

INVESTOR'S BUSINESS DAILY

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MUTUAL FUND MONTHLY

RS Investments' Pilara Measures Stocks' Return On Invested Capital

FUND MANAGER Q&A

BY PAUL KATZEFF

INVESTOR'S BUSINESS DAILY

Andrew Pilara is a glass-half-full type of money manager. He sees the upside approaching: a market that favors active managers such as himself over index investors. And he can hardly wait.

He is co-manager of four stock funds at RS Investments. Those include \$1.9 billion Partners^{RSPFX}, which is part of the IBD Mutual Fund Index. The four funds make up the parent firm's value group, of which Pilara is chief investment officer. The group runs \$6.14 billion in combined assets. It is one of RS's seven style-oriented clusters of funds.

Pilara and Joe Wolf, a co-manager on three funds, talked with IBD from their quarters in San Francisco about how they invest.

IBD: Each of your funds relies on a relatively small number of bets, right?

Pilara: RS Investors is the most concentrated. It holds 25 to 30 names. It takes the best ideas from the other three funds. Each of those holds 45 to 55 names.

IBD: And in Partners your weighting in financial services is about 20%. That sounds scary, with the mortgage securities meltdown. But I don't see a lot of names in the port-

folio with exposure to that segment.

Pilara: Yes, the bank and (interest-rate) spread business is only 3% of the fund. We still think there are a number of issues in that sector that have to be remedied.

IBD: I see insurers like Assured Guaranty^{AGO} and Hanover^{THG}.

Pilara: You'll see insurance companies, money managers, what we consider "value" real estate opportunities. Not that we like real estate. We don't. But when we can buy dollars for 50 or 60 cents, we will. We are not speculators, however, going into the down and dirty financials. We think the risks are much too great. In Value Fund we've got an even greater weight in insurers. And we have diversified financials like Invesco^{IVZ}. That's a name we really like.

IBD: One of your top performers is Century Aluminum^{CENT}. The company makes aluminum products. Is that simply a play on global economic growth?

Pilara: A key metric we look at is return on capital. Theirs is going up significantly. This is a template for what we do. We look for structural changes. Those can be industry-wide or company specific.

In the aluminum industry, we see a shift in the cost curve. Electricity is a

RS Partners



Andrew Pilara Jr.



Joe Wolf

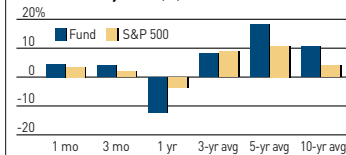
- Symbol: RSPFX
- Manager tenure: 13 years
- Assets: \$1.9 billion
- Expenses: 1.49%
- Phone: (800) 766-3863

Total returns as of 5/2/08

| | | | |
|-------------|--------|--------------|--------|
| 2007: | -3.80% | 5-yr. avg.: | 18.24% |
| YTD: | -0.55% | 10-yr. avg.: | 10.61% |
| 3-yr. avg.: | 8.26% | | |

Source: Morningstar Inc.

Total returns, as of 5/2/08



Sector weightings, as of 12/31/07

| | % of stock assets | Rel. to S&P 500 |
|----------------------|-------------------|-----------------|
| Information | 16.32 | |
| Software | 7.81 | 2.09 |
| Hardware | 1.47 | 0.15 |
| Media | 7.04 | 2.37 |
| Telecom | 0 | 0 |
| Service | 49.64 | |
| Health care | 7.64 | 0.67 |
| Consumer services | 10.43 | 1.45 |
| Business services | 11.23 | 2.41 |
| Financial services | 20.34 | 1.20 |
| Manufacturing | 34.03 | |
| Consumer goods | 6.79 | 0.82 |
| Industrial materials | 14.58 | 1.11 |
| Energy | 10.32 | 0.73 |
| Utilities | 2.34 | 0.66 |

*as of 4/30/08

significant cost component. So who's at the low end of the cost curve? This company is.

With new management, they are moving to make investments in Iceland, where you get low-cost electricity from hydrothermal sources. That new plant is on the low end of the cost curve. So will another one, which is due online in 2010-ish, also in Iceland.

The price of aluminum going to \$1.35 per pound from the 80-cent level doesn't hurt. But we're not rushing to buy more with the stock trading around 70. (After starting its current stake on Feb. 13, 2006, the fund's average cost is 24.90.)

IBD: How do the four funds in your group at RS compare to each other in terms of strategy?

Pilara: The philosophy is

the same for the four. We have a 12-person team. We're all analysts. We're divided into three pods: consumer, resources and financials.

Investors is the most concentrated. It takes ideas from the three others. Partners is a small-cap portfolio. Value is a midcap. Natural Resources is a dedicated sector fund.

IBD: Describe your overall investment approach, please. You look for companies trading at a discount to the present value of their future cash flow, right?

Pilara: Yes. We believe return on invested capital is the essential measure. We look for companies with improving rates of return. And we use discounted cash flow models when we look at a majority of stock.

(Continued)

IBD: *Are you building or trimming your exposure to foreign stocks in the diversified funds?*

Pilara: We don't look at investment exposure geographically. We're domestic stock investors. We invest where we have feet on the ground (for our research). I have visited China, for example. But our exposure to foreign markets is through U.S. companies with foreign operations.

IBD: *Is the overall market's rotation towards growth making your job harder?*

Pilara: It's probably making it easier. I'm being tongue-in-cheek. Over the 35 years I've been in this business, there have been rotations to value, rotations to growth. I just don't think it makes much difference. It's never difficult to find 40 or 45 stocks. It really doesn't affect what we do.

I might take a Warren Buffett approach. He said he's agnostic about value vs. growth. He doesn't believe the distinction affects the operations of a true investor.

IBD: *Aaron Rents^{RNT} earnings per share fell last*

year. Return on equity is shrinking. Pretax margins peaked in 2006. What do you like there?

Pilara: When we look at an investment, we ask what are the unit economics? At Aaron, that means what does it cost to open a store? What does inventory cost? And so on. Then we model it over three years. What are the returns on an investment in this store, this box? With Aaron, returns are excellent. Free cash flow is excellent.

IBD: *What attracted you to Lions Gate Entertainment^{LGF}, which produces and distributes film and TV content? The return on equity has gone up, down, up the past three years.*

Pilara: We like the cash flow characteristics of the library. And we like the cash flow that results from the way they finance new films. Free cash flow of the company will improve over the next three years.

IBD: *Peabody Energy^{BTU} is up a relatively modest amount so far this year. Many investors are concerned that the overall industry's big run-up last year has outpaced its earnings growth outlook.*

Pilara: From where we're coming from, it's not earnings growth that drives stock prices. It is returns on capital. Peabody is not as cheap as it was when we entered it three years ago.

But it depends mainly on coal from the Powder River Basin in Wyoming. Surface mining of low-sulfur coal there is relatively low cost, compared with coal from Appalachia, Illinois and other sources used by many of Peabody's competitors. So we see Peabody in a rising return-on-capital situation.

IBD: *I see Bright Horizons Family Solutions^{BFAM} is being taken over. It popped 37% on Jan. 14.*

Wolf: BFAM dominates employer-sponsored child care, which is a very high-return-on-invested-capital model. They serve more than 700 clients, including more than 95 Fortune 500 companies and 75 of the 100 "best companies to work for" as recognized by Working Mother magazine. BFAM plans to grow its asset base by about 6% to 8% a year.

BFAM increases tuition by 4% to 5% a year ...

There are high barriers to entry ... Their established brand name is very meaningful.

IBD: *Coinstar^{CSTR} skyrocketed 16% Friday to an all-time new high on a surge in Q1 EPS. The company makes coin-counting machines and runs the Red-box DVD-kiosk business with McDonald's and runs other lines.*

Wolf: Coin-counting machines are one of the highest gross margin returns on investment businesses — essentially profit per square foot — for grocery stores.

For Coinstar, the machines generate 35% EBITDA margins and 30%-plus returns on invested capital ... It's a very stable business with no economic sensitivity ... And there are significant barriers to entry because of the enormous scale required to cover the fixed overhead of the route network ... Coinstar has no competitors.

IBD: *When you buy a stock, I imagine you do it in several bites rather than one big gulp.*

Pilara: Right. We try not to leave footprints in the market. Hopefully, we let volatility be our friend and not our enemy.

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RS Partners Fund Performance¹

(Average Annual Total Returns as of 03/31/08)

| | First Quarter 2008 | 1-Year | 3-Year | 5-Year | 10-Year | Since Inception (07/12/95) |
|--|-----------------------|---------|--------|--------|---------|-------------------------------|
| RS Partners Fund, Class A | | | | | | |
| without sales charge | -8.63% | -15.65% | 3.47% | 18.41% | 9.95% | 13.32% |
| with maximum sales charge | -12.98% | -19.65% | 1.81% | 17.27% | 9.42% | 12.89% |
| Russell 2000 [®] Value Index ¹ | -6.53% | -16.88% | 4.33% | 15.45% | 7.46% | 11.19% |
| S&P 500 [®] Index ² | -9.45% | -5.08% | 5.85% | 11.32% | 3.50% | 8.81% |

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

Sector Allocation³

(As of 03/31/08)

| | |
|--------------------------|--------|
| Consumer Discretionary | 26.54% |
| Financial Services | 17.40% |
| Materials and Processing | 14.94% |
| Health Care | 10.28% |
| Energy | 8.11% |
| Technology | 7.99% |
| Utilities | 1.95% |
| Consumer Staples | 1.23% |
| Autos and Transportation | 1.08% |
| Cash | 10.48% |

Top Ten Holdings⁴

(As of 03/31/08)

| | |
|--------------------------------|-------|
| Century Aluminum Co. | 4.79% |
| Key Energy Services, Inc. | 4.62% |
| Allegheny Technologies, Inc. | 4.50% |
| ACI Worldwide, Inc. | 4.22% |
| Scientific Games Corp. | 3.96% |
| Coinstar, Inc. | 3.70% |
| Carter's, Inc. | 3.52% |
| The Cooper Cos., Inc. | 3.42% |
| Lions Gate Entertainment Corp. | 2.98% |
| Peabody Energy Corp. | 2.94% |

† 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. Please keep in mind that any high double-digit returns are highly unusual and cannot be sustained. The Fund's total gross annual operating expense ratio as of the most current prospectus 1.51% for the Class A shares. Class A performance quoted "with maximum sales charge" reflects the current maximum sales charge of 4.75%. 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. Certain share classes are subject to lower maximum sales charges whether paid at the time of purchase or deferred. Any sales charges are in addition to the Fund's fees and expenses as detailed in the Fund's most current prospectus. Fees and expenses are factored into the net asset value of your shares and any performance numbers we release. Total return figures reflect an expense limitation in effect during the periods shown; without such limitation, the performance shown would have been lower. Performance results assume the reinvestment of dividends and capital gains. The return figures shown do not reflect the deduction of taxes that a shareholder may pay on Fund distributions or the redemption of Fund shares. Current and month-end performance information, which may be lower or higher than that cited, is available by contacting RS Investments at 1-800-766-FUND and is frequently updated on our Web site: www.RSinvestments.com.

¹ The Russell 2000[®] Value Index is an unmanaged market-capitalization-weighted index that measures the performance of those companies in the Russell 2000[®] 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[®] 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, the index does not incur fees and expenses.

² The S&P 500[®] Index is an unmanaged market capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. 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, the index does not incur fees and expenses.

³ The sector allocation represents the Global Industry Classification Standard (GICS), which was developed by Morgan Stanley Capital International (MSCI) and Standard & Poor's (S&P). The Fund's holdings are allocated to each sector based on their GICS classification. Cash includes short-term investments and net other assets and liabilities.

⁴ Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.

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