

## Capture Upside, Protect Downside

*The investment philosophy of Davis Appreciation & Income Fund is premised on the belief that equities are a relevant part of an investment portfolio over the long term. The Fund combines the growth potential of stocks with the income of bonds. Portfolio Managers Andrew Davis and Keith Sabol seek durable businesses at value prices to structure a portfolio with which to participate in the stocks' upside potential while providing a degree of protection against downside risk.*

**Q: What is the investment philosophy of the fund?**

**A:** We believe in purchasing durable businesses at value prices and holding them for long periods of time. Our core investment philosophy is that a full range of security types is a relevant part of an investment portfolio for long term investing. We believe that if we can manage the use of the entire stack of securities, from equities to convertible securities, straight debt or preferred stock, we ought to be able to provide an investor with equity-sized returns, but with less risk and volatility.

**Q: What are the key elements of your investment process? What are the key metrics that you are looking at?**

**A:** We follow a three-step investment process. First, we consider valuations, creating valuation models for each of the companies considered. Second, we analyze the investment potential of businesses using the time-tested Davis Investment Discipline and purchasing only those businesses that we believe are trading at a discount to their estimate of fair value. Third, having identified attractively priced convertible securities, stocks and bonds issued by durable businesses, we seek to structure a portfolio with the potential to participate in some of the stocks' up-

side potential while providing a degree of protection against downside risk.

Our review of intrinsic value comes down to a measure that we call 'owner earnings'. In essence, we make adjustments to GAAP earnings in order to assess the true cash flow (or owner earnings) that will accrue to the benefit of the business's owners. Our fundamental approach is to try to buy companies valued at an inexpensive multiple of owner earnings both in an absolute sense and relative to the companies' ability to grow their owner earnings.

The operating performances of the businesses we buy ultimately drive most of our future investment performance, so we take great care in the selection and research process. After we've identified a business we'd like to own, we seek to combine various elements of the capital stack to create a skewed risk/reward profile where we can potentially capture more of the upside and avoid more of the downside that might be inherent in a particular situation.

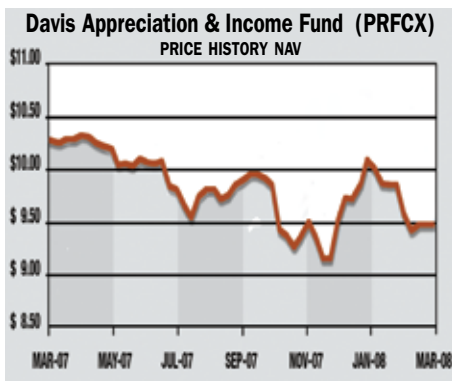
We like convertible bonds, especially when we can get the classic convertible bond investor's risk/reward profiles, where maybe we can capture 80% of the upside and 50% of the downside of a given stock price move. Since the



**ANDREW A. DAVIS** has more than 19 years of experience in securities analysis and investment management. He has managed the Davis Appreciation & Income Fund since joining the Davis Funds in 1993. Previously, he worked as the head of the Convertible Securities Research Department at a major brokerage firm. Davis is a graduate of Colby College.



**KEITH SABOL** joined Davis Advisors in 2005 as a Portfolio Manager of the Davis Appreciation & Income Fund. Sabol was previously a Principal at Quantanium, LLC and a Portfolio Manager for Federated Investors. He is a graduate of The United States Military Academy at West Point, served as Captain for the U.S. Army during Operation Desert Storm and has an M.S. from Carnegie Mellon University.



world is not perfect, we often seek to make combinations of common stock with other elements of the capital stack to attempt to replicate that kind of a profile as closely as possible.

**Q: Could you give an example of how you balance the risk/reward profile?**

**A:** Certainly. In 2006, we established a position in Amazon.com convertible bonds. Before doing so, we met with the management and did a site visit and came to appreciate a lot of the company's advantages. Our analysis led us to believe that the level and durability of Amazon's growth rate as well as its operating leverage potential were underappreciated by the market. Because the bond was convertible into Amazon's common stock at a price far higher than where Amazon was trading at the time, it would not capture much of the upside return if our thesis were correct. As a result, we opted to own a blend of Amazon's convertible and common stock, equally weighted. Over the next 18 months the stock indeed

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rallied, moving closer to the convertible's conversion price. The returns were positive for our shareholders but created the need for us to reduce our common stock position. Why? The combined position was now overly sensitized to the movement of the common stock, resulting in too little downside protection. As a result, we reduced our exposure by selling some common stock to balance the risk/reward profile.

Because of this reward/risk balancing act, we expect that there will be two (or more) securities for every company. But those securities, in combination, truly represent our single investment idea.

**Q: Where do you find ideas?**

**A:** One benefit of a down market is that you don't have to continually find new companies - a lot of your better old ideas just went on sale. Our tendency toward ideas comes from voracious reading of sources from all over the world.

We are more quantitative and screen oriented. We have a set of models that help me complete rough-cut calculations of owner earnings and multiples of owner earnings. We compare those valuation metrics across companies within industry groups and sectors. That process helps flag ideas that are statistically cheap. An attractive price alone is never enough to justify an investment, but it is enough to warrant reviewing annual reports and current events of well priced companies and, for some, building financial models.

**Q: Are you looking at historical earnings or do you pay more attention to the future earnings?**

**A:** You can use history to inform your expectations of the future, but shouldn't rely on it entirely. For each of the positions in the portfolio, we have a fully integrated income statement, balance

sheet and cash flow model. We make and test various assumptions throughout that modeling process to get comfortable with the range of probable outcomes and with the probability that we'll generate rates of return that are appropriate given the risk of the particular investment.

**Q: How many positions do you generally have in the portfolio?**

**A:** Right now, there are 39 issuers in the portfolio. We tend not to think so much from a top-down perspective, but rather from a bottom-up perspective; we seek a true understanding of individual businesses. It's really evaluation and fundamental understanding that are ultimately driving us at the security level to ship capital from one idea to the next in the portfolio.

**Q: What would you do in a situation where the stock of a company you believe in happens to languish for one reason or another?**

**A:** An example of one company we believe is in that situation right now is Forest City Enterprises (FCEA). Forest City is a dominant master plan community developer of the first order and we believe that the management has a fantastic grasp on how to earn outsized shareholder returns.

Currently, they are perceived to be over-leveraged, a concept with which we would disagree. Investors have lumped this company with inferior companies in similar or related businesses. They may be right but we don't think so. We have reevaluated our thesis to question whether we've missed something. We have had to decide whether to sell the company because its stock has performed poorly, whether we should wait and assume that rational thinking will eventually win out, or whether we should double down and take an even larger position. In order to make an educated decision, we recently re-tested our thesis and spoke with the management. The

fundamental drivers of the business remain intact; there continues to be news of new tenants coming into their developments, yet the stock continues to languish. We remain firm in our conviction that the company is a best in class developer and that the market doesn't appreciate the differences in its business model compared to that of the average real estate developer. We have taken the opportunity presented by this dislocation to buy more of the company.

**Q: What kinds of risk do you monitor and what do you do to mitigate it?**

**A:** This portfolio is designed around the concept of weighting the capital stack appropriately within ownership of each company and having the right balance of available securities. Equities, preferred stock, straight debt, convertible debt - these categories allow us to spread or mitigate risks.

Moreover, we adjust our expected return hurdles to match the perceived risk of the companies we are evaluating. We also try to "right-size" our gross exposures to issuers to reflect the risk that we see in the position and how that might relate to other portfolio holdings. We try to maintain a broadly diversified portfolio.


Reiterating what we've said earlier, underwriting the current value of a business and correctly assessing its growth potential remain the key to our process. The most important question we ask ourselves at the end of the day is what we are willing to pay to acquire a position in a company. There have been a number of instances where we have not been able to buy as much stock as we wanted because the stock rallied out of our price range. We rarely chase prices up. We are never so arrogant as to expect that we'll be able to "bottom tick" a stock purchase; we fully expect that at some point during our holding period the stock will probably trade below where we first bought it and can add more to the position then.

**Q: Could you illustrate your thinking with a historical example of a situation where you decided to reduce the overall size of a position in the portfolio?**

**A:** Coca Cola is probably a good example. We bought that stock a year ago when it was around \$48 dollars and we could model a conservative volume growth profile with a decent discount rate. We were in the 11.5% range for an expected return in our modeling process and had price targets somewhere above the \$60 range.

Subsequently, Coke's organic growth performance improved and market woes caused investors to value Coke's relative predictability more dearly. So, when we revisited our valuation after adjusting volume growth rates and expectations going forward, we found essentially an implicit discount rate below 10%. We didn't think that rate was justifiable in the face of other opportunities that we were seeing in the market. So we chose to reduce the overall size of that position. We sold some of the common stock as well as some of the bonds with which it was paired. This sale enabled us to right-size our gross exposure and preserve our target risk profile. Importantly, this sale enabled us to reallocate capital to other better opportunities.

**Q: What else do you think is important for our readers to understand about your investment style?**

**A:** We are proud to be able to say that the largest group of investors in the Davis Appreciation and Income Fund is our family, our board of directors and the employees of our firm. Simply put, we eat our own cooking. We aren't just managers, we are owners. We like the motivation that this produces. We reap the benefits of good performance and feel the pain of weak markets, just like every other shareholder. 

## Davis Appreciation & Income Fund

Symbol	<b>RPFCX</b>
Website	<a href="http://www.davisfunds.com">www.davisfunds.com</a>
Address	Davis Selected Advisers LP 2949 East Elvira Road Suite 101 Tucson, AZ 85706
Tel. No.	800-279-0279
Inception	05/01/1992

### PORTFOLIO

Total Net Assets*	\$494.5
Avg Mkt Cap (\$ Weighted) *	\$46,000
Average Price/Earnings Ratio	19.85x
Average Price/Book Ratio	4.62x
Turnover Ratio	23%

### INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$25
Min Initial IRA Investment	N/A

### RISK (AGAINST S&P 500 DAILY REINV - 3 YEARS)

Alpha	0.16
Beta	0.64
R-Squared	0.78
Ann. Std Deviation	6.18
Sharpe Ratio	0.29

### RETURNS VS. LIPPER CONV SEC FD INDEX

	RPFCX	Index
1 Year (Cum.)	-7.76%	-1.48%
3 Year (Ann.)	5.70%	7.20%
5 Year (Ann.)	10.09%	9.88%

### RETURNS VS. S&P 500 DAILY REINV INDEX

	RPFCX	Index
1 Year (Cum.)	-7.76%	-5.08%
3 Year (Ann.)	5.70%	5.85%
5 Year (Ann.)	10.09%	11.32%

### FEES AND EXPENSES

Max Sales Charge - Front**	4.75%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.01%

### PORTFOLIO MANAGER

Andrew Davis	1993
Keith Sabol	2005

\* millions \*\*for amount invested less than \$100,000

Data through: 03/31/2008

Source: Company Documents; Lipper

Ticker staff searches for mutual funds for their consistency in performance and durability of investment style.

Our interview covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. Through an interview we uncover long-term strategies and processes that help to generate long-term returns.

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