the balance sheet at 2020 year-end to cover two full years of operating shortfalls, they are now positioned to acquire assets and begin to grow again. Valuations have yet to fully reflect the much improved environment, but we feel confident that time is not far off.

Echoing sentiments we expressed earlier, it says a great deal about the maturation of the real estate sector that it has weathered yet another catastrophic event. As of this writing, there have been only two bankruptcies among our universe of over 170 companies. Frankly, these were in the works well before COVID-19. While there might be one or two more, investor conversations have shifted from anxiety over demand and rent payment to prognostications about growth trajectories. And while there will be more unanticipated events as the years unfold, we are heartened that the public real estate model has proven durable and worthy of inclusion in any properly diversified portfolio. 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.

Davis Advisors is committed to communicating with our investment partners as candidly as possible because we believe our investors benefit from understanding our investment philosophy and approach. Our views and opinions include "forward-looking statements" which may or may not be accurate over the long term. Forward-looking statements can be identified by words like "believe," "expect," "anticipate," or similar expressions. You should not place undue reliance on forward-looking statements, which are current as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate.

Objective and Risks. Davis Real Estate Fund's investment objective is total return through a combination of growth and income. There can be no assurance that the Fund will achieve its objective. Under normal circumstances the Fund invests at least 80% of its net assets, plus any borrowing for investment purposes, in equity, convertible, and debt securities issued by companies principally engaged in the real estate industry. Some important risks of an investment in the Fund are: **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 6/30/21, the top ten holdings of Davis Real Estate Fund were: Prologis, 7.06%; Public Storage, 4.89%; Equinix, 4.16%; Essex Property Trust, 3.92%; Welltower, 3.92%; AvalonBay Communities, 3.89%; Simon Property Group, 3.81%; Rexford Industrial Realty, 3.50%; Brixmor Property Group, 3.42%; Terreno Realty, 3.39%.

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

We gather our index data from a combination of reputable sources, including, but not limited to, Lipper, Wilshire, 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 10/31/21, 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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