

## Fourth Quarter 2011 Mutual Fund Commentary RS Small Cap Growth Fund

### Market Commentary

Equity markets remained volatile in the fourth quarter but regained some of the ground lost in August's market sell-off as investors welcomed signs of modest improvement in the U.S. economy. Small cap stocks as measured by the Russell 2000<sup>®</sup> Index<sup>1</sup> outpaced the broader S&P 500 Index in the fourth quarter after suffering significantly during a third quarter correction. Easing recession fears helped boost performance in more cyclically sensitive shares in the energy, producer durables, and materials sectors, and those sectors outperformed the broader Russell 2000<sup>®</sup> Growth Index<sup>2</sup>. The fourth quarter highlighted the tug of war between better valuations for small cap stocks and stronger than expected fundamentals vs a weak macro backdrop. Despite a strong fourth quarter, valuations are still below average and merger & acquisition activity has picked up.<sup>3</sup>

### Performance Review

For the three-month period ended December 31, 2011, RS Small Cap Growth Fund (Class A Shares) returned 11.72%, underperforming a 14.99% return by the benchmark Russell 2000<sup>®</sup> Growth Index. The Fund's relative performance for the period was held back by stock selection in the consumer discretionary and technology sectors. Stock selection in the health care, energy, and financial services sectors contributed positively to relative performance. RS Small Cap Growth Fund declined 2.33% for the full year 2011, but outperformed the Russell 2000<sup>®</sup> Growth Index, which declined 2.91%.

### Portfolio Strategy

RS Small Cap Growth Fund is managed according to our philosophy that long-term share price appreciation is driven by sustainable earnings growth. We are focused on innovative companies whose core business can transition from a small market-cap company to a mid- or even large-capitalization company over time. We seek out innovation among products or services that are growing organically, creating new markets or taking market share away from existing companies and are focused on finding companies that we believe will achieve an appreciation in business value regardless of the underlying market environment. The Fund is managed by three co-portfolio managers who have worked together for over ten years and who, along with four research analysts, serve as sector specialists. We conduct over 2,000 company meetings each year, through in-person

Performance quoted represents past performance and does not guarantee future results.

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 1.47%. 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](http://www.RSinvestments.com).

Please refer to the most current Fund prospectus for complete details on expenses including fees and also Please read the prospectus carefully 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.

meetings, conference calls, trade shows, etc. We then back up our findings through discussions with industry leaders and third-party sources.

We are long-term investors and seek to establish definable “anchor points,” or quantifiable metrics indicating a company’s potential long-term growth trajectory. Anchor points allow us to maintain our research focus as a company executes its business strategy, and they arise out of our high-level discussions of a company’s long term capabilities and performance goals over three to five years. The RS Growth Team translates these goals into quantifiable metrics to be evaluated over the company’s growth cycle. These long-term anchor points serve as guide posts to help us measure a company’s progress toward its goals, regardless of what is taking place in the overall market. Anchor points help us to align our research with management’s stated goals and to prevent distraction caused by short-term stock price movements and inevitable market volatility.

In constructing the portfolio, we combine investments in companies with established business models and demonstrated financial success with exposure to promising and developing companies that are in the earlier stages of their growth cycle. We believe that this multi-tiered approach allows us to capitalize on the growth potential across the small cap spectrum, while also managing risk and seeking a well diversified portfolio for our investors.

### **Portfolio Review**

In a volatile year for equity markets, RS Small Cap Growth Fund sought to mitigate losses through disciplined stock selection and our focus on risk management. Beginning early in the third quarter, we took steps to adjust the Fund’s risk-reward profile to reflect a more uncertain economic environment and a more risk averse investment climate. We reduced portfolio exposure to early-stage, “promising” smaller cap companies, while we raised our weighting in more proven companies with established market positions and earnings performance. We also reduced the Fund’s weighting in the consumer discretionary sector due to our concerns over how discretionary spending would fare in a less certain economic environment.

In this environment, a number of the Fund’s individual investments in the consumer discretionary space came under pressure in the fourth quarter as we believe investors at times focused more on fear than fundamentals. Nonetheless, we believe that our investments continue to perform well relative to our long-term anchor points, which are focused on long-term growth potential as opposed to quarter-to-quarter earnings fluctuations. Our anchor points for companies in the consumer sector typically focus on the size and growth potential of the addressable market and the company’s ability to increase share of that market.

In the consumer sector, our biggest detractor for the quarter was consumer footwear company Crocs, Inc. (0.98% position as of 12/31/2011). The company has broadened its product line beyond its signature plastic clogs to encompass a wider range of casual and more fashionable styles for adults and children and has been aggressively expanding into new markets in Europe and Asia. The costs associated with this growth strategy have weighed on the company’s recent earnings performance. The company also suffered a small execution misstep earlier this fall, stocking too many cold weather styles while the weather was still warm. While these setbacks have recently weighed on the Crocs’ stock price, we believe that the company’s growth prospects remain on track. Top-line revenue growth has been solid, especially for new styles, which already accounted for roughly one-third of the company’s products sold in the third quarter. We believe the brand has substantial room to grow in the United States and abroad, and we continue to hold the position.

Stock selection in the technology sector also weighed on relative performance, as uneven corporate earnings performance and uncertainty over enterprise capital spending continued to overshadow some stocks in the sector. The uncertain spending environment has made it challenging for companies to assess end-user demand and optimal inventory levels. This proved the case for LED

lighting technology company Cree Research (0.94%), a detractor for the quarter. Earlier this year, Cree shipped more units to its distribution channel than the market could then absorb. The result was some inventory building and price cutting that dampened the company's subsequent financial performance. We remain constructive on long-term potential for Cree and for the LED technology area in general. LED lighting currently accounts for approximately 1% of the \$20 to 30 billion lighting market. We believe that share could grow significantly over the next three years as consumers and business users discover the ultimate cost savings associated with this technology. As a leading manufacturer of higher end, high performing components used in LED lighting, we believe Cree is uniquely positioned to benefit from this migration. The recent price cutting may help to speed greater adoption of this technology, since the higher initial price of these long lasting bulbs has been one impediment to their purchase.

We continue to find opportunities in the health care sector, where the underlying fundamentals remain promising in a landscape characterized by rising healthcare costs, an aging population, and the emergence, through healthcare reform, of 30 million newly insured healthcare participants. Our emphasis has been on finding innovative companies that we believe offer sustainable competitive advantages and the potential for superior long-term earnings growth. We seek to avoid exposure to companies with government reimbursement or regulatory risk.

Fund performance benefited from an investment in Medivation (1.28%), a biotech company with a promising new drug for prostate cancer. Medivation's drug delivered very positive results in Phase III clinical trials. The results were so encouraging that company ended the trial early in order to administer the drug to patients receiving the placebo. When evaluating biotechnology investments, a key metric is the potential addressable market. Prostate cancer is one of the most common cancers affecting men, and the drug, if approved, would address a multi-billion dollar market.

Align Technology (1.27%) was another strong performer in health care. Align Technology is the maker of the clear Invisalign orthodontic teeth aligner that continues to gain popularity with orthodontists and patients alike as an alternative to traditional wires and brackets. The company's growth prospects have been enhanced with the rollout of its new G3 platform, which is designed to address more complex orthodontics cases especially in the teen market. We believe that Invisalign has so far only tapped a small portion of its potential market. The company has the potential to nearly double its global market share as it continues to penetrate new market segments in the United States and abroad, especially in China, where the orthodontics market is growing 30% a year. The company continues to report strong revenue growth and profit margins, and we remain constructive on its long-term prospects.

While the Fund's overall stock selection in the health care sector aided relative performance in the fourth quarter, our investment in biopharmaceutical company Endocyte (0.00%) detracted from our results. Endocyte is a development-stage biotechnology company focused on discovery and development of targeted therapies for cancer and inflammation. The company's shares fell sharply in December following Phase II trial results for its ovarian cancer therapy EC145. The development process for the drug will now be longer and more expensive and due to this uncertainty, we chose to exit the position.

The Fund's relative performance was aided by stock selection in the energy area, due in part to our investment in Complete Production Services (0.00%). The oilfield services provider was acquired by competitor Superior Energy Services (0.00%) for a 61% premium. In the energy sector, we continue to emphasize oil services and equipment providers with proprietary technology or highly engineered services that are in high demand to improve the safety and efficiency of resource extraction. These are proven secular growth stories that we believe will benefit the Fund over the long-term and these sectors are generally less sensitive to sharp swings in underlying commodity prices. Earlier in the year, the Fund's benchmark, the Russell 2000 Growth Index, underwent rebalancing that

substantially raised the weighting of energy stocks within the index portfolio. In the interests of risk management, we felt it important to bring the Fund composition more closely in line with this new benchmark composition and took advantage of this change to add exposure to some of our favorite names within the energy sector.

### **Annual Review**

RS Small Cap Growth Fund outperformed the benchmark Russell 2000® Growth Index despite delivering modest negative returns for the twelve-month period ended December 31, 2011. Correlations touched an all-time high in 2011 and were well above their long-term averages. The Fund's relative performance during a volatile year for small cap stocks was aided by stock selection in the health care sector, and in particular from our investment in Pharmasset (0.00%), a biotechnology company focused on developing next generation treatments for hepatitis C (HCV). The company was acquired by Gilead Sciences (0.00%) in the fourth quarter. Other positive contributors included beauty products retailer Ulta Salon, Cosmetics & Fragrance (1.44%) and long-time technology holding NetLogic Microsystems (0.00%), a supplier of communications semiconductors, which was purchased for a 57% premium by Broadcom Corp (0.00%).

Several of our investments in the technology sector detracted from the Fund's relative performance for the year. In particular, inventory issues plagued optical components manufacturer Oclaro (0.50%), as well as LED lighting technology company SemiLEDs (0.55%). A slower than anticipated roll-out of 3D movie technology in theaters nationwide also curtailed performance by RealD (0.00%), another detractor for the period.

### **Outlook**

As we look ahead, we believe that the equity market may remain volatile as investors await more clarity on the global economic outlook and political developments in Europe and at home. Despite this environment, we remain cautiously optimistic on the outlook for our portfolio of small cap companies as they continue to maneuver through a less certain economic environment. As long-term investors, we are looking beyond short-term cyclical factors and positioning the Fund to benefit from innovation and secular growth opportunities across a variety of industries. We continue to seek out innovative secular growth companies with sustainable competitive advantages that we believe will lead to solid earnings growth over the entire business cycle.

Thank you for your continued investment.

Sincerely,



Steve Bishop  
Co-Portfolio Manager



Melissa Chadwick-Dunn  
Co-Portfolio Manager



D. Scott Tracy, CFA  
Co-Portfolio Manager

As with all mutual funds, the value of an investment in the Fund could decline, so you could lose money. Investing in smaller companies can involve risks such as having less publicly available information, higher volatility, and less liquidity than in the case of larger companies. Overweighting investments in certain sectors or industries increases the risk of loss due to general declines in the prices of stocks in those sectors or industries. Investments in technology companies may be highly volatile.

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](http://www.RSinvestments.com).***

**Sector Allocation<sup>4</sup>**  
(As of 12/31/11)

Health Care	19.45%
Technology	17.73%
Consumer Discretionary	15.67%
Producer Durables	14.91%
Financial Services	8.27%
Energy	7.95%
Materials and Processing	6.53%
Consumer Staples	1.85%
Utilities	1.57%
Cash	6.07%

**Top Ten Holdings<sup>5</sup>**  
(As of 12/31/11)

Team Health Holdings, Inc.	2.02%
Old Dominion Freight Line, Inc.	1.67%
Rock-Tenn Co., Class A	1.62%
Tractor Supply Co.	1.58%
Under Armour, Inc., Class A	1.58%
j2 Global, Inc.	1.57%
Wright Express Corp.	1.56%
HMS Holdings Corp.	1.53%
BioMarin Pharmaceutical, Inc.	1.50%
HEICO Corp., Class A	1.50%

## Performance

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

	Fourth Quarter 2011	1-Year	3-Year	5-Year	10-Year	Since Inception <sup>6</sup>
RS Small Cap Growth Fund, Class A						
without sales charge	11.72%	-2.33%	22.59%	2.68%	2.43%	12.67%
with maximum sales charge	6.41%	-6.97%	20.62%	1.68%	1.94%	12.44%
Russell 2000 <sup>®</sup> Growth Index <sup>2</sup>	14.99%	-2.91%	19.00%	2.09%	4.48%	7.86%

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

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<sup>1</sup> The Russell 2000<sup>®</sup> Index measures the performance of the 2,000 smallest companies in the Russell 3000<sup>®</sup> Index, which consists of the 3,000 largest U.S. companies based on total market capitalization. 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.

<sup>2</sup> The Russell 2000<sup>®</sup> Growth Index is an unmanaged market-capitalization-weighted index that measures the performance of those companies in the Russell 2000<sup>®</sup> Index with higher price-to-book ratios and higher forecasted growth values. (The Russell 2000<sup>®</sup> Index measures the performance of the 2,000 smallest companies in the Russell 3000<sup>®</sup> Index, which consists of the 3,000 largest U.S. companies based on total market capitalization.) Index results assume the reinvestment of dividends paid on the stocks constituting the index. You may not invest in the index, and, unlike the Fund, it does not incur fees and expenses.

<sup>3</sup> Source: Bank of America Merrill Lynch, Small Cap Strategy, Steven Desanctis, January 3, 2012.

<sup>4</sup> The Fund's holdings are allocated to each sector based on their Russell classification. If a holding is not classified by Russell, it is assigned a Russell designation by RS Investments. Cash includes short-term investments and net other assets and liabilities.

<sup>5</sup> Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.

<sup>6</sup> Class A shares inception date November 30, 1987.

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