

# The Search for Sustainable Growth

*RS Growth strategies are based on a straightforward premise – sustainable earnings growth drives long-term stock prices and those companies that can deliver typically exhibit five characteristics: a competitive advantage, superior margins, gaining market share, strong organic revenue growth and a capable management team. Allison Thacker, co-portfolio manager of RS Small Cap Growth Fund, RS Select Growth Fund and other RS Growth strategies explains how the art of scouring the investment universe in search of such companies and estimating their future values relies heavily on a team approach and constant learning.*

## **What drives your investment process and stock selection?**

We look at companies that have organically driven revenue growth - revenue growth that is not spurred by acquisitions but rather is driven by the adoption of a service or a product that they have brought to market.

When we talk to companies, we focus on their three-year goal and where they want to take the business over that time period, in an attempt to understand the core of the business and the longer-term opportunity. We call those elements “anchor points.”

In the process, we find that a lot of the companies we are investing in are gaining share, so we use quantitative metrics to look at the company’s track record as we try to highlight the companies that do have a competitive advantage in the marketplace.

Finally, we like to meet the management teams in order to understand where they are taking the business over the longer term. We think we can generate an advantage in trying to know where the company is going to be in the next three to five years as opposed to where they are today. This often allows us to have projections of earnings that are substantially higher than what the market is accepting today, and that is usually how we drive performance across our funds.

## **What are the advantages of investing based on sustainable earnings?**

We think it gets back to the view of compounding.

Those companies with earnings power that exceeds the market average over a business cycle will outperform the market and their peers. And if they can repeat this performance over several business cycles, investors can reap rich rewards.

## **Looking at balance sheets, what characteristics do you primarily focus on?**

We look for growth companies with high-quality balance sheets. Most of our growth companies do not have debt and rely on internally generated cash flow to fund their businesses. This is one of the reasons we focus on companies with sustainable organic revenue growth and strong operating margins.

## **How do you execute your research process?**

Each of our portfolio managers is an investment analyst, first, with significant sector knowledge and experience.

Our research process has historically been successful at identifying fast-growing companies that have the potential for sustainable and strong revenue growth and high margins. To get those investments into the portfolio most effectively, the trading takes place at the edge of the portfolio, with our analyst/portfolio managers who have the most information about the specific security.

In most cases, our investment team members have covered a specific sector for the majority of his or her career, giving us an experience advantage. We feel that by covering sectors over a long period we can develop deep expertise and networks



**ALLISON K. THACKER** is Managing Director, co-portfolio manager and an analyst in the RS Growth Team. She has been a co-portfolio manager of RS Technology Fund since April 2003, RS Small Cap Growth Fund and RS Select Growth Fund since 2007, RS Mid Cap Growth Fund since July 2008, RS Small Cap Equity Fund since April 2009, and RS Growth Fund since May 2009. Thacker also co-manages separate accounts.

Prior to joining the firm in 2000 as an analyst covering Internet and consumer discretionary stocks, Thacker worked as an analyst for the energy investment banking group at Merrill Lynch for two years. She holds a B.A. in economics from Rice University and an M.B.A. from Harvard Business School.

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**RS Growth Mutual Funds**

FUND NAME	SYMBOL	INCEPTION
RS Small Cap Growth Fund	RSEGX	1987
RS Select Growth Fund	RSDGX	1996
RS Mid Cap Growth Fund	RSMOX	1995
RS Growth Fund	RSGRX	1992
RS Technology Fund	RSIFX	1995

**RS Growth Team**

INVESTMENT PROFESSIONAL	JOINED
Stephen J. Bishop	1996
James L. Callinan, CFA	1996
Christopher W. Clark	2007
Melissa Chadwick-Dunn	2001
Allison K. Thacker	2000
D. Scott Tracy	2001
John Tilney	2009

within a sector which enables us to make better investments.

**Where does your fundamental research begin?**

In our small cap area we look at about 3,000 small cap companies by having two ways of sourcing ideas—a quantitative scoring system and a fundamental screening process.

We also employ a quantitative scoring model which actually is not market oriented but rather investment fundamentals oriented. It effectively highlights companies that may not be on our radar by measuring the fundamental characteristics we look for: strong revenue growth, strong margins, improving margins, earnings per share growth, earnings revisions, and an attractive valuation.

**Can you briefly explain the differences between the RS Small Cap Growth Fund and RS Select Growth Fund?**

RS Small Cap Growth Fund is our small cap growth strategy. The Fund, which is benchmarked against the Russell 2000 Growth Index, has on average 70 to 90 holdings with the market cap purchase range between \$200 million and \$3 billion.

This is a portfolio where we would participate in IPOs and companies in the early stages of demonstrating that they're sustainable growth companies with high margins and the potential for strong return on equity.

The RS Select Growth Fund is a small and mid-cap fund. The name is "Select" because it invests in fewer holdings, usually between 45 to 60, within the purchase range of \$500 million to \$10 billion. This fund looks for very high quality small and mid-cap growth companies that we can hold on a multi-year basis and have the longer term three-year type growth targets. The reason why the fund is more concentrated than our small-cap or a mid-cap product is because we require higher hurdles for margins and return on equity for the holdings.

**Describe the research process for small- and mid-cap companies with a few examples.**

We do a lot of industry work in terms of trying to understand the end markets for the product or services of the small cap companies because usually they are less developed.

Our seven-member team conducts over 1,000 company meetings and 300 channel checks annually. We spend a lot of time out of the office visiting companies, as well as their customers and competitors, and other people in the industry in trying to understand not only the companies' perspective of where they are going over three years but also other industry participants' views, as we try to gauge the industry dynamics.

In fact, this process is not substantially different between small- and mid-cap companies. In our opinion, there is a lot more optionality in a small cap company in that the financial statements do not have the maturity to show that the company has a competitive advantage, so we have to spend more time trying to understand what really differentiates their products.

For example, in 2001 we saw AOL agree to use the services of goTo.com, an Internet search company funded by the venture capital firm Idealab, which was intriguing to us in the sense that AOL was a dominant property at the time. goTo had a very interesting search model, in which they said that all unbiased results were good, but they felt that the most relevant type of search results were the ones that businesses are willing to pay for. Back then that sounded like sheer sacrilege.

goTo hadn't seen much traction on its own but at the time AOL did big search business. When AOL agreed to take a couple of links from goTo, we went and met their management team in Pasadena, California to find out the reason behind AOL's strategic move. The idea of paid links was part of the marketplace over time and it was bound to be a very significant business.

At the time, the average cost-per-click was \$0.10, in subsequent years in many verticals it has reached well over a dollar. We spent a tremendous amount of time developing our view of where search was going and how paid search would interact with free search. So, we were a big investor in goTo.com in the early 2000s, driving our investment in the company which was renamed Overture before being bought by Yahoo! Over time, our position in goTo has driven our holdings in Yahoo! too.

That is a classic example of developing a real view on a subsector of an industry, especially in a growth industry where a lot of things were changing. Furthermore, we had a lot of investments come off of that expertise over time regardless of their market cap.

Another example of how we apply our processes in a completely different industry area would be energy. We noticed in 2004 and 2005 that a lot of energy companies were popping up on our screen, so it seemed like we needed to do some work in the sector to understand what was going on.

Even though the industry is not classically known as a strong growth area, those companies were definitely growing, which urged us to take on that industry by looking at all the companies that were getting good scores on our quantitative scoring system. We set up some meetings with companies and tried to develop a view of what was stirring in the industry, why the energy stocks were doing well, and why the fundamentals were good. Our ambition was to determine if there was a real growth story.

We came to the conclusion that over the next ten years oil and gas were becoming harder to find on a global scale, that these companies are becoming more global and sophisticated, and that the new reality would call for the integration of more technology to solve these problems.

Core Laboratories N.V., a provider of advanced geology services to the oil and gas business with over 70% of their revenues on international projects, was differentiated from most energy companies in both growth potential and return on investment. On average, energy companies get only about 40% to 45% of the oil and gas in place out of every formation that they find, and so 60% of it still sits in the ground. Core Laboratories has all these services that help oil and gas companies improve the recovery rate while cutting down on costs and improving efficiency.

The company had earned strong revenues and earnings growth and its margins were over 20%. They are not very capital intensive and have maintained strong return on equity because of the disciplined buyback program as well as their high margins.

To us, it summed up what we were looking for—strong sustainable revenue growth. Core Laboratories had a proprietary element to their offering, too. They had great margin and profitability and a management team who were significant investors in the company and very committed to returning capital to

shareholders through buybacks. That is why we invested in this business as part of RS Small Cap Growth Fund and then, as it grew over time and we got more comfortable with their core competitive advantages, it also made into RS Select Growth Fund before eventually “graduating” into RS Mid Cap Growth Fund.


### **How do you perceive risk and what do you do to manage it?**

There are a variety of ways through which we monitor risk. One of them is the Northfield risk model that we use to take examine the Funds’ risk on a monthly basis.

We have weekly portfolio construction meetings where we talk about the funds. We have developed several internal systems to look at risk, and we like to think of them as an early warning signal.

There are two things that we typically track. Every week we look at the ten stocks that are contributing the most underperformance on a one-month basis. We then revisit the investment thesis on these ideas, trying to make sure that nothing has gone wrong with the investment thesis because that would be a main reason for us sell an investment. While that process tends to highlight underperformance in some of the bigger positions in the fund, we also want to take a look at the smaller positions in the fund so that we are able to highlight when any of them begins to underperform.

Our second screen highlights stocks with consistently declining relative strength versus the market. We then follow a similar process of going back through the investment thesis on these ideas deciding whether our thesis still holds, whether the stock is still attractive and whether we should sell the stock.

It is important to us to make sure that our performance is coming from stock selection as opposed to drivers based on market-oriented factors. 

## **RS Growth Mutual Funds**

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