

## Second Quarter 2010 Mutual Fund Commentary RS Partners Fund

### Performance and Market Commentary

For the second quarter of 2010, RS Partners Fund (Class A Shares) declined 10.70% versus the 10.60% decline for the benchmark Russell 2000® Value Index<sup>1</sup>. Year-to-date, the Fund posted a -0.58% return versus -1.64% for the benchmark. Despite the YTD relative outperformance of 106 basis points, we are disappointed with the Fund's results given our absolute-return orientation and our focus on risk management.

The second quarter was a very difficult and volatile time for the U.S. equity markets, with the volatility index (VIX) nearly doubling during the quarter. With fears of a double dip recession becoming more prevalent, many investments that were strong performers during the first quarter sold off sharply during the second quarter. Nowhere was this more evident than in financials. In fact, the financial services sector went from being the Fund's best performing sector in the first quarter to its worst performer during the second quarter.

Concerns related to a slowing economy, deflation, Europe, and deteriorating credit all conspired to reduce investor appetite for a myriad of businesses. In addition, the uncertainty surrounding financial re-regulation cast a dark cloud over the financial services sector. With its focus on protecting consumers and de-risking our systemically important financial institutions, the primary goals surrounding financial reform legislation are well intended. We view improved regulatory oversight positively to the extent that it discourages excessive risk taking at the community and regional bank level. Importantly, given our keen focus on risk management, we have consciously avoided investments in companies that we felt would be overly exposed to re-regulation. Longer-term, it is our view that improved regulation will serve to eradicate the marginal lending models that have negatively affected the supply and demand dynamics of the credit markets. In turn, these reforms should improve risk-adjusted returns for those community and regional banks that possess solid underwriting standards and strong deposit franchises. As such, despite a challenging second quarter, we continue to believe in the merits of our financial investments and have used the recent sell-off as an opportunity to consolidate capital around our highest conviction ideas.

### Portfolio Positioning

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 1.60%. 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 and is available by contacting RS Investments at 800-766-3863 or visiting [www.RSinvestments.com](http://www.RSinvestments.com).

## **Financials**

We have increased the Fund's exposure to financial services over the past year as we became increasingly more constructive on the sector. During this period, we deployed incremental capital toward those financial services companies that we felt possessed solid capital positions, stable and reliable funding sources, strong management teams, increasing returns on capital, and solid risk management over our three year investment horizon. While we have been particularly focused on the banking industry, we continue to be very discriminating relative to the Fund's bank investments. We continue to look for businesses with solid deposit franchises and sound capital ratios that generate strong pre-provision cash flows. Specifically, we have concentrated our investments in Relationship Lenders, which are characterized as those that lend primarily to in-market customers with the goal of building a collection of "advantaged liabilities," as well as related fee-income business.

Unlike more transactional lenders that seek asset growth through the syndicate market, the strength of the Relationship Lender model exists in its ability to build "advantaged liabilities" in the form of core deposits. These deposits, many of which are housed in non-interest bearing accounts, provide our banks with a long-term, low cost capital source with limited liquidity triggers. In turn, when a core depositor seeks a loan, the bank enjoys a lower cost of funds (and lower leverage) relative to said credit given that the borrower is required to "self-fund" a portion of the loan with deposits. The relationship model also provides these banks with visibility into the inner workings of their respective lending bases, which should lead to solid and informed underwriting and better ongoing monitoring of outstanding credits. This superior knowledge of the borrower and related deposits should lower the risk grade and capital requirements of a loan portfolio, provided that the lender has been disciplined in its capital allocation process. It is therefore imperative that we understand how a given management team thinks and talks about capital allocation (e.g., return parameters, capital structure, operating culture, compensation measures). Finally, we focus on the capital adequacy of the business. In fact, many of our investments were initiated by participating in a capital raise that provided the business with what we deemed to be more than adequate levels of capital.

While we see early signs that credit losses may be peaking, our investment thesis does not rely on improving credit. To the contrary, in our analysis of these credit based financial institutions we spend the lion's share of our time and efforts stress testing our draconian downside case. We begin our work by vigorously analyzing the composition of the loan portfolio, understanding past and present underwriting standards, engaging in discussions with management regarding how they deal with problem credits and their most troubled assets. In addition to interviewing senior and middle management, we accomplish this by speaking with mortgage brokers, distressed asset buyers, strategic end users, and in-market (both bank and non-bank) competitors. These discussions help us identify the key risks to a particular banking model relative to credit, capital adequacy, asset/liability management, competitive landscape and regulatory environment. These risks inform our credit forecasts, which can be stress tested for sufficiency of capital and to determine the risk of a future liquidity event. Our downside loss scenarios are then used to determine how much additional degradation would need to occur in order to create capital issues, which could necessitate a potentially dilutive capital event, and drive absolute downside to our entry point.

Despite a challenging quarter, it continues to be our view that the banking industry is structurally improving. We believe that the elimination of irrational competitors and a return to more economic pricing of credit risk will lead to structurally higher returns for those companies (i.e., Relationship Lenders) that we believe are best positioned to weather the current economic environment. In addition, we expect that the better positioned banks will garner significant market share from weakened competitors. In general, we believe that valuations within financials remain relatively attractive. Looking forward, we would expect the portfolio to continue to favor banks and life insurance vs. REITs and property & casualty insurance. With returns on new business improving at select banks and life insurance companies, we remain interested in those companies that possess

sustainable longer term business models, while seeking to purchase our stake at levels that we believe provide us with an asymmetric risk / reward profile.

### ***Consumer, Business Services, Health Care, and Technology***

We continue to allocate capital toward companies with less cyclical exposures that are undergoing company-specific changes that we believe will lead to improving returns. We remain cautious regarding more discretionary consumer-related businesses as we feel that these companies face ongoing challenges due to the high levels of unemployment, increased savings rates, and depressed home valuations. With the U.S. government having propped up the mortgage market, we remain defensively positioned with respect to the consumer as we await further visibility regarding what impact the withdraw of this artificial support will have. Therefore, to the extent that we make investments that are impacted by the consumer, we seek businesses that serve less discretionary needs or have more recurring cash flow characteristics.

As detailed in last quarter's commentary, healthcare has been an area where we have been especially active in allocating capital. As the impact of healthcare reform becomes clearer, we believe that winners and losers will emerge. As such, we continue to allocate capital to those companies that should benefit from the incremental 30 million new insured lives in the United States, after taking into account any incremental taxes or other reform-related costs that might be borne by the business. Within business services and technology, we continue to allocate capital to businesses that have maintenance-type revenue streams with high renewal rates and recurring cash flow businesses that we believe will thrive, even under softer economic conditions. As such, we feel that we are well positioned for whatever unfolds with the broader economy.

### ***Hard Assets***

The hard assets pod is divided between businesses that we generically label as "industrials" and those falling under the natural resource heading. The primary difference between the two groups relates to the laws of mean reversion. In industrials, processing and service oriented businesses excess returns are typically competed away over time, which is why we focus on *improvements* in returns on invested capital when assessing investment opportunities. In contrast, our view is that returns on capital in the natural resource space are a function of where a company's producing assets sit on a supply cost curve. Effectively, we believe that returns are typically driven by the "quality of the rock" and, because geology doesn't change over our 3-5 year investment time horizon, returns on capital in the natural resource space are not often subject to mean reversion. Due to this fundamental difference, we believe that each segment deserves its own separate commentary.

### ***Industrials***

While the operating environment for many industrial companies has improved over the past year, we remain concerned about most companies' ability to generate positive pricing in an environment where significant excess labor and manufacturing capacity persists. As a result, we have slanted our exposure towards what we believe to be the higher quality, more durable franchises within the industrial landscape. We like purchasing these businesses at steep discounts to warranted value, as we believe that our downside risk remains limited. Moreover, we remain convinced that the opportunity to own defensible, differentiated business models, run by outstanding management teams, will set the foundation for attractive future returns.

### ***Natural Resources***

Our objective in managing investments within natural resources is to optimize risk adjusted returns across a full commodity price cycle. An important part of our process involves visiting various natural resource projects around the world. We do this to gain perspective on how future projects will impact the supply cost curve for a commodity and to identify the owners of what we believe are the most cost advantaged projects in a given commodity. Importantly, we believe that this work provides us

with a basis for assessing current and future incentive prices for various commodities, as well as helping us in our efforts to generate project-by-project net asset value models for the companies we own. We believe that the best way to generate superior through-cycle returns for our investors is by:

1. Owning only those low-cost, advantaged producers of commodities (“advantaged” in the sense that the companies own assets that sit at the bottom of a steeply sloped supply cost curve and can earn excess returns on capital, independent of the commodity cycle);
2. Investing in advantaged companies that have management teams focused on generating returns that exceed their cost of capital irrespective of commodity price;
3. Limiting sovereign and geological risk; and
4. Purchasing stakes in these few advantaged producers only when we believe that their share prices are trading below net asset value.

We believe that the current environment for natural resources is mixed and that in the absence of a coordinated pick-up in global demand, commodity prices will continue to oscillate around their respective incentive prices with a high degree of volatility. We will use short-term dislocations between price and underlying economic value to establish positions in the most advantaged assets at reasonable prices, and will conversely use periods of strength to reduce exposure to businesses when valuations look stretched. As such, our portfolio turnover may pick up slightly versus historical levels, although our name turnover likely will remain quite low.

The longer-term outlook for natural resources remains positive, in our view. Supply costs for many commodities continue to rise for geological reasons, excess capacity remains relatively low, the longer-term demand trends from emerging market countries remain favorable, and the risk of inflation in basic commodities continues to rise. Our objective is to continue to expose our investors to what we believe are the most advantaged natural resource companies across the commodities spectrum when valuations are attractive. By doing so, we strive to provide our investors with all the benefits associated with an investment in the natural resource space, while seeking to mitigate the associated risks.


### **Outlook**

We are neither macro economists nor top-down investors. However, we believe that we are in a period of protracted volatility as the markets continue to grapple with a variety of issues, including ongoing deleveraging, deflation/inflation risks, government budget deficits, higher taxes, and the potential for rising risk premiums. We remain cautious with respect to the levels of financial and operational leverage that we will tolerate within our portfolio companies. We have never attempted to maximize short-term results, as we do not believe that our investors would be adequately compensated for the level of risk that we would have to assume.

With the possibility for increasing interest rates, inflation, risk premiums and taxes conspiring to raise the market discount rate, we believe that markets may remain under pressure for some time. As business analysts, we enjoy fundamentally-driven environments where company-specific structural changes and improvements in cash flow returns on invested capital are the primary determinant of investment results. We firmly believe that the strength of our team, a consistent and repeatable process, and a realistic investment horizon are critical factors in generating superior long-term, risk-adjusted returns for our clients.

We thank you as always for your ongoing support.

Sincerely,



MacKenzie Davis, CFA



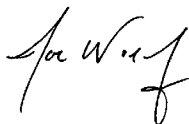
David Kelley



Andrew Pilara



Ken Settles, CFA



Joe Wolf

As with all mutual funds, the value of an investment in the Fund could decline, so you could lose money. Investments in companies in natural resources industries may involve risks including changes in commodities prices, changes in demand for various natural resources, changes in energy prices, and international political and economic developments. Investing in small- and mid-size companies can involve risks such as having less publicly available information, higher volatility, and less liquidity than in the case of larger companies. Investing in a more limited number of issuers and sectors can be subject to greater market fluctuation. 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. Foreign securities are subject to political, regulatory, economic, and exchange-rate risks not present in domestic investments. 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.

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, 2010.

***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).***

#### **Appendix – Stock Examples**

**Dionex Corp.** (DNEX, 2.0% as of 6/30/2010) is a high-end instrumentation company that manufactures and assembles ion chromatography (IC) and high performance liquid chromatography (HPLC) systems along with related consumables and services. This equipment is used by chemists and regulatory agencies to separate and analyze chemical components. In fact, the Environmental Protection Agency often designs regulations for water testing around Dionex technology.

Dionex is a unique franchise that generates mid-teens returns on capital. These returns are derived from the unique combination of high gross margins (greater than 66%) with limited R&D and capital intensity. We believe new CEO Frank Witney can improve returns by an additional 5-10% due to 1) increasing aftermarket penetration, 2) introducing new HPLC products and 3) leveraging recent

Asian investments for sales and distribution. These drivers should improve cash flows materially while requiring limited incremental investment. Additionally, Witney is pursuing a balanced capital allocation strategy of niche acquisitions and share repurchases. We believe that Dionex's 2009 acquisition of ESA Biosciences, Inc. should provide for returns well in excess of its cost of capital within a reasonable time period.

Our due diligence, which included customer and competitor interviews as well as site visits, revealed a durable business within a supportive industry structure. Our work allowed us to disaggregate the significant installed base of IC equipment and then isolate the recurring and growing cash flows related to consumables and service. Dionex's IC devices are specifically designed to maximize capture rates of aftermarket sales, which are characterized by higher than corporate average gross margins with minimal capital requirements. We felt that the lack of capital intensity for consumable production was particularly evident while touring the Company's Sunnyvale, California facility.

With Dionex, our downside protection is predicated upon both the durability of returns, underpinned by the Company's dominant share within the duopolistic IC market as well as the heavily regulated nature of its customer base, and cash flows generated by its consumable and service revenues. We purchased Dionex at a time when we felt that the market was concerned about the stability of the businesses due to significant economic uncertainty. Our ability to disaggregate the IC business into equipment and aftermarket as well as our work with HPLC customers allowed us to underwrite our position with a high degree of confidence, providing a backstop to allow management's business strategy to unfold.

**Myriad Genetics** (MYGN, 2.8% as of 6/30/2010) is a leader in molecular diagnostic testing. Since initiating our investment earlier this year, the stock has traded off significantly and we have used recent price weakness to add to our position. In our view, nothing fundamentally has changed and Myriad remains a business that we like for its high margins and low capital intensity characteristics. While the Company markets eight diagnostic tests, the BRACA test is Myriad's primary product, representing approximately 80% of revenue. The BRACA test assesses a woman's risk of developing breast or ovarian cancer based on whether she carries a mutation in the BRACA gene. The BRACA test was introduced 15 years ago and is accepted as the standard of care for high risk patients (e.g., those with positive family histories). Women who test positive have an increased risk in developing breast or ovarian cancer that is over 10 times greater than that of the general population.

Myriad enjoys a leading market position with no current competition. Proprietary unpublished data on 4,000 unique BRACA mutations took over 10 years to compile and provides Myriad with significant barriers to entry. In addition, the BRACA product is protected by 23 different patents, with none of the key patents expiring before 2018. This lack of competition conveys significant pricing power, allowing the company to easily pass through biannual price increases. Given the high predictability of cancer risk, BRACA is considered to be cost effective by payers such that 96% of the test's costs are borne by insurance, with an average copayment of just \$50 to the patient.

There are two key markets for BRACA: 1) patients diagnosed with breast cancer who are tested by their oncologist to help guide therapy (e.g., lumpectomy vs. bilateral mastectomy). This is a \$600 million market that is roughly 50% penetrated; and 2) patients that are BRACA carriers but have not been diagnosed with breast cancer. These tests can be ordered by a woman's OB/GYN and are beneficial because appropriate preventive therapies can be offered to a woman testing positive that will significantly reduce her cancer risk. This is a \$6 billion opportunity that currently is only 2% penetrated.

Last year, the Company spun out its biotech division (which was focused on developing drugs for cancer and was consuming \$50 million a year) into a separate company called Myriad

Pharmaceuticals (MYRX). We believe that the spinout of this unprofitable biotech business and a refocused effort on the molecular business creates a much higher certainty of return on investment and will significantly improve return on invested capital. Instead of investing in high risk drug development projects, Myriad is now keenly focused on its high return diagnostic business. As a result, the Company's R&D spend has decreased from \$140 million in F2008 to an estimated \$25 million in F2010. Moreover, we feel that this spinout freed up capital for increased investment in its sales force and direct-to-consumer advertising, which should help Myriad further penetrate both overseas markets (e.g., Europe) and the \$6 billion domestic OB/GYN market.

Myriad has a strong balance sheet with \$450 million in cash and generates over \$150 million of free cash flow each year. The Company enjoys very high incremental margins with low variable costs. Operating margins are currently 37% and we believe these could increase into the high 40s over our three-year investment horizon. Current Return on Invested Capital (ROIC) is approximately 50% and increasing. On F2011 metrics, we believe that the Company is valued at a very attractive Reinvestment Cash Flow Yield of 15%.

**Sector Allocation<sup>2</sup>**  
(As of 6/30/10)

Financial Services	38.94%
Consumer Discretionary	13.63%
Technology	11.23%
Health Care	9.84%
Energy	7.24%
Materials & Processing	5.47%
Utilities	2.21%
Consumer Staples	1.93%
Cash	9.51%

**Top Ten Holdings<sup>3</sup>**  
(As of 6/31/10)

ACI Worldwide, Inc.	3.62%
First Horizon National Corp.	3.54%
Associated Banc-Corp	3.40%
Coinstar, Inc.	3.20%
BorgWarner, Inc.	2.99%
Compass Minerals International, Inc.	2.97%
Myriad Genetics, Inc.	2.84%
Denbury Resources, Inc.	2.83%
The Cooper Cos., Inc.	2.82%
StanCorp Financial Group, Inc.	2.74%

## Performance

(Average Annual Total Returns as of 6/30/10)

	Second Quarter 2010	1-Year	3-Year	5-Year	10-Year	Since Inception <sup>4</sup>
RS Partners Fund, Class A						
without sales charge	-10.70%	21.85%	-8.51%	0.19%	12.54%	10.91%
with maximum sales charge	-14.95%	16.07%	-9.98%	-0.78%	11.99%	10.55%
Russell 2000 <sup>®</sup> Value Index <sup>1</sup>	-10.60%	25.07%	-9.85%	-0.51%	7.48%	8.68%

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

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 1.60%. 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 and is available by contacting RS Investments at 800-766-3863 or visiting [www.RSinvestments.com](http://www.RSinvestments.com).

<sup>1</sup> The Russell 2000<sup>®</sup> Value Index is an unmanaged market-capitalization-weighted index that measures the performance of those companies in the Russell 2000<sup>®</sup> Index with lower price-to-book ratios and lower forecasted growth values. (The Russell 2000 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>2</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>3</sup> Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.

<sup>4</sup> Class A shares inception date July 12, 1995.

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