

## First Quarter 2011 Mutual Fund Commentary RS International Growth Fund

### Investment Environment

In our view, success as a long term investor depends upon the ability to handle news. Recent months have been particularly rich in newsworthy events, all of them apparently important, some of them tragic. There was a series of supply shocks early in the year, ranging from a Chinese drought to Australian floods. This was followed by widespread unrest in the Arab world, leading to a surge in the price of oil, followed by the Japanese disaster, in which natural destruction was worsened by nuclear uncertainty. The ongoing crisis in the European periphery was not resolved, but only relegated to a back seat.

What was the reaction to these cataclysmic events? Several markets experienced precipitous declines, followed by panic and fear. In fact, at the time of writing, most markets have turned in very mediocre performance. The US and continental Europe were up a little so far this year; so was China, despite its vigorous monetary tightening. Even Japan was only down by about 10%, and the yen has been very strong. Dividing up markets by industry rather than by country shows that the energy sector has been especially strong, which is not surprising considering the strength of the oil price; but this has not unsettled the bond markets, where credit spreads tightened further. In our view, all of this looks like impressively resilient performance in the face of a torrent of bad news.

This reminds us of an important belief; that the value of a company does not depend very much on its immediate prospects; and it is actually very difficult for an individual event, however impressive, to interrupt or even significantly alter an enterprise's long-term progress, and hence to change its valuation. Many investors tend to underestimate the durability of businesses in our view, and often overreact to events.

Of course, some changes really do matter, but they tend to be evolutionary rather than sudden. For example, the gradual rise in the profitability of the banking sector to an unsustainable level in the run up to the financial crisis took a very long time, and has probably still not unwound. What really matters to us is a company's competitive position, how sustainable it is, and whether it is being undermined or strengthened.

Our unwillingness to react to events does not mean that we can ignore them completely, but in the court of investment they are very unreliable witnesses in our view. The evidence of gradual change in the overall economy has to be taken more seriously, however. In this case, the witnesses are usually reliable, but have to be rigorously cross examined. Most indications during the quarter were that the global economy was continuing to recover. Companies are starting to invest again; there has been an increase in share buy-backs and dividends, and a pick up in corporate activity. Consumers are still cautious, but their confidence is generally improving in our view – except in the UK, where a policy of austerity has not had the invigorating effect that its proponents expected. As Keynes put it, “what the economy needs is not rest, but exercise.”

There has been a lot of debate recently about the relative attractions of emerging market and developed country equities. Some investors have been switching from the former to the latter. It may be that, in the short term, the increase in the rate of growth will be greater in the developed world; but the absolute level will remain fairly modest in our view compared to the developing world. In any case, this black and white approach fails to recognize the fact that the growth drivers on each side

are increasingly similar. Germany, for example, is being powered by demand from emerging countries. These issues are best addressed at the company level, where it is clear that the world is far more complicated than our current categories allow.

### **Portfolio review**

Our trading activity remained at a low level during the quarter. We have invested in ARM Holdings (0.78% position as of 3/31/11), the British semiconductor designer, which is benefiting from the rapid uptake of smartphones and tablet computers around the world. ARM joins an increasing group of companies in the Fund where we believe the accelerating rate of change in technology will have a profound impact on their prospects. Reductions to SAP (1.01%), which may be more of a victim than beneficiary of such change, funded the purchase.

Developing a theme discussed in previous reports, we have increased our exposure to the booming German economy by taking a holding in media giant Axel Springer (0.50%). The outlook for advertising spending in Germany is encouraging, and we believe the increasingly widespread adoption of devices like the iPad might prove to be a net benefit to the owners of popular content.

During the quarter we conducted a review of those investments that we broadly categorize as global industrial cyclicals. We concluded that a significant common source of demand, China, remains in a strong position. Profit margins at the company level are back to around record levels, but the prospect of further revenue growth as the global economy continues to recover remains appealing. The anecdotal evidence from company contacts suggests that industries ranging from compressors to autos and ball bearings are struggling to keep up with demand. Stock market valuations suggest some, but not all of this good news is priced into the shares. Our greatest concern relates to the emergence of new competitors in China, where technological attainment and private enterprise are both proceeding at a furious pace. We monitor this threat at the company level.

### **Performance Review**

International markets ended the quarter in positive territory, with the MSCI EAFE Index<sup>1</sup> up 3.45%. Against this backdrop, the RS International Growth Fund (Class A Shares) slightly underperformed the market over the quarter returning 3.20%.

2011 began with the underlying contributions to performance broadly reflecting the prevailing mood swings of the market. Concerns over recent events in North Africa and inflationary pressures weighed on the developing markets, while developed markets generally performed better. Then, March brought the devastating Japanese earthquake, and subsequent tsunami, shocking both the

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. 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 1.75%. Please refer to the most current Fund prospectus for complete details on expenses including fees. 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. 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. Current and month-end performance information, which may be lower or higher than that cited, is available by contacting RS Investments at 800-766-3863 or visiting [www.RSinvestments.com](http://www.RSinvestments.com).

world and markets. The Fund is underweight in Japanese stocks due to long term concerns over high debt levels, aging demographics, and an inflexible political system.

Alternative energy companies have benefited from the perception that nuclear power will play a smaller role in future electricity generation. The Fund's holdings in Vestas Wind Systems (0.88%) and SMA Solar (0.57%) benefited from such sentiments.

However, European luxury goods holdings PPR (Gucci) (2.62%) and Richemont (Cartier) (2.87%) were weaker, as markets worried about a short term reduction in Japanese demand, a major end market of these goods. Over the long term, we believe Japanese demand will return and therefore saw share price weakness as an opportunity to increase the Fund's holdings in these companies.

In a move away from the headlines, Chinese internet stocks have been beneficial to returns. Over the past quarter and, importantly, over the longer term, the Fund's holdings in Baidu (4.07%), the Chinese search giant, and Tencent (1.82%), the Chinese social networking site, have been strong contributors.

Several of the Fund's financial holdings fared less well, with the likes of Garanti Bankasi (1.56%) and Standard Chartered (2.49%) adversely affected by concerns over inflation and a consequently less stimulative monetary environment in several developing economies.

### **Outlook**

We remain optimistic with three main planks to our optimistic case: continuing growth in economies and profits; low interest rates, which we believe are likely to remain low; and pervasive nervousness in the markets. Markets rarely fall very far in our view with so many people hovering so close to the exit.

A quick review of these three arguments shows them all to be intact in our view. Growth was very strong last year, and looks set to continue, albeit at a slightly slower pace. Company earnings have been exceptionally buoyant, rising by over 40% in the US last year, for example. The recovery phase is now over, so growth in profits will probably slow down this year; but we believe the main drivers are still strong.

The emerging countries are growing rapidly simply by copying the route map of the developed world. As the fast growing economies become a larger part of the whole, we believe that the global economy is likely to continue to expand faster than it has during the last twenty years – even if the leading emerging economies slow down. For example, the respectable economist Willem Buiter estimates that real global GDP is now roughly equally split between the developed and developing countries. In twenty years' time those we now call the developing countries will be 70% of real global GDP, and growth between now and then should average around 4.6% per year. Other experts come to similar conclusions by different routes, but the general message is clear: in terms of growth, we believe that the next twenty years will be more like the 50's and 60's than the 80's and 90's.

The overhang of debt in the developed world has hardly been addressed at all yet, so interest rates will have to remain low. Printing money need not produce inflation if there is no demand for credit, as the Japanese example shows. With governments and consumers eager to repay debt, banks deleveraging, and other companies holding more cash than they know what to do with, the demand for credit is likely to remain very weak. There have been some price rises of commodities whose supply is limited, such as oil; but we do not view this as inflation. Markets are unlikely to be derailed by a change in policy in our view.

Overall, we believe investor sentiment is still fragile. This is the most subjective argument, although the incredibly low real yields on inflation protected bonds do indicate a high degree of caution, and we think that there is little evidence of irrational exuberance these days.

Finally, When J.P. Morgan was asked what the market would do, he replied with one word: 'Fluctuate'. This is no doubt correct, but we think that it will fluctuate upwards over time. We are not making any significant change in strategy, but we are trying to find more companies with proprietary innovations, which will allow them to expand sales and protect their margins as the recovery matures, capital spending picks up and competition intensifies.

We thank you for your continued support.

Sincerely,

James Anderson  
Co-Portfolio Manager

Timothy Campbell  
Co-Portfolio Manager

John F. Carnegie  
Co-Portfolio Manager

Tom Coutts  
Co-Portfolio Manager

David Salter  
Co-Portfolio Manager

Kavé Sigaroudinia  
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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 March 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).***

## Regional Allocation

(As of 3/31/11)

European	37.0%
Developed Asia	20.3%
UK Equity	20.4%
Emerging Markets	20.2%
Cash	2.2%

## Top Ten Holdings<sup>2</sup>

(As of 3/31/11)

<u>Company</u>	<u>Country</u>	<u>Percentage of Total Net Assets</u>
Baidu	China	4.07%
BHP Billiton	United Kingdom	3.57%
Atlas Copco	Sweden	3.20%
Richemont	Switzerland	2.87%
Banco Santander	Spain	2.78%
PPR	France	2.62%
Standard Chartered	United Kingdom	2.49%
Rakuten	Japan	2.45%
Inditex	Spain	2.33%
British American Tobacco	United Kingdom	2.28%

## Performance

(Average Annual Total Returns as of 3/31/11)

	First Quarter 2011	1-Year	3-Year	5-Year	10-Year	Since Inception <sup>3</sup>
RS International Growth Fund, Class A						
without sales charge	3.20%	15.17%	-0.72%	3.16%	4.96%	6.52%
with maximum sales charge	-1.71%	9.71%	-2.32%	2.16%	4.45%	6.24%
MSCI EAFE Index <sup>1</sup>	3.45%	10.90%	-2.53%	1.78%	5.83%	7.14%
MSCI EAFE Growth Index <sup>4</sup>	2.30%	12.88%	-2.16%	2.50%	5.15%	5.41%

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

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<sup>1</sup> 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.

<sup>4</sup> 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.

<sup>2</sup> Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.

<sup>3</sup> Class A shares inception date February 16, 1993.

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