



An Update from
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Portfolio Managers
Annual Review 2009

Performance Overview

The Davis Appreciation and Income Fund's Class A Shares delivered a total return on net asset value of 49.68% for the one year period ended December 31, 2009, compared with a return of 26.46% for the S&P 500® Index.¹ Over the same time period, the average convertible securities fund tracked by Lipper returned 41.09%, and the average moderate allocation fund tracked by Morningstar returned 24.23%. Because short-term results are less interesting to us than long-term results, we find it more meaningful that over the long term the Fund has generated a somewhat better return than the market with less risk. Since the Fund's inception on May 1, 1992, its Class A Shares have generated an average annual total return on net asset value of 8.29% versus an average annual total return of 7.92% for the S&P 500® Index.¹ At the same time, since May 1992,

the Fund has had an annualized standard deviation (a commonly used statistical proxy for risk) of 13.66% versus 14.89% for the S&P 500® Index.²

According to a Morningstar report on the Davis Appreciation and Income Fund, "This fund's returns have come roaring back. . . . enabling its 10-year annualized return to remain better than most peers' Managers Andrew Davis and Keith Sabol buy out-of-favor stocks trading well beneath what they deem to be their fair values. The team usually requires that the holding offer some sort of income during the time it takes for the stock to realize its value. Consequently, the fund invests in real estate investment trusts, which are required to distribute nearly all their income, or a variety of high-yielding securities from across the capital structure—including high-yield common stocks and convertible bonds. . . ."³

Total Returns as of 12/31/09	1 Year	5 Years	10 Years	Inception (5/1/92)
Davis Appreciation and Income Fund Class A Shares				
<i>without a sales charge</i>	49.68%	1.69%	3.51%	8.29%
<i>with a maximum 4.75% sales charge</i>	42.53	0.71	3.00	7.99
S&P 500® Index	26.46	0.42	-0.95	7.92

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 1.07%. 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 data quoted. For most recent month-end performance, visit davisfunds.com or call 800-279-0279.

¹Class A shares, not including a sales charge. **Past performance is not a guarantee of future results.** ²Source: Morningstar EnCorr. ³Morningstar Mutual Funds, August 31, 2009.

Our Strategy

Our long-standing investment goal is to capture most of the market's upside performance while participating in less of its downside.⁴ We use the Davis investment discipline to identify the businesses we wish to own, and then we seek to achieve our objective by investing in convertible bonds, equity, preferred stock, and straight debt of these target companies. We blend securities from these categories, taking into account valuations and other attributes of the particular securities employed. Because of the favorable return profile of many convertible securities, we like to include them when they are available from particular issuers at acceptable prices. In constructing our Portfolio we consider the risk versus reward trade-off at both the issuer and portfolio levels. At purchase, we size the issuer exposure and equity sensitivity of our positions to match our view of that issuer's fundamentals and valuation and our return expectations. These blends are adjusted over time on an event-driven basis to reflect changes in our outlook.

In the second half of 2009, the Fund returned 25.79%, which compares favorably with the 22.59% return of the S&P 500® Index.⁵ This result puts the Fund slightly ahead of the S&P 500® Index since December 31, 2005 and with a positive return as compared with the Index's negative result.⁵ Even though we wound up in a good place, the path was more challenging than we would have liked. While we remain confident in our approach to evaluating businesses, we believe there are opportunities for

us to think more comprehensively about risk. As always, we seek to apply what we have learned from past mistakes in order to become better investors.

The Markets⁶

During the first half of 2009 both high yield and investment grade bonds outperformed the S&P 500® Index in large part due to dramatically improving credit conditions. In our mid-year commentary we cautioned that the pace at which the Fund outperformed the S&P 500® Index would not be sustainable in the long run. Credit spreads cannot shrink to zero and the closer spreads get to normal the less likely capital appreciation becomes. Nevertheless, despite the strong rally in the credit markets in the first half of 2009, bonds of all types continued their advance in the last six months of the year. The Barclays Capital U.S. Credit Index, an investment grade bond index, rose 8.6% and the Barclays Capital U.S. Corporate High Yield Index rose 21.3% from July through December,⁷ although both lagged the S&P 500® Index. With the credit tailwind persisting but weakening, we were not surprised to see the Fund perform more in line with the S&P 500® Index in the second half of 2009.

With credit conditions improving beyond our expectations, the Hedge Fund Research (HFRX) Convertible Arbitrage Strategy wound up as the best performing hedge fund strategy of the year.⁸ The expansion of bond premia that drove the results of arbitrage-based strategies continued to drive the performance of convertible

⁴While we seek to structure a portfolio that will increase in value when the S&P 500® Index increases in value and that will provide downside protection when the S&P 500® Index decreases in value there can be no assurance that the portfolio will perform in line with our expectations. ⁵Class A shares, not including a sales charge. **Past performance is not a guarantee of future results.** ⁶This report includes candid statements and observations regarding investment strategies, individual securities, 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. **Past performance is not a guarantee of future results.** ⁷2010 US Convertibles Outlook: Back to Basics – Barclays Capital, 1/7/2010, and Convertible Market Watch – June 2009, Barclays Capital, 7/1/2009. ⁸2010 US Convertibles Outlook: Back to Basics – Barclays Capital, 1/7/2010.

bonds relative to their underlying stocks, which had positive implications for our Fund as well. It is interesting to note that the Barclays U.S. Convertibles Composite rose enough in 2009, up 50.72%, to almost fully recover the prior year's 34.59% loss.⁹ The HFRX Convertible Arbitrage Strategy rose 42.46% in 2009 after posting a 58.37% loss in 2008.¹⁰ Even so, an investor who put a dollar in the index two years ago would have just \$0.59 today. This is a clear example of the permanent loss of capital that can result from forced deleveraging.

According to Barclays Capital, the size of the convertible securities market shrank from \$294 billion in face value in 2008 to \$249 billion in face value near the end of 2009.¹¹ A combination of factors, including the normal cycle of puts, calls and maturities exacerbated by several tender offers, was responsible for reducing the size of the convertible securities market. At the same time, the scarcity value of convertible bonds seems to be propelling valuations higher relative to the underlying stocks. The need to be selective in such an environment is why the Fund maintains flexibility to invest outside of the convertible securities market.

One aspect of this valuation environment is that the implied volatility of convertible bonds has not collapsed as quickly as the market's implied volatility, as measured by the Chicago Board Options Exchange Volatility Index[®] (VIX[®]). All else being equal, one would expect the implied volatility of convertible securities to ultimately follow the market's, which would mean reduced bond valuations. With bond yields low, equity valuations near normal and implied volatility on the high side, one might characterize this as an issuer's market. We will be surprised if we do

not see a significant number of new convertible issues. An increased supply of bonds will ultimately be beneficial as it will both lower valuations and result in more investment opportunities. Nevertheless, these new bonds are unlikely to perform as well as those issued in early 2009 by companies needing to raise capital in a buyer's market.

With the economy apparently stabilizing and equity and credit markets behaving more normally, underlying stock price performance should resume its place as the dominant driver of performance for most convertibles. In that event, it is unlikely that the Fund will continue to outperform the S&P 500[®] Index. As a reminder, our objective is not to beat the S&P 500[®] Index, but rather to capture most of the market's upside while mitigating risk. With that in mind, we expect future returns to be more tempered.

Understanding Fund Performance

In our 2009 mid-year commentary we noted that we seek to incorporate information from across markets to strengthen our analysis. For instance, one shortcoming in the past was failing to explicitly consider credit market assessments of companies when we reviewed their equity. Under standard operating conditions most companies' balance sheets present relatively modest risk to the company's equity. This is why credit and equity markets are said to be uncoupled. Under stress like we witnessed in 2008 and into the first quarter of 2009, however, the markets couple. When that occurs, correlations increase and credit risk can go from meaning almost nothing in the equity markets to meaning everything. No one could have predicted the magnitude of the meltdown in the credit market, but the worst performing stocks and bonds on the way down

⁹2010 US Convertibles Outlook: Back to Basics – Barclays Capital, 1/7/2010. ¹⁰HFRX website. ¹¹Convertibles 2010: Back to Basics – Barclays Capital, 12/16/2009.

tended to be those with the highest credit spreads before the crisis unfolded. By evaluating credit information more rigorously, as we are doing now, we believe we could have moderated risk in the Portfolio in the past and we hope to moderate risk in the future. One way we make better use of credit information now is to assign higher discount rates to companies with higher credit spreads. This approach will naturally lead us to take an increasingly conservative view of the equity value of companies that the fixed income markets consider more risky.

In addition, we continue to track investors' inflation expectations by examining the forward inflation rates implied by U.S. Treasuries and Treasury Inflation-Protected Securities (TIPS) as well as the market for inflation swaps. Based on our findings the decidedly deflationary outlook that prevailed at the end of 2008 and into the first quarter of 2009 has given way to much more normal inflation expectations. Indeed we think the market is expecting inflation beyond the next five years to be in the 3% to 3.5% range, broadly in line with long run averages of Consumer Price Index (CPI) growth. If inflation expectations increase further, we believe there is a risk the Fed might act swiftly to raise rates and reverse its quantitative easing strategy.

In the last half of 2009, the only major position added to the Fund was a mix of convertible bonds and common stock of Allegheny Technologies Incorporated (ATI), a producer of specialty materials including titanium, nickel and related alloys, and specialty steels.¹² These products are used in a wide range of industrial applications such as aircraft and aircraft engine parts; health care products (including artificial joints and

superconducting components used in magnets of MRI machines); specialty armors; energy services, particularly drilling; and electrical power transmission. The primary driver of the company's growth is its titanium business, which benefits from the long-term trend to use more titanium based materials in aircraft. The company is a big supplier to Boeing, a relationship that has proved troublesome in the short run as Boeing has struggled to keep its new 787 Dreamliner on schedule. Nevertheless, with the jet now in tests, the long awaited ramp-up in production should begin shortly, helping to drive several years of promising growth for ATI. In addition, ATI has long imported titanium sponge, a raw material, from Kazakhstan. In the near future the company should benefit from the start-up of its own sponge facility in Utah. Such vertical integration reduces both sovereign risk and transportation costs while providing key customers a higher degree of protection against supply disruptions.

Our investment in ATI serves to highlight our approach to building a position. In late August we tried without success to obtain convertible bonds at a good price relative to the stock. Wanting to build a position in the company, we acquired common stock initially to establish most of the equity exposure we wanted and then as some convertible bonds became available at what we considered the right price we bought those to achieve our desired aggregate position size. After a strong run-up the stock experienced a sell-off and more bonds became available at an attractive price. We swapped some of our ATI stock to make room for the stock equivalent of the convertible bonds we purchased. This allowed us to retain the equity exposure we wanted but improve

¹²Individual securities are discussed in this piece. 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 return of a security to the Portfolio will vary based on weighting and timing of purchase. This is not a recommendation to buy or sell any specific security.

the risk-reward balance by owning bonds in lieu of the stock. As always, we consider it important to not only purchase a company's stock at the right price, but also to pay a fair price for the bonds relative to the rest of the company's capital structure. To date we are pleased to report that this investment is working out well.

The next most noteworthy activity in the Fund in the second half of 2009 was a rebalancing of our Citigroup (C) position. On January 22, 2008 we traded all of our Citigroup common stock for a new issue convertible preferred with a conversion ratio of about 1.48. Those preferred shares subsequently converted into common shares, but at a conversion ratio that was adjusted to 13.07 when the U.S. Government converted its preferred shares in July 2009. As a by-product of this adjustment, our Citigroup position outperformed the Fund and the market from January 22, 2008 through July 30, 2009. In August we sold about 20% of our stock. In December the company issued another mandatory convertible preferred as part of its plan to exit the Troubled Asset Relief Program (TARP). We further reduced the risk of our position by replacing a portion of our common shares for the newly issued preferred. We readily admit that Citigroup is a company

that made mistakes and has been tarnished by the exceptional assistance it received. Nevertheless, it has a solid international franchise, a recognized brand and a newly strengthened capital base. The improvement in the capital markets suggests that the businesses Citigroup seeks to sell will command better than book value pricing. It is possible the company may ultimately be viewed as having excess capital that could be reinvested in the business or be used to repurchase shares. The stock overhang related to the government's significant ownership clearly stifles appreciation potential in the short term. But we think that the Obama administration's emphasis on recouping TARP dollars quickly suggests that the government is likely to sell as soon as feasible. We believe removing the onus of government ownership could potentially be the catalyst to realizing significant value from our Citigroup position.

As fellow shareholders in the Fund, we understand what you expect from us: careful research, scrutiny and deliberation based on experience when investing your money and ours. We remain mindful of our responsibility and grateful for the trust you have placed in us, and look forward to continuing our investment journey together. ■

This report is authorized for use by existing shareholders. A current Davis Series, Inc. prospectus must accompany or precede this material if it is distributed to prospective shareholders. You should carefully consider the Fund's investment objectives, 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, 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 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: market risk: the market value of shares of common stock can change rapidly and unpredictably; company risk: the market value of a common stock varies with the success or failure of the company issuing the stock; and small- and medium-capitalization risk: small and mid-size companies typically have more limited product lines, markets and financial resources than larger companies, and their securities may trade less frequently and in more limited volume than those of larger, more mature companies. Some of the risks of owning high-yield, high-risk debt securities are that: many issuers only resort to offering high-yield, high-risk debt securities when they cannot get financing from more traditional sources, such as banks; issuers of high-yield, high-risk debt securities are likely to have a substantial amount of other debt that is more senior; high-risk debt securities may be difficult to sell; and prices of high-yield, high-risk debt securities are more volatile than prices of higher-rated securities. See the prospectus for a complete listing 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. Our views and opinions regarding the investment prospects of our portfolio holdings include "forward looking statements" which may or may not be accurate over the long term. 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. These opinions are current as of the date of this piece but are subject to change. Market values will vary so that an investor may experience a gain or a loss. The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. As of December 31, 2009, Davis Appreciation and Income Fund had invested the following percentages of its assets in the companies listed: Allegheny Technologies Incorporated, 2.28%; Citigroup, 3.72%.

Davis Funds has adopted a Portfolio Holdings Disclosure policy that governs the release of non-public portfolio holding information. This policy is described in detail in the prospectus. 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 substantial fees for selling its products 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 concerning Davis Advisors' products; 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' payment(s) to a financial intermediary as a basis for recommending Davis Advisors.

Over the last five years, the high and low turnover ratio for Davis Appreciation and Income Fund was 28% and 17%, respectively.

The net expense ratio for Davis Appreciation and Income Fund Class A for the fiscal period ended December 31, 2009 was 1.06%.

Effective July 1, 2009, Davis Advisors voluntarily and permanently reduced any management fee breakpoints ABOVE 0.55% to 0.55%.

We gather our index data from a combination of reputable sources, including, but not limited to, Thomson Financial, Lipper and index websites. Standard Deviation is a measure of the average deviations of a return series from its mean; often used as a risk measure. A large standard deviation implies that there have been large swings or volatility in the manager's return series.

The **Lipper Convertible Fund** peer groups are composed of funds that, by portfolio practice, invest primarily in bonds and preferred stocks which can be converted to common stock. The **Morningstar Moderate Allocation Fund** peer groups invest in both stocks and bonds and maintain a relatively higher position in stocks. These funds typically have 50%–70% of assets in equities and the remainder in fixed income and cash.

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 **HFRX Convertible Arbitrage® Index** is a total return index that is published by Hedge Fund Research, Inc. The Index tracks hedge funds that follow a convertible arbitrage strategy by employing an investment process designed to isolate attractive opportunities between the price of a convertible security and the price of a non-convertible security, typically of the same issuer. The **Chicago Board Options Exchange Volatility Index® (VIX®)** is an index designed to track market volatility as an independent entity. The Index is calculated based on option activity and is used as an indicator of investor sentiment, with high values implying pessimism and low values implying optimism. The **Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. The **Barclays Capital U.S. Corporate High Yield Index** is an unmanaged index of fixed-rate, noninvestment grade debt issues rated Ba1 or lower by Moody's, rated BB+ or lower by S&P, rated below investment grade by Fitch Investor's Service or if unrated previously held a high yield rating or have been associated with a high yield issuer, and must trade accordingly. The **Barclays Capital U.S. Credit Index** is an unmanaged index representative of publicly issued U.S. corporate debt, foreign debentures and secured notes that meet specific maturity, liquidity and quality requirements. The **Barclays Capital U.S. Convertibles Composite** includes all four major classes of USD equity-linked securities including: convertible cash coupon bonds, zero-coupon bonds, preferred convertibles with fixed par amounts, and mandatory equity-linked securities. Investments cannot be made directly in an index.

After April 30, 2010, 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.

