RS | investments

Fourth Quarter 2011 Mutual Fund Commentary
RS Emerging Markets Fund

Investment Environment

Overall, 2011 was a miserable year for returns from emerging market (EM) equities. Not only did they fall significantly in absolute terms, but they markedly underperformed developed equities. The fourth quarter was better, with a strong rally in October sufficient to leave investors in positive territory over the three months, despite further declines in November.

Eurozone fears continue to dominate, with the principal focus of anxiety among emerging market investors having now shifted firmly from overheating to contagion. The abrupt falls in EM foreign currency (FX) flows in September highlighted concerns that the rapid withdrawal of western credit from EM could lead to an unpleasant liquidity squeeze at a time when investors are looking to the emerging economies to take up much of the strain of global growth.

However, banking systems remain essentially self-funded across most of the EM universe, with loan to deposit ratios well below 100% in nearly all Latin and Asian economies, while the decline in external debt ratios in recent years has been well-documented. Certainly, Eastern Europe looks far more vulnerable on these metrics, and the fund continues to have no direct exposure to this region, though even here new lending has been effectively zero since 2008, and ratios have at least been on an improving trend.

In addition, policy makers in EM have deliberately kept liquidity conditions tight for most of the past twelve months, and are now in the enviable position of being able to cushion any shockwaves with rate cuts, fiscal easing and bailouts as necessary. The fly in the ointment is that this is no panacea. The structural and cyclical stresses faced by different EM economies vary enormously, as they do across developed markets. And just as EM tightening was far more limited than many commentators thought was appropriate in the aftermath of the last crisis, debate now rages about the scope that each economy has to ease policy meaningfully. Some will navigate dislocations better than others.

Naturally, it is China that continues to be subject to the greatest scrutiny in the search for signs of subtle shifts in policy. It is clear that the pace of activity has slowed: growth in real fixed asset investment has fallen from roughly 25% to around 15%, exports have decelerated, and consumer inflation is now below 5% (National Bureau of Statistics). The recent cut in reserve requirements for the banking system was an understandable response to fluctuations in external capital flows but, as we know, broader monetary policy in China remains a function of quantity rather than price. Nevertheless, we would expect more monetary easing at some point in 2012.

However, Beijing's determination to reverse the perception that residential property is a one-way bet suggests that they may wish to see a few marginal developers and banks go bust before we see significantly looser policy. On the assumption that further bad news brings forward the greatly anticipated inflection point in policy, we continue to see little point in worrying excessively about which way the market will lurch in the coming months. Of greater long-term importance is whether structural policy changes will emerge from the transition of power in October, or if a protracted period of economic uncertainty will continue to defer the prospect of Beijing releasing any real control over the cost of capital for Chinese companies.

What of the EM economies that lack the People's Republic of China's buffers? India is probably the most notorious example of an emerging economy that remains vulnerable to liquidity squeezes, given its dependence on foreign inflows to fund the current account and fiscal deficits. Unsurprisingly the rupee has been under particular pressure, reaching a multi-decade low against the US dollar. And, while the structural issues are well-known, there would appear to be little in the cyclical outlook to entice foreign investors either: non-core inflation has remained stubbornly high, aggravated by the rupee and elevated energy prices, leaving the Reserve Bank of India with limited room for manoeuvre. Nevertheless, the market has already judged India severely this year; it is the worst performer among the major EM countries in 2011, and the fund has benefited from its underweight position.

Finally, after a year in which discussion of the sustainability of different political systems has been brought into particularly sharp relief, December has been a bad month for two of the strongmen of the EM world – Kim Jong-il for obvious reasons but, of more immediate relevance, Vladimir Putin, whose political obituary has been written with gleeful haste by large chunks of the western media. We are reluctant to read too much into the results of the recent Duma election – Putin retains significant support, especially in the regions, and US$515 billion of FX reserves should go a long way towards buying political acquiescence. Nonetheless, the results are clearly a personal blow. Any acceleration of liberal reforms would be a positive outcome but given the biggest gainers in the election were the communists and hard-line nationalists, the 'anyone but Putin' camp should probably be careful what they wish for. The investment implications are for anyone to guess. But for now, the prospect of further imminent easing of the corporate tax burden on the energy sector has probably receded.

Fund Review

The ongoing low weighting in traditionally 'defensive' sectors like telecoms and utilities in the fund reflects a lack of excitement about the long-term growth prospects offered by many of the names in these areas, while in the consumer staples sector it is often a struggle to reconcile lofty valuations with fragile competitive moats.

In contrast, one could argue that larger positions in sectors traditionally regarded as more cyclical may express a less gung-ho macro view than might first appear. The fund's financials exposure contains plenty of commercial banks where we are happy to look through short-term volatility for the attractive secular growth story, but also includes a large position in Asian insurers, and no exposure to property.

Indeed, is it global growth, rather than EM growth, into which the fund is really geared? One could point to the sizeable holdings in North Asian technology and auto exporters or a position in resources that favours oil (China 10% of demand according to the U.S Energy Information Administration) over industrial commodities (China 40% of demand according to U.S Energy Information Administration). But, of course, our preference is to pick stocks, rather than make near-term macro calls.

Energy remains the top overweight position for the fund and we are far more excited about Tullow Oil's (2.94% position as of 12/31/2011) opportunity in the West African Transform Margin, or that of Petrobras (1.35%) in Brazilian pre-salt, than we are about oil going to US$150. The amount of money to be made in Vale (3.10%) over the next five years will depend on the extent to which iron-ore supply fragments, rather than how many houses China builds next year. We continue to own a diverse range of companies under the information technology umbrella where again the focus is on identifying long term winners. It is the ability to shift into new technologies and destroy competitors that gets us giddy over Samsung Electronics (4.45%), rather than the outlook for next quarter's sales.

Performance Review

During the fourth quarter of 2011 the RS Emerging Markets Fund returned 7.97%, outperforming the MSCI Emerging Markets Index[1] which returned 4.45%. The quarter was volatile with a number of stocks experiencing price moves in excess of 30%.

Once again the fund's overweight exposure to the energy sector through smaller oil and gas exploration companies added significantly to relative performance with Gulf Keystone (2.24%) being the top contributor, and African Petroleum Corp (0.57%, offshore West Africa) also helping. Gulf Keystone's share price reacted well to significant upgrades to resource estimates at its Shaikan discovery in Kurdistan, which rose by 3.1bn barrels of oil to 8bn. The shares were further buoyed by a rumoured £7bn bid for the company from ExxonMobil (0.00%).

At the country level, China was the fund's top performing market. Returns were driven by a turnaround in the fortunes of two of the country's embattled rail stocks, CSR Corp (1.07%) and China Railway Construction (0.93%). Their strong performance was a combination of several supportive government policies towards the troubled Ministry of Rail, and a reversal of the extreme valuations that appeared to be assigning negative growth to the sector, despite nearly 20,000 km of planned railway construction.

Stock selection in South Korea was also helpful, led by the fund's largest holding, Samsung Electronics (4.45%). Samsung's results continue to be very good, particularly in mobile devices and components where its sales have been exploding. Samsung recently overtook Apple to become the world's largest vendor of smartphones with a c.25% global market share (Bloomberg News; October 28, 2011). The company's strong performance in turn helped Cheil Industries (1.22%) which supplies various materials and chemicals to Samsung Electronics.

Other notable contributors to performance were a number of the fund's Brazilian holdings, including Mercadolibre (0.75%, online retailer) which saw very strong quarterly numbers well ahead of consensus, and Itausa (investment holding company). Finally an eclectic mix of resource companies including Kenmare Resources (1.59%, Mozambique mineral sands miner) and First Quantum Minerals (1.20%, Zambian copper miner) performed strongly.

On the negative side, financial holdings in Taiwan, India and Turkey were all weak. China Life Insurance (2.08%, Taiwan) was the biggest detractor, reflecting general weakness in the Taiwanese financial sector caused by election uncertainty, the European debt overhang, and some modest losses from equity positions. IDFC (0.75%, Indian infrastructure lender), HDFC (1.20%, Indian mortgage provider) and Garanti Bank (1.00%, Turkish bank) continued to be weak amid concerns about the Indian and Turkish economies.

Other notable detractors from fund performance included Dragon Oil (3.37%, E&P in Turkmenistan) which saw no significant news flow over the quarter, and Hyundai Mobis (1.84%, auto parts) that was modestly impacted by fears of a possible slowdown at Hyundai Motor and Kia. In Taiwan, Mediatek (1.00%, chipset manufacturer) once again struggled as competition continued to strengthen in its core 2G mobile phone division and it disappointed the market with its shipments for 3G smartphones.

Investment Outlook

At any given point in time, we rarely have a strong view on the near-term direction of markets. Despite the sharp falls already experienced in the MSCI EM index in 2011, this continues to be the case. We are certainly open to the possibility that things could get worse before they get better: after all, monetary policy works with a lag, and we acknowledge that current earnings estimates may be vulnerable even for those companies exposed to economies where policy makers are lucky enough to have plenty of levers.

Nor do we have a particularly strong view on the near-term outlook for 'EM' versus 'DM' (developed markets) - we prefer to leave this to the sell-side strategists. Bulls of the EM asset class will doubtless point to the irony of EM equities having already underperformed significantly on the back of a 'risk off' trade that resulted from a deterioration in DM fundamentals. In turn, DM bulls might contrast the widespread optimism for potential policy easing in EM with the mournful talk of 'lost decades' and extended austerity in DM, and wonder if there is a contrarian opportunity to be exploited.

Nevertheless, in the long term it is fundamentals that drive share prices, and here the emerging markets are well placed. Combining this with valuations at the low end of historic norms, we are very excited about the prospects for the varied businesses in the fund.

We thank you for your continued support.

Sincerely,

Richard Sneller	William Sutcliffe
Co-Portfolio Manager	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 December 31, 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.

Regional Allocation
(As of 12/31/11)

Asia-Pacific	56.0%
Latin America	21.9%
Europe	10.1%
Middle East & Africa	5.6%
South Africa	2.5%
Other	5.6%
Cash	2.0%

Top Ten Holdings[2]
(As of 12/31/11)

Company	Country	Percentage of Total Net Assets
Samsung Electronics	South Korea	4.45%
Dragon Oil	Other Emerging	3.37%
Vale On Adr	Brazil	3.10%
Tullow Oil	Other African	2.94%
China Shenhua En.Co.	China	2.77%
Taiwan Semiconductor Manufacturing	Taiwan	2.62%
Gulf Keystone	Other Emerging	2.24%
Hon Hai Precision Industries	Taiwan	2.18%
China Life Insurance (Taiwan)	Taiwan	2.08%
Hyundai Glovis	South Korea	1.89%

Performance

(Average Annual Total Returns as of 12/31/11)

	Fourth Quarter 2011	1-Year	3-Year	5-Year	10-Year	Since Inception[3]
RS Emerging Markets Fund, Class A						
without sales charge	7.97%	-20.98%	21.69%	2.78%	14.71%	8.68%
with maximum sales charge	2.82%	-24.72%	19.72%	1.78%	14.16%	8.32%
MSCI EMF Index[1]	4.45%	-18.17%	20.42%	2.70%	14.20%	6.68%

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 1.57%. 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.

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.

1 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.
2 Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.
3 Class A shares inception date May 1, 1997.