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Davis Appreciation & Income A RPFCX

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By Todd Trubey

Davis Appreciation & Income's similarities to its famous sibling, Davis New York Venture, are deep if not obvious.

For starters, the Davis shop's fiduciary vigor informs the investment process at all its funds. As at Venture, this fund features strong businesses in defensible positions run by managers who think like owners. Yet managers Andrew Davis and Jason Voss, like Venture's Chris Davis and Ken Feinberg, demand a value-driven margin of safety. Although few holdings make the cut, they're typically held for more than three years when they do. Finally, this fund, like Venture, consciously uses the S&P 500 index as its bogy.

The way the funds approach this bogy tops their list of differences. While Venture view head-to-head with it, this fund, once a standard convertible bond fund, aims to capture 80% of the S&P 500's gains but lose less than half as much in downturn, giving investors an asymmetrical risk/reward profile. As such, the fund's core remains in converts, which are chiefly offered by small- and mid-cap firms. (That's why only nine firms' securities appear here and in large-cap-leaning Venture.) That risk/reward goal also drives the fund's yield-heavy REIT stake (20% of assets) and the fund's two artificial convertibles, which blend a firm's straight debt and common stock.

The fund's stakes in those other asset types mean it isn't a pure convert fund, but we think that's fine. First, few convert funds now invest only in convertibles, and this one retains a 65% convert stake. Moreover, it's the convertible bond's asymmetrical risk/reward profile investors should prize, not the security itself. Finally, in mid-2003 Davis and Voss changed the fund's mandate because they thought recent convertible issuance had insufficient downside protection.

We think this Analyst Pick merits more attention from investors who appreciate the Davis way but seek a more income-heavy offering than Venture.

Kudos

- Solid long-term record.
- Stable management.
- Davis family heavily invests in its funds.

Risks

- Top holdings are heavily weighted, creating high company-specific risk.
- The fund lagged when equitylike convertibles soared in 1998 and 1999.
- The fund's heavy use of REITs could sting if that hot sector cools.

Strategy

Managers Andrew Davis and Jason Voss prefer to own securities from about 30-40 firms with strong management and reasonable valuations. They believe that a portfolio largely invested in convertibles can offer 80% of the S&P 500 index's upside return while avoiding 50% of its downside risk. When they can't find an ideal convertible they'll mix a convert with the firm's common stock of bundle stock and straight debt.

Management

Andrew Davis has managed the fund since coming to the firm in 1993 from PaineWebber, where he managed convertible securities research. Jason Voss came to Davis Selected Advisers in 1998 and joined as comanager in fall 2000. Davis also manages Davis Real Estate.