



An Update from
Christopher C. Davis and Kenneth C. Feinberg
Portfolio Managers
Annual Review

Results and Reflections

The table below summarizes the results of Selected American Shares compared with the S&P 500® Index, against which my partner Ken Charles Feinberg, our colleagues and I judge ourselves. Our objective is to outperform this Index after fees and expenses over the long term as we have done since being entrusted with the Fund's management in 1993.

Although the longer-term numbers are satisfactory on both an absolute and a relative basis, we once again call your attention to a figure that is not in the table—specifically the results of the S&P 500® Index and the Fund since the market peak in March of 2000. Almost eight years have passed since then, during which time the market's return has been only 1.4% including dividends and negative if dividends are excluded. To make matters worse, these results do not include the expenses paid by most investors.

During this time, Selected American Shares returned 4.8% per year after expenses.¹ While exceeding the market by more than 3.4% per year is more than satisfactory on a relative basis, an absolute return of 4.8% falls short of our long-term goals.

Looking ahead, the fact that we are now eight years into a period of anemic returns means that even if the market does well in the next two years (and it is

certainly not off to a promising start in 2008), it is likely that the decade that began in 2000 and will end in 2010 will be one of the worst decades for stock investors since the Depression.

This grim-sounding pronouncement does not mean that we are bearish about the future, but rather that we are realistic about the past. Looking ahead, the fact that valuations have come down so far since the late 1990s significantly improves investment prospects. This fact should make investors more enthusiastic rather than more discouraged. After all, they have the opportunity to buy the same businesses at much lower prices relative to their earnings.

But this is not the way most people's minds work. Instead, eight years of lackluster stock returns combined with concern about falling home prices and a slumping economy have made this a time of almost unanimous pessimism.

This pessimism is reflected in investors' behavior and amplified by the media. For example, in 2007 investors fled from domestic equity mutual funds, resulting in the second-highest levels of redemptions ever. Further, the rate of redemptions steeply accelerated as the market fell late in the fourth quarter. The media tells us that the public's assessment of the nation's economy has slipped to its lowest level in nearly 15

Annualized Total Returns as of December 31, 2007					
	1 Year	3 Years	5 Years	10 Years	Since 5/1/93
Selected American Shares Class S	4.79%	9.88%	14.22%	8.16%	12.58%
S&P 500® Index	5.49%	8.62%	12.82%	5.91%	10.61%

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 S shares as of the most recent prospectus was 0.90%. 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 quoted. For most recent month-end returns, visit selectedfunds.com or call 800-243-1575.

¹Class S shares. **Past performance is not a guarantee of future results.**

years.² And on its February 11 cover, *Business Week* loudly declared in large red letters “Meltdown...The Worst is Yet to Come.” Interestingly, the cover and table of contents for this same issue also highlight articles such as “Growth is slowing in wireless and broadband,” “Bonds...are losing value fast,” “Experts are now questioning...free trade,” “The wounded deal economy,” “Brace yourself: Home prices could fall an additional 25%,” and even “Raising fears about bone fractures among women,” making it one of the most fearful, gloomy and pessimistic issues we can recall.

Warren Buffett has famously said that his success comes from the simple fact that he tries to be “fearful when others are greedy and greedy when others are fearful.” While this advice is clearly right, it is hard to follow. In fearful times, investors must struggle to stay the course. They look at their portfolios and see only the price declines. They turn on the television and see only bad news.

Yet for long-term investors such trying periods are inevitable. For example, since Davis Advisors was founded in 1969, we have gone through two bear markets, several wars, numerous recessions, an oil crisis, a hostage crisis, double-digit interest rates, double-digit inflation, double-digit unemployment, political scandals, stock market crashes, the NASDAQ bubble, September 11, and more. Certainly there were numerous periods in which investors may have gotten discouraged or decided to get out until things improved. Yet, over this entire period, equities still returned a satisfactory 10% per year. Although we have only managed Selected American Shares since 1993, shareholders in the mutual fund that we started in 1969 earned 13.2% during the same period of time.³ With both funds, getting out in times of pessimism would have almost certainly resulted in returns far below those achieved by simply staying the course.

Nevertheless, in pessimistic times investors worry that this time is different and that equities will no longer produce satisfactory returns as they have in the last 70 years. An old Wall Street saying holds that these very words—“this time is different”—are the four most expensive words in investing. In times of great optimism, the bulls use them to justify irrational prices and pie-in-the-sky projections. In times

of pessimism, the bears use the same four words to justify selling stocks at discount prices. Both are mistakes. Our goal as investors is to be neither pessimistic nor optimistic, but realistic.

To maintain a realistic perspective, we must remember there is always something to worry about. Today is no exception. Topping today’s concerns is the fact that home prices have fallen sharply and there is no consensus as to when they will stabilize or how severely this will impact other aspects of the economy. The impact of this downturn was first felt at its center in the homebuilding industry and then spread in waves to mortgage lenders, insurers and holders of asset-backed securities, then to consumer spending and ultimately to employment. This cycle has a type of economic feedback that is worrisome. For example, if falling home prices lead eventually to higher unemployment, then higher unemployment in turn leads to more mortgage delinquencies and foreclosures. These foreclosures lead to forced sales, which push home prices down further, starting the cycle again.

Given this pessimism and concern, why have we been buying stocks and making investments rather than raising cash and sitting on the sidelines? The answer can be found in another Warren Buffett observation about pessimistic times: “We want to do business in such an environment, not because we like pessimism but because we like the prices it produces.” Because the market is a discounting mechanism, today’s prices already reflect a great deal of pessimism. Put another way, when people have a pessimistic outlook, they are willing to sell businesses for much lower prices than when they feel optimistic. In such times, we would much rather be buyers than sellers.

This contrarian orientation does not mean that we do not take today’s concerns seriously. Just because prices already reflect a great deal of pessimism does not mean we can be certain that things will not get worse than the pessimists believe.

But investing involves probabilities, not certainties. In order to assess these probabilities, we must maintain a longer-term perspective. Such a perspective allows us to keep today’s headlines about residential real estate in context. Assessing what is now called

²February 4, 2008 *Washington Post*–ABC News poll. ³This is not a solicitation for any other fund. While both funds are managed using the same Davis investment discipline, they may be subject to different investment restrictions and performance may vary.

the housing bubble reveals a four-stage pattern. This pattern is a familiar one that has recurred throughout different asset classes and indeed throughout financial history. While each recurrence varies in its specifics and severity, the pattern remains surprisingly constant and can be reduced to the words of an old Spanish proverb: "What wise men do in the beginning, fools do in the end."

In the first stage, an overlooked or underappreciated asset class produces wonderful returns for some period of time. In the second stage, capital provided by individuals and institutions flows into that area, often fueled by intermediaries charging high fees and commissions. In the third stage, participants increase leverage and reduce quality standards, convinced that past high returns justify doing so. In the final stage, the combination of higher leverage and lower quality proves toxic and the majority of lenders and participants, particularly those who came in during the late stages, suffer losses.

Since the great Tulip Mania and South Sea Bubble of the mid-seventeenth and early eighteenth centuries, this pattern has been repeated over and over again. In the last 20 years alone, there have been at least four large asset classes that followed this pattern, with residential real estate now becoming the fifth. In each case, early participants did fine but then aggressive promoters drew in huge amounts of participants, leverage increased, quality standards were reduced (or the definition of the asset class was broadened), and billions of dollars were lost. Starting in the 1980s, the first leveraged buyout (LBO)/junk bond craze culminated in the demise of Drexel Burnham Lambert. In the early 1990s, commercial real estate was the darling, leading to the S&L debacle and the bankruptcy of the Bank of New England, among others. In the mid-1990s, the Russian bond default triggered an emerging market debt crisis culminating in the collapse of Long Term Capital Management. In the late 1990s, the advent of the Internet and the early fortunes made there led to huge venture capital funds, record-setting IPOs and massive loans to speculative telecom companies, most of which became worthless.

This brings us to the current crisis in residential real estate and the related credit markets. For decades, conventional wisdom has said that you could not lose money by owning your home. While home ownership is an important means of saving and investing for most families, in recent years it had

become a means of speculating. Highly commissioned mortgage brokers pushed adjustable-rate loans offering low teaser rates and requiring little documentation on to borrowers who would not be able to afford them once the interest rate adjusted up. Other borrowers used their home equity like a piggy bank, borrowing up to 100% of appraised value and increasing this amount whenever they could get a higher appraisal.

Lenders did not mind making these loans for two reasons. First, they could repackage them and sell them in the secondary market. Second, even if the borrower could not repay the loan, rising home prices would allow the house to be refinanced or sold at a profit to some other buyer who was likely to finance it the same way. The result was a sort of Ponzi scheme requiring constant refinancings, constantly rising prices and more and more unsuitable buyers.

As credit dried up and interest rates climbed higher, the bubble burst, starting in the sub-prime area and moving outward. Already, an estimated 25% of all sub-prime mortgages are delinquent, up from 11% in 2004. (The term delinquent means that the borrower has missed at least one payment.) Foreclosures are climbing and the peak of adjustable-rate and teaser-rate re-pricing does not occur until the third quarter of this year. Lenders that focused disproportionately on this sector and financed themselves only in the capital markets are in deep trouble. Many have already gone out of business while others stand near the brink.

As would be expected, the downturn at the low end of the market has affected prices across the board, making 2007 the first year since 1941 that home prices have fallen nationwide.

Moving from the direct participants to the indirect participants, the news has been equally grim. The financial engineering that allowed institutions to slice up and repackage mortgages also added multiple layers of leverage to the system. What is worse, most of these securities are held by firms that must carry them at market value, compounding the likely economic losses as the securities are marked to market or reduced in value to reflect the impact of panicked sellers. This means that even if a mortgage is current and ultimately repaid, the holder of that mortgage-backed security may have to price it as if it is delinquent. As a result, enormous market losses are being reported across the finan-

cial services industry both here and abroad. Although some of these paper losses will not become real cash losses, they are treated the same for accounting purposes. The resulting charges forced many financial institutions to raise capital, largely from cash-rich foreign investors, at depressed prices (see our discussion of Merrill Lynch to follow). Those that cannot raise capital may face a worse alternative than stock dilution.

If our job is to be realistic, then we must also consider other less grim data. After all, realism requires weighing all available facts in order to assess probabilities. Although this process involves inherent risks and uncertainties, there are some important facts that the markets seem to have forgotten. These facts lead us to conclude that the economy and market will weather this storm and that this is a time to look for opportunities. As my grandfather Shelby Cullom Davis once said, "You make most of your money in a bear market; you just don't realize it at the time."

Here are some facts to think about. First, in order to size today's risks, we should start by looking at the amount of total mortgage debt outstanding. At the end of September 2007, approximately \$10.5 trillion of mortgages were outstanding, of which approximately \$1.3 trillion were sub-prime. To this debt, we might also add \$2.4 trillion of consumer and credit card debt for a total of about \$12.9 trillion of household indebtedness.

On the other side of the balance sheet, we should put the total estimated value of housing stock, which today stands at approximately \$21 trillion. This implies that mortgages currently represent about 50% of home values or, put another way, that homeowners have about \$10.5 trillion of equity in their homes. In addition to real estate, households also hold other assets, including more than \$7 trillion in cash and money market funds, \$14 trillion in stocks, bonds and mutual funds, and \$13 trillion in insurance and pension accounts, according to Federal Reserve data.

While we know that these assets are not evenly distributed and that the strain on lower income households is disproportionately large, these facts lead us to conclude that our financial institutions and our economy will come through this downturn in residential real estate just as they have weathered every

past bubble and crisis. For example, the stock market crash at the beginning of this decade wiped out \$6 trillion of market cap in the S&P 500® Index alone, a useful number to remember when considering that total mortgage debt outstanding is currently \$10.5 trillion and that the vast majority of this amount will be repaid.

While it is likely that three to five years of appreciation will be given back in real estate, most people still view their house as their home, not as an investment. Consequently, they are unlikely to walk away even if their equity is significantly reduced as long as they are able to make their monthly payments. Furthermore, recent interest rate cuts have helped to keep payments affordable on adjustable-rate mortgages. In fact, we are now seeing an upswing in refinancing, which is a promising development. As always, the key indicator remains unemployment, which could change this analysis if it rises dramatically.

The turmoil and pessimism that surround the financial sector have also made investors forget that much of the economy lies beyond real estate and consumer spending. A number of sectors, including technology, capital goods and many commodities, remain vibrant and many U.S. companies continue to grow significantly outside the United States (more on this later). In short, in our view American businesses and our economy are more resilient than pessimists would have us believe.

Portfolio Thoughts⁴

Because of the facts discussed above, we view the current tumultuous environment as one of opportunity, particularly within the financial sector. Although we have had our share of unpleasant surprises (see Mistakes and Lessons for details), we are excited by the recent investments we have made.

One example that merits mention is Merrill Lynch. We have followed this global leader for more than 15 years and have regularly met with senior management. Although we have always had a high regard for Merrill's franchise, until recently we never had what we refer to as the trifecta: the right management, the right business and the right price. The combination of John Thain's leadership with Merrill's formidable network of financial advisors, its strong investment banking and capital market's position,

⁴The information provided in this report does not provide information reasonably sufficient upon which to base an investment decision and should not be considered a recommendation to purchase or sell any particular security. **Past performance is not a guarantee of future results.**

and the opportunity to buy the shares at a significant discount to our assessment of fair value came together at the end of December. Because of the large losses incurred under prior management, the company was forced to raise capital by selling new shares at a discounted price. We participated along with Temasek, the investment authority of Singapore, and purchased approximately \$171 million for Selected American Shares at \$48 per share. While the shares may trade below this price in the future (and did in the weeks following our purchase), we believe that they will produce a satisfactory return over the long term and we are delighted to be shareholders.

Another example is Bank of New York Mellon Financial, which was created when Bank of New York merged with Mellon in 2007. Despite having the word “bank” in its name, this global firm focuses almost exclusively on securities processing, global custody, treasury services, and asset management. As a result, Bank of New York Mellon Financial has relatively modest exposure to deteriorating residential and sub-prime real estate. Specifically, while it holds approximately \$179 million in collateralized debt obligations and \$1.5 billion in sub-prime mortgage-backed securities, these amounts pale in comparison to the \$3.4 billion the company should earn this year. The stock, which was spotted by Ken and our first-rate analyst Charles Cavanaugh, was one of the best performing financial companies in the Fund last year, climbing 17%. CEO Bob Kelly has made excellent progress toward achieving the costs savings that should come from integrating these two strong organizations.

Outside of the financial sector, one portfolio development that bears mentioning is the steady increase in our international holdings.⁵ This trend began in the mid-1990s when we determined that virtually all industries should be analyzed on a global basis. How could it be sensible to have one analyst study Anheuser-Busch and another study companies like Heineken and Grupo Modelo (brewers of Corona)? Why would one analyst study Merck and another Roche, or one study ConocoPhillips and another BP? In essence, the globalization of our research effort simply followed the globalization of the industries and companies that we study. The faster growth of many foreign economies has also improved the prospects of many U.S. multinationals and added

impetus to our efforts. In fact, given that more than 40% of the profits of S&P 500[®] companies now come from outside the United States, it no longer even makes sense to think of the S&P 500[®] Index as a domestic index.

Nevertheless, convention still labels companies based on where their stock is listed rather than where they earn their profits. As a result, we call your attention to the fact that about 13.9% of Selected American Shares is invested in shares of companies listed outside of the United States.

While all of our analysts have played a part in the globalization of our research efforts, one deserves special mention. Stephen Chen came to the United States from Taiwan at age 15. He attended Indiana University’s Kelley School of Business where he majored in Accounting, subsequently earning both his C.P.A. and his C.F.A. After working as an auditor for PricewaterhouseCoopers, a risk manager for JPMorgan and an analyst for a well-regarded investment firm, he joined Davis five years ago. This was a lucky day for our shareholders. Since then, Stephen’s contribution to our results has been outstanding. In addition to seeing the opportunity in energy-related companies such as Transocean, he became expert in a range of industries that benefit from the powerful emergence of the Chinese economy, including commodity companies such as Rio Tinto, infrastructure and development companies such as Hang Lung Group, port operators such as China Merchants, and shippers such as China Shipping Development. He is a driven entrepreneur with a long-term perspective and tremendous intellectual honesty. He cares deeply about shareholder returns and about doing things the right way. Ken and I and the entire team are proud to have him as a colleague.

Mistakes and Lessons

We have often quoted the old adage “You only find out who is swimming naked when the tide goes out.” This has never been truer than in the financial markets today. While we are pleased that we studied and then passed on so many financial companies that have since collapsed, we are still embarrassed by a number of the ones we do own. This embarrassment is not caused by the fact that most financial companies are reporting and will report reduced

⁵Companies operating, incorporated or principally traded in foreign countries may have more fluctuation as foreign economies may not be as strong or diversified, foreign political systems may not be as stable and foreign financial reporting standards may not be as rigorous as they are in the United States.

earnings as credit costs ratchet up. That is an inevitable part of the cycle. Instead our embarrassment is caused by the staggering losses reported by companies whose cultures and risk controls deteriorated far more than we would have imagined.

With the tide rushing out, no company in our Portfolio has been more exposed than Citigroup, which has already taken charges of \$28.8 billion, roughly six times the write-downs taken by JPMorgan Chase. While Citigroup was once among our largest holdings, we gradually reduced the position, which now stands at about 0.9% of our assets, roughly one quarter of what we have in JPMorgan Chase, for example. With a new CEO and an enviable global franchise, we are watching the company closely.

Just as Citigroup's losses are embarrassing in comparison with a competitor like JPMorgan Chase, Morgan Stanley's loss of \$10.6 billion stands in stark contrast to the \$2.4 billion loss taken at Goldman Sachs (which we do not own).

In the case of both Morgan Stanley and Citigroup, what we missed was not something that stood out in their financial statements relative to their competitors, at least not in the quarters leading up to this mess. Rather, we mistakenly assessed the deterioration in their *cultures*.

At any leveraged financial firm, culture is critical and it starts at the top. At such firms, the chief executive officer must serve as the ultimate chief risk officer. He or she must understand the nature (if not the specifics) of the risks that the firm is taking and ensure that the firm is adequately compensated for these risks. Beyond this, the chief executive must also make sure that incentive systems, particularly for traders, take into account capital and risk rather than simply short-term GAAP income.

Finally, our second greatest percentage loss in the Portfolio last year occurred in our holding of municipal bond insurer Ambac. Although this company has never been among our top 30 holdings and currently represents about 0.2% of the Fund, we were clearly mistaken in our assessment of the risk embedded in its portfolios, the possibility of the rating agencies removing its triple-A rating and the likelihood of significant stock dilution. Having said this, the histories of Ambac and its competitor MBIA, whose shares we added at the end of the fourth quarter, are not yet written and many aspects of their business remain very valuable. In times of great dislocation, strange things can happen. During the Enron saga, for example, shares of Williams Companies fell from a high of \$49 to less than \$1, only to trade at \$32 today. Similarly, another energy company, AES, fell to as low as 92 cents only to recover to \$19 today. Please know we are studying Ambac and MBIA carefully. Both situations are fluid and could change rapidly.

Concluding Thoughts

While these are difficult and uncertain times for investors, long experience has taught us to hold fast and look for opportunities when others are fearful. We are believers in the underlying strength and resilience of the American business model and convinced that stock investing remains one of the best ways to compound wealth over generations. Our Portfolio is made up of durable, well-managed companies that should grow more valuable in the years to come. Such increasing value should reward patient investors.

In the meantime, our family, directors and colleagues remain among the largest shareholders in Selected American Shares and never forget the responsibility and trust that you have placed in us. ■

This report is authorized for use by existing shareholders. A current Selected Funds prospectus must accompany or precede this piece if it is distributed to prospective shareholders. You should consider the investment objectives, risks, fees, and expenses of the Fund carefully before investing. The prospectus should be read carefully before investing or sending money.

In this report Davis Advisors investment professionals make 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.

Selected American Shares' investment objective is capital growth and income. In the current market environment, we expect that income will be low. There can be no assurance that the Fund will achieve its objective. Selected American Shares invests primarily in common stock of U.S. companies with market capitalizations of at least \$10 billion. The most important risks of an investment in Selected American Shares 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; financial services risk: investing a significant portion of assets in the financial services sector may cause a fund to be more volatile. Securities within the financial services sector are more prone to regulatory action in the financial services industry, more sensitive to interest rate fluctuations and are the target of increased competition; and foreign country risk: companies operating, incorporated or principally traded in foreign countries may have more fluctuation as foreign economies may not be as strong or diversified, foreign political systems may not be as stable and foreign financial reporting standards may not be as rigorous as they are in the United States. As of December 31, 2007, Selected American Shares had approximately 13.9% of assets invested in foreign companies. 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 views expressed by the Davis Advisors investment professionals in this report are subject to change, and some of the stocks discussed may no longer be owned. The information provided in this report should not be considered a recommendation to buy, sell or hold any particular security. As of December 31, 2007, Selected American Shares had invested the following percentages of its assets in the companies listed: Merrill Lynch, 1.32%; Bank of New York Mellon Financial, 1.31%; Heineken, 1.00%; ConocoPhillips, 4.55%; Transocean, 0.94%; Rio Tinto, 0.40%; Hang Lung Group, 0.37%; China Merchants, 0.99%; China Shipping Development, 0.32%; Citigroup, 0.85%; JPMorgan Chase, 3.46%; Morgan Stanley, 0.44%; Ambac Financial, 0.20%; MBIA, 0.13%.

Selected 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 selectedfunds.com or call 800-243-1575 for the most current public portfolio holdings information.

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. Investments cannot be made directly in an index.

We gather our index data from a combination of reputable sources, including, but not limited to, Thomson Financial, Wilshire Atlas, Lipper, and index websites.

After April 30, 2008, this piece must be accompanied by a supplement containing performance figures through the most recent quarter end.

Shares of the Selected 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.