RS | investments

Fourth Quarter 2011 Mutual Fund Commentary
RS International Growth Fund

Investment Environment

The evidence of the last few years should have demolished the notion that capital markets are efficient. But we continue to behave as though prices are an honest predictor of the future. Nowhere is this problem more acute than in the Eurozone. Rises in government bond yields and falls of stock prices have been heralded regularly as signals of imminent disaster and have had global effects. An overwhelming consensus now exists that sovereign defaults and a breakup of the euro are inevitable. A return to global recession is seen as the likely result.

The Eurozone does enjoy particularly fertile conditions for a self-reinforcing downward spiral, with weak asset prices affecting the economy and vice versa. The prevalent mood is uncertain and worried. Many market participants on both buy and sell sides have been experiencing difficult conditions since the onset of the global financial crisis and are therefore predisposed to feeling glum about the outside world. The risk of being wrong in such volatile conditions has led investment managers further to reduce their time horizons. Pension funds are under pressure that is exacerbated by exceptionally low bond yields. Companies are hoarding cash rather than investing in the face of uncertainty. Taking all these factors together, it seems optimism, and tolerance for volatility in the interests of longer-term gain, are at a nadir.

The inter-relationship between financial markets and the real world, the reflexivity most famously characterised and exploited by George Soros, has again come to the fore during a period of stress. However, this feedback loop might be broken in several ways: most likely through effective policy action, or through stronger external demand; and these bearish conditions could rapidly reverse. We suspect that there are particular reasons why current market prices should not be seen as unbiased or efficient sources of information about the world.

Much weight has been given to rising sovereign yields in southern European countries, widely cited by commentators as evidence that debt sustainability is out of reach and disaster no longer avoidable. This may prove to be a self-fulfilling prophecy. But these bond markets have been largely deserted by many investors since the summer, leaving them at the mercy of hedge funds' speculative attacks. Tightening balance sheet constraints at the market-making banks have exacerbated the lack of liquidity.

In the equity markets we suspect that the exceptional spike in daily volatility could have much to do with the dramatic shift in market participation, from long-term investors to traders in millisecond increments, the High Frequency Traders.

Using technology located at the heart of the stock exchanges themselves, these traders apply complex algorithms to detect the initial signs of large buy or sell orders, then trade at a furious pace in anticipation of the price impact these orders bring. An electronic arms race is underway as all participants fear being the slowest guy in the room. Since the May 2010 'Flash Crash' this questionably useful activity has attracted increasing scrutiny; at the least, it appears to exacerbate volatility in already volatile times. Linkages between markets and regions are also tightened by these pattern-seeking algorithms, which means bad news ripples through global markets in seconds. Over one-third of all equity activity in Europe, and over half in the United States, now consist of High Frequency Trading (The Financial Times; October 2011).

This latest manifestation of a financial market activity that serves itself rather than providers or recipients of capital is extracting enough profit from actual investors to pay for the laying of a new cable beneath the Atlantic, minus the kinks and bends that currently slow things down by five milliseconds. The implications for investors with multi-year time horizons are mixed: ever increasing levels of volatility on one side, but greater inefficiencies and opportunities on the other.

Portfolio Review

Once again, the Fund's turnover remained low in the last quarter, with investment decisions focused on the long term. We bought Sociedad Quimica y Minera de Chile (SQM, 0.63% position as of 12/31/2011), which produces potash, iodine and lithium from reserves primarily based in the Atacama Salt Desert. These reserves are high quality with low extraction costs, making them very attractive. SQM supplies less than 1% of global potash demand, allowing it to increase its production capacity substantially without changing the attractive dynamics of the wider potash market. Geographically, the Chilean producer is particularly well placed to supply Brazil's growing demand for this fertiliser. Currently, lithium accounts for less than 10% of the company's revenues, but SQM has the largest proven reserves and currently supplies over a quarter of the global market. The metal is already commonly used in batteries for smartphones and tablets, but also has the potential for use in electric vehicle batteries. We believe these assets could be very attractive over the longer term.

Understandably, we are often asked for our view on Europe. The simple answer is that we do not have one. Continental Europe is not one homogenous block and trying to make sweeping generalisations can mask important differences. The Eurozone as an entity undoubtedly faces tough challenges, but there are large differences at the national level. News coverage has focused on the difficulties in the southern countries, but usually fails to mention the strength of the northern nations. Germany's GDP growth for 2011 is still forecast to be around 3%, well ahead of the US and UK. Sweden's is estimated at over 4%; and despite the headwind of a strong Franc, Switzerland's is just under 2% (GDP Figures source: The Economist Intelligence Unit). When looking at the prospects for the holdings in the Fund, we consider what is happening at the specific company level and work up from there; the macro environment for a company is an important part of that analysis. With that in mind it is perhaps worth noting that whilst more than a third of the Fund is invested in Europe, over half of this is in companies listed in Germany, Sweden and Switzerland.

As the largest economy in Europe, Germany is the driving force. It has already undergone many of the structural changes contemplated by Italy and Spain, to ensure that its companies would be competitive on the global stage. As a result, it weathered the global financial crisis well, unemployment is now at a 20 year low and the corporate sector has produced healthy profits. The Fund includes the media company Axel Springer (0.47%), which we think will benefit from rising advertising spending in Germany as the real domestic economy continues to fare much better than consensus expects. Building materials company HeidelbergCement (0.60%) and travel operator, Tui (0.55%) should also benefit.

Germany also is the largest exporter in Europe, with exports making up around half of its GDP. Being a member of the Eurozone has been of substantial benefit to the country. If Germany had still had its own currency, doubtless it would have been seen as a safe haven and therefore been much stronger than the euro, a situation which would have eroded German exporters' competitiveness. Using the euro has prevented such currency headwinds. The Fund includes a number of these exporters, including the luxury car maker Porsche (0.87%) and the sportswear brand Adidas (1.71%). As with both of these companies, the key demand growth drivers for German exports are now coming from outside Europe, with China in particular importing an ever greater share of German products.

Similarly, Switzerland has a strong export market and domestic economy, although its companies have faced strong currency headwinds. We own a number of Swiss companies, ranging from the global luxury goods giant Richemont (Cartier, 2.45%), through the power generation and automation industrial ABB (1.31%), to Geberit (1.34%) which provides sanitary and piping systems, with just under half of its revenues coming from a combination of its home market and Germany.

We have long been proponents of the strength of some of the Swedish industrial companies. Atlas Copco (industrial compressors, tools, construction and mining equipment, 3.57%) and Sandvik (cutting tools and mining equipment, 1.29%) manufacture high quality tools, operate in attractive niche markets, and are strong cash generative businesses. Sweden's Handelsbanken (1.66%) is one of the few European banks in the Fund. It focuses on 'old fashioned' retail banking in a strong local economy and has a good track record for its lending.

From an abstract perspective, it is easy to say investors should be excited when everyone else is bearish, but much harder to put into practice amid the doom and gloom. Given the current levels of pessimism pervading market commentaries over the future of the euro and Europe, we have been wondering if the question we should be asking is: what if the very worst doesn't happen? With that in mind we are looking into some potential new investments.

Performance Review

Despite the raised levels of volatility and very pessimistic news coverage, international equity markets actually rose over the last quarter of 2011. The RS International Growth Fund returned 5.85%, outperforming the MSCE EAFE Index[1] and MSCI EAFE Growth Index[2], which returned 3.38% and 3.94%, respectively.

At the end of September stocks were indiscriminately sold off as market participants panicked about the state of the global economy; many of these stocks bounced back with gusto at the beginning of the quarter. This highlights the large impact volatility is currently having on markets and, in turn, on month by month performance. Looking to the Fund, its holdings in Atlas Copco (3.57%), the Swedish engineering company, and Baidu (4.79%), the Chinese internet company, both showed strong share price moves under such conditions. Both of these stocks are large holdings of the Fund and as such made a significant positive impact on its performance over the quarter.

Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than their original cost. The Fund's total gross annual operating expense ratio as of the most current prospectus for the Class A Shares is 1.60%. The performance quoted, unless otherwise indicated, does not reflect the current maximum sales charge of 4.75% that became effective on October 9, 2006. If the maximum sales charge were included, the performance stated above would be lower. Current performance may be lower or higher than performance data quoted. Performance current to the most recent month-end is available by contacting RS Investments at 800-766-3863 and is frequently updated on our Web site: www.RSinvestments.com.

Performance quoted represents past performance and does not guarantee future results. The Fund is the successor to The Guardian Baillie Gifford International Growth Fund; performance shown includes performance of the predecessor fund for periods prior to October 9, 2006. Please refer to the most current Fund prospectus for complete details on expenses including fees and also for more information on sales charges as they do not apply in all cases and if applied are reduced for larger purchases. Performance results assume the reinvestment of dividends and capital gains.

Rolls Royce (2.45%), the UK jet engine supplier, performed well on the back of a company announcement. It is setting up a joint venture with Pratt & Whitney to develop the next generation of engines for mid sized aircraft. It is simultaneously selling its stake in its small-engine joint venture to partner Pratt & Whitney for $1.5bn. This has been taken very positively by the market but how much value is being created and how much is simply a re-phasing of future profits and cashflows is less clear.

It was the Fund's Japanese stocks that detracted over the quarter. Its holding in Rakuten (3.15%), the e-commerce business, performed poorly. Rakuten's acquisition of Kobo, a Canadian e-reader company, was a new direction that surprised and disappointed the market.

The Fund's holding in Garanti Bankasi (1.46%) was impacted by general worries over the Turkish economy. Turkey has run up a large current account deficit making it reliant on external financing to maintain growth. The central bank is struggling to set policies which control inflation without pushing up the exchange rate; and has been reluctant to raise interest rates. The market believes the economy is overheating and the unorthodox policies which are being enforced are not working. Turkish banks have been negatively impacted.

A dominant factor of the markets over the past three months has been the rally of Western oil majors, such as BP (0.00%). These stocks have been benefiting as the oil price nudged ever higher and investors have looked towards what they consider to be safe havens. The Fund does not hold these stocks and this detracted from its relative returns. Instead we prefer to invest in smaller E&P companies, such as the Brazilian company OGX (0.87%). We believe these offer greater growth prospects than the western majors whose challenge is to maintain their current rates of production.

Investment Outlook

We are cautious about our ability to forecast the resolution of the Eurozone crisis, which is after all a multinational political project of great complexity and historical significance. We do however feel that there are some areas where we disagree with the market consensus. It is understandable that the German commitment to the euro is called into question when the main leverage that Berlin has over its neighbours is the threat of expulsion, but we believe that commitment remains strong among both the government and the populace.

We also believe that southern Europe is not beyond redemption. Spain and Italy are grappling with the same problems of low growth and public deleveraging as the US, UK and Japan, amongst others. To conclude that low bond yields in these countries marks them out as safe havens strikes us as perverse. Without the support of quantitative easing in the debt markets, European governments are being forced to confront their problems uncomfortably quickly. If the crisis abates, the tax, pension and labour market reforms now being put in place should serve these countries well in coming years. Indeed, the scenario of a sharp recovery in domestic European assets represents a risk to the Fund in the shorter term at least in relative terms, not least because the region's heavily beaten down banks could easily double in value. With this in mind our investment teams continue to assess companies that meet our requirements for growth and competitive strength that might benefit from an end to the euro crisis.

Elsewhere in the world, our optimism about long-term developments in China, based on the durable forces of urbanisation, emulation and education, remains undimmed. The investment opportunities that result are by no means restricted to the Chinese market. There will certainly be booms and busts along the path of China's development, but we stress that the country has ample resources to solve problems as they arise, whether in the banking sector, local government or elsewhere. We view the specific instance of falling luxury real estate prices, which have generated so much angst, as the successful achievement of a government policy designed to boost much needed social housing at the expense of speculation. The American economy has also just enjoyed a particularly

strong quarter of positive economic surprises, showing reviving strength in the areas of manufacturing, employment, consumer confidence, job creation and even housing (Citigroup Economic Surprise Index, a daily measure of whether economic data is better or worse than economists' projections).

We thank you for your continued support.

Sincerely,

James Anderson	Tom Coutts	Tom Record
Co-Portfolio Manager	Co-Portfolio Manager	Co-Portfolio Manager
David Salter	Kavé Sigaroudinia	Nick Thomas, CFA
Co-Portfolio Manager	Co-Portfolio Manager	Co-Portfolio Manager

Sarah Whitley
Co-Portfolio Manager

As with all mutual funds, the value of an investment in the Fund could decline, so you could lose money. International investing involves special risks, which include changes in currency rates, foreign taxation and differences in auditing standards and securities regulations, political uncertainty and greater volatility. These risks are even greater when investing in emerging markets.

Any discussions of specific securities should not be considered a recommendation to buy or sell those securities. Fund holdings will vary.

Except as otherwise specifically stated, all information and portfolio manager commentary, including portfolio security positions, is as of December 31, 2011.

RS Funds are sold by prospectus only. You should carefully consider the investment objectives, risks, charges and expenses of the RS Funds before making an investment decision. The prospectus contains this and other important information. Please read it carefully before investing or sending money. To obtain a copy, please call 800-766-3863 or visit www.RSinvestments.com.

Regional Allocation
(As of 12/31/11)

European	36.0%
UK Equity	22.7%
Developed Asia	20.6%
Emerging Markets	18.5%
Cash	2.3%

Top Ten Holdings[3]
(As of 12/31/11)

Company	Country	Percentage of Total Net Assets
Baidu	China	4.79%
Atlas Copco	Sweden	3.57%
Rakuten	Japan	3.15%
BHP Billiton	United Kingdom	3.01%
Standard Chartered	United Kingdom	2.70%
PPR	France	2.64%
British American Tobacco	United Kingdom	2.62%
Inditex	Spain	2.53%
Rolls-Royce Holdings	United Kingdom	2.45%
Richemont	Switzerland	2.45%

Performance
(Average Annual Total Returns as of 12/31/11)

	Fourth Quarter 2011	1-Year	3-Year	5-Year	10-Year	Since Inception[4]
RS International Growth Fund, Class A						
without sales charge	5.85%	-13.19%	10.82%	-2.48%	4.13%	5.29%
with maximum sales charge	0.81%	-17.32%	9.03%	-3.43%	3.63%	5.02%
MSCI EAFE Index[1]	3.38%	-11.73%	8.16%	-4.26%	5.12%	5.93%
MSCI EAFE Growth Index[2]	3.94%	-11.82%	8.85%	-2.81%	4.62%	4.35%

Performance returns for periods of less than one year are not annualized.

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1 The Morgan Stanley Capital International (MSCI) EAFE (Europe, Australasia, Far East) Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. Unlike the Fund, the index does not incur fees or expenses.
2 The Morgan Stanley Capital International (MSCI) Growth Index for Europe, Australasia, and Far East (EAFE) is generally considered to be representative of international stock market activity. Index results assume the reinvestment of dividends paid on the stocks constituting the index. Unlike the Fund, the index does not incur fees or expenses.
3 Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.
4 Class A shares inception date February 16, 1993.

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