

## Second Quarter 2011 Mutual Fund Commentary RS Emerging Markets Fund

### Market Review

*'I know that I know nothing'*: the famous phrase attributed to Socrates reflects the belief that wisdom begins with recognition of one's own ignorance. And at a time when the sell-side strategists solemnly inform us that the immediate outlook for the global economy and markets has seldom been more uncertain — and, indeed, when non-Europeans might be forgiven for thinking that the continental map is still dominated by the country that gave birth to Western philosophy — the idea of seeking succour in the wisdom of the Greeks seems pleasingly apposite.

In fact, the immediate problem faced by investors appears to be one of unfamiliarity, rather than uncertainty. As the centre of gravity of the global economy continues to shift east, the traditional Pavlovian trading responses are less sure-footed. With central banks around the world heading in different directions, and currencies remaining out-of-whack, markets are struggling to understand changes in the value of money. So-called 'risk assets' have been subject to violent swings as traders weigh the potential for growth surprises against the likelihood of shifts in central bank policy. And the allure of the traditional 'safe havens', their issuers festering in debt paralysis, seems to run an increasingly contrary path to economic logic.

Our views have been out-of-step with those of the market of late. To some extent, this reflects our continued faith in emerging growth at a time when concerns over inflation and the risk of policy error have been rising. Conscious of these risks, we had already made some small adjustments to the portfolio where we felt the stresses would be particularly keenly felt. However, we have no intention of abandoning those stocks where our conviction in significant long-term upside remains strong. Where this remains a simple matter of time horizon, we are happy to be patient. But is it possible that we are guilty of confusing short-term cyclical headwinds with longer-term structural deterioration? This is important, and merits further discussion.

The angst over inflation is understandable: credit growth has continued to grow in excess of GDP in many countries, while real rates remain negative in others. But it is far from obvious to us that emerging policy makers are as woefully behind-the-curve as they have often been portrayed. True, policy makers were initially slow to hike rates, although this was understandable in an environment where developed market monetary policy had created so much easy money in search of growth and yield. The dilemma facing emerging policy makers was that traditional tightening to combat the inflationary impact of inflows risked making their countries even more attractive as destinations for foreign investors, but at the same time there was also a reluctance to let the currencies go at a time when the export recovery still looked fragile. For many countries, therefore, capital and credit controls were the solution: regrettable to the free-market purists, perhaps, but a lesser evil compared to the destabilizing influence of gargantuan cross-border flows, and a pragmatic means of allowing currency appreciation to occur at a more orderly pace. And while this may have disappointed traders in search of a 90's style Asian liquidity bubble, the prospect of some of the hotter money heading for the exits has hardly been unwelcome for policy makers keen to remain masters of their own destiny.

There is an interesting debate to be had about levels of structural inflation in different emerging markets, and the extent to which this may be offset by productivity improvements over the longer-term. But for now, policy has been tightened, month-on-month inflation trends have finally started to fall, and rate rises are nearer the end than the beginning.

The most obvious risk to this scenario is another spike in commodity prices. The surge in Brent above U\$125 earlier in the year undoubtedly caught us off-guard — a function of loose monetary conditions, demand from emerging markets remaining strong, demand from developed markets snapping back rapidly, and of course two ‘black swan’ events in the form of the Arab Spring (given the accompanying fears over supply-side disruptions) and the Fukushima tragedy (given the potential for a ‘no nuke’ backlash and an increase in demand for more traditional energy sources). And while high oil prices are an irritant for those in the narrow, happy income band in which most of us are lucky enough to find ourselves, they can be a far more profound source of misery for consumers in the poorer parts of the world.

The threat posed by high oil prices is not one that we dismiss out of hand. This is not to say that we are long-term oil bulls: most in the team are Schumpeterians at heart, and believe that technology will ultimately succeed in creating cheaper substitutes for energy and materials. Nonetheless, we acknowledge the possibility that Malthusian constraints may endure for extended periods of time, opening the door for oil prices to remain elevated in the medium-term, and we continue to monitor events in the Middle East with keen interest. Of course, the fact that some of the world’s most exciting energy companies happen to be in emerging markets offers bottom-up stock-pickers an attractive way of ‘hedging’ against this particular risk.

But as long-term fundamental investors, we thrive on searching beyond the market’s usual knee-jerk reaction to macro shocks. Every trader knows that high oil and food prices are ‘bad’ for emerging markets. ‘Emerging markets’ has, of course, become an increasingly clumsy way of describing a disparate group of countries unified solely by their desire not to remain as such. The oil importers of Asia include some with twin deficits and some with bulging surpluses. They include those running policies we believe to be sustainable, as well as those we consider more questionable. Some are home to companies with strong growth prospects, some are not. Nor, for that matter, do we believe that higher energy prices should be considered uniformly positive for a number of the Latin and EMEA oil exporters over the longer-term, especially for those countries where they risk masking the need for urgent structural reform. This is a heterogeneous group of countries, and the tools at the disposal of each vary hugely.

When those tools include trivial levels of central government debt and U\$3 trillion of reserves, one could be excused a degree of smugness. But the China story continues to attract a huge amount of cynicism. Only a couple of months ago, the market was worried that a failure to raise interest rates would send the Chinese economy into an inflationary spiral; now the concern is that the tightening has been over-zealous, and has forced the economy to the brink of a hard landing.

We can quibble over the definition of ‘hard landing’ in an economy where growth is extremely unlikely to deviate significantly from the high-single digits. And just because China has been proving the naysayers wrong for 20 years is no reason to suspend our critical faculties. We would certainly agree that the Chinese economy contains imbalances, most obviously relating to property prices in the tier one cities. But travelers who count the apartments lying empty in Shanghai or Shenzhen before getting the next flight home are missing the more balanced situation in the cities that make up the remaining 95% of China’s property market. And while the fact that luxury properties in Miami’s Biscayne Bay currently cost far less than two-bed apartments on Beijing’s 4<sup>th</sup> Ring Road is interesting headline-fodder, the broader economic significance of such tid-bits is probably limited given that this particular ‘bubble’ has been built on cash. We do think it’s quite likely that high-end property prices have further to fall - Beijing has made it quite clear that improving property affordability is a political aim, consistent with their desire for ‘harmonious society’. However, part of the improvement in affordability will be brought about by a huge increase in social housing projects. Given that this is a pet project of Li Keqiang, the likely successor to Wen Jiabao, fretting about whether the headline target of 36 million social housing units will be met or not is missing the point -

in the context of a total housing stock that's probably not much more than 150 million units, it will still be a reassuringly big number. In this sense, we remain skeptical that a hard landing comes about from a property bust.

Ultimately, given China's flexibility to launch a mighty policy response in the event that the economy lurches downwards, debating how many houses will be built this month or next strikes us as a fairly pointless exercise. We are far more interested in how many houses, highways and railways China might need to build over the next five to ten years. We would rather discuss China's progress on educational or financial reform than contemplate short-term oscillations in cabbage prices. This is an economy which will face challenges in the decades ahead as it attempts the tricky task of rebalancing the economy from investment towards consumption, and we welcome serious debate on these issues. But for commentators to dismiss the rise of China based on lazy comparisons with the West seems both ungracious and deluded.

### **Performance and Portfolio Review**

During the quarter RS Emerging Markets Fund (Class A Shares) returned -2.86% while the MSCI Emerging Markets Index<sup>1</sup> returned -1.04%.

The Russian index was weak following a strong Q1, and tracking the retrenchment in the oil price. Stock selection here was unhelpful, notably the overweight positions in Petropavlovsk (gold miner, 0.75% position as of 6/30/2011) and Evraz (steel producer, 0.79%). Petropavlovsk has made meaningful progress in implementing better internal reporting structures, particularly relating to the way it guides external production forecasts. Though a sudden re-rating is unlikely, we believe that it will slowly regain the market's faith as it meets or exceeds the 600koz guidance for 2011 and beats conservative guidance in future years. Similarly, concerns regarding capex commitments have recently been allayed. With weakness across the materials sector, the holding in Evraz also detracted. Apart from the sale of the 40% stake in Rapsadskaya (coal mine, 0.00%), upside triggers for the company include strong growth in domestic construction and private infrastructure development; the Russian PM Putin recently announced an increase in state funding for road construction, a combination of pre-election campaigning and a long-term goal.

Several energy holdings in the Fund hampered relative performance, in stark contrast to Q1 when many of these companies were amongst the top contributors. Overweight positions in oil companies Dragon Oil (Turkmenistan, 3.06%), Chariot Oil & Gas (Namibia, 0.69%), Petrobras (3.51%) and OGX (Brazil, 0.80%), Tullow Oil (Ghana and Uganda, 1.02%) and Gulf Keystone Petroleum (Kurdistan, 0.91%) all hurt. Operationally newsflow from these companies has been broadly encouraging. For example, Dragon is increasing the number of shallow wells it is drilling suggesting

Performance quoted represents past performance and does not guarantee future results. The Fund is the successor to The Guardian Baillie Gifford Emerging Markets 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 1.57%. 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).

some upside risk to the 20% production guidance for this year, and Tullow Oil announced an increase to its annual production in its 1H trading statement. Clearly the decline in the crude price had a greater bearing than individual company operations.

Turning to the positives, stock selection in Taiwan was a notable contributor. The overweight position in China Life Insurance (Taiwan, 2.47%) was helpful with the company announcing a better than expected 2010 Embedded Value (+44% yoy) driven by decent growth in the value of new business signifying a successful shift towards higher margin products. Far Eastern Department Stores (1.47%) delivered decent returns; the company is benefiting from strong domestic demand, and we see a number of catalysts including the operating upswing of three mega hypermarket stores from 2012, and the launch of the individual visitor scheme for mainland Chinese. Stock selection in South Korea was also helpful, with a range of holdings from Samsung Fire & Marine (insurance, 1.50%), Hyundai Mobis (auto parts manufacturer, 2.28%), Hyundai Glovis (auto logistics, 1.51%) and Cheil Industries (electronics materials, 0.96%) positively contributing.

As previously mentioned, the overweight positions in the energy and materials sector detracted over the quarter. A standout exception was the holding in Kenmare Resources (1.65%), benefitting from sharp increases in the prices of its products. The minerals sands sector offers the prospect of strong demand growth and tight supplies which should result in firm prices in the medium term. Kenmare is one of few companies in the sector which is in production and offers the prospect of increasing output. Stock selection in the Consumer Discretionary and Financials sectors was also a positive. In the consumer space, companies such as Hero Honda (Indian motorcycles, 0.87%), Astra International (Indonesian conglomerate, 1.02%) and CBD (Brazilian retailer, 0.00%) performed well, whilst Bank of Ayudhya (Thailand, 1.64%) and Bank Rakyat (Indonesia, 0.94%) were rewarded for ongoing strength in their results.

## **Outlook**

For those investing on horizons that can be measured in years rather than weeks, the old adage about markets being little more than voting machines in the short-term rings as true as ever in our view: it is the weighing machine on which we remain focused. And it is in this sense that we retain our longer-term optimism. The attractions of the stocks and themes that make up the core of the Fund remains intact: with very few exceptions, the companies are continuing to deliver exactly as we had hoped in operational terms, while valuations are such that we continue to see the potential for the shares to return multiples of their current value on a five-year view.

Even in the absence of anything resembling a proper summer in Scotland - we are inclined to maintain our sunny disposition. A tide of events has been against us, but it is unlikely to last forever, and our favourite stocks are looking cheap in our view. If the long-term growth opportunity for Samsung Electronics (3.23%) or Hon Hai (2.14%) is as compelling as we believe, why exactly do they trade on single-digit multiples of forward earnings? And is Chinese steel demand really likely to fall so precipitously that Vale (2.825%) deserves to trade on only 6x earnings? Aren't the market valuations of Alibaba (0.67%), Baidu (2.05%) and Tencent (0.00%) still fractions of what these exciting businesses are really worth?

Of course, our markets may well continue lurching from euphoria to despair in response to the latest macro releases in Greece or Spain, ongoing tightening may lead to more short-term downgrades, and it's quite possible that a nasty hangover looms when the Fed finally calls last orders: these are simply not calls that we feel qualified to make. Yet in true Socratic fashion, while we know our limitations, we are also prepared to hold our convictions with confidence. The prospect of greater differentiation between the winners and losers, beyond the frantic risk-on / risk-off trades that have dominated returns in recent years, is naturally one that should be welcomed by fundamental stock-pickers. We will not retreat meekly to the index or to stocks where limited downside is the main attraction. We will remain fully-invested, resolutely committed to seeking out long-term growth.

We thank you for your continued support.

Sincerely,



Richard Sneller  
Co-Portfolio Manager



William Sutcliffe  
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. The value of a debt security is affected by changes in interest rates and is subject to any credit risk of the issuer or guarantor of the security. 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 June 30, 2011.

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**Regional Allocation**

(As of 6/30/11)

Asia-Pacific	55.0%
Latin America	20.1%
Europe	8.9%
South Africa	6.0%
Middle East & Africa	4.8%
Other	4.0%
Cash	1.2%

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

(As of 6/30/11)

Company	Country	Percentage of Total Net Assets
Petrobras	Brazil	3.51%
Samsung Electronics	South Korea	3.23%
Dragon Oil	Other Emerging	3.06%
Vale S. A.	Brazil	2.82%
China Shenhua Energy Company Ltd.	China	2.51%
China Life Insurance	Taiwan	2.47%
Hyundai Mobis	South Korea	2.28%
Taiwan Semiconductor Manufacturing Company	Taiwan	2.19%
Hon Hai Precision Industry Co.	Taiwan	2.14%
Baidu	China	2.05%

## Performance

(Average Annual Total Returns as of 6/30/11)

	Second Quarter 2011	1-Year	3-Year	5-Year	10-Year	Since Inception <sup>3</sup>
RS Emerging Markets Fund, Class A						
without sales charge	-2.86%	22.44%	3.69%	11.50%	16.73%	10.56%
with maximum sales charge	-7.48%	16.60%	2.02%	10.43%	16.17%	10.19%
MSCI EMF Index <sup>1</sup>	-1.04%	28.17%	4.53%	11.75%	16.54%	8.53%

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) Emerging Markets Free (EMF) Index is a market capitalization-weighted benchmark index composed of companies representative of the market structure of emerging market countries in Europe, Latin America, and the Pacific Basin: it excludes closed markets and those shares in otherwise free markets which may not be purchased by foreigners. There are no expenses associated with this index while there are expenses associated with the Fund. The MSCI EMF Index is an unmanaged index and is not available for direct investment.

<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 May 1, 1997.

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