RS | investments

Fourth Quarter 2011 Mutual Fund Commentary
RS Strategic Income Fund

Performance

(Average Annual Total Returns as of 12/31/2011)

RS Strategic Income Fund (Class A – RSIAX)

	Fourth Quarter 2011	1-Year	3-Year	5-Year	10-Year	Since Inception (12/31/09)
without sales charge	3.23%	5.66%	n/a	n/a	n/a	7.29%
with maximum sales charge	-4.33%	-1.33%	n/a	n/a	n/a	4.11%
Barclays Capital U.S. Aggregate Bond Index[1]	1.12%	7.84%	n/a	n/a	n/a	7.19%

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

Fund Highlights

Portfolio Overweights

- RS Strategic Income Fund (the "Fund") outperformed its benchmark in the fourth quarter due largely to its overweight to several non-Treasury sectors, with a major part of the outperformance coming from the overweight to high yield bonds and loans, as high yield sectors rebounded strongly (Barclays U.S. High Yield Bond Index[2] (the "High Yield Index") was up 6.46% in the fourth quarter, about flat in the second half of the year, and up 4.98% for 2011 as a whole)[1]
- Non-Agency mortgage-backed securities (non-Agency MBS) and commercial mortgage-backed securities (CMBS) were the next largest overweights and added to the Fund's performance. The Fund focused on select bonds that survived our rigorous analysis and stress testing.
- Non-U.S. dollar holdings were a positive in the fourth quarter, although for the year as a whole, the Fund's holdings having exposure to U.S. rates did better, as they benefitted from a flight to quality. We ended with only a 10% allocation across seven countries. The biggest exposures were to Norway, Australia, and Mexico. The Fund did not own any Euro denominated bonds.

Fund Highlights (cont)

Portfolio Underweights

- Underweight in Treasuries helped performance since the Treasury sector fared less well relative to earlier quarters once the European debt crisis eased.
- Underweight in Agency MBS detracted from the Fund's performance since the MBS sector outperformed, but this was partially offset by our holdings in non-Agency MBS, which fared better.
- Underweight in investment grade corporates added to the Fund's performance, as did security selection in that sector.

Market Overview

- Domestic markets (both equity and fixed income) were held hostage to the volatility caused by the European sovereign debt crisis in 2011, as well as some concerns about economic growth. The markets swung wildly between "risk on" and "risk off."
- Europe took significant actions, particularly in the fourth quarter, to combat its problems, but volatility ensued. Agreements would be made, but details were lacking at some points, and the solutions were not viewed as "comprehensive" (particularly with regard to a "firewall" backstop of money sufficiently large relative to the size of the problem).
- Absent European risk, low Treasury yields pushed investors to add non-Treasury assets.

Outlook

- **U.S.:** We expect continued modest gross domestic product (GDP) growth of 2% or a bit higher for 2012, with firmer job growth in the 150,000 to 175,000 range. We look for moderate inflation with core peaking below 2.5% in the first quarter of 2012 and then moving down. The Federal Reserve (the "Fed") continues to indicate it expects to keep the Fed Funds target rate at 0 to 0.25% into 2013, and the Fed continues to utilize unconventional policy tools to provide additional monetary stimulus. We see the Fed as "ready, willing and able" to counter systemic and financial contagion risks that will likely continue to emanate out of Europe.
- Though improving, still-high unemployment and a weak housing market should continue to have a negative effect on economic growth.
- Volatility is likely to remain at elevated levels.
- We see value in multiple U.S. fixed income sectors, given the much wider spreads available in most non-Treasury sectors than a year ago (although many investment grade sectors have lower yields than a year ago).
- Treasury yields are likely to stay at unusually low levels well into 2012 at least.
- European sovereign debt risk will be the key wildcard in 2012. We expect continued market volatility near term; sovereign debt problems and the related European banking system confidence issues are the key drivers and may make the weaker economic outlooks problematic. Closely monitoring developments such as: Euro zone "fiscal compact" progress; European Central Bank (ECB) actions; sovereign auctions; sovereign downgrades; economies/potential for credit crunch; Italy and Spain progress on deficits and economy; Greek private sector involvement (PSI)/debt swap restructuring; and functioning of the unsecured bank issuance market (it is hard to imagine a fully stable European situation without that market restarting).

Fund Commentary

Performance

The Fund (Class A shares) returned 3.23% for the fourth quarter fourth quarter ended December 31, 2011, compared with the Fund's benchmark, the Barclays Capital Aggregate Bond Index (the "Index"), which returned 1.12% for the same period.[1] For all of 2011, the Fund returned 5.66% while the benchmark returned 7.84%[1].

The average fund in the Lipper[1] Multi-Sector Income Funds peer group returned 2.56% in the fourth quarter and 2.89% for all of 2011.

(As of 12/31/2011)	1-Year	3-Year	5-Year	10-Year
RS Strategic Income Fund (Class A) Average Annual Total Return	5.66%	n/a	n/a	n/a
Lipper[1] Multi-Sector Income Funds Average Annual Total Return	2.89%	n/a	n/a	n/a
Lipper[1] Multi-Sector Income Funds Category Ranking*	34/192	n/a	n/a	n/a
Lipper[1] Multi-Sector Income Funds Category Percentile	18%	n/a	n/a	n/a

**Lipper rankings are based on total return with dividends reinvested and do not take into account or reflect sales charges.*

Market Overview

In real estate, the three most important things are location, location and location. For investments in 2011, the corollary was Europe, Europe and oh, by the way, Europe. Whether we thought about the equity or fixed income markets, both were subject to the whim of the financial uncertainties in Europe. It did not matter that there might have been only a tenuous connection to events there; the markets reacted (often strongly) every time a potential problem reared its ugly head. And it reared its head frequently in 2011. As a result of this unprecedented volatility, investors took on a bipolar response to risk; it was either “risk on” (for example, buying equities or bonds in any of the non-Treasury sectors) or “risk off” (fleeing these very same equities and non-Treasuries for the safety of U.S. Treasuries) at the first sign of trouble in Europe. Gyrations became the norm.

The problems in Europe were caused by sovereign nations undertaking unsustainably high debt levels to fund popular spending programs. Concern over these large budget deficits first emerged in 2010 when investors suspected that Greece might not be able to repay their debts and would have to default. (That concern later grew to include Ireland.) A sovereign default would obviously hurt bondholders, but in the case of Europe, it was feared that such a default would severely damage the European banking system itself. Because many banks throughout the euro-zone and European Union hold bonds issued by several of the member countries, a sovereign default could have wide ranging consequences. These institutions would likely suffer crippling losses and possibly fail. Even if the banks avoided insolvency, they would be severely weakened and unable to perform their role as a lender. As a result, the “credit crunch” would likely trigger a sharp economic contraction and possibly a recession. As it turns out, these concerns were premature. The European Central Bank (ECB) and the International Monetary Fund (IMF) developed a joint plan that appeared credible enough to prevent the potential default(s). Unfortunately, the plan did not solve the problem; it just kicked the can down the road.

The sovereign debt problem re-emerged in 2011, bigger and more complex. It was not restricted to just Greece and Ireland this time; this time the list of potentially defaulting countries included Italy and later, Spain. Put another way, the problem was no longer limited to two countries that made up less than 4% of the euro-zone’s GDP on a combined basis; it now included the third largest country in the euro-zone (Italy), which accounts for 15% of the euro-zone’s GDP by itself. (Adding Spain would increase it to nearly 25%.)[3] Given the increased size of the potential problem, the stakes for a successful resolution were clearly raised.

Many uncertainties emerged in 2011. Rather than recount them all, we would note that a key problem was that as these issues unfolded, Europe’s policymakers and regulators seemed, from our perspective, to greatly underestimate the severity of the problem facing them (at least publicly). In addition, they showed no urgency in addressing it unless prodded to do so by disruptions in the capital markets. Perhaps getting 17 countries to agree is like herding cats, but the process was fitful at best. And each unanswered question ratcheted up the precariousness of the situation. Uncertainty and volatility ruled. And investors responded by going into “risk off” mode and waited for signs that it was safe to resume the “risk on” posture again. Until it wasn’t. Rinse and repeat… This cycle was the defining characteristic of 2011.

To be sure, the fixed income market was also driven by other notable events in 2011. First, the historically unquestioned AAA rating of the US was downgraded by Standard & Poor’s due to the lack of progress in getting our fiscal house in order. Not unlike countries in Europe, the United States is also on a path of unsustainable debt levels and spending levels that are not in line with our revenues. However, attempts to control the growing deficit over the summer were mired in a very partisan debate about how such deficit reductions should be achieved. Political gridlock resulted and nowhere was this more apparent than in the complete failure of the congressional “Super Committee”[4] tasked with identifying over $1 trillion in deficit reductions in November. Not only did they fall short of that goal, they fell short by over $1 trillion. They could not agree on *any* cuts! We also note that the legislative effort to extend the expiring payroll tax cut by a year resulted in a last-minute agreement to extend it by *two months*.[3] You can’t make this stuff up…

Expectations surrounding the growth of the US economy were volatile in 2011 as well. Earlier in the year, the economy’s positive growth trajectory was expected to be only temporarily slowed by the supply disruptions caused by the Japanese disasters. Consistent with that, the June report of the Blue Chip Consensus forecast for 2011 GDP was a solid 2.6%. However, that forecast was revised sharply downwards when the growth rate in the first half actually came in at under 1% (as revised in late July) and weak economic data continued to come out in July and August. By September, the Blue Chip Consensus U.S. GDP outlook was revised down to 1.6% for 2011, and the outlook for 2012 was revised down from 3.1% to 2.2% over that same period.) By the end of the year, that consensus forecast for 2011 nudged back up to 1.7% (with some further upward risk) as measures of employment and consumption showed strength. The forecast for 2012 remained at 2.2%.[5]

Against this backdrop and the frequent flights-to-quality arising from the European debt crisis, Treasuries were the preeminent sector of the fixed income market in 2011. The Treasury sector, as measured by the Barclays Capital Treasury Index[6], returned 9.81% for the year and 0.89% in the fourth quarter.[1] Sharp-eyed readers can correctly conclude that Treasuries achieved the bulk of their performance in the first three quarters of the year when concerns of sovereign debt risk escalated and then dominated the headlines. When those concerns receded in the fourth quarter, and U.S. economic data showed signs for strength, interest in Treasuries faded and the sector’s performance moderated.

In terms of yield changes during the fourth quarter, the 2-year Treasury note wound up unchanged at 0.24% while the yield on the 10-year note declined by 0.04% to close the year at 1.88%. For the full year, the yield on these two benchmark issues declined by 0.35% and 1.42%, respectively, while the yield of the 30-yr benchmark dropped by 1.44%. (The greater decrease in longer maturity yields can be partially attributed to the Fed’s “Operation Twist;” $400 billion of the Fed’s shorter-maturity holdings are expected to be sold in favor of longer maturities by June 2012.)[7]

In a very similar fashion, the non-Treasury portions of the bond market performed well in the fourth quarter when the flight-to-quality to Treasuries eased. Corporate bonds and commercial mortgage-backed securities were the two best-performing sectors, returning 1.70% and 3.11%, respectively. Mortgage-backed securities (MBS) came in third place, posting a return of 0.88% for the quarter. For the full year, these sectors earned 8.35%, 6.02% and 6.23%, respectively.[8]

However, these results are not as positive as they might seem. Since these various sectors have different durations, it’s a bit misleading to compare these raw numbers without taking that into account. Accordingly, when we compare these sectors relative to their comparable-duration Treasury benchmarks, we see that corporate bonds and MBS actually *under*performed in 2011 to the tune of -3.22% and -1.06% respectively. (CMBS outperformed by 0.47%.) When we focus on the fourth quarter, we see these three sectors each outperformed as the European debt crisis receded. Specifically, corporate bonds, MBS and CMBS outperformed by 0.61%, 0.24% and 2.49%, respectively.[8]

In summarizing these results, just remember that corporate bonds, MBS, CMBS, etc. exhibited the same performance pattern over the course of 2011: they either all outperformed Treasuries as a group or they all underperformed. Here’s the breakdown: Q1) Outperformed Treasuries (sovereign risk had not yet re-emerged), Q2) Underperformed modestly (MBS were the exception) when it appeared that the sovereign debt crisis was just limited to Greece, Q3) Underperformed sharply when the uncertainty in Europe expanded to include Italy and was at its most severe, and then Q4) Outperformance resumed as sovereign risk receded. In other words, Europe, Europe and Europe (and a dash of “U.S. economy”).

Let’s take a closer look.

As noted above, 2011 proved to be a very tough year for the credit market. After a solid performance in the first half of the year, which saw the credit sector outperform similar maturity Treasuries by 1.00%, the re-emergence of the European sovereign debt crisis plus softer U.S. economic data caused yield premiums to move dramatically higher into the second half of the year. As a result, corporate bonds, as measured by the Barclays Capital Credit Index[9] underperformed Treasuries by 4.17%. For the full year, the Index underperformed Treasuries by 3.22%, the second-worst full-year result since the Index's inception, but did post a positive 7.84% total return for the year.[8]

Finance issues were particularly hard hit in 2011. (The Finance sector underperformed Treasuries by 6.28% while the Industrial and Utility sectors fared a bit better, underperforming by 2.33% and 1.60% respectively.) Investors worried about the exposure of US banks to European debt.[10] Even those banks with no material direct exposure to Europe were affected as the fear of contagion and the uncertainties of counterparty risk in a globalized financial system dominated. Furthermore, uncertainties surrounding new regulations from the Dodd-Frank Act and increased capital requirements helped to push bank risk premiums higher. These negative influences overshadowed several positive factors in the bank sector: reduced systemic leverage, an improved outlook for the U.S. economy and strong investor demand for corporate bonds.

The CMBS sector traded very much like the corporate bond sector in 2011. It outperformed Treasuries in the first half by 1.53%[11] but as with corporates, they lost a lot of ground as the sovereign debt crisis prompted a "risk off" response. The underperformance was particularly dramatic in the third quarter as the CMBS sector lost 3.52% to Treasuries.[12] On the other hand, CMBS was able to recoup some of the third quarter's weakness by outperforming in the last quarter of the year (by 2.49%) as non-Treasury fixed income and "risk on" regained their footing.[8] Aaa rated bonds within the CMBS universe (the focus of our holdings) were best for the year, but lower rated CMBS did best in the fourth quarter on the risk rebound.

The risk recovery and stronger U.S. economic data in the fourth quarter helped below investment grade corporate. High yield bonds, which posted a loss for the third quarter at -6.06%[2], were up 6.46% in the fourth quarter, so it was about flat in the second half of the year, and up 4.98% for 2011 as a whole).[8] Similarly, the S&P/LSTA Leveraged Loan benchmark was up 2.91% in the fourth quarter, after being down 3.83% in the third quarter, returning 1.52% for the full year.[13]

As discussed above, the MBS sector underperformed Treasuries in the third quarter, along with all the other sectors. However, it had little to do with the volatility in Europe. Since Agency MBS payments are guaranteed by the government, there is no credit risk. Rather, MBS investors worried about the prospect of a broad government initiative to make it much easier for homeowners to refinance their mortgages. To be sure, reduced monthly payments would bolster the housing sector and likely inject stimulus into the economy, but any such program is a zero-sum game and MBS investors would be on the other side of the trade. (Heightened prepayment risk would severely erode the value of their holdings.) As it turns out, the government did unveil some enhancements to their Home Affordable Refinance Program (HARP) in the fourth quarter, but the terms were less expansive than originally feared and the MBS sector subsequently rebounded.

On the global front, the debt of the so-called "peripheral" countries in Europe (Greece, Ireland, Portugal, Italy and Spain) experienced substantial volatility but mixed performance during the fourth quarter. Greek bonds did worst as fears of an imminent unplanned default were followed by the push to a much larger "voluntary" haircut to be taken by bond holders (PSI or "private sector involvement). On the quarter, Greece's government bonds plunged and posted an additional negative 37.4% return on a local currency basis, following a substantial drop in prior quarters and ended the year down just over 60%[14], as measured by Citigroup's World Government Bond Index (WGBI). Portugal was the next largest drop for the quarter at -3.7% return and an also large -22.4% return for the year.[15] Italy continued to be a focus of concern and posted a -3.0% return for the quarter, and -5.73% for the year.[16] Spain broke from the pack and actually posted another positive quarter, up 1.8%, and returned positive7.3% for the year.[17] Ireland was actually strongest for the year. It suffered a relatively small loss of 1.6% in the fourth quarter after a large positive return in the third quarter, and was up 11.5% for the year as a whole.[18]

Portfolio Review

We first address performance, and then dive further into portfolio positioning.

The Fund returned 3.23% in the fourth quarter and +5.66% for the full year. The Fund pulled further ahead of the peer average during the fourth quarter, outperforming peers again by 0.67%. For the year the Fund beat the peer average by 2.77%. The Fund also outperformed its benchmark in the fourth quarter, by 2.11%, but trailed its benchmark by 2.18% for the year.[1]

The outperformance in the fourth quarter was primarily driven by the high yield bond and bank loan credit allocation, which accounted for about 1.6% of the performance difference on a combined basis. The sector allocation to CMBS added another 15 basis points ("bps"). Security selection in investment grade credit was strong, and added 0.13% to relative performance, while Agency MBS security selection subtracted 0.02%.

The Fund's lower exposure to U.S. interest rate risk than the benchmark did not play much of a role given the more limited moves in U.S. Treasury rates in the fourth quarter. It certainly detracted from performance for the year as the Fund did not benefit as much from the sharp drop in Treasury rates that occurred during the flight to quality. Overall our non-US exposures were a small positive for the fourth quarter performance, adding 0.05% overall, including both non-US dollar bond positions, currency hedges and a net currency exposure of about 2.5%.

After some substantial reallocations in the third quarter, the shifts in the allocation were smaller in size in the fourth quarter, but the theme was to modestly increase our exposure in a number of "spread" (non-Treasury) sectors as we saw value at the levels available after the third quarter's dramatic market volatility. Spread sector allocations increased about 6.8% in total, despite taking down our high yield strategy allocation late in the quarter.

Despite a small reduction in our high yield strategy, the Fund's largest allocation is still to the high yield corporate strategy (bonds plus bank loans), which totaled about 34.1% of the Fund at year end, down 1.1% from the third quarter. (Neither sector is included in our benchmark.) We see these sectors as fundamentally attractive. Credit fundamentals should help support performance, and we still assess that the potential for (and size of) a default spike in the U.S. is low given that so many corporations took advantage of previous refinancing opportunities with new issue markets wide open for the better part of 2 years through mid 2011. Expected 2012 maturities in high yield bonds are close to zero, and in loans are only around $35 billion. We believe available yields for some high yield bonds and loans are very attractive, but do expect some further price volatility. Despite rebounds in the fourth quarter in these "high beta" sectors, yields rose on the year. The High Yield Index[2] yield to worst[19] was down 1.15% in the fourth quarter, but was up 0.85% for 2011 as a whole. The High Yield Index[2] ended the fourth quarter at 8.4% (about 7.3% for Ba/B)[8] and loans ranged from 4.75% to 7.5% for Ba and B credits. [20] These stand out in a near zero environment for "safe" assets. We believe that both sectors are poised to perform well in a slowly improving economy.

The next largest allocation in the Fund is to U.S. dollar investment grade corporates, totaling about 20% at year end, a small increase over the quarter. This actually represents a substantial underweight relative to the benchmark, since we see even better value in some other sectors (particularly the high yield strategies, thus the combined corporate credit position is a substantial overweight). The Credit index option adjusted spread (OAS)[21] was 217 at year end (financials 337 OAS versus Industrials and Utilities around 185 OAS), and had a yield to maturity of 3.6%.[10]

The largest increase in allocation was to Agency MBS, up by 2.7% to end the year at a 9.7% allocation. While a number of sectors may offer higher potential excess returns, MBS spread did appear attractive and we assessed relatively less downside risk than some higher "beta" (more volatile) sectors. MBS continue to move up in our assessment of value and risk versus reward. The Fund had a combined allocation of over 11% to Treasuries and Agency MBS at year-end. The Fund is still quite underweight those two sectors relative to the benchmark, but the combined allocation was up over 10% in the second half off the year. The Fund remains underweight in exposure to US interest rate moves (a shorter duration than the benchmark), and we still believe this positioning has the potential to be beneficial over time.

The non-agency residential mortgage-backed securities (RMBS) allocation also increased by a small amount and stood at 12.4% of the portfolio at year end.

A combined 21.9% of the Fund is allocated to non-agency RMBS and CMBS, up by about 1.6% on the quarter. Weak fundamentals (still high delinquencies and soft property prices) in both residential and commercial real estate persist, placing great importance on our process of rigorously analyzing and stress testing the underlying loans and deal structures of potential investments. New issue supply is still non-existent in non-agency RMBS and still low in CMBS (a positive technical for both). Despite this significant hurdle, we have been able to identify bonds with sufficient credit enhancement and attractive risk/reward characteristics. Potential for bottom home prices on the horizon may provide additional opportunities.

The largest sector reduction was to non-U.S. dollar holdings which were reduced by 6.3% in the third quarter. Corporate credit was also reduced by 1.6% across the investment grade and high yield sectors.

We like the diversification benefits of investing some of the portfolio in – mainly hedged -- non-USD assets. We kept our allocation to non U.S. dollar bonds around 10% over the fourth quarter, staying with this lower allocation as we continue to see fewer attractive opportunities abroad that we think can outperform the attractive US spread sectors. Also we were seeking to limit exposure to sovereign stresses and economic weakness in Europe. Our biggest positions at quarter-end were Australia and Norway. About three quarters of the non-USD bond positions are currently hedged back to U.S. dollars, leaving a net currency exposure of 2.5%. The two largest currency exposures (the Norwegian krone and the Mexican peso) together made up 1.5% of that. We think these exposure may benefit if commodities rebound, and particularly if oil continues to rise.

Outlook

We believe that 2012 will resemble 2011 in many respects. The US economy should continue to grow at a modest pace (2+%) and there are some encouraging signs that it might accelerate. Interest rates will remain low and inflation is not likely to be an issue. We expect Europe to continue to be a major risk factor, and as amply demonstrated in 2011, the single largest wildcard in our outlook. And most importantly, volatility is likely to persist at elevated levels. We should get used to this.

We should also become accustomed to political gridlock. As we saw in 2011, the divisions between the two political parties seem vast and unbridgeable. As a result, we do not expect any material progress towards solving our deficit and debt problems until the political landscape potentially becomes clearer following the 2012 elections.

On the other hand, U.S. economic data has picked up in recent months, and we expect that the Fed will not only remain very accommodative, but that the Fed is ready, willing and able to combat any systemic risks emanating out of Europe. The labor market has shown some improvement recently. First-time unemployment claims have been dropping and job growth has been increasing. We note that the unemployment rate dropped to 8.5% in December after starting the year at 9.4%.[22] Despite these improvements, we think there's still much room for improvement, as slack labor will continue to be a disinflationary factor.

We also believe the housing market will remain lackluster, with some further modest price decreases likely. A significant portion of home sales are still coming from foreclosures and these distressed sales have had a dampening effect on home values. That said, we anticipate the possibility of a new government program to further bolster the housing sector beyond the already-announced changes to HARP, mentioned above. Any measure to increase the availability of mortgage credit would be a popular move in an election year and a source of uncertainty for the MBS sector.

Against this backdrop, we continue to favor many of the non-Treasury segments of the bond market. We see high yield bonds and bank loans as fundamentally attractive, with supportive credit fundamentals and very little funding needed across the two sectors. The limited "maturities" greatly reduce the chance for (and potential size of) a default spike in the U.S. even if the economy were to weaken. Corporate bonds are also attractive as last year's underperformance has left them near recession-type valuations. We continue to remain positive on the corporate sector due to its attractive valuations. We expect the positive factors that supported the market last year (an improving economy, strong corporate revenues and profitability, strong demand in a low yield environment, etc.) to persist. However, we believe the volatility should remain for the sector overall and particularly for financials. A negative surprise in Europe can easily swamp these positive fundamental factor on a near term basis. We have sought to focus on lower beta (less volatile) holdings for our additions in the fourth quarter.

We do not see the need to have a large exposure to Treasuries, even though the European debt crisis remains a very significant wildcard.

We believe the CMBS sector still provides attractive yields along with supportive fundamentals. We intend to continue to concentrate on bonds that we believe have ample credit support and deals that are backed by more seasoned, less levered and better underwritten loans. (Seasoned loans have the benefit of a demonstrated track record of reliable payments by the borrower.) As the fundamentals of this sector slowly improve, the results of our stress tests indicate these AAA-rated assets should be well-insulated from potential losses and should be competitive with Treasuries over the next six months.

Similarly, we remain positive on non-Agency MBS due to a very positive supply/demand imbalance. New issuance has dwindled to zero since 2010 and until regulatory uncertainties are resolved, the dearth of new deals will likely continue. On the other hand, we expect demand to remain robust in 2012. As with CMBS, the challenge remains to find enough suitable assets to maintain our desired sector allocation.

In summary, our current investment strategy for the Fund continues to favor the non-Treasury sectors and we plan to focus our risk-taking in areas where we believe the fundamentals, structure, and risk premiums (yields above Treasuries) adequately compensate the Fund for risk. Currently the largest U.S. allocations relative to our benchmark are high yield bonds and loans, non-Agency MBS and CMBS. In addition, we remain positive regarding the prospects for the Scandinavian countries and Australia/New Zealand in our global exposure and we intend to continue to have an allocation to non-U.S. assets for their diversification benefits.

We will continue to adhere to our disciplined investment process through the different economic cycles. As always, we greatly appreciate the confidence you have shown in us and welcome the opportunity to continue helping you to meet your investment needs.

Sincerely,

Leslie Barbi Co-Portfolio Manager	Kevin Booth Co-Portfolio Manager	Howard W. Chin Co-Portfolio Manager
Robert J. Crimmins, Jr. Co-Portfolio Manager	Marc Gross Co-Portfolio Manager	Jonathan Jankus Co-Portfolio Manager

Guardian Investor Services LLC, the Fund's sub-adviser

The foregoing is the opinion of the Fund's management team as of the date of this report and is subject to change without notice.

As with all mutual funds, the value of an investment in the Fund could decline, so you could lose money. Bond funds are subject to interest rate risk, credit risk and prepayment risk. When interest rates rise, bond prices generally fall, and when interest rates fall, bond prices generally rise. Currently, interest rates are at relatively low levels. Please keep in mind that in this kind of environment, the risk that bond prices may fall when interest rates rise is potentially greater. The values of mortgage-backed securities depend on the credit quality and adequacy of the underlying assets or collateral and may be highly volatile. Derivative transactions can create leverage and may be highly volatile. It is possible that a derivative transaction will result in a loss greater than the principal amount invested and the Fund may not be able to close out a time or price. Floating rate investments issued in connection with leveraged transactions are subject to greater credit risk than many other investments.

High yield bond investing includes special risks. Investments in lower rated and unrated debt securities are subject to greater loss of principal and interest than investments in higher rated securities.

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.

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.

Mutual funds are offered 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.

Sector Allocation

(As of 12/31/2011)	% Fund
Treasury / Agency	1.0%
Investment Grade Credit	19.9%
High Yield Credit	34.1%
Agency MBS	9.6%
Non Agency MBS	12.4%
ABS	1.0%
CMBS	9.5%
Global - Non USD	9.8%
Other	2.0%
Cash & Equivalents	0.6%

Top Ten Holdings[23]

(As of 12/31/2011)	Coupon Rate	Maturity Date	% Fund
FNMA - MBS	3.500	01/12/41	2.86%
FNMA - MBS	4.000	01/12/41	2.79%
FNMA - MBS	4.500	01/12/41	1.93%
Mexican Bonos	7.250	12/15/16	1.62%
U.S. Treasury Bonds	3.750	08/15/41	1.37%
Kinetic Concepts, Inc.	7.000	05/04/18	1.22%
Immucor, Inc.	7.250	08/17/18	1.21%
BJ’s Wholesale Club, Inc.	7.000	09/28/18	1.21%
Gibson Energy	5.750	06/15/18	1.20%
Sequa Corp.	3.630	12/03/14	1.17%

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[1]The Barclays Capital U.S. Aggregate Bond Index is generally considered to be representative of U.S. bond market activity. The Barclays Capital U.S. Aggregate Bond Index is an unmanaged index that is not available for direct investment and there are no expenses associated with the index while there are expenses associated with the Fund. The Lipper Multi-Sector Income Fund Index Objective Average is the average of all the funds in the group in existence in the Lipper database for the periods, and does not reflect the deduction for sales charges.

[2]The Barclays Capital U.S. Corporate High Yield Bond Index is generally considered to be representative of the investable universe of the U.S.-dominated high-yield debt market. The Barclays Capital U.S. Corporate High Yield Bond Index is not available for direct investment and there are no expenses associated with it, while there are expenses associated with the Fund.

[3] Source: Bloomberg.

[4] A 12 member committee created by the Budget Control Act of 2011 with 3 members from each party and each chamber of Congress.

[5] Source: Blue Chip Economic Indicators July 10, 2011, October 10, 2011 and December 10, 2011.

[6] The Barclays Capital U.S. Credit Index is a subindex of the Barclays Capital U.S. Government/Credit Index. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The non-corporate sectors are Sovereign, Supranational, Foreign Agency, and Foreign Local Government.

[7] Source: The Federal Reserve Web site. www.federalreserve.gov.

[8] Source: Barclays Capital Index Summary, Barclays Capital Inc.

[9] The Barclays Capital U.S. Credit Index is a subindex of the Barclays Capital U.S. Government/Credit Index. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The non-corporate sectors are Sovereign, Supranational, Foreign Agency, and Foreign Local Government.

[10] Source: Barclays Capital IG Credit Sector Details.

[11] Source: Barclays Capital Index Summary, Barclays Capital Inc. Q211.

[12] Source: Barclays Capital Index Summary, Barclays Capital Inc. Q311.

[13] The S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan Index covers more than 1,100 loan facilities and reflects the market-value-weighted performance of U.S. dollar denominated institutional leveraged loans. The S&P/LSTA Leveraged Loan Index is not available for direct investment and there are no expenses associated with it, while there are expenses associated with the Fund.

[14] Source: Bloomberg Sheets, SBGRL.

[15] Source: Bloomberg Sheets, SBPEL.

[16] Source: Bloomberg Sheets, SBITL.
[17] Source: Bloomberg Sheets, SBSPL.
[18] Source: Bloomberg Sheets, SBIRL.
[19] Yield to worst is the lowest potential yield that can be received on a bond without the issuer actually defaulting.
[20] Source: S&P/LSTA Leveraged Commentary & Data, Discounted Spreads.
[21] The option adjusted spread (OAS) is the flat spread which has to be added to the treasury yield curve in a pricing model to discount a security payment to match its market price.
[22] Source: Bloomberg unemployment rate.
[23] Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.