

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

### Investment Environment

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 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 has drawn Italy into the crisis and weakened the euro. What began as an economic crisis is becoming a political one.

It is hardly surprising, against this background, that markets have shifted to 'Risk Off' mode. Creditor currencies in Japan and the emerging markets have been strong, as have government bond markets. Credit spreads have widened; gold and silver have risen. Equities have been weak, especially the economically sensitive sectors such as retailing and industrial equipment. Financial stocks were especially hard hit, particularly in Europe where CDS markets implied that access to dollar funds for many large banks was in peril. Defensive sectors, such as staples and healthcare, declined less, but were nonetheless weak.

There are plenty of happier, and possibly more important, events taking place in other parts of the world however. Interest rates seem to be on the turn in the developing world. Brazil and Turkey announced cuts. 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 9.5% - slightly embarrassing for those who claim that China cannot prosper without selling ever larger amounts to the rest of us.

The corporate sector is embarrassingly healthy. The amount of cash on company balance sheets is well into unprecedented territory. It tends to be the winners in each sector who have disproportionate amounts of liquidity, so the prospect of a general corporate restructuring with minorities bought out for cash is looming. Google (0.00% position as of 9/30/2011) has started; will Apple (0.00%) or Nestle (0.00%) be next? Does Europe need so many airlines? Meanwhile, UBS (0.00%) has proved once again that proprietary trading is a zero sum game. It may be that a combination of regulatory break ups, transaction taxes and shareholders running out of patience will finally bring high finance to heel.

### Portfolio Review

Sometimes, doing very little or nothing is the right thing, if not the easiest, for a long-term investor to do. The fundamentals underpinning growth in China, Asia more widely and other emerging countries are still intact. Indeed the World bank is still forecasting 3.6% global GDP growth in 2012. Trade with customers in these markets drives the earnings of companies listed right across the globe. The Fund's lower exposure to large European banking names, and our preference for well managed

companies which are orientated towards these growing economies and new technologies, reflects our views on the future economic growth drivers.

The pace of change in the world seems to us to be increasing; the implications of new technologies, network effects, tipping points and non-linear growth profiles for companies feature strongly in our investment discussions. We have been assessing the opportunities and threats presented by these technological shifts for the Fund. As a result of such conversations, over the summer we have been adding to ARM Holdings (2.25%).

ARM's microchips are used in a range of applications, most notably mobile phones, as they give the best data processing capability with minimum power consumption. The business is relatively capital light, as ARM does not actually make the chips itself, but licences its technology to semiconductor and technology hardware companies, which include the designs in their products. The best analogy for ARM is that it is more like an architect than a house builder. The company generates further revenue from royalty payments received on every product sold based on ARM technology. We expect the use of ARM's chips to accelerate over coming years as smartphones and tablets, such as the iPad, become increasingly popular and individual items use a greater number of more complex chips. The substantial cost of research and development in this area, combined with the demands for greater standardisation by the equipment manufacturers, creating a network effect, should further reinforce ARM's incumbent position. Additional growth opportunities come from other appliances, such as televisions, fridges and washing machines, becoming 'smarter' in order to improve their energy and resource efficiency levels. Combined with rising royalty levels, this should all lead to improving margins and strong earnings growth.

It is not always about new technologies though, the strength of some companies lies in simply being more efficient and flexible than their competition. The Fund invests in Inditex (3.02%), the holding company behind Zara, the successful Spanish fashion retailer. Inditex has successfully exported its core Zara format throughout the world, when other high street fashion chains have struggled. Around 17% of sales now come from Asia and just under a quarter of future retail space growth is planned for China alone. The question is; 'how has it achieved this?' According to the fashion magazines, Zara's popularity comes from its repeated ability to stay right on trend, but the simple and distinctly unfashionable answer which lies behind this is logistics. Inditex's primary competitive advantage is its ability to take products from conception to sale in a very short period, thus responding to customer demand much more quickly than its competitors. Higher average costs are offset by greater fashion flexibility, lower inventory risk and little or no spending on advertising. The company has made substantial investment in logistics in Spain, and this allows it to serve store locations around the world efficiently at very low cost. Recent results have been excellent and the company has net cash of €2.8B, so is in a good position to fund its expansion plans. This is a Spanish retailer with global appeal.

## Performance Review

For the three-month period ended September 30, 2011, RS International Growth Fund (Class A Shares) declined 21.69%, underperforming a 18.95% decline by the benchmark MSCI EAFE Index<sup>1</sup> and 18.94% decline by the benchmark MSCI EAFE Growth Index<sup>2</sup>.

Fortescue (1.63%) and Atlas Copco (3.22%) detracted from returns. Fortescue is an Australian miner that produces iron ore, a major input to steel production. Atlas Copco is a Swedish engineering company that produces high quality compressors, industrial machinery and mining equipment. These companies both benefit from high levels of development and construction throughout the world. As such the shares have been negatively impacted by the current pessimistic sentiment on the global economy.

As we've already discussed the Fund is positioned to benefit from rapid technological changes. The Fund's tech holdings were large drivers of its performance over the quarter; some for the better and some for the worse. On the positive side the Fund's holding in Autonomy (0.00%), the British company that specialises in developing software for the analysis of unstructured information, aided performance. In August, Hewlett-Packard (0.00%) announced a takeover bid for Autonomy at a significant premium to its share price. We sold the Fund's holding and realised this gain.

The Japanese tech stocks, Rakuten (3.49%) and Gree (1.19%), also aided the Fund's performance over the quarter. Rakuten is an e-commerce conglomerate whose main business is an on line shopping mall called "Ichiba". Rakuten is benefiting from increased online spending in its home market of Japan and is beginning to venture into overseas markets. Gree is a mobile internet company that offers proprietary and third-party game content, allied with a social network service. It is benefiting from a growing customer base and the trend of more users enjoying gaming on their cell phones.

However, Aixtron (0.75%), a German company that designs the MOCVD machines that produce LEDs, detracted from performance. China is a major growth area for Aixtron due to the energy saving objectives included in China's five year plan. It has seen a delay in Chinese orders as current manufacturing facilities and the shortage of trained staff has resulted in customers not being ready to receive the MOCVD machines. We remain positive on Aixtron and see this push back in orders as a delay rather than a long term problem.

As long term investors we try to look through short term noise. We have seen the current volatility in markets as an opportunity to add to some of the Fund's holdings that experienced relative price weakness.

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%. 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).

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. 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.

## Outlook

The global investment outlook seems to be dominated in most people's minds by the outlook for Greece. Financial historians of the future will find this puzzling. Even if the Greek economy halves in size, this is still less than 1% of Europe's output. Greece's problems are unique: the Greek state cannot finance its activities, and tried to conceal the consequent rise in debt. It has become clear that it will never be able either to cut or tax its way to solvency. Italy's debt, by contrast, peaked in 1994 and the country should have a primary surplus next year. Contagion is unlikely.

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 our 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 have tended to avoid western banks, and other businesses which depend on a revival by the indebted western consumer. 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 internet is undermining older business models, and technological progress is speeding up in many fields. 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,

James Anderson  
Co-Portfolio Manager

Tom Coutts  
Co-Portfolio Manager

Tom Record  
Co-Portfolio Manager

David Salter  
Co-Portfolio Manager

Kavé Sigaroudinia  
Co-Portfolio Manager

Nick Thomas, CFA  
Co-Portfolio Manager

Sarah Whitley  
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. 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)

European	36.5%
UK Equity	21.8%
Developed Asia	20.3%
Emerging Markets	18.0%
Cash	3.4%

## Top Ten Holdings<sup>3</sup>

(As of 9/30/11)

<u>Company</u>	<u>Country</u>	<u>Percentage of Total Net Assets</u>
Baidu	China	4.82%
Rakuten	Japan	3.49%
Atlas Copco	Sweden	3.22%
Bhp Billiton	United Kingdom	3.04%
Inditex	Spain	3.02%
Standard Chartered	United Kingdom	2.62%
PPR	France	2.54%
Tencent Holdings	China	2.48%
British American Tobacco	United Kingdom	2.44%
Richemont	Switzerland	2.41%

## Performance

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

	Third Quarter 2011	1-Year	3-Year	5-Year	10-Year	Since Inception <sup>4</sup>
RS International Growth Fund, Class A						
without sales charge	-21.69%	-13.22%	-0.40%	1.68%	4.12%	5.04%
with maximum sales charge	-25.41%	-17.36%	-2.00%	-2.63%	3.62%	4.77%
MSCI EAFE Index <sup>1</sup>	-18.95%	-8.94%	-0.66%	-3.00%	5.48%	5.83%
MSCI EAFE Growth Index <sup>2</sup>	-18.94%	-15.16%	-0.27%	-1.81%	5.22%	4.20%

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

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%. 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).

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. 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.

<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>2</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>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 February 16, 1993.

Distributed by: Guardian Investor Services LLC (GIS), 7 Hanover Square, New York, NY 10004.

Not a Deposit	Not FDIC or NCUA Insured	May Lose Value	No Bank or Credit Union Guarantee
------------------	--------------------------------	----------------------	---

GIS is a member: FINRA, SIPC.

©2011 RS Investment Management Co. LLC

CO1141QL\_IGF