

## Third Quarter 2011 Mutual Fund Commentary RS Partners Fund

### Philosophy and Process

We believe that company-specific value creation is often mispriced in the public markets and, as such, we have built a team of investment professionals who employ a research process that is private equity-like in nature. As business analysts, we are interested in understanding how companies create value over time. We work in teams, dissecting businesses into their component parts to gain insights into how and where capital is being allocated, and the cash flows and returns associated with those capital decisions. As value investors, we believe that capital preservation is the key to long-term wealth creation, and only deploy our shareholders' capital when we feel that the purchase price available in the market provides us with what we view as a reasonable risk profile. We acknowledge that investment returns are a function of entry price and, as such, we define risk as the permanent impairment of our clients' wealth, as opposed to stock price volatility. We acknowledge that over short periods of time we may under perform a benchmark, but believe that our differentiated team structure, philosophy and process will continue to provide us with the opportunity to generate superior risk-adjusted returns over a reasonable investment timeframe.

### Performance

For the third quarter of 2011, RS Partners Fund (Class A Shares) generated a return of -20.97% versus -21.47% for the benchmark Russell 2000<sup>®</sup> Value Index<sup>1</sup>. Producer durables and materials & processing were the portfolio's two best performing sectors during the third quarter, led by Waste Connections (a waste collection and disposal company operating in secondary markets of the western United States) and New Gold Inc. (a gold mining company), respectively. Financial services and technology were the sectors that weighed most heavily on the portfolio's performance during the quarter, led by First Horizon National Corp. (a regional commercial bank focused on the Southeastern United States) and Atmel Corp. (a designer of semiconductor integrated circuit products and capacitive touch solutions), respectively.

Year-to-date, the Fund posted a return of -17.77% versus -18.51% for the benchmark. Producer durables and consumer discretionary were the portfolio's two best performing sectors during the first nine months of 2011, again led by Waste Connections as well as specialty retailer Gamestop Corp.,

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 1.54%. 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).

Please refer to the most current Fund prospectus for complete details on expenses including fees. 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.

respectively. Conversely, financial services and energy were the two sectors that most negatively impacted the portfolio's relative performance for the year-to-date period. Within financials, regional bank First Horizon National Corp. was the biggest laggard. Within energy, oil and gas producer Denbury Resources underperformed during the quarter.

The highly correlated, macro-driven market has made stock picking difficult, as evidenced by the fact that this has been the worst year since 1998 for active managers (JP Morgan US Equity Strategy Flash, 9/2/2011). An increasingly myopic market has shown little patience, and this has manifested itself in poor performance among some very good businesses that are in the midst of significant structural change. Nowhere is this more evident than in financial services, a sector shunned by investors. Our more constructive view of financials has clearly weighed on our performance this year. In our view, the market is overlooking some very exciting investment opportunities in financials, and we have used recent weakness to add incremental capital to our highest conviction ideas.

While we are frustrated with the portfolio's absolute performance during the first three quarters of the year, we remain highly encouraged. Our portfolio companies generally continue to strengthen their competitive positions, invest capital wisely and improve their returns, in spite of the fact that these actions are not currently being rewarded in the market place. We remain committed to our core philosophy and are using the current market environment to selectively deploy capital. Our process has proven itself over time, and has worked successfully over the long-term. The portfolio performed well in both 2009 and 2010, largely the result of good decisions made by the Team during the depths of the 2007-2008 financial crises. Similarly, the team remains confident that the decisions that we are making today and concentrating capital in our highest conviction ideas will ultimately be rewarded.

## **Portfolio Positioning**

### ***Financials***

During the third quarter we saw a significant decline in the value of many of our financial investments. This decline largely resulted from the growing European sovereign debt crisis and concerns that knock on effects to the US economy would prompt a double dip recession. In addition, dramatic declines in US Treasury yields (the 10 year note fell from 3.2% at June 30th to 1.9% by quarter end) are impacting asset reinvestment opportunities for most financial services businesses. Furthermore, the government's stated objective to keep rates at historically low levels for the foreseeable future and intentionally flattening the yield curve through "Operation Twist," is pressuring spreads. Despite these macro economic concerns, we believe that valuations more than reflect our downside assumptions and we have been adding to our highest conviction names.

As mentioned in previous quarterly letters, after a relatively long period with minimal exposure to banks, we repositioned our financials portfolio in late 2009/early 2010 in order to focus on relationship lenders with strong core deposit franchises. With capital and liquidity issues more than adequately addressed, we believe that these low cost core deposit franchises are well positioned to generate improving risk adjusted returns. Within the insurance space, we continue to focus on businesses with advantaged distribution models and niche product offerings that provide a significant competitive advantage. Our approach to creating shareholder value in the insurance space is to focus on companies with a strong market presence in specialty lines of business that can leverage a structurally advantaged distribution model. We continue to believe that these business models will generate superior risk-adjusted returns over our longer-term investment time horizon.

Unlike 2008, the market's concerns related to financials have more to do with profitability than to capital and liquidity. Industry balance sheets are significantly more conservative than they were three years ago, with capital ratios having improved 35% from pre-crises levels and nearly 1/3 of bank assets in liquid assets. In general, valuations within financials are attractive. We remain

interested in those companies that possess sustainable longer term business models, while also seeking to purchase our stakes at levels that we believe provide an extremely favorable entry point.

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

Our cautious stance related to the consumer economy remains. However, we believe the market has become consumed with fears related to the recent S&P downgrade of U.S. government backed securities and the precarious situation in Europe. As such, although we remain cautious regarding underlying fundamentals, we believe more businesses are becoming mispriced, even in the face of a potentially deteriorating economic environment. As the market discounts macro- and company-specific concerns, we believe we will be presented with compelling opportunities to both add to existing positions as well as initiate select new positions. As always, we seek to invest in companies undergoing company-specific structural change that can lead to an improvement in the Return on Invested Capital (ROIC) profile of the enterprise, irrespective of broader trends in general economic activity.

In addition, healthcare continues to be an area where we have been actively searching for new opportunities. As the impact of healthcare reform becomes clarified, we believe winners and losers will emerge. As such, we continue to allocate capital to those companies that we believe should thrive under different health care reform scenarios. Within business services and technology, we continue to allocate capital to businesses that have understandable and predictable revenue streams with high customer retention rates and recurring cash flow characteristics. As such, we believe that the portfolio is appropriately positioned for whatever unfolds within the broader economy.

### ***Hard Assets***

The hard asset pod is divided between businesses that we generically label "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, 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, returns are 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 tend not to mean revert over time. As a result, in the natural resource space we use short-term volatility, often driven by changing expectations regarding near term commodity price movements, to establish positions in businesses that we believe are structurally advantaged, both in-terms of asset quality and management's capital allocation acumen. Due to this fundamental difference, each segment deserves its own separate commentary.

### ***Industrials***

As we have stated in past commentaries, we remain concerned about most industrial companies' ability to generate positive pricing in a world where significant excess labor and manufacturing capacity persists. As a result, we have slanted our exposure towards what we view as the higher quality, more durable franchises within the industrial landscape. When we can buy these businesses at what we view as reasonable prices relative to our downside calculation, and estimate equity returns based on company specific initiatives, we deploy our clients' capital.

### ***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 current net asset value.

Commodity prices and natural resource equities were very weak during the third quarter due to concerns about the outlook for economic activity and commodity demand. Interestingly, exchange-traded commodities declined much more than non exchange-traded commodities, possibly suggesting that current demand is better than expectations for future demand. We are not economists and our guess regarding near-term demand trends is likely no better than anyone else’s. However, we remain confident that the longer-term outlook for commodities is intact, driven primarily by limited spare capacity and rising marginal costs of supply. Thus, while commodity prices may continue to decline, we believe that these short-term price movements provide patient, long-term investors with opportunities to deploy capital at very attractive prices relative to asset values.

We believe 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 attempt to use short-term dislocations between price and underlying economic value to establish positions in what we believe to be 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 turnover in the portfolio may pick up slightly versus historical levels, although our turnover with respect to companies held in the portfolio 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 the most advantaged natural resource companies across the commodities spectrum when valuations are attractive. By doing so, we believe that we are best able to provide our investors with all the benefits associated with an investment in the natural resource space, while also mitigating the associated risks. As long term investors, we believe that these are the markets that establish the foundation for strong future returns, and we are excited about the prospects moving forward.

### **Team**

Over the past several years, we have followed the advice we give our management teams, reinvesting heavily in hiring and developing our most precious resource – our people. To that end, we are pleased to announce that during the third quarter we further strengthened our team with two terrific new hires:

Paul Hamilos joins our Financials Team after serving as a Vice President of the Principal Transaction Group at Macquarie Group, where he focused on the specialty finance industry. Previously, he was an Associate at American Capital Strategies focusing on mezzanine debt financing within the financial sponsors group. Paul holds a B.S in business administration, with a concentration in finance and banking, from the University of Missouri and an M.B.A from The University of Chicago Booth School of Business. Paul is a CFA Charterholder.

Andy Walker joins our Hard Assets Team after serving as a research analyst at Janus Capital Group for twelve years, covering the power and industrial sectors. Previously, he was a financial analyst in the corporate finance and investment banking divisions of Goldman, Sachs & Co. Andy holds a B.A. in economics and history from Yale University and an M.B.A. from Harvard Business School. Andy is also a CFA Charterholder.

These personnel additions were made to strengthen our team so that we can further increase our knowledge and understanding of our portfolio companies. We are firm believers that, in the final analysis, knowledge is the best risk mitigant. Moreover, our business model requires that each investment professional be responsible for just one new investment idea every three to four months. As such, we are able to encourage team members to be extraordinarily thorough in their due diligence and give them the time and resources to become the most knowledgeable investors in the market. With the addition of Paul and Andy, we believe that our team today is as deep and as strong as it has ever been.

### Outlook

We believe that we are in a period of protracted volatility as the markets 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 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. As business analysts, we enjoy fundamentally-driven environments where company-specific structural change 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 have put us in a position to benefit long-term investors. Moreover, we think that the portfolio is very well positioned for an environment where individual company-specific cash flow fundamentals are properly rewarded.

We are, as always, thankful for your patience and support.

Sincerely,



MacKenzie Davis, CFA



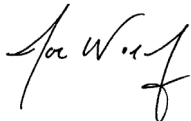
David Kelley



Andy 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 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).***

#### **Appendix – Stock Examples**

**GameStop Corp.** is the world's largest specialty retailer of video games and related hardware and accessories, with 6,700 stores worldwide and almost \$10 billion in annual revenue. Gamestop has ~25% overall market share of the gaming category but, importantly, has a ~90% share of pre-orders and a ~60% share of first week sales. These figures are important because they demonstrate the importance of GameStop as a critical marketing/distribution partner to publishers given that high quality video games typically cost tens of millions of dollars to develop and, similar to big budget movies, much of the ultimate economics of games are determined by the early success of new releases. GameStop also has ~80% share of the used video game market, which is both highly profitable and a significant driver of new game sales, as many gamers trade in old games to buy new ones.

Gamestop's dominant market position, in addition to its small store size, low rent, minimal fixed assets, and high sales per square foot, drive store-level returns on capital over 30%. Furthermore, Gamestop's management is making prudent decisions to drive overall returns materially higher. For example, the recent implementation of a successful loyalty program (PowerUp Rewards) is enabling Gamestop to take significant market share and allowing the company to penetrate new categories such as digital content sales. Increased sales combined with a significant reduction in square footage growth are driving better asset turns, improved margins, and materially higher returns on invested capital.

Despite a strong competitive position, stellar unit-level economics, and improving returns on capital, Gamestop currently trades at just 8X 2011 EPS, and 4X EBITDA with a Reinvestment Cashflow Yield of 16% – valuation levels typically ascribed to businesses that are becoming obsolete. Investors in general are concerned about the potential disintermediation of GameStop's business model as more and more gaming content is consumed via streaming and downloading, at the expense of packaged software sales. We believe that these concerns are overblown. First, there are significant technological hurdles to overcome before digital distribution can become prevalent, including long download speeds (the average file size of a game is 10-30 GB and can take up to 12 hours to download) and a lack of available storage. While it is reasonable to assume that these hurdles will eventually be overcome, new technologies always take longer than expected to become fully adopted. More importantly, we believe that the inability for consumers to trade-in or re-sell digital video games creates a significant barrier to the mass adoption of digital downloading. It is very common for gamers to buy a new game for \$60, play it for a few weeks, and then trade it in to GameStop for a \$30 credit to buy another new game. This cannot be done with games that are downloaded digitally and thus makes video games much different than other forms of media such as books, movies, and CDs that are more frequently purchased digitally.

We view the ability of video game publishers to increase their “digital sales” as largely incremental to the packaged goods software sales. For example, Activision has been very successful selling add-on digital and online content to its Call of Duty franchise, yet the number of new software units sold has grown following the release of each new version. Furthermore, GameStop’s strong customer relationships and marketing expertise have enabled them to have a meaningful role in the sale of these digital goods. GameStop sold almost \$300 million of digital goods in 2010 and expects this number to grow to \$1.5 Billion by 2014.

As with all of our investments, we spend a significant amount of time thinking about the downside if we are wrong about future business prospects. In this respect, we take great comfort in GameStop’s flexible real estate portfolio, strong balance sheet, abundant free cash flow generation, and superb management team. The average lease duration of GameStop’s stores is just over 2 years, which means that if demand for packaged software does decrease meaningfully, the company will be able to aggressively close stores and maintain profitability for years to come. We estimate that even if packaged video game sales were to decline at a rate comparable to that of music CDs, GameStop would still generate free cash flow over the next five years that is in excess of its current enterprise value. This makes GameStop a very different company than Blockbuster, which was materially less nimble because it had long-term lease obligations, significant debt, and minimal free cash flow and therefore lacked the flexibility to adapt its business model in response to declining demand.

**Redwood Trust Inc.** is a \$1.2 billion market cap mortgage REIT specializing in underwriting, purchasing, securitizing and investing in jumbo-prime mortgages. The company’s primary business is focused on redeveloping the jumbo-prime private label securitization market, which has been largely ignored since the start of the credit cycle. The jumbo-prime market is very attractive because these loans have below average credit risk. Redwood Trust has identified that this segment does indeed come with lower risk, yet continues to command premium pricing given that these loans have historically fallen outside the scope of the government sponsored entities (GSEs). Redwood Trust does not originate mortgages, so the company depends on relationships with other originators – principally banks. Redwood Trust is able to offer relationship-focused banks, such as First Republic Bank based in San Francisco, the opportunity for product suite expansion, while retaining sole control of the customer relationship and without sacrificing asset/liability management. This extends the product offering of smaller banks, allowing them to compete more effectively with their larger counterparts.

We believe, Redwood Trust is well positioned to benefit from the federal government’s eventual withdraw from the highly lucrative jumbo-prime mortgage space. Through the GSEs, the federal government has entered the jumbo-prime market, writing mortgages up to \$729,500 in higher cost markets such as California and New York. Because of this program, and owing to a reluctance on the part of the private label market, the GSEs currently account for 90-95% of mortgage volumes, with Redwood Trust and bank balance sheets comprising the rest. We expect that volumes will increase for Redwood Trust given that GSE limits were recently reduced to \$625,500, effective October 1, 2011. Furthermore, we anticipate that incremental withdrawals will occur over time as Fannie Mae and Freddie Mac seek to achieve their mandate to shrink 10% per year.

Redwood Trust’s conduit business produces long-term cash flow streams (over ten years) with IRRs in excess 15%. The attractive cash flow profile that underlies the business is bolstered by Redwood Trust’s high quality management team. Led by Chairman George Bull, CEO Martin Hughes and CIO Brett Nicholas, the company survived the credit crises because of its disciplined balance sheet management and proactive credit discipline. As a result, the company’s exceptional record through this challenging period, coupled with its proactive role in reshaping the private label market, has established Redwood Trust as best in class and a trusted partner for both relationship focused banks and RMBS investors. We believe our downside is well protected given Redwood Trust’s sound balance sheet (\$255 million of cash and \$1.1 billion of available-for-sale securities against

less than \$140 million of long-term recourse debt), high level of transparency into credit and investment decisions, and the fact that the company trades at a 25-30% discount to its current liquidation value.

## Sector Allocation<sup>2</sup>

(As of 9/30/11)

Financial Services	25.10%
Technology	18.56%
Consumer Discretionary	13.88%
Health Care	10.71%
Energy	8.93%
Materials & Processing	7.28%
Utilities	6.32%
Producer Durables	3.35%
Consumer Staples	0.00%
Cash	5.88%

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

(As of 9/30/11)

GameStop Corp.	5.72%
Groupe Aeroplan, Inc.	4.04%
Compass Minerals International	3.95%
Calpine Corp.	3.62%
Myriad Genetics, Inc.	3.58%
Waste Connections, Inc.	3.34%
Acxiom Corp.	3.33%
Atmel Corp.	3.32%
New Gold, Inc.	3.30%
AOL, Inc.	3.16%

## 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 Partners Fund, Class A						
without sales charge	-20.97%	-3.51%	2.28%	-0.75%	10.75%	10.41%
with maximum sales charge	-24.73%	-8.11%	0.63%	-1.71%	10.21%	10.08%
Russell 2000 <sup>®</sup> Value Index <sup>1</sup>	-21.47%	-5.99%	-2.78%	-3.08%	6.47%	8.19%

*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 1.54%. 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).

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<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.

- 2** 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.
- 3** Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.
- 4** Class A shares inception date July 12, 1995.

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