
FREDERIC T. KUTSCHER ASSOCIATES, INC.

Comprehensive financial counsel for individuals, families and trusts

March 25, 2003

Earlier this winter we sensed that international events and domestic economic weakness would precipitate even more market volatility. Consequently, we planned to write our quarterly letter emphasizing the importance of focusing on the long-term investment view.

To do this, we sought perspectives from investment professionals we respect who had lived through extremely volatile markets in the past. We searched for managers who could recall the emotions of investors during events like the Cuban Missile Crisis, the oil shocks of 1973 and 1974, and Black Monday in 1987. We were particularly impressed with the insights of our friends at Selected American, who offered to send us the enclosed soon-to-be-published "The Successful Investor."

The enclosed piece is a concise but comprehensive summary about what is required as "investor behavior for building long-term growth." We exhort you to take ten minutes to read it. But, if you feel you have more demanding chores, here is a short summary of its major points:

- Historically, stocks have returned roughly 11% annually on average; but, due to the inconsistencies of economics, politics and market psychology, the year-to-year returns have varied significantly. (For example, -22% in 2002 and +38% in 1995).
- During periods of high volatility, many stock owners abandon the logic of buying low and selling high; they become depressed or euphoric and surrender to their emotions.
- Market timing is tempting when fear and panic dominate, but "timing" is quite injurious to one's financial health.
- And the proof is in the pudding: Although the U.S. stock market average return has been about 11% (with stock mutual funds averaging roughly the same), the average mutual fund customer using stock funds has averaged 5% per year because of emotional buying or selling.

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March 25, 2003

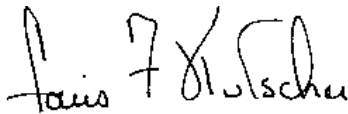
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- Such emotional responses are exacerbated by a whole host of influences, especially the talking and writing heads who have a vested interest in creating urgency in order to get people to “tune in tomorrow to find out what happens next.”

In summary, our persistent message is that the laws of economics and the markets haven't changed. If you are a long-term investor, have confidence in the long-term picture, even when negative returns or positive returns tempt otherwise.

Sincerely,

FREDERIC T. KUTSCHER ASSOCIATES

A handwritten signature in black ink that reads "Louis F. Kutscher". The signature is written in a cursive, slightly slanted style.

LOUIS F. KUTSCHER

The Successful Investor

Mastering Investor Behavior
for Building Long-Term Wealth

Selected
FUNDS

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The Successful Investor

The Davis family is one of the most successful investment stories in American history, having accumulated a fortune of more than \$2 billion* through buy and hold investing for over 50 years and three generations of portfolio management.



Shelby Cullom Davis

Starting in 1947, Shelby Cullom Davis, a former insurance commissioner, invested \$100,000 in high-quality, well-managed, growing companies and compounded his fortune into over \$800 million by the early 1990s. With the aim of offering his father's investment discipline to a greater diversity of investors, son Shelby M.C. Davis founded Davis Advisors in 1969 and created one of the most distinguished track records of any manager on Wall Street. He steered the firm's flagship mutual fund, the Davis New York Venture Fund, to a performance record that rivaled Peter Lynch and the Magellan Fund. Today, the Davis family investment fortune is managed by portfolio managers Christopher C. Davis, Kenneth Charles Feinberg and Andrew A. Davis, who are guided by

our firm's Founder and Senior Research Advisor, Shelby M.C. Davis.

While many would attribute the Davis family's extraordinary success to investment selection, this tells only part of the story. The other major contributor to the family's ability to build wealth has been

its adherence to a set of basic principles concerning investor behavior that any individual can learn and practice. Specifically, the Davises have always advocated adhering to a long-term perspective, buying and selling rationally (as opposed to emotionally), and using high-quality sources of information when making investment decisions.

In the following pages, we introduce some of the time-tested principles that have guided the Davis family through both good and bad periods of market history. While not an exhaustive list, these basic lessons constitute keys to the family's success, learned over half a century, and we hope they will serve as a useful guide in helping you achieve your ultimate financial goals.

Lessons from Over 50 Years of Success on Wall Street

*As of December 31, 2002.

Past performance is not a guarantee of future results.

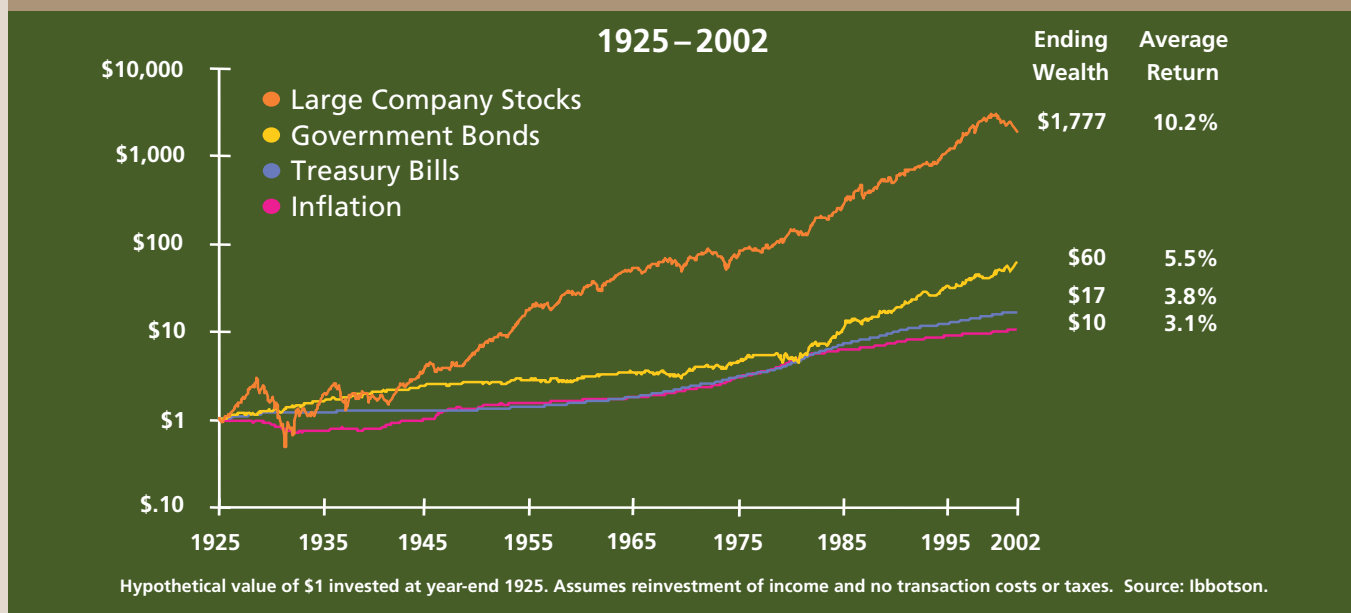
Realistic Expectations for Equity Returns

Historically, stocks have delivered superior returns versus bonds or cash, and have been an effective hedge against inflation. This is because over long periods of time, equities reflect the profit growth of real businesses. Equities are naturally well-suited as an engine for long-term growth of capital. Meanwhile, bonds, cash and other income-oriented asset classes can offer income and stability of principal for near-term spending needs.

As the accompanying chart shows, stocks have historically delivered returns in the range of 10–11% annually. This equates roughly to 7–8% profit growth and a dividend yield of about 3%. It is interesting to note the long-term average return for equities is far lower than the 20–30% returns that investors came to expect throughout the late 1990s but far higher than the negative returns that stock investors experienced in the recent bear market.

What is a reasonable return expectation for equities over the long term? Recognizing the relationship between businesses and stock returns over time, the Davis family has sought to invest in high-quality, well-managed, growing companies that can deliver above-average profit growth of 8–13%. It is the family’s belief that by owning higher-quality companies (and buying them at a discount), investors have the possibility of achieving above-average stock returns over time. Assuming equity returns far in excess of growth rates that real businesses have been able to achieve is to subject oneself ultimately to disappointment, in our opinion. Similarly, we would advise against making “doomsday” predictions for the U.S. equity markets, given the tremendous resilience the economy and American businesses have shown throughout history. In short, we believe that successful investors are not optimists or pessimists, but realists.

Equities Have Been the Best Long-Term Wealth Building Vehicle



Past performance is not a guarantee of future results.

Why Stocks Should Be A Long-Term Investment

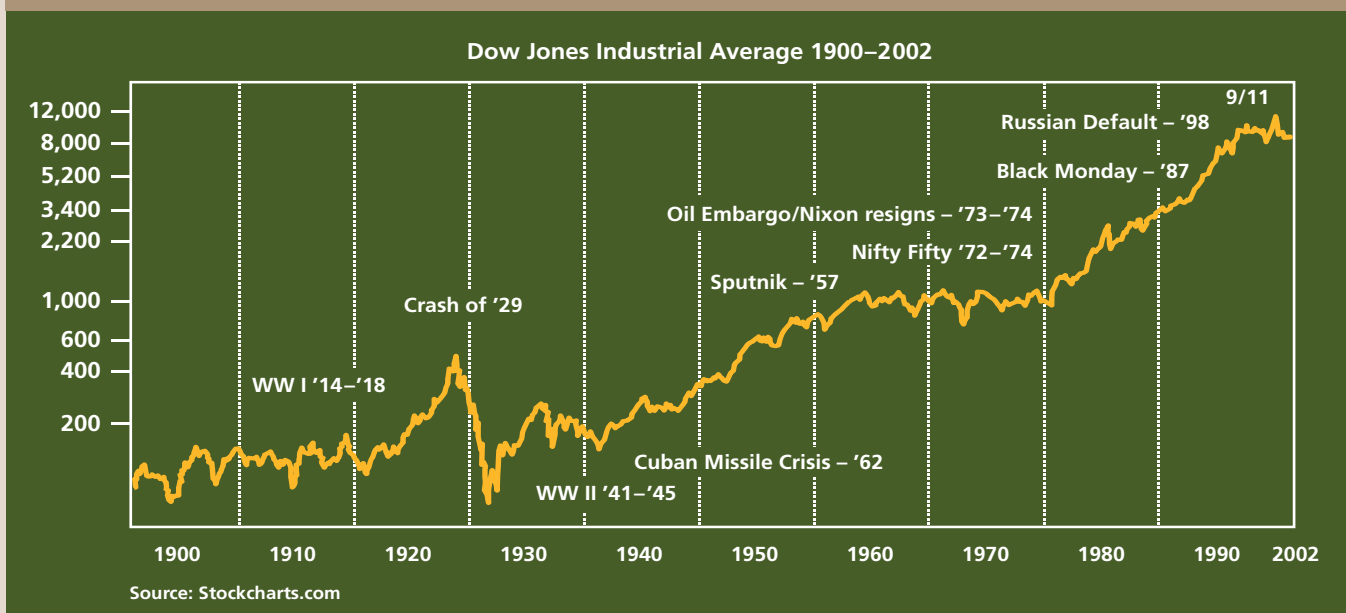
Even though the stock market has averaged close to 11% over the long run, this growth was not achieved in a straight line. The history of the stock market is marked by periods of tremendous volatility reflecting economic and political uncertainty. In order to benefit from the long-term benefits of participating in the profit growth of businesses, investors must look beyond short-term volatility and focus on the likelihood that certain businesses will be more valuable in the future than they are today. As legendary value investor Benjamin Graham pointed out, in the short run, the market is a “voting machine,” reflecting how investors feel, whereas in the long run it is a “weighing machine,” reflecting the growth in actual profits and business values.

Investors should also recognize that the stock market has historically advanced in a staircase-like fashion, moving upwards (e.g., in the 1950s) and then sideways (e.g., in the 1970s) over multi-year periods. Since the market is really just an average of many corporations’ performance, this pattern merely shows that in certain environments, market

advances are relatively broad-based (with many corporations experiencing stock price appreciation), while in other environments, individual company results are more disparate leading the averages to produce relatively flat returns overall. As a remedy for this “start and stop” growth pattern, we would suggest that investors consider using active managers, who invest selectively, in lieu of or in addition to owning a market average such as an index fund. The most successful active managers have demonstrated an ability, historically, both to participate in the broad-based advances and to outperform when the market averages move sideways.

By understanding the way stock market returns were historically achieved, investors can set proper expectations about volatility, remain steadfast during periods of uncertainty, and look beyond the short term to the long-term appreciation of business values. A basic knowledge of stock market history can also help investors understand some of the potential benefits of hiring skilled active managers.

The Historical Trend of the Stock Market Has Been Positive, But By No Means a Straight Line



Past performance is not a guarantee of future results.

Why Rational Investing Does Not Come Naturally

Making a long-term commitment to equities is far easier said than done. Most investors focus entirely on the search for superior investment strategies without realizing that their own behavior can either enhance or negate the results of the investments themselves.

Rationally speaking, “buying low” and “selling high” is a self-evident formula for making money on investments. It is a logic that people employ when shopping at the grocery store or selling a house. However, many seem to abandon this logic when it comes to stocks, buying when prices rise and selling when prices fall. In other words, investors have a tendency to “buy high” and “sell low,” despite all intentions to do the reverse.

This curious departure from rational behavior occurs because investing is an emotional experience. Put simply, people *feel* more confident and thus invest more when prices

are high, just as they feel more pessimistic and are tempted to sell when prices are low. Recognizing this discrepancy between rational and emotional behavior, successful investors must develop a *counter-emotional* discipline. Essentially, they must form a habit of investing in the moments of greatest pessimism, when common sense (if not emotions) tells us that the opportunities have to be greater, and of taking profits when the mood in the market is euphoric.

One way of achieving the necessary discipline to being a successful investor is to hire financial professionals who are not only qualified to construct financial plans according to individuals’ goals, but who are also prepared to guide investors through difficult periods in the market, when maintaining discipline proves the most challenging.

The Effects of Stock Market Volatility on Human Emotions



For illustrative purposes only. This is neither a graph of actual performance nor a guarantee of future price appreciation.

Past performance is not a guarantee of future results.

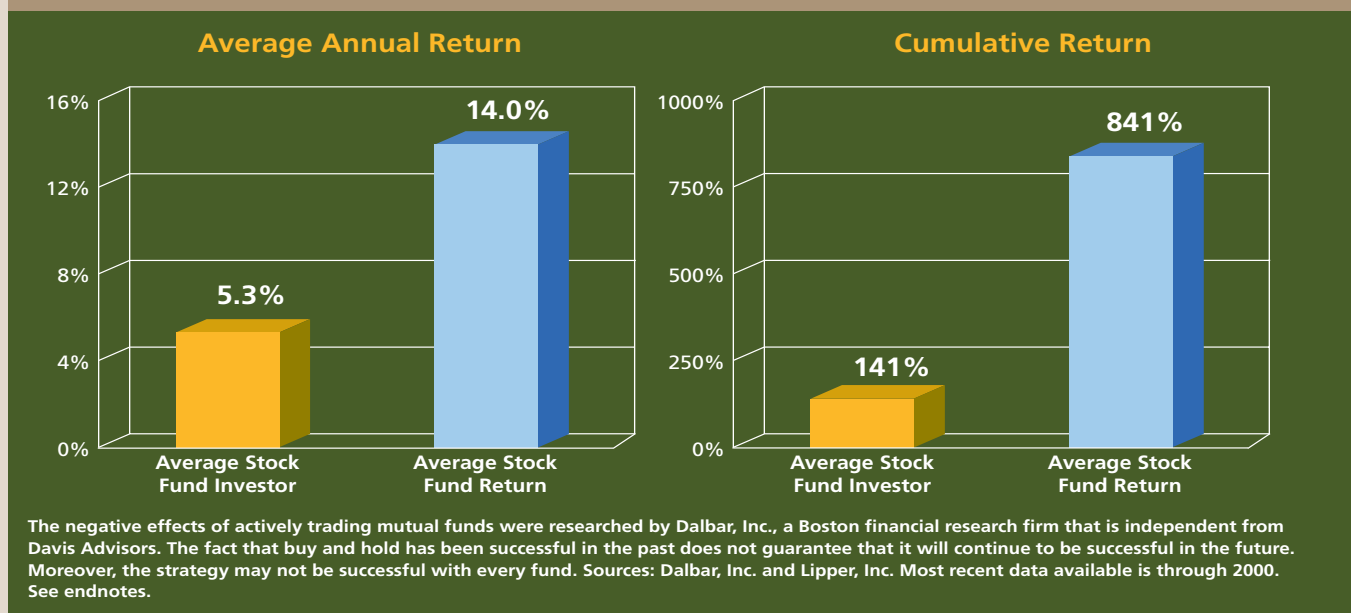
The Cost of “Timing”

Investing on the basis of emotion rather than on the basis of discipline can have dire consequences for stockholder returns. A study by Dalbar shows, for instance, that while the average equity mutual fund returned an average annual return of 14% per year from 1984 to 2000, the average mutual fund investor in those same funds only benefited from 5% average annual performance, a difference of 9% per year. While this particular study uses mutual funds and mutual fund investors as the basis for its conclusions, we believe Dalbar’s findings in this instance apply more generally to the behavior of other investors as well, including institutions.

The way this dramatic underperformance occurs is clear: Driven by the cycle of emotions described above, investors bought funds that had experienced above-average performance, only to sell out of those funds when they traversed more difficult periods.

Consequently, we believe it makes good financial sense for investors not only to seek out managers who have demonstrated an ability to beat the market consistently, but also to choose managers in whom they can maintain conviction over the long term, so as to avoid the cost of switching. Financial professionals can help investors through the process of searching for the right managers and staying invested during the inevitable periods of underperformance. In our view, the cost of financial advice seems relatively modest when compared to the cost of self-inflicted underperformance that results from constantly switching managers.

Average Stock Fund Investor Return vs. Average Stock Fund Return (1984–2000)



Past performance is not a guarantee of future results.

Evaluating Sources of Information

The challenge of practicing a counter-emotional approach to investing is difficult by itself. It becomes all the more difficult when one considers the proliferation of investment advice from various sources that bear no accountability for their recommendations, including the media.

The media's record of providing insightful investment advice is questionable at best. For instance, in 1981, the year before one of the longest bull markets in U.S. stock market history began, *Business Week* published its famous cover story, "The Death of Equities?" Not only did the article appear at the start of a new bull market (as opposed to heralding the end of an asset class), but it also ignored the fact that for the previous six years, the S&P 500® Index had actually compounded at an average annual rate of 18%. More recently, a number of television networks can be cited for having zealously promoted dot.com and other "New Economy" companies that have since gone out of business.

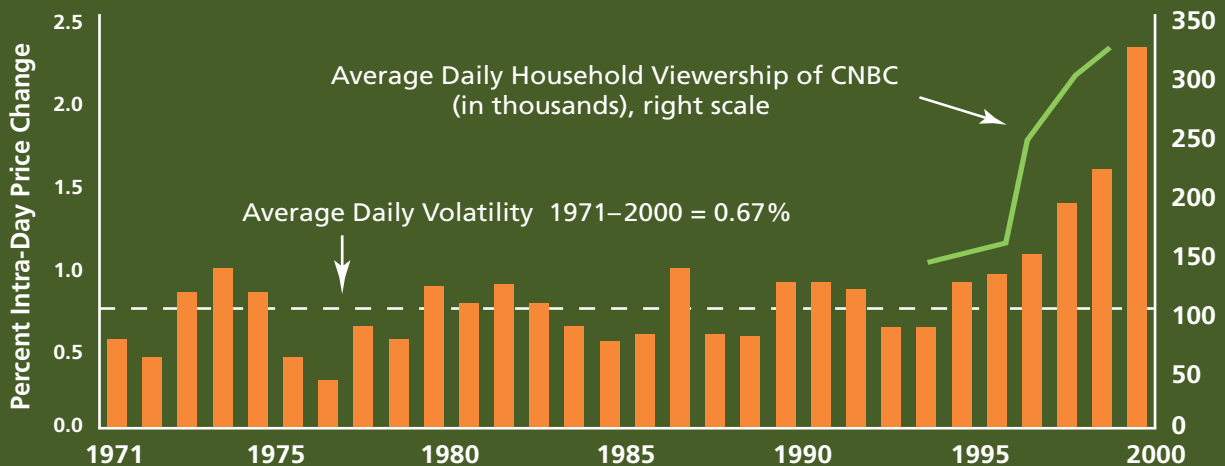
One can argue that the media creates as much confusion as it does clarity when it comes to investment advice.

When selecting managers, investors should understand what sources of information serve as the basis for a given manager's investment ideas. Since it is often unclear which other sources of information are trustworthy, the Davis family has always conducted its own firsthand research into companies. Our research draws on three main sources of information: (1) publicly available financial reports such as SEC filings and annual reports, (2) information provided directly by the companies in which we invest or might invest, and (3) third parties with firsthand knowledge such as competitors, vendors, suppliers, employees, and customers.

In summary, individuals should avoid becoming distracted from their long-term financial plan as a result of news and other sources whose first priority is to maximize current viewership, not provide long-term, wealth building advice.

Increased Market Volatility

NASDAQ 1971–2000



Source: Union Bank of Switzerland.

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Principles of The Successful Investor

Set Realistic Expectations — Stocks have historically been the best performing asset class for growth of capital over the long term. This is because stock prices track corporate profits and business values, which tend to grow over time. When planning long-term financial goals, it is important to set return expectations for equities in relation to the growth of real businesses.

Make Stocks a Long-Term Investment — Notwithstanding their historical returns, equities have not advanced in a straight line. Market volatility is a normal and inevitable part of investing. For this reason, investors should consider their allocation to equities as long-term in nature and be prepared to ride through stock market volatility, using cash and bonds for short-term needs. Investors should also consider the potential benefits of using high-quality active managers, especially in times when the market averages are likely to move sideways.

Invest Rationally, Not Emotionally — Investing is an emotional experience, which explains why many have difficulty following the simple principle of “buy low” and “sell high.” To become a successful investor, we believe it is necessary to develop and maintain a rational discipline that runs counter to emotions. Hiring financial professionals is one way to help maintain and reinforce this discipline.

Avoid “Market Timing” — History has shown that switching investment managers based on short-term performance can be a costly mistake. To avoid the considerable cost of switching, investors should work with their financial advisors to select managers in whom they can maintain conviction through temporary periods of underperformance.

Choose Your Sources of Information Carefully — Maintaining a long-term discipline is complicated by the constant distraction of the media, which seems to exacerbate the emotional experience of investing. Investors should keep in mind that the media is incented above all to increase viewership and not to provide well-grounded financial advice. We encourage individuals to base financial planning decisions on an informed view and high-quality information.

Past performance is not a guarantee of future results.

This report is authorized for use by existing shareholders. Prospective shareholders must receive a current Selected Funds prospectus, which contains more information about risks, fees and expenses. Please read the prospectus carefully before investing or sending money.

Selected Funds investment professionals make candid statements and observations regarding economic conditions and current and historical market conditions. However, there is no guarantee that these statements, opinions or forecasts will prove to be correct. All investments involve some degree of risk, and there can be no assurance that the Selected Funds' investment strategies will be successful. The value of equity investments will vary so that, when sold, an investment could be worth more or less than original cost.

Shelby Cullom Davis. Shelby Cullom Davis borrowed \$100,000 in 1947 and turned it into an \$800 million fortune by the year 1994. While Shelby Cullom Davis' success forms the basis of the Davis Investment Philosophy, this was an extraordinary achievement and other investors may not enjoy the same success.

S&P 500® Index. 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 toward stocks with large-market capitalizations and representing approximately two-thirds of the total market value of all domestic common stocks. Investments cannot be made directly in the S&P 500® Index.

Dalbar Study. The negative effects of actively trading mutual funds were researched by Dalbar, a Boston-based financial research firm that is independent from the Selected Funds. The original Dalbar report covered the time periods from 1984 through 1998 and was published in the March 2000 issue of *Mutual Funds Magazine*. The Dalbar report was updated through 2000 using information from Lipper, Inc. The fact that buy and hold has been a successful strategy in the past does not guarantee that it will continue to be successful in the future. For the period from 1984 through 2002, the average annual return for the average stock fund was **10.22%**; the cumulative return for the average stock fund was **535.82%**.

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