

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

### Market Review

The third quarter was a very nervous time for financial markets. Economic statistics had been deteriorating for some time, partly as result of the short term effects of Japan's earthquake, but mainly because financial crises tend to cast a long shadow. A culture of repaying debt seems to be entrenched in several large developed economies. If both government and people are trying to cut back there are bound to be problems.

What has changed recently is investors' confidence in the authorities' ability to cope. Protracted and highly politicised negotiations in the US culminated in the country's debt being downgraded. In Europe, there remain deep disagreements about how to address the Greek crisis, and mounting scepticism that the Greeks can deliver on their promises. The EU's prevarication is drawing larger European countries into the crisis and weakening the euro. What began as an economic crisis is becoming a political one.

There are plenty of happier, and possibly more important, events taking place in other parts of the world however. Interest rates seem to be peaking in the developing world. Brazil and Turkey announced cuts. In time, others are likely to follow (India raised her rates, but is lagging the trends of other economies). Emerging market current account surpluses are now clearly declining, rebalancing the world economy. America is exporting more than ever before, while net exports are now a significant drag on the Chinese economy. Despite this, China is still growing at a healthy clip – slightly embarrassing for those who claim that China cannot prosper without selling ever larger amounts to the rest of us.

### Portfolio Review

It is in such an environment as this that it pays to remember that we invest in companies, not economies, and are free to choose not to invest in those areas most exposed to the well documented problems. In stark contrast to the prevailing mood, we are particularly excited by a number of opportunities within Emerging Markets which we believe offer investors the potential to earn multiples of their original investment. Furthermore, the significant de-rating suffered by Emerging Market equities over the last couple of years makes this a striking starting point.

We have talked in the past about the likely path of oil demand from the developing economies. The IEA has consistently underestimated increases in energy consumption from EM and we see little sign of this changing. The supply response has been more gradual with noticeable interruptions along the way, particularly recently. The Fund has been seeking to take advantage of companies at the forefront of exploring and developing relatively new oil frontiers. The West African Transform Margin is one such area. This stretch of coastline running from Sierra Leone to Ghana has been subject to explorative drilling for decades but is only recently proving its potential. Tullow Oil (3.51% position as of 9/30/2011) is just one of a handful of companies involved in potentially transformational drilling programs in this area.

Elsewhere within the energy sector we have been struck by the poor performance of Petrobras (3.07%), a company now trading on less than book value but where we expect returns to remain comfortably above their cost of capital and production growth to stay strong. The similar weakness in Vale's share price perhaps speaks to concerns over the direction of Dilma Rousseff's policies but is

a mid-single digit p/e really appropriate for a company generating such high returns and with such clear avenues for further growth?

Inevitably much of our enthusiasm for a number of the energy and material names must hinge on the outlook for China, a country that continues to polarise debate both internally and externally. Whilst we share some of the concerns regarding the squeeze on credit to the private sector we do not anticipate an imminent change to either the shape or the trajectory of China's growth.

Commodity demand remains well underpinned as the investment juggernaut continues, consumption is booming and the last few years have proven that China is learning to live without any growth contribution from net exports. We remain underweight the Chinese banks and have yet to be tempted back to the property sector but the attractions of a number of internet and insurance companies continue, in our view, to be grossly underestimated by the broader market.

In marked contrast to China, we have been struck by the ready availability of credit to the Brazilian private sector. Consumer and private lending is a relatively new phenomenon in a country accustomed to high real and absolute interest rates but loan growth of late has been prolific. We expect this to help underpin the likes of MercadoLibre (0.71%) and we have been examining the performance of the banking sector's loan book with increasing interest. For the time being, the likes of Itau (0.59%) and Bradesco (1.53%) have been executing well and their ability to adapt to a more conventional banking business model continues to impress us.

Inevitably, however, a bout of weak performance forces a frank assessment of where we disagree with the market. Is it wrong, for example, for the Fund to have been so underweight defensive sectors such as the telecom companies? And why have we doggedly maintained the Fund's holdings in a number of the tech megacaps in the face of struggling Western demand? In the telecom sector we expect data revenue growth to disappoint and for the declines in voice to accelerate as the move online increases. It is hard for a growth manager to conjure up excitement for a declining profit stream in what are often public service entities.

The Fund's holdings in the likes of TSMC (2.64%), Hon Hai (-1.93%) and Samsung Electronics (-5.10%) all fall into the category of dominant players in growing industries with strengthening competitive positions. Hon Hai in particular has suffered from concerns over margin declines and weak end demand. We believe the outlook for both margins (the fruits of -its massive investment in automation and lower cost facilities is about to reap its rewards) and demand (key suppliers of tablets and still winning share in PC-s) is far more favourable than the market currently anticipates. We have similar conviction in TSMC where we expect high-teens earnings growth through the cycle and Samsung Electronics, where their dominance in flash memory is likely to underpin rising earnings for several years to come.

### **Performance**

For the three-month period ended September 30, 2011, RS Emerging Markets Fund (Class A Shares) declined 24.26%, underperforming a 22.46% decline in the benchmark MSCI Emerging Markets Index. The quarter was particularly volatile with a number of stocks experiencing price moves in excess of 20%.

As a reminder the fund's exposure to Energy companies tends to be through smaller oil and gas exploration companies rather than the national oil champions. Several of these holdings, such as Tullow Oil, Dragon Oil (3.41%) and Gulf Keystone Petroleum (1.74%) helped the relative performance of the fund over the quarter. Tullow Oil performed particularly strongly after successful drilling at its Zaedyus exploration well in French Guiana. Results from the well came in at the top end of estimates, and crucially have proven the Tullow thesis that the geological feature that hosts

Tullow's Jubilee field in Ghana are reflected on the other side of the Atlantic. In doing so, the well has potentially opened up a large new oil province off the South American coast.

A number of the technology holdings, including the Taiwanese companies TSMC and Mediatek (1.47%) and - South Korea's Samsung Electronics also added to relative performance. Mediatek was particularly strong as the company's recent chipsets appear to be gaining traction in the Chinese 3G market. The success of Lenovo's A60 smartphone that uses Mediatek's latest chip was a significant catalyst. There was little stock specific news for Samsung Electronics, but results continue to be relatively resilient, while much of the negative news in the market appears to have already been discounted in the share price. Several other South Korean stocks were also beneficial for relative performance, with overweight positions in Hyundai Glovis (auto logistics) (1.72%), NHN (internet search engine) (0.88%) and E-Mart (retailer) (1.00%) all helping. E-Mart has been strong since it was spun out of Shinsegae (0.12%) earlier in the summer, whilst Glovis continues to benefit from the good growth at Hyundai Motor Group.

On the negative side, stock selection in China hurt the fund. There has been continued negative newsflow for the rail infrastructure sector. Earlier in the year there were corruption allegations at the Ministry of Rail and during the quarter there was a fatal collision between two 'high speed' trains. This appears to have been a fault with the warning systems rather than any problem with the trains or track per se, however, all rail related companies have been very weak subsequently. The fund's two Chinese rail holdings, CSR Corp (0.69%) and China Railway Construction (0.81%) therefore hurt relative performance.

Chinese companies listed on US exchanges were also hit hard as the convoluted ownership structure behind some of these companies has yet again become an area of attention. The holding in Focus Media (advertising) (0.67%) performed poorly as a result, despite posting good first half results.

Ping An Insurance (1.08%), was another Chinese holding that detracted from relative performance. Ping An suffered from the general weakness in the Chinese insurance sector but this was exacerbated by rumours that one of its major shareholders, HSBC (0.00%), is planning to sell its stake. HSBC has firmly denied the rumour.

Material companies were the other notable detractors from relative performance, as worries about global growth hit commodity prices. With the exception of the gold company, Gold Fields (1.44%),

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 1.57%. 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).

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. 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.

companies such as Kenmare Resources (Mozambique mineral sands miner) (1.20%), Aluminium Corporation of China (0.69%), Evraz (Russian steel) (0.78%) and Cemex (Mexican cement) (0.00%) all hurt relative performance. Cemex's share price was particularly weak over fears that slowing growth in its key markets of the US and Europe and a weaker peso will inhibit the company's ability to meet their substantial debt obligations. The likelihood of a significantly dilutive debt for equity swap has increased and this undermines the operationally and financially leveraged investment case. With this in mind, we sold your holding during the quarter.

## Outlook

The current situation raises, in an acute form, an important issue which has bedevilled investors in markets throughout history. It is one that Keynes, for example, wrestled with for years before coming down decisively on one side. It is this: Should an investor try to predict and anticipate developments in the economy as a whole, and make that the determining factor in his approach ('Credit Cycling' as Keynes called it); or should he make long term commitments to strong companies with good prospects, and regard price declines caused by other investors' attitudes to the overall situation as opportunities to buy favoured businesses at low valuations?

Clearly, we favour the latter approach, as did Keynes – eventually. But this method cannot be employed uncritically. We need to be reasonably sure that the economic storm will not persist indefinitely and envelop the entire world, and we need to be confident that our favourites can remain afloat.

As far as the first issue is concerned, we are reasonably sure that the world is not coming to an end. Half of it is unaffected and growing tolerably quickly. The problems mainly lie in countries with debts in their own fiat currencies. They are not going to run out of money. There are many possible combinations of default, monetisation, devaluation, inflation and even austerity, which will resolve their problems. It is impossible to say how all this will pan out, but politicians are beginning to realise that there is too much saving going on and that a significant stimulus is required. Companies will be the main beneficiaries.

Will these companies weather the storm? We cannot be sure in every case, but the Fund is dominated by well-financed businesses, whose growth prospects depend largely on demand from the robust half of the global economy. We believe that the current crisis, and the indiscriminate 'risk on – risk off' flip flopping that it has produced, has led good companies to become undervalued. Of course, they may become even cheaper.

This is a period of accelerated change. Many old industries and companies are being replaced by new ones. The gap between winners and losers is widening, but the stock market is being even more inefficient and indiscriminate than usual. Now is a good time to be a long-term equity investor.

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 September 30, 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 9/30/11)

Asia-Pacific	54.6%
Latin America	18.0%
Europe	8.4%
South Africa	6.0%
Middle East & Africa	6.9%
Other	5.3%
Cash	0.9%

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

(As of 9/30/11)

Company	Country	Percentage of Total Net Assets
Samsung Electronics	Asia Pacific	3.70%
Tullow Oil	Middle East & Africa	3.51%
Dragon Oil	Other Emerging	3.41%
Petrobras	Latin America	3.07%
Vale On Adr	Latin America	2.92%
China Shenhua	Asia Pacific	2.73%
Taiwan Semiconductor Manufacturing.	Asia Pacific	2.64%
China Life Insurance (Taiwan)	Asia Pacific	2.50%
Hyundai Mobis	Asia Pacific	2.29%
Naspers	Middle East & Africa	1.99%

## Performance

(Average Annual Total Returns as of 9/30/11)

	Third Quarter 2011	1-Year	3-Year	5-Year	10-Year	Since Inception <sup>3</sup>
RS Emerging Markets Fund, Class A						
without sales charge	-24.26%	-22.18%	5.61%	4.24%	16.67%	8.26%
with maximum sales charge	-27.87%	-25.87%	3.90%	3.22%	16.10%	7.90%
MSCI EMF Index <sup>1</sup>	-22.46%	-15.89%	6.59%	5.17%	16.41%	6.48%

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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