

Taking Stock of One of Our Top Ultimate Stock-Pickers

Looking for 'tollbooths' and 'advantaged businesses' with the managers at RS Capital Appreciation Fund.

Ultimate Stock-Pickers | 12-13-11 |

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While we typically focus on analyzing the aggregate behavior of our Ultimate Stock-Pickers to uncover new investment ideas, we find it instructive to occasionally zero in on one of our managers. As part of this process, we recently spoke with Larry Coats and Christy Phillips, two of the three co-managers at RS Capital Appreciation Fund (RCAPX) (formerly the Oak Value Fund), which is not only one of a handful of Ultimate Stock-Pickers actually beating the market so far this year, but is also a fund that has generated generally pleasing results over the years. With RS Capital Appreciation Fund's approach to stock picking closely resembling the approach that our stock analysts at Morningstar use to identify value, we thought it might be interesting to compare and contrast our methodologies, as well as our takes on individual names.

While the managers at RS Capital Appreciation Fund may not have produced world-beating results, it has steadily outpaced its peers and the market. For example, from 2001 to 2010, RS Capital Appreciation Fund generated a 2.0% compound annual growth rate, compared with 1.4% for the S&P 500 Index and 0.9% for its large blend fund peers. The fund has been at its best during periods of market stress, with much of its outperformance over this 10-year time frame due to market-beating returns during volatile periods in 2001, 2003, 2008, and 2009. With economic and market uncertainty once again at the forefront this year, it is no surprise to see RS Capital Appreciation Fund generating returns in excess of both the S&P 500 Index and the large cap blend category. While the fund's approach to stock-picking can be considered especially timely, we feel that the manager's process fairly closely resembles the type of approach individual stock-pickers might want to think about when assembling a portfolio, so a discussion on the tactical considerations in constructing such a portfolio might be useful.

The managers at RS Capital Appreciation Fund are fully committed to a team approach, and no stock is purchased or sold unless all three managers—David Carr, Larry Coats, and Christy Phillips—of the fund

agree. Therefore, in 2003, when Coats became a co-manager and Phillips joined the fund, they were not expected to merely aid in implementing RS Capital Appreciation Fund's existing approach, but to add their own voices to improve and deepen the investment process. While the fund had historically pursued a high-quality value investing approach, the three managers dedicated much of 2004 and 2005 to narrowing down their "investable universe" to focus primarily on businesses with "advantaged economics" that could be sustained over time. Much as Morningstar's stock analysts do with their assessment of economic moats, the managers at RS Capital Appreciation Fund honed in on firms that not only generated above-average profitability and returns, but that also benefited from superior brands, scalable business models, geographic diversity, and conservative balance sheets—all of which manifested into some sort of franchise advantage, cost or scale advantage, or distribution advantage.

When looking back over the fund's historical performance, the managers realized at the time that their "advantage as investors (was) in identifying and pricing companies with competitive, structural, and economic advantages" and not in "judging how cheap a bad business should be." As such, the managers at RS Capital Appreciation Fund scoured the universe of stocks they follow (basically all of the firms represented in the Russell 1000 Index) and rated these companies on a scale of 1 to 5—with 5 being the most advantaged companies and 1 the least. Through this process, the managers have identified 150-200 companies that they have rated a 4 or 5, and they concentrate the bulk of their attention on these stocks. In Coats' own words, "we gave ourselves permission to create a don't-care pile" of stocks. By limiting their investment set in this way, the managers believe that they give themselves, in Phillips' words, "the best opportunity to stay philosophically focused," which allows them to pounce on names quickly when the market provides a window to purchase these stocks at attractive prices.

RS Capital Appreciation Fund Top Stock Holdings (as of September 30, 2011)

	Star Rating	Moat Size	Price (USD)	Price/Fair Value	Uncertainty Rating	% of Stock Portfolio
Oracle (ORCL)	4	Wide	31.69	0.77	Medium	6.3
CME Group (CME)	4	Wide	248.06	0.68	High	6.0
MasterCard (MA)	3	Wide	377.42	1.09	High	5.9
Coach (COH)	3	Narrow	62.45	1.14	High	5.7
Discvry Comm (DISCK)	4	Narrow	37.95	0.84	Medium	5.2
Aflac (AFL)	4	Narrow	43.78	0.75	Very High	5.2
Ecolab (ECL)	3	Narrow	55.90	1.08	Medium	5.0
Qualcomm (QCOM)	4	Wide	55.18	0.89	Medium	4.5
Kraft (KFT)	3	Narrow	36.70	0.94	Medium	4.4
Praxair (PX)	3	Narrow	103.53	1.09	Medium	4.3

Stock Price and Morningstar Rating data as of 12-09-11.

Looking over the fund's holdings at the end of the third quarter, our analysts appear to agree with RS Capital Appreciation Fund's assessment of what constitutes an advantaged company, as all 26 of its stock holdings have an economic moat—with 15 of these companies benefiting from a wide moat, in our analysts' opinion. When discussing the fund's concept of advantaged businesses, though, we discovered that there were several points of emphasis that the managers hone in on that differ slightly from the considerations our analysts use in assigning economic moats. For example, while both processes hinge on past and expected ROICs, potential for growth is not a consideration in Morningstar's moat methodology, whereas it is a key factor for RS Capital Appreciation Fund, as the managers believe that owning a few high-quality "growing and advantaged" businesses (with respect to structural, competitive, and economic position), purchased at attractive valuations, should yield above-average results over the long run. In Coats' own words, "our objective is to own a part of a growing business" when looking to add a holding to the portfolio.

To that end, RS Capital Appreciation Fund has a strong attraction to companies with a broader level of geographic diversity, believing that this is "integral to their ability to generate growth," with the managers noting that over half of the revenue generated by the holdings in their portfolio comes from outside of the United States. This geographic scope also allows RS Capital Appreciation Fund to diversify country risk, which brings us to another point that the fund's managers believe is key. As many may have already guessed, focusing

solely on advantaged companies can lead to a fairly concentrated portfolio, with the fund typically holding 20-30 stocks in any given quarter. According to Phillips, "high conviction and diversity do not have to be at odds—you have to be deliberate about diversification and risk management throughout the investment process." As such, the managers assess all their holdings, including the potential correlations of the underlying businesses, across 45 different categories of risk, delving deeper than simple industry classifications in an attempt to make sure the portfolio is deliberately diversified in its macro and end-market exposures.

An interesting example of how this influences their stock-picking arose recently in their decision to sell Cisco (CSCO) and purchase Autodesk (ADSK) during the third quarter. Looking at the move from a purely sector-driven basis, the managers just swapped out one technology name for another. Further, the move was not based just on fundamentals or valuation considerations, as the managers of the fund felt that both companies were about equally attractive, with each trading at comparable discounts to their estimates of intrinsic value. That said, Autodesk provided a factor that Cisco could not, which was "capital efficient" exposure to the "engineering, construction, infrastructure, and housing markets." As Autodesk serves all of these various industries, the move allowed RS Capital Appreciation Fund to gain this exposure through an advantaged company at an attractive price, using the proceeds from its sale of Cisco to fund the purchase.

Looking for More Fertile Soil in the Investment Landscape

When we asked Coats and Phillips which industries are most fertile when it comes to looking for advantaged companies, they noted that they typically avoid cyclical and commodity-based industries, as evidenced by the fact that they currently hold only one energy name, Chesapeake Energy (CHK). In the consumer space, they have a preference for companies with global brands and recurring sales, as they believe this type of company offers relatively good growth prospects with lower risk. Interestingly, while our analysts believe the health-care industry has a relatively high proportion of moaty companies, Coats has a more subdued take, noting that health care creates some "challenges in long-term predictability." In financials, Coats and Phillips noted their preference for nontraditional names, such as payment processor businesses that function as "tollbooths" and whose business models don't require balance sheet leverage. RS Capital Appreciation Fund's investment in MasterCard (MA) probably best illustrates this theme. Notably, the fund's portfolio

contains no banks, with Coats noting that traditional banking activities have historically generated ROEs of about 15% over a cycle, and believing that RS Capital Appreciation Fund can achieve higher returns elsewhere.

Most interesting to us was the managers' take on the technology sector, which has tended to have something of a reputation as an "avoid" sector among many long-term, value-driven investors due to the constant threat of technological disruption. RS Capital Appreciation Fund is a fairly avid investor in the sector, with technology names accounting for about 20% of its portfolio at the end of the third quarter. Coats and Phillips noted that they believe it is possible to find many technology companies that are advantaged and possess sustainable business models, and that the potential for growth in technology stocks makes many of them attractive long-term investments. As we've noted in previous articles, we've seen many of our Ultimate Stock-Pickers move into technology names this year, catching up to RS Capital Appreciation Fund's long-term interest in the sector. Oracle, the fund's top holding, would seem to fit the profile that Coats and Phillips laid out, and the fund has held the name since 2006, drawn by its recurring revenue and high incremental margins.

Four RS Capital Appreciation Fund Holdings to Consider Further

	Star Rating	Moat Size	Price (USD)	Price/Fair Value	Uncertainty Rating	Market Cap (USD bil)
Aflac (AFL)	4	Narrow	43.78	0.75	Very High	21.0
BlackRock (BLK)	4	Wide	172.68	0.80	Medium	31.8
CME Group (CME)	4	Wide	248.06	0.68	High	16.7
Teva Phrmctcl (TEVA)	5	Narrow	40.20	0.69	Medium	38.3

Stock Price and Morningstar Rating data as of 12-09-11.

Based on our conversation with the fund's managers, and looking more closely at RS Capital Appreciation Fund's holdings, we thought there were four specific stocks worth highlighting. Two of these names—CME Group (CME) and Aflac (AFL)—were among the fund's top 10 positions at the end of the third quarter, accounting for 6.0% and 5.2%, respectively, of the stock portfolio. The other two—Teva Pharmaceuticals (TEVA) and BlackRock (BLK)—are more recent additions, with Teva (at 4.0% of the portfolio) closer to a full position than BlackRock (at 2.6%) at the end of the most recent period.

Aflac (AFL) ★★★★★

The managers at RS Capital Appreciation Fund believe Aflac has a superior business model, noting that the fund has held the stock

almost continuously since its formation in 1993, taking advantage of market gyrations to flex the position up and down. Recently, as fears over Aflac's exposure to Europe (via its investment portfolio) drove the stock down, the managers once again increased the fund's exposure to the insurance firm. Morningstar analyst Drew Woodbury agrees that Aflac is an advantaged business. Although it is usually classified as a life insurance company, Woodbury notes that Aflac took supplemental policies for specific diseases or illness, a product that was a side offering for many life insurers, and turned it into its core product. Its focus on these supplemental policies gives it a cost advantage over competitors, allowing it to price policies cheaper and still boast strong underwriting margins. Woodbury also notes that Aflac had a first-mover advantage in Japan, as it was one of the few companies able to offer these policies during the strict financial market regulation of the past. While the Japanese government is loosening restrictions, which will increase competitive pressures, he believes that Aflac will continue to be one of the more profitable insurance companies we cover. While Woodbury agrees that the shares are undervalued, he is a bit less sanguine about the risk posed by the European debt exposure, given the high leverage exhibited by life insurance firms like Aflac, and he believes that the idea is only suitable for risk-tolerant investors.

BlackRock (BLK) ★★★★★

RS Capital Appreciation Fund bought into BlackRock during the third quarter, with the managers noting that they had long been attracted to the business, but according to Coats, "the issue was always valuation." Depressed capital markets allowed the fund an opportunity to get into the asset manager at a good price. Coats believes that BlackRock has an "ideal mix" of assets under management, diversified by asset class exposure, investment approach (active versus passive), and investors (by both type and geography). His take on the company squares with that of our analyst, Gregory Warren, who believes that BlackRock has the widest moat in the asset management industry. It is also interesting to note that Coats' take on BlackRock highlighted a common theme that came up during our discussion with RS Capital Appreciation Fund, which is the concept of a "tollbooth" business—that is, a fee-collecting business that is relatively stable and a good vehicle for taking advantage of larger industry trends with lower risk. Few asset managers would normally be thought of in this way, as fund performance, asset flows, and market swings can lead to volatile results for the industry. But of all of the asset managers, BlackRock probably comes closest to this ideal due to its size (with more than \$3 trillion in assets under management) and diversification. While the

stock has moved up recently, and Warren would like to see a larger margin of safety before purchasing. BlackRock is certainly worth keeping on one's radar in order to exploit any dips in the same manner that RS Capital Appreciation Fund did in the third quarter.

CME Group (CME) ★★★★★

CME Group, the fund's second-largest holding behind Oracle, also fits neatly into the tollbooth theme, with CME Group being a relatively low-risk play on capital market growth, particularly in the area of derivatives. Morningstar analyst Gaston Ceron agrees that CME Group benefits from a wide moat. He also notes that CME Group has been the great unifier in the futures exchange business and today operates four futures exchanges—CME, CBOT, Nymex, and Comex—with a broad range of trading products. In Ceron's view, a key source of CME Group's competitive strength is its clearinghouse operation, which effectively prevents its products from being fungible at competing exchanges. While CME Group's involvement in the MF Global scandal has pushed the stock price down of late, Phillips at RS Capital Appreciation Fund believes that this is "noise that is disproportionately focused on one topic that doesn't change the long-term strength of business" and views this decline as more of an opportunity than a threat. While Ceron largely agrees, he would still like to see a slightly larger margin of safety before recommending the shares.

Teva Pharmaceutical Industries (TEVA) ★★★★★

Teva was the sole 5-star stock in RS Capital Appreciation Fund's portfolio when we talked with Coats and Phillips, so we were curious to get their take on the pharmaceutical firm. Teva is something of a mixed play in the pharmaceutical world, with not only a portfolio of patented drugs, but a large generic drug business as well. Like many other pharmaceutical firms, Teva does face some headwinds, as its largest branded drug, Copaxone, is now exposed to generic competition. Our analyst, Michael Waterhouse, recognizes this risk, but also thinks it is somewhat muted by the fact that Copaxone is a very difficult drug to manufacture, which will help to limit potential competition. While the managers at RS Capital Appreciation Fund also agreed that the market is overly concerned with the patent expiration issue, they noted that their attraction to the company is mainly based on the generic side of the business and the company's ability to leverage its global distribution network. Teva is a generics industry leader, benefiting greatly from the economies of scale on this side of the business, and its global reach puts it firmly in RS Capital Appreciation Fund's sweet spot. On top of that, the generics

business should continue to benefit from the patent cliff other branded drug manufacturers are currently facing. All that said, RS Capital Appreciation Fund has yet to build a full stake in the name, and they are watching the Copaxone story to see how it plays out.

Disclosure: Brett Horn owns shares in the following securities mentioned above: Cisco Systems. It should also be noted that Morningstar's Institutional Equity Research Service offers research and analyst access to institutional asset managers. Through this service, Morningstar may have a business relationship with fund companies discussed in this report. Our business relationships in no way influence the funds or stocks discussed here.

Economic Moat™ Rating: Strength of competitive advantage is rated: None, Narrow, or Wide. There are two major requirements for firms to earn either a narrow or wide moat rating: (1) the prospect of earning above-average returns on capital; and (2) some competitive edge that prevents these returns from quickly eroding. The assumptions Morningstar makes about a firm's moat determine the length of "economic outperformance" that we assume in the latter stages of our valuation model. We also quantify the value of each firm's moat, which represents the difference between a firm's enterprise value and the value of the firm if no future net investment were to occur. Said differently, moat value identifies the value generated by the firm as a result of any future net new investment. Our Moat Trend Rating reflects our assessment of whether each firm's competitive advantage is either getting stronger or weaker, since we think of moats as dynamic, rather than static.

Price/Fair Value: Morningstar analysts use a discounted cash-flow model to develop a Fair Value Estimate, which serves as the foundation for the Morningstar Rating for stocks.

Uncertainty Rating: Morningstar analysts evaluate the range of potential intrinsic values for a company and assign an Uncertainty Rating: Low, Medium, High, Very High, or Extreme. The Uncertainty Rating determines the margin of safety required before we would recommend the stock. The higher the uncertainty, the wider the margin of safety.

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RS Capital Appreciation Fund (RCAPX) Performance† (Average Annual Total Returns as of 9/30/11)						
	Third Quarter 2011	1 Year	3 Year	5 Year	10 Year	Since Inception (1/18/93)
RS Capital Appreciation Fund, Class A						
without sales charge	-12.68%	-1.89%	1.35%	-0.28%	2.68%	7.97%
with maximum sales charge	-16.82%	-6.54%	-0.28%	-1.25%	2.18%	7.69%
S&P 500® Index¹	-13.87%	1.14%	1.23%	-1.18%	2.82%	7.29%

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

Sector Allocation² (As of 9/30/11)	
Consumer Discretionary	12.6%
Consumer Staples	8.4%
Energy	4.1%
Financial Services	26.3%
Health Care	7.2%
Materials & Processing	9.2%
Producer Durables	12.0%
Technology	19.4%
Utilities	0.0%
Cash	0.9%

Top Ten Holdings³ (As of 9/30/11)	
Oracle Corp.	6.26%
CME Group, Inc.	5.96%
MasterCard, Inc., Class A	5.85%
Coach, Inc.	5.65%
Aflac, Inc.	5.15%
Discovery Communications-C	5.15%
Ecolab, Inc.	4.94%
QUALCOMM, Inc.	4.50%
Kraft Foods, Inc.	4.40%
Praxair, Inc.	4.25%

† 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. As of the most current prospectus, the Fund's total gross annual operating expense ratio is 1.35%. Performance quoted "with maximum sales load" reflects the current maximum sales charge of 4.75%. 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 at www.RSinvestments.com.

The Fund is the successor to The Oak Value Fund; performance shown includes performance of the predecessor fund for periods prior to September 7, 2010.

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.

Any discussions of specific securities should not be considered a recommendation to buy or sell those securities. Fund holdings will vary.

1 The S&P 500® Index of 500 primarily large-cap U.S. stocks is generally considered to be representative of U.S. stock market activity. Index results assume the reinvestment of dividends paid on the stocks constituting the index. Unlike the Fund, the index does not incur fees or expenses.

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.

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