ValueInvestor INSIGHT

The Leading Authority on Value Investing

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Buried Treasure

Conventional wisdom holds that natural-resources investing is all about commodity prices. MacKenzie Davis and Ken Settles, who excel at it, beg to differ.

Laughing at adversity is a common value investor trait, says MacKenzie Davis, and one that is getting a particular workout today. "You have to be thrilled to be buying in the face of such remarkably negative sentiment," he says. "If we're halfway right about what we own, we're going to do incredibly well."

Davis and co-managers Ken Settles and Andrew Pilara have been far more than halfway right in managing the RS Global Natural Resources Fund, which over the past ten years has earned a net annualized 14.1%, vs. 8.4% for S&P's North American Natural Resources index.

Not all bargains are created equal, say Davis and Settles, who are "cherry-picking" ideas in such areas as oil, natural gas, industrial gases and gold mining. See page 2

INVESTOR INSIGHT

RS Investments

MacKenzie Davis *(l)*, Ken Settles *(r)*

Investment Focus: Seek companies with "advantaged" assets and high returns on invested capital, whose share prices excessively reflect commodity-price concerns.

Trading Up

High-quality businesses rarely sport bargain stock prices, but Tim Hartch and Michael Keller see many exceptions to that rule in today's dismal market.

INVESTOR INSIGHT

Brown Brothers Harriman & Co.

Timothy Hartch *(l)*, Michael Keller *(r)*

Investment Focus: Seek companies trading at a wide discount to intrinsic value that provide essential products and services to a large base of loyal customers.

Tim Hartch recalls a corporate sale he helped manage at Brown Brothers Harriman in which three potential buyers bid around $100 million for a company, while a fourth offered $200 million. "Two important lessons there," he says. "Valuation is not an exact science, and sometimes the 'market' overpays."

Now managing more than $5 billion in equity assets, Hartch and his co-managers have proven adept at recognizing market mispricings. Their longest-lived investment partnership has earned a net annual 7.9% since 2001, vs. -3.9% for the S&P 500.

Mining a select group of what they consider superior businesses, Hartch and large-cap co-manager Michael Keller see bargains today in such areas as insurance, software, online services and dentistry.

Inside this Issue

Insight: RS Global Natural Resources

MacKenzie Davis and Kenneth Settles of RS Investments explain why the secular outlook for natural resources stocks has improved in the past six months, how they avoid betting on commodity prices, why they often find typical valuation multiples useless, and why they see opportunity in XTO Energy, Denbury Resources, Praxair and Agnico-Eagle Mines.

How broadly do you define "natural resources" for the purposes of managing your fund?

MacKenzie Davis: It's an all-cap global fund that invests across commodity classes – water to oil – and can even extend to industries that supply into the commodity food chain. Right now roughly 40% of the fund is in energy and 35% is in what we call materials and processing. We have flexibility to invest directly in commodities and other assets, but we focus exclusively on equities.

We all know natural resources businesses are cyclical, but have you been surprised by the intensity of the ups and downs in the past year?

MD: Absolutely. First let me step back, though, and describe how we think about commodity prices. Prices generally move between, at the upper boundary, the price at which demand is destroyed – think $4 per gallon gasoline – and at the lower boundary, the cash cost of the marginal producer, which is where supply starts to be destroyed. If prices aren't high enough, supply is constrained and when prices are too high, surpluses occur either through demand destruction or an increase in supply. The mean around which the commodity price oscillates is the marginal cost of supply, which is the price required to allow the marginal producer to earn a reasonable return on invested capital.

What surprised us on the way up in this last cycle was the lack of supply response in most commodity classes, which allowed prices to rise much further than we would have expected. On the way down, we and just about everybody else were surprised by the velocity of the demand destruction as the financial crisis very quickly evolved into a global economic crisis. The demand falloff, coupled with a rapid de-stocking of built-up inventory, created kind of a perfect storm pushing commodity prices down.

What caused the slower supply response in the last up cycle?

MD: Part of it was the secular trend, which continues today, toward the next increment of supply for many commodities being higher cost and more difficult to extract from geographically remote and geologically challenged regions of the world. That makes it increasingly difficult to bring supply into the market – which, by the way, underpins much of our long-term outlook for natural-resources prices in general.

> **ON THE CRISIS' EFFECTS:**
> **We'd argue that the secular outlook for natural resources has actually gotten better in the past six months.**

More unique to the last cycle was the fact that a lot of the host countries for development projects were disillusioned with the contracts they signed when oil was $20-30 per barrel and copper was $1.50 per pound and began to nationalize more resources. The impact of that didn't help the supply response at all.

Another thing I'd mention in the last cycle that helped constrain supply was that the existing supply of labor and engineering talent started to be stretched. The average age of members in the Society of Petroleum Engineers is in the mid-50s, and there has just been a lack of investment in human capital across the various industries.

Elaborate on the secular supply challenges you see for many commodities.

Ken Settles: The basic point is that the marginal cost of supply continues to increase significantly for most of the commodities we pay attention to, which is a function of deteriorating geology. With oil and natural gas, we've already drilled the shallow targets that have the most easily accessed reserves and are now having to drill deeper, more complex and more expensive wells to get at more remote oil and gas. A couple data points: reserves per well of natural gas have declined by more than 60% since 1990, while over the same period the amount of capital required to bring on a new Mcf of gas has risen from $1 to $3. Oil reserves per well have dropped by 50% since 1990, while finding and development costs have risen from $5 per barrel to $20 per barrel. In base metals, such as copper and gold, we're seeing the same dynamics.

The result of all this is that you need a continually increasing price to incent the economic producer to bring new projects into the market. When demand eventually begins to grow again, that puts significant upward pressure on prices.

In fact, we'd argue the secular outlook for natural resources has actually gotten better in the past six months. Many development projects have been taken off line either because they're not profitable at current low prices or they can't be funded in the current financial environment. Drilling activity is down by more than 40% in the U.S. just since October and is likely to head lower. Capital spending in the mining sector is expected to drop 50% from 2008 to 2009. Given the multi-year lead time of many projects, that lack of investment today is likely to result in even more violent price increases when demand returns.

MD: If you consider the problems the industry had in meeting demand during the first two-thirds of this decade – when credit was incredibly easy to come by – you can imagine how much harder it will be in an era when credit and access to capital will be significantly tighter.

Can you draw more specific distinctions in the supply picture across various commodity sectors?

MD: Our research focuses on understanding the economics of each of the projects that make up the existing supply base, to determine the supply cost curve. We also spend a lot of time in the field analyzing the economics of the projects that are coming into the market, because they will determine the slope of the cost curve of the future.

We define the fundamental attractiveness of an individual commodity as a function of the shape of the existing and future supply cost curves. We're much less interested in industries with flat cost curves, such as zinc, say, or in processing businesses that operate downstream from the actual mines or wells. In those businesses there's a lot less differentiation between the low- and high-cost producer, so no one ends up being advantaged. In those cases, you're just betting on the commodity price.

Isn't just betting on the commodity price pretty much what you're doing anyway?

MD: No. Our analysis shows that while natural resource stocks are positively correlated to changes in the price of the underlying commodity over short periods of time, they tend to be much more closely correlated with returns on invested capital over longer time periods of three to five years. The differentiated returns on capital among the producers of a specific commodity, furthermore, tend to be a function of significant differences in the cost structures and capital efficiency of each company's producing assets. These differences typically relate to the underlying geology, so they can't really be competed away. Our focus then is on identifying the low-cost producers – over time and prospectively – that have a built-in and sustainable competitive advantage.

KS: It's exactly the fact that investors focus so intently on the current commodity price in setting stock prices which provides us with opportunities to buy when truly advantaged companies go down along with everything else. The market underestimates what can be massive differences in the operating and capital cost structures of these companies.

ON GOLD:

The secular supply story is extremely favorable. We struggle a bit to understand the demand side at any given time.

MD: A lot of value investors won't invest in the natural resources space because they look in aggregate and see that the companies don't create any value, so you might just as well own the commodity. While that's true in aggregate, to Ken's point, the difference between the high-cost producer and low-cost producer from a return standpoint is massive. Low-cost producers can create a tremendous amount of value.

Describe your valuation methodology.

KS: Natural-resources companies have natural depletion rates, so the asset bases can look very different five, 10 or 20 years out. Given that, a metric like a price-earnings multiple provides little insight. A company making a lot of money that is depleting its high-return assets may look incredibly cheap, but if it can't replace those assets it's likely to be a classic value destroyer.

MD: As I mentioned, we spend most of our time in the field analyzing specific projects. That allows us to estimate a company's net asset value per share today at current prices, as well as in the future at what we expect to be the long-term price for the commodity, which is is marginal cost of supply we discussed earlier.

I'm simplifying, but in the end we are looking to invest when from the current share price there is at least a 50% upside to the net asset value we see three years out and, more importantly, where there is limited downside to current NAV. We would argue that today's commodity-price environment is not sustainable, so when we assume a more normalized situation we're often seeing upside that is significantly higher than our current assessment of NAV.

What are some of the specific estimated long-term prices you're using today?

MD: For oil, it's $70-75 per barrel and we would expect that to keep rising over time, which makes oil a very attractive sector to us right now. For natural gas, we use $7-8 per Mcf, but see some potential decline in that over time due to the emergence of a number of potentially large and low-cost shale plays. For copper, the long-term price is now around $2 per pound, which we expect to keep rising.

What about gold?

KS: We invest in gold stocks using the same process we use for other commodities, but there's no doubt there are times when gold prices take on a bit of a life of their own. We think a reasonable supply-based price today is around $750 per ounce, but expect that marginal cost of supply to rise quite rapidly. Over the past three years gold production has been flat, but measures of grade quality have fallen by 20%. So from a supply standpoint, there's an extremely favorable secular story for gold. We struggle a bit more to understand the demand side at any given time, but that isn't our analytical focus anyway.

Where do your ideas tend to come from?

MD: Most of them come from spending time on the road visiting facilities and talking to people out there about how capital is actually being allocated. We were in Scandinavia last fall, for example, looking at some aluminum and hydro assets, but we also visited a gold mine in Finland. We were the first investors to visit the mine and were impressed by the economics attached to it, which eventually led to our investing in Agnico-Eagle Mines [AEM]. We'll talk more about it later on, but essentially our work on the quality of Agnico's assets and the soundness of its management philosophy put it on our radar screen, and then the market gave us a chance to buy into it at the right valuation.

KS: Unlike most other areas, it's very difficult to screen for value in natural-resources stocks. Companies with high-cost assets or an inability to reinvest at high returns can at times look extremely cheap, but we think they make lousy investments. That's why we spend all our time looking at specific assets and projects – that prepares us to act when markets move based on commodity prices.

How far afield do you go geographically?

KS: By the nature of the businesses we invest in we have very broad geographic exposure, at least indirectly. But we don't have material direct exposure to emerging markets because we believe the associated risks, including political risks, are nearly impossible to quantify and generally don't provide sufficient returns to adequately compensate for those risks. One big issue is that rising prices have a disproportionately negative impact on emerging countries, which are least able to offset inflation because their per-capita commodity consumption is rapidly increasing, not flat-to-declining as is the case in most of the developed world. All that said, we think we have exposure to most of the long-term growth aspects of these emerging economies simply by owning natural resource producing companies elsewhere.

Do you pay attention to diversification across commodity-related sectors?

KS: We do. It doesn't work so well at broad inflection points where demand across-the-board goes way up or down, but generally we do see benefit in holding a mix of non-correlated assets. We own Martin Marietta Materials [MLM] and Praxair [PX], for example, because they meet our criteria, but also because the fact their operations generally benefit from lower commodity prices offers significant diversification benefits.

ON OIL-SERVICES STOCKS:

They're very levered on the way up and the way down – arguments that suggest otherwise generally aren't true.

One specific question on oil-services stocks: the notion that these stocks would hold up well because of enviable contracted backlogs has proven to be patently wrong – did you fall victim to that?

KS: If you study past cycles, service stocks in general – and particularly the most capital-intensive among them – have created very little value across a cycle. Incremental capacity is pretty easy to come by and the supply cost curve is flat. That makes them very levered on the way up and the way down, and arguments that suggest otherwise generally aren't true. If you're a rig contractor and one of your customers who represents a third of your rig count comes to you in bad times and says we can either renegotiate the rates today or we can let the contract run as is and then never do business with you again, what do you end up doing? Services stocks can be good ones to rent in an up cycle, but they aren't the types of things you want to own over a full cycle.

Describe your investment case today for XTO Energy [XTO]?

KS: XTO is an independent oil and gas company with roughly 80% of its production coming from onshore natural gas wells in the U.S. It's one of the largest gas producers in the Freestone Trend and Barnett Shale in Texas, and has growing positions in the Woodford Shale in Oklahoma and the Fayetteville Shale in Arkansas.

We've owned this stock for some time and consider it a prime example of how advantaged assets, high returns on invested capital and excellent management translate into attractive investment returns. The stock has dramatically outperformed its peers and commodity prices over the past decade. In fact, over that time there are few stocks period that have done as well.

MD: Today you can buy into the company, which has created billions and billions of dollars of shareholder value over time, at the current net asset value of proved reserves only, using recession pricing of $50-per-barrel oil and $6-per-Mcf natural gas. We think that's amazing.

KS: In natural gas, the overall decline rate of wells runs around 25-30% per year, requiring companies to reinvest on average 50-75% of their free cash flow just to replace what they produce in a given year. As a result, differences in decline rates result in pretty material differences in maintenance capital spending requirements. One of XTO's primary advantages is that it has an overall well decline rate of only 15%, which is a function of the geology of its assets and of management purposely managing toward that metric. They buy assets with low decline rates, but also moderate production growth to keep decline rates and capital spending down. Very few companies in the business manage that way.

The company also very carefully manages its finding and development costs, which are roughly half the industry average of around $3 per Mcf. That's another structural advantage that sets them apart.

Is management, which you clearly hold in high regard, buying up assets today?

KS: They actually bought a number of assets in 2008, but turned around and hedged the cash flows of the new assets at relatively high commodity prices to insure a minimum rate of return. Overall, they have 75% of their 2009 gas production hedged at more than $8.50 per Mcf, versus today's price of only $4.50 per Mcf.

They believe they got the assets they wanted last year and are certainly financially capable of buying more, but they can't control when attractive assets go on sale. In fact, their track record of generating great returns from acquisitions has been less based on when they purchased in a cycle than on their ability to buy assets that ended up having double or triple the proved reserves they felt they were paying for.

How are you looking at XTO's valuation with the shares currently trading at around $32?

KS: Running a discounted-cash-flow analysis on proved reserves, using $6 gas and $50 oil, we put the current net asset value around $30 per share. So we see very little downside from today's price. On the upside, if we use our base-case $7.50 to $8.00 gas price, the NAV three years out increases to around $75 per share. Again, these numbers use only proved reserves. If we make some conservative assumptions about probable and possible reserves coming on line, the discount to NAV at today's share price gets shockingly high.

Is the balance sheet at all a concern here?

MD: They have twice over the past few months monetized some of the deep in-the-money hedges they had on, in order to reduce some of the debt associated with last year's acquisitions. Even without that, they're generating so much free cash flow – probably around $2 billion this year – that there aren't any real concerns about debt.

What do you consider to be the advantaged assets of oil company Denbury Resources [DNR]?

KS: Denbury has gone through a structural change, transforming itself from a high-cost Gulf of Mexico producer into a specialty oil company focused on carbon-dioxide-enhanced oil recovery. By far its most interesting asset is Jackson Dome, the largest naturally occurring source of carbon dioxide east of the Mississippi River. In certain oil fields, carbon dioxide can be injected to produce oil that is otherwise unrecoverable using primary and secondary methods of recovery. With ownership of this low-cost source of carbon dioxide and the pipelines to transport it, Denbury's strategy has been to acquire mature oil fields throughout the Gulf Coast region and significantly increase both production and reserves in those fields at highly competitive capital and operating costs. To us, this tertiary oil-recovery business is a true advantaged asset – unique, low-cost and unlikely to be competed away.

This business model has much to commend it. The geological risk is quite low – they're working with mature oil fields that have 60% or more of the proved reserves still in place, but which can't be accessed without using high-pressure carbon dioxide to bring it to the surface. Denbury buys from owners who have exhausted what they can get out of the fields, so it doesn't have to pay high prices for additional development potential. Exploration costs are low, because there's

INVESTMENT SNAPSHOT

XTO Energy
(NYSE: XTO)

Business: Acquisition, development and production of natural gas resources located primarily in the U.S. Current reserve base of two billion barrels of oil equivalent.

Share Information
(@2/20/09):

Price	**31.99**
52-Week Range	23.80 – 73.74
Dividend Yield	1.6%
Market Cap	$18.54 billion

Financials (TTM):

Revenue	$7.70 billion
Operating Profit Margin	45.6%
Net Profit Margin	24.8%

Valuation Metrics
(@2/20/09):

	XTO	S&P 500
Trailing P/E	9.0	10.5
Forward P/E Est.	11.6	12.2

Largest Institutional Owners
(@12/31/08):

Company	% Owned
Wellington Mgmt	6.5%
Barclays Global Inv	3.9%
State Street Corp	3.9%
Harris Associates	3.4%
Vanguard Group	3.1%

Short Interest (as of 1/27/09):

Shares Short/Float	3.2%

XTO PRICE HISTORY

THE BOTTOM LINE

Even with advantaged assets and first-class management, the company trades today as if the recession will never end and it will just pump its proved reserves dry, says Ken Settles. Assuming base-case natural gas prices of $7.50-8 per Mcf, he expects the company's net asset value three years from now to be at least $75 per share.

Sources: Company reports, other publicly available information

no risk of drilling dry holes. Finally, because the company owns the carbon dioxide source, actual production costs are much lower. Industrial providers of CO-2 charge something like $2 per Mcf, but Denbury can deliver CO-2 to its fields for no more than 30 cents per Mcf.

How finite is the company's competitive opportunity?

KS: Jackson Dome has more than enough new carbon dioxide to support all the different projects Denbury has on tap for the next five to 10 years. Beyond that, though, once the oil fields have been fully injected with CO-2 and stop lifting oil, much of that CO-2 can be recaptured and reused. That could double the life of the Jackson Dome reserves.

Another option Denbury is already pursuing is to buy, at low cost, waste carbon dioxide from industrial companies in the Gulf region. They are currently building a pipeline to the Houston area through which a lot of that new source of CO-2 can flow. Looking further down the road, if any type or carbon cap-and-trade system is put in place, Denbury would split the credits 50/50 with the industrial companies they get waste CO-2 from.

What are your estimates for net asset value, against a current share price of $12.30?

KS: Here our estimate of current proved-only net asset value – using a $50 oil price – is $13 per share, slightly above the current share price. That includes no reserves that are classified as "probable," which in Denbury's case we'd argue are more like proved reserves because of the low geological risk. The market is assigning no value to those today.

At a mid-cycle price of $75-per-barrel, we estimate the net asset value three years out to be at least $25 per share. Again, that assigns no value to anything but proved reserves. It assigns no value to the new Houston CO-2 pipeline, or to potential carbon credits.

MD: So using only bare-bones assumptions we have a potential double, with little or no downside and lots of free options on the upside. Those are bets we'll make any time.

Turning to more of a processing business, why are you high on Praxair?

MD: Praxair's is another business model that we find extremely attractive. The company is one of largest industrial-gas companies in the world, basically taking air and separating it into its chemical components, which it then delivers to a wide variety of users like steel mills, food processors, hospitals, etc.

Coming out of the last recession Praxair went through a rigorous reassessment of its business and came to the conclusion that the more concentrated its supply assets were geographically, the better its returns. Today they'll essentially go into a large industrial company, like a steel mill, and build an air-separation plant that pipes gases directly into that mill. They'll sign a take-or-pay contract for 15 to 20 years with the mill, targeting a 12% after-tax unlevered rate of return. The gases they supply may be only 1% of the mill's cost of goods sold, but they are absolutely critical to its proper functioning.

INVESTMENT SNAPSHOT

Denbury Resources
(NYSE: DNR)

Business: Acquisition, development and production of oil and natural gas in the U.S. Gulf Coast region. Owns large carbon dioxide reserves used to enhance production.

Share Information
(@2/20/09):

Price	**12.29**
52-Week Range	5.59 – 40.32
Dividend Yield	0.0%
Market Cap	$3.04 billion

Financials (TTM):

Revenue	$1.46 billion
Operating Profit Margin	55.8%
Net Profit Margin	30.9%

Valuation Metrics
(@2/20/09):

	DNR	S&P 500
Trailing P/E	6.9	10.5
Forward P/E Est.	15.0	12.2

Largest Institutional Owners
(@12/31/08):

Company	% Owned
Fidelity Mgmt & Research	14.5%
RS Investments	5.7%
Wellington Mgmt	4.5%
AllianceBernstein	4.5%
TIAA-CREF	4.4%

Short Interest (as of 1/27/09):

Shares Short/Float	3.6%

DNR PRICE HISTORY

THE BOTTOM LINE

The company's business model focuses on using high-pressure carbon dioxide to extract oil and is "unique, low-cost and unlikely to be competed away," says Ken Settles. Using proved-only reserves and a mid-cycle oil price of $75 per barrel, he expects the company's net asset value within three years to be at least $25 per share.

Sources: Company reports, other publicly available information

With the air-separation facility built and a solid portion of its output accounted for, the company directs the remaining capacity towards its merchant gas business – selling to relatively nearby customers like hospitals, usually under five-year contracts – or to a wide variety of smaller industrial buyers like welding shops, which purchase gas via small canisters. Those business lines are higher-margin for Praxair, producing returns on capital of 15-20%. The on-site business, which makes up about 25% of revenues, gives it a lot of leverage and a competitive advantage over companies trying to sell packaged gas without it. Geographically, they've so far focused on North and South America, but have some concentrated activity in Europe and a developing business in Asia.

Another attractive aspect of the business is that they've generally been able to maintain pricing power. The on-site customers become somewhat captive because going elsewhere would entail finding someone else to build a facility, who would have to price in order to earn a return on that facility. As a result, Praxair has historically been able to maintain pricing across economic cycles, which is very unique for an industrial processing business.

Describe the competitive environment.

MD: In the on-site business the market is largely split with three main competitors – the others being Air Products, Linde and Air Liquide – which have followed Praxair's example and there doesn't tend to be wide geographic overlap. It's more fragmented on the small-user merchant and packaged-gas sides, but even there you're seeing big players like Airgas buying up a lot of smaller companies to consolidate the business.

Is this a growth business?

MD: One area of expansion in the on-site business is in selling hydrogen extracted from natural gas to refineries, a business which generates returns in the mid-teens. The company is also continuing to expand their basic model into Asia, which has excellent potential but isn't something we're counting on to any great degree.

Existing backlog – which consists primarily of four new facilities that have been financed and are under development – should support mid-single-digit revenue growth over the next three years. That would be on top of the 3-5% price increases they get every year and any organic growth from existing facilities.

I should mention that the company has also very consistently taken 3-5% of sales out of its costs on an annual basis, which has allowed it to protect its margins over time.

At a recent $63.40, how cheap do you consider the shares?

MD: With a return to a more normalized economic environment and assigning no value to the backlog, we estimate the company will earn after-tax cash flow, less maintenance capital spending, of around $2.5 billion within three years. (The number this year should be around $2 billion.) Based on our assessment of the quality of the business and the management, we think the shares should trade at a yield on that after-tax cash flow of just under 10%, which

INVESTMENT SNAPSHOT

Praxair
(NYSE: PX)

Business: Production and sale of atmospheric, process and specialty gases and high-performance surface coatings, primarily in North and South America.

Share Information
(@2/20/09):

Price	**63.41**
52-Week Range	47.40 – 99.74
Dividend Yield	2.5%
Market Cap	$19.51 billion

Financials (TTM):

Revenue	$10.80 billion
Operating Profit Margin	19.2%
Net Profit Margin	11.2%

Valuation Metrics
(@2/20/09):

	PX	S&P 500
Trailing P/E	16.7	10.5
Forward P/E Est.	14.2	12.2

Largest Institutional Owners
(@12/31/08):

Company	% Owned
T. Rowe Price	4.7%
State Street Global Adv	3.7%
Vanguard Group	3.3%
Marsico Capital	3.2%
Barclays Global Inv	3.1%

Short Interest (as of 1/27/09):

Shares Short/Float	1.1%

PX PRICE HISTORY

THE BOTTOM LINE

Strong pricing power, already-funded new facilities coming on line and a keen focus on cost control should help the company weather cyclical challenges, says MacKenzie Davis. If the company can increase annual after-tax cash flow by a total of 25% within three years, as he expects, he believes the share price would exceed $100.

Sources: Company reports, other publicly available information

would translate into a share price of $90 per share. On top of that, again assuming a return to normalcy, the backlog is worth probably another $12 per share.

How are you looking at the downside?

MD: If we assign zero value to the backlog and assume recessionary levels of pricing and volume, we still think the stock is worth $60 per share. If there's no economic improvement in the next three years, the backlog from the new facilities would be worth another $7. It's always a bit odd to see a stock trading below what we conservatively estimate as the downside price, but we're seeing much more of that than usual today.

Your investment in Agnico-Eagle has done quite well since you purchased it last year. Why do you still find it attractive?

KS: The company's strategy has historically been to purchase resource assets that look rather limited, but which they believe have the potential to be much larger and can be accessed at low cost. They fly under the radar of the bigger gold companies, which target only the biggest mines in the world, so can avoid bidding wars when assets go on sale.

That's important, because we find there are two general management styles at natural-resource companies. One is focused primarily on maximizing production, so they don't much care about the capital costs that go into getting that production. That works quite well in a rising commodity-price environment, but we believe it makes it very difficult to create value over time. The other strategy looks at production as a residual of the capital-allocation process, which if it's done right results in the generation of attractive returns over time. Agnico's management team has been together for over a decade and they're very much in the latter camp and have created value consistently year over year.

The core asset of the company is the LaRonde mine in Quebec, which is a low-cost asset that generates significant free cash flow that can be deployed elsewhere, including at developing mines they have in Canada and Mexico, as well as the one we mentioned earlier, the Kittila mine in Finland. All of these projects have the potential to produce at costs of around $300-400 per ounce, near the lower end of the supply cost curve we've spoken about.

With the shares trading at $54.65, what upside do you see from here?

KS: As you mentioned, gold stocks have had quite a run in the past couple of months, so the shares obviously aren't the bargain they were last October.

Using a low-end gold price of $700 per ounce, we come up with a current net asset value for the company of around $35 per share. Assuming the futures strip prices of around $1,000 per ounce are right – adding in our assumptions about proved reserves three years out – we get an NAV of closer to $85 per share. We originally bought closer to our downside NAV price, but there's still nice upside to our more normalized case.

We've been very conservative in our assumptions about production expansion, so there could be further upside if the developing mines are expanded as extensively as we believe they can be. The

INVESTMENT SNAPSHOT

Agnico-Eagle Mines
(NYSE: AEM)

Business: Exploration and development of gold-mining properties located in Canada, Finland, Mexico and the U.S. LaRonde gold mine in Quebec is Canada's largest.

Share Information (@2/20/09):

Price	**54.65**
52-Week Range	20.87 – 83.45
Dividend Yield	0.3%
Market Cap	$8.46 billion

Financials (TTM):

Revenue	$368.9 million
Operating Profit Margin	15.9%
Net Profit Margin	19.8%

Valuation Metrics (@2/20/09):

	AEM	S&P 500
Trailing P/E	108.9	10.5
Forward P/E Est.	28.5	12.2

Largest Institutional Owners (@12/31/08):

Company	% Owned
Fidelity Mgmt & Research	6.4%
T. Rowe Price	4.8%
BlackRock Inv Mgmt	3.6%
Van Eck Assoc	3.3%
Aletheia Research & Mgmt	2.7%

Short Interest (as of 1/27/09):

Shares Short/Float	n/a

AEM PRICE HISTORY

THE BOTTOM LINE

Given its potential to increase production at a series of low-cost mines, the company should be able to significantly increase its net asset value without any further increases in the price of gold, says Ken Settles. Assuming roughly today's gold price three years' out, he expects the company's NAV to be closer to $85 per share.

Sources: Company reports, other publicly available information

Finland mine and some of those in Canada could likely double production in the next five years, at continued low cost, but we haven't at all included that in our NAV calculations.

Speaking generally again, have the past nine months delivered any to-be-learned-from lessons?

MD: The second half of last year really just reinforced in our minds the true benefit of owning advantaged assets. The biggest issues we had were in companies that may have been doing the right things structurally to improve returns, but because they were more in processing-type businesses the macro tidal wave just overwhelmed any incremental improvements they might be making in their operations. Eastman Chemical [EMN] and Allegheny Technologies [ATI] are good examples – management was doing everything we hoped they would, but any competitive advantage they were able to create got eroded awfully quickly when demand got cut in half. We still own both companies and believe in their futures, but the stocks have simply gotten crushed.

ON EFFECTS OF INFLATION:

We're not macroeconomists, but it's hard to imagine the stimulus we're seeing won't result in inflationary pressures.

KS: The speed of the market's move down also highlighted for us the importance of constantly updating our fieldwork so we can be ready to take advantage of valuation opportunities when they happen. One day Praxair trades at $100 a share and then it's at $50. Having your work done ahead of time to take advantage of the volatility in the market is very important.

You're likely biased, but can someone with long-term concerns about the inflationary impact of crisis-fighting fiscal and monetary policies find appropriate refuge investing in natural-resources stocks?

MD: We're not macroeconomists, but it's hard to imagine that the global stimulus we're seeing won't result in inflationary pressures at some point in the future. Would rising commodity prices benefit commodity producers? Sure. But that raises more of a strategic asset-allocation question that we as managers of a natural-resources fund don't really concern ourselves with. We just stay focused on understanding those supply cost curves, identifying the owners of advantaged assets and investing in them when their share prices are attractive. If we do that well, we'll be fine whether inflation takes off or not. VII

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RS Global Natural Resources Fund (RSNRX) Performance†
(Average Annual Total Returns as of 12/31/08)

	Fourth Quarter 2008	1-Year	3-Year	5-Year	10-Year	Since Inception (11/15/95)
RS Global Natural Resources Fund, Class A						
without sales charge	-29.45%	-46.76%	-8.73%	7.76%	14.12%	8.47%
with maximum sales charge	-32.80%	-49.29%	-10.20%	-6.72%	13.57%	8.07%
S&P North American Natural Resources Sector Index™ [1]	-29.03%	-42.55%	-3.36%	8.96%	8.37%	N/A
S&P 500® Index[2]	-21.94%	-37.00%	-8.36%	-2.19%	-1.38%	5.04%

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

Sector Allocation[3]
(As of 12/31/08)

Other Energy	36.3%
Materials and Processing	36.2%
Utilities	16.6%
Integrated Oils	4.5%
Financial Services	1.0%
Cash	5.5%

Top Ten Holdings[4]
(As of 12/31/08)

Goldcorp, Inc.	5.05%
Kinross Gold Corp.	4.96%
Allegheny Technologies, Inc.	4.78%
XTO Energy, Inc.	4.72%
Denbury Resources, Inc.	4.70%
Occidental Petroleum Corp.	4.50%
BHP Billiton Ltd.	4.33%
Talisman Energy, Inc.	3.81%
Spectra Energy Corp.	3.74%
Martin Marietta Materials, Inc.	3.65%

† 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 1.47% 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 800-766-3863 and is frequently updated on our Web site: www.RSinvestments.com.

1 The S&P North American Natural Resources Sector Index™ is a modified cap-weighted index designed as a benchmark for U.S.-traded securities in the natural resources sector. The index includes companies involved in the following categories: extractive industries, energy companies, owners and operators of timber tracts, forestry services, producers of pulp and paper, and owners of plantations. 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 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 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.

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

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