

Real Asset Strategies

Commodities vs. Natural Resource Equities



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Executive Summary

Investors look to the commodity market to provide three primary benefits: portfolio diversification, inflation protection, and equity-like returns. However, empirical data shows that over the last decade, shifts in underlying fundamentals have undermined the role which commodities are expected to play in a diversified portfolio, particularly relative to natural resource equities. In this paper, we will review how changes in fundamentals impact the unique return streams generated by both commodities and natural resource equities in the context of the benefits expected from each investment option. In the process, we present the case for employing natural resource equities as a means to benefit from favorable long-term secular trends in the space while seeking superior risk-adjusted returns, similar diversification benefits, and more reliable inflation protection relative to commodities.

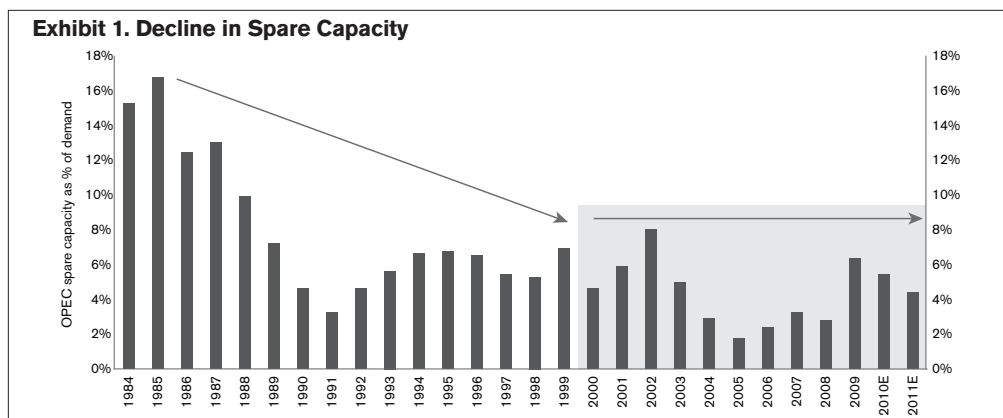
Introduction

Over the last decade, investors have increased their allocations to commodities significantly, from \$10 billion in 2000 to \$257 billion at the end of 2009.¹ The growth in assets under management for commodity futures strategies has been primarily a function of performance experienced between 1970-1999. Over this time frame, commodities exhibited negative correlations with other asset classes, provided inflation protection, particularly during the 1970's, and generated equity-like returns. As a result, commodities became a core allocation as investors concluded that their inclusion significantly improved the real risk-adjusted returns of a diversified portfolio.

Over the last 10 years, however, commodities have delivered more mixed results. Diversification benefits have been undermined by an increased correlation with equity markets, while returns have been partially offset by a shift in futures curves. Correlations with inflation have remained positive, but are almost identical to the protection provided by higher returning asset classes such as natural resource equities. As a result, many investors have begun to question the role that commodities futures play in a diversified strategy.

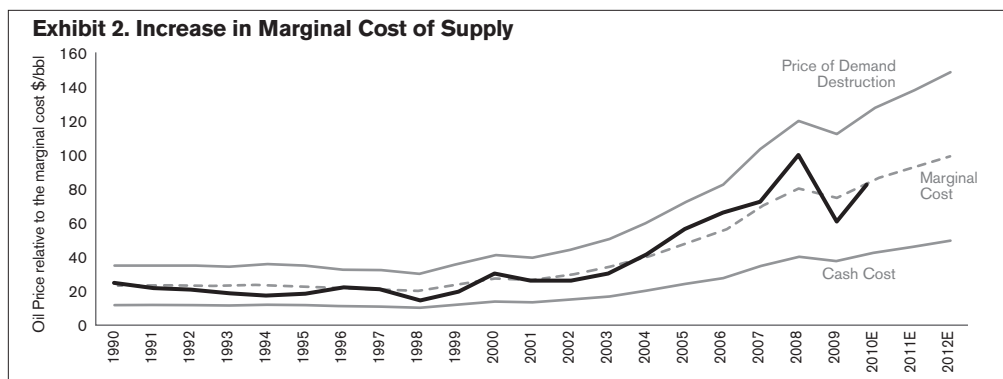
The objective of any asset allocation model is to generate a diversified portfolio which optimizes real risk-adjusted returns. Most investors rely on an asset-based framework, using historical correlations and returns to determine allocations. This process breaks down, however, when fundamentals for specific asset classes begin to change. As fundamentals shift, a disconnect can arise between the underlying assumptions and reality.

We contend that commodity fundamentals began to change in the late 1990's. Twenty years of underinvestment in supply coupled with the emergent demand from developing economies resulted in a significant reduction in spare capacity for many commodities.



Source: Sanford Bernstein

In addition, the marginal cost of supply for most commodities began to rise, after falling in real terms for nearly three decades. The increase is due to the continued maturation and declining efficiency of the supply base. For example, oil reserves per well have declined more than 50% over the last decade, while copper and gold head grades have dropped approximately 40% over the same time frame. Future projects will require higher prices to generate economic returns, meaning that the incentive price needed for incremental production to meet incremental demand will continue to increase.



Source: Sanford Bernstein

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These shifts in commodity fundamentals have important implications for investors, and have caused many institutions to reassess the way in which they gain exposure to the asset class. In this paper, we analyze the three primary attributes associated with commodities – diversification, inflation protection, and equity-like returns – and address how underlying changes in excess capacity and the rising marginal cost of supply impact each of them. We then compare commodity futures versus natural resource equities in the context of these three attributes, noting that over the past decade, natural resource equities have provided superior real risk-adjusted returns relative to commodities. Having acknowledged the shift in commodity fundamentals, we conclude by making the case for an allocation to an actively managed natural resource equity strategy within a broadly diversified portfolio.

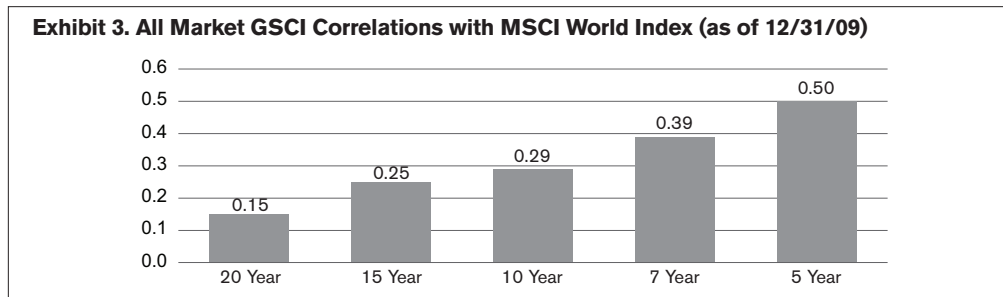
Commodities Investing

There are a number of ways to gain exposure to commodities. An investor may take physical delivery of a commodity by owning barrels of oil, gold bullion, or bushels of wheat – an impractical approach for most. More typically, investors gain exposure to commodities through commodities futures such as the S&P Goldman Sachs Commodity Index (S&P GSCI)² and the Dow Jones-UBS Commodity Index³ (DJ-UBS). Alternatively, investors can access the space by owning equity interests in the companies that produce the commodities.

Diversification Benefits

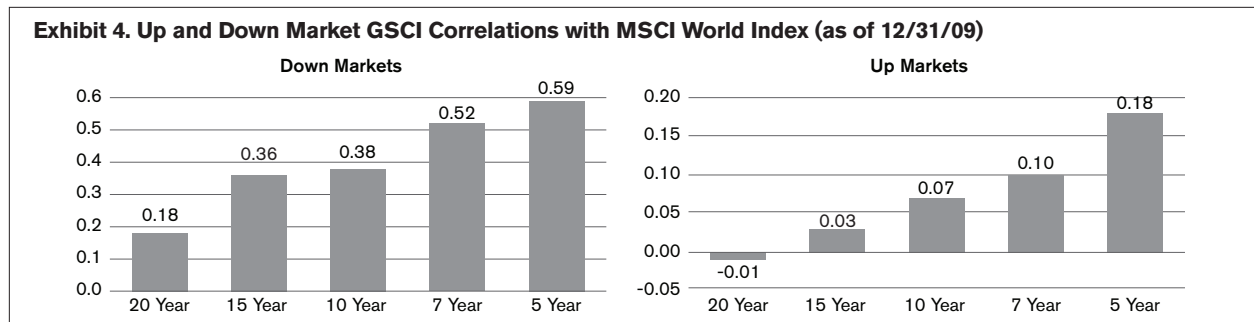
One of the primary drivers for allocations into commodities has been the diversification benefits. Many investors cite data going as far back as 40 years to illustrate the fact that commodities have exhibited low correlations versus other asset classes.

From 1970-1999, commodities futures strategies were negatively correlated with both equities and bonds, making them an ideal diversification tool. However, over time, the correlations between commodities and equities have increased, as seen in the chart below.



Source: RS Investments; FactSet

When the correlations are disaggregated into periods in which equities generated positive returns and periods in which equity markets declined, two key observations can be made.



Source: RS Investments; FactSet

First, most of lower correlation exhibited in “All Markets” is a function of the correlations generated when the equity markets are generating positive returns – precisely the time when portfolio protection is needed least. Second, “Down Market” correlations have increased significantly, rising more than 40% over the last decade. The inclusion of low to negatively correlated assets in a diversified portfolio is intended to offset negative equity returns, and it is clear that commodities have become increasingly ineffective in that role.

We believe the rise in correlation between commodities and equities can be traced to a simple factor: reductions in spare capacity. In the decades leading up to the late 1990s, there was excess productive capacity for most commodities due to new technologies and new discoveries that increased supply at lower real unit costs. As a result, meaningful increases in commodity prices were driven primarily by supply shocks such as the Arab Oil Embargo and the First Gulf War, as opposed to fundamental changes in the supply/demand balance. These supply shocks caused commodity prices to rise, with the threat of inflation resulting in declines in the equity markets. As shown in Exhibit 5 below, commodities and equities were negatively correlated in downturns in the equity markets leading up to the late 1990s.

Exhibit 5. Commodity and Equity Returns in Four Prior Downturns (1970–1990)				
	Jan '73–Sep '74	Dec '80–Jul '82	Sep '87–Nov '87	June '90–Oct '90
S&P GSCI Total Return Index ²	127.35%	6.40%	1.78%	49.99%
S&P 500 Index ⁴	-39.70%	-11.79%	-29.58%	-11.08%
MSCI World Index ⁵	-40.12%	-14.33%	-20.36%	-24.01%

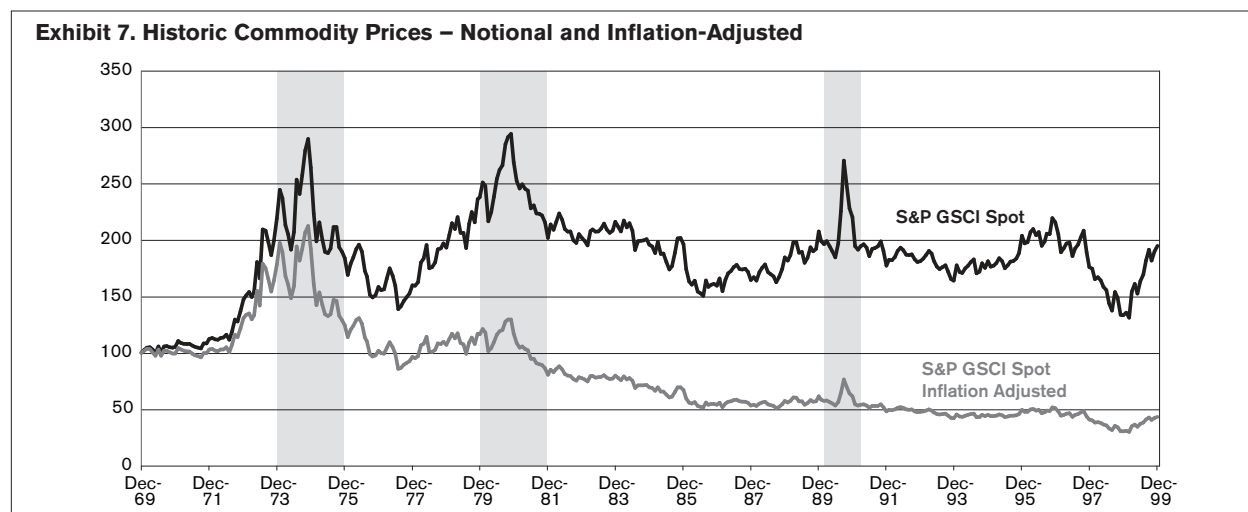
By the late 1990s, much of the excess capacity had been absorbed following two decades of underinvestment in new supply and steady demand growth. From that point forward, changes in global economic activity have had a more meaningful impact on commodity price cycles. While supply shocks may still lead to periods of low to negative correlation, the equity market and commodity market cycles are now driven by a common variable – economic activity – and, as such, we expect correlations to remain elevated going forward. Exhibit 6 illustrates this point by showing that in each of the market downturns since 1998, commodities and equities have been positively correlated. Furthermore, the differentiation between commodity and natural resources equities, as represented by the S&P North American Natural Resources Sector Index is not significant.

Exhibit 6. Commodity and Equity Returns in Last Three Downturns (1998–2009)			
	Jul '98–Aug '98	Feb '01–Sep '01	June '08–Feb '09
S&P GSCI Total Return Index	-13.30%	-18.93%	-64.66%
S&P 500 Index	-15.37%	-23.12%	-46.41%
MSCI World Index	-13.45%	-24.64%	-49.82%
S&P NANRSI ⁶	-22.25%	-17.89%	-55.52%

The distinction between commodities and natural resource stocks in terms of their respective down market correlations has become much less meaningful. It is no longer clear that commodities provide better diversification benefits than natural resource equities.

Inflation Protection

Inflation protection is often cited as another primary rationale for allocating capital to commodities. Historically, commodities have helped to offset the impact of short-term supply shocks on portfolios. For instance, oil price spikes in 1973-74, 1979-80, and 1990 were caused by geopolitical events in the Middle East. These periods were characterized by a rapid rise in commodity prices that negatively impacted the equity markets and resulted in an increase in consumer and producer prices. However, because increases in commodity prices were driven more by supply shocks than by fundamental changes in longer-term supply/demand trends, the price spikes were relatively short-lived and were generally followed by even greater declines in commodity prices, as shown in Exhibit 7 below.



Source: FactSet, RS Investments

In fact, for the better part of 30 years, commodity prices declined in real terms and did little to protect the long-term purchasing power of a portfolio.

Thus, the inflation protection characteristics normally associated with commodities futures have not been a function of spot commodity prices. In two of the three decades between 1970 and 2000, spot commodity prices had the lowest correlation with changes in inflation of any of the three return streams related to commodity futures indices, which can be disaggregated as follows:

1. Spot Price – changes in the spot price of the underlying commodity
2. Roll Yield – returns generated (lost) from the futures curve when it is in backwardation (contango)
3. Interest on Collateral – interest earned on collateral posted when purchasing the futures contract

In fact, it is the interest on collateral that has had the highest correlation with inflation, which is not surprising as the collateral is effectively a portfolio of short duration and inflation-protected bonds. Collateral interest's correlation with inflation was highest in the 1970s, and is the only one of the three component returns which has been consistently positive net of inflation across all measured periods.

Exhibit 8. Component Returns of Futures Contract – Correlation with Inflation				
	30 Year (1970–1999)	10 Year (1970s)	10 Year (1980s)	10 Year (1990s)
S&P GSCI Total Return	0.01	(0.05)	(0.15)	0.15
S&P GSCI Price Return Impact	(0.01)	(0.07)	(0.08)	0.05
GSCI Roll Yield Impact	0.01	0.02	(0.31)	0.37
GSCI Interest on Collateral Impact	0.50	0.66	0.56	0.38

Source: FactSet, RS Investments

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In addition, the inflation protection characteristics of commodities have been negatively impacted by shifts in the futures curves over the last 10 years. Specifically, the negative roll yield caused by the futures curves being in contango more frequently than in the past has offset 75% of the returns generated by spot prices between 2000-2010. We contend that the shift in the futures curve is related to the improvement in underlying fundamentals for most commodities. In particular, limited spare capacity and rising marginal cost of supply should lead to futures curves discounting higher long-term commodity prices more frequently.

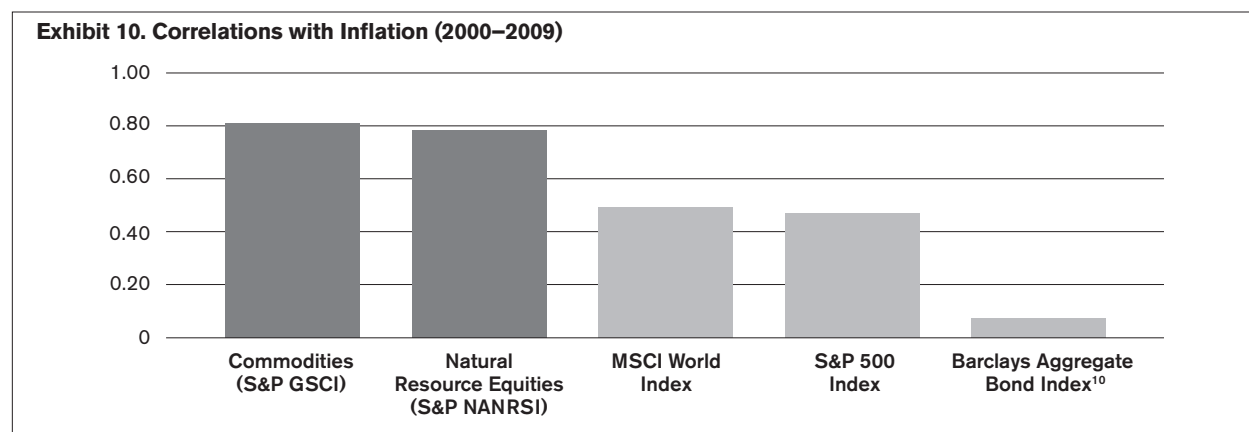
As long-term commodity price expectations have risen, natural resource stocks have outperformed commodities, as shown in the table below. The significant difference in returns generated by equities is due largely to the benefits associated with operating leverage, as well as the negative impact of roll yield on commodity indices.

Exhibit 9. Commodity and Natural Resource Index Returns (2000–2009)		
Commodities	Cumulative	Annualized
S&P GSCI Total Return Index	63.69%	5.05%
Dow Jones UBS (AIG) Commodity Index Total Return ³	99.12%	7.13%
Reuters/Jefferies CRB Total Return ⁷	137.17%	9.02%
Natural Resource Equities		
S&P North American Natural Resources Sector Index	141.46%	9.22%
MSCI World Commodity Producers Index ⁸	161.95%	10.11%
MSCI Commodity Related Equity Index (MSCI CRX) ⁹	255.30%	13.52%

(1/2000-12/2009)

Past performance is not a guarantee of future results

The data suggests that natural resource equities have been at least as effective as commodities in protecting investors from longer-term commodity price inflation, which is the primary focus for institutions with long-duration liabilities. In fact, both asset classes exhibited similar correlations with inflation since the late 1990s. While supply shocks may still result in brief periods when commodities outperform natural resource equities, we contend that the favorable fundamentals for most commodities should result in continued upward pressure on commodity prices over time. This trend should allow natural resource equities to continue to outperform commodities and act as a more effective hedge against longer-term inflation.



Source: FactSet; Bureau of U.S. Labor Statistics based on annual data: 1/2000-12/2009.

Another way to analyze the anticipated inflation benefits associated with commodity futures and natural resource equities is to address the impact of unexpected shifts in long-term commodity price assumptions. Both equities and the futures market reflect future expectations. A futures curve in contango suggests that the commodity market is discounting higher long-term commodity prices. With the exception of gold, natural resource equities tend to discount flat commodity prices in the future, often at levels which are at or below current spot prices. This relationship, in conjunction with the operating leverage inherent to a commodity producer, would result in natural resource equities providing superior protection against unanticipated increases in inflation expectations.

In summary, the inflation protection characteristics commonly associated with commodities futures have been impacted by the underlying shift in fundamentals. Commodity futures will likely continue to provide superior protection against short-term supply shocks. However, over the last decade natural resource equities have generated superior returns relative to commodities and provided similar correlations to long-term inflation trends. We contend that there is a clear case for the inclusion of natural resource equities as a means to protect the purchasing power of a portfolio.

Returns

In addition to diversification and inflation-protection, investors have also sought exposure to commodities for unique sources of returns. However, the equity-like returns generated by commodity indices have not been a function of rising real commodity prices. As discussed above, commodity prices declined in real terms until the late 1990s, yet the S&P GSCI generated real returns of 11.71% annualized from 1970–1999. Instead, the equity-like returns commonly associated with commodity investments have historically been driven more by the returns related to the interest earned on collateral and the roll yield. The table below shows the contribution of the three sources of return to the overall returns for the S&P GSCI Total Return Index from 1970–1999 both in aggregate and by decade.

Exhibit 11. Contribution to S&P GSCI Annualized Returns by Component (1970-1999)				
	30 Year (1970–1999)	10 Year (1970s)	10 Year (1980s)	10 Year (1990s)
GSCI Total Return	11.71%	21.25%	10.67%	3.89%
Spot Price Returns ¹¹	2.24%	9.05%	-1.37%	-0.63%
Roll Yield Returns	2.08%	4.62%	2.41%	-0.53%
Interest on Collateral Returns	7.39%	7.58%	9.62%	5.05%

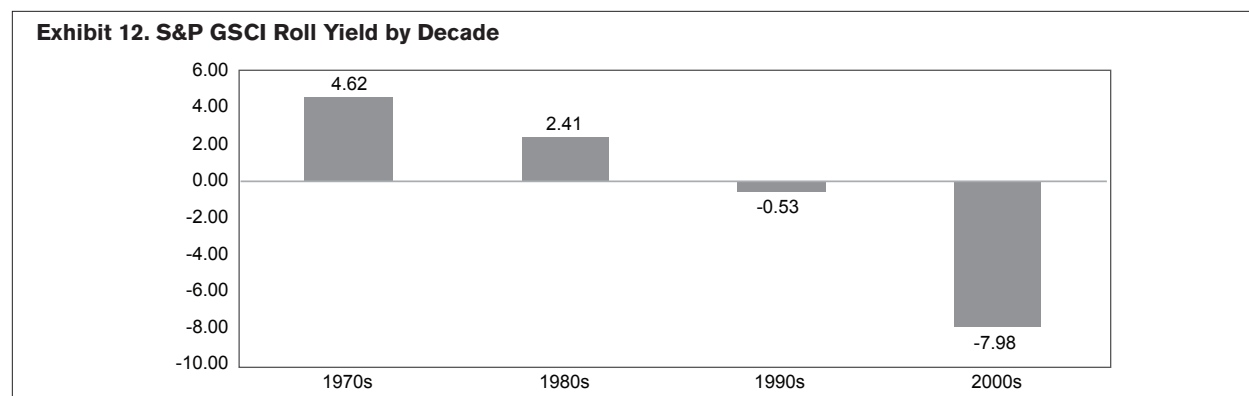
Source: FactSet, RS Investments

Even in the inflationary 1970s, interest earned on collateral and roll yield generated 57% of the total return of the S&P GSCI. This is not surprising given that the futures curves for most commodities were generally in backwardation while interest rates were relatively high during much of this period. Thus, the commonly accepted idea that “commodities offer inflation protection and equity-like returns” is based largely upon the past performance of short duration bonds and, secondarily, the historical shape of the futures curves for commodities – both of which are very different today. The behavior of commodity prices has historically had very little to do with either the returns generated by commodity indices or the inflation protection benefits purportedly offered by such vehicles.

Roll Yield

Given the lack of spare capacity for most commodities, and given the outlook for continued upward pressure on the marginal cost of supply, it is reasonable to expect the futures market to discount higher commodity prices moving forward. This is a much different dynamic than in previous decades, where the threat of supply disruption prompted near-month commodity prices to spike while the rest of the curve correctly discounted a return to a negative real pricing environment.

As seen in the following chart, over the last 40 years roll yield has moved linearly from being a significant positive driver of overall commodity futures returns to being a material negative. We contend that this inversion largely is due to the improvement in fundamentals for many commodities. Clearly the trend suggests that roll yield is not mean reverting and is not solely a function of short-term changes in inventories.



Source: FactSet, RS Investments

As noted previously, the shift in the futures curve has also largely offset the returns generated by rising spot commodity prices over the past 10 years. In fact, the table below shows that in each of the last three decades, spot price returns and roll yield returns have effectively negated each other.

Exhibit 13. Spot Price and Roll Yield Returns (1980-2009)			
	1980s	1990s	2000s
Spot Price	-1.37	-0.63	10.16
Roll Yield	2.41	-0.53	-7.98

Source: FactSet, RS Investments

Ironically, the improvement in fundamentals that has attracted investors to commodities is reflected in the significant shift in commodity futures curves and is the reason why allocations to commodities may be less effective in generating attractive returns and protecting investors from longer-term inflation than they have been historically.

Interest on Collateral

The interest earned on collateral has been another important source of returns for investors, generating 63% of commodity index returns from 1970-1999. Most commodity investors use short duration notes and inflation protected securities as collateral, as historically these investments have effectively captured the impact of fluctuations in commodity prices. However, inflation protected securities are indexed off changes in consumer prices, which may or may not reflect underlying commodity price inflation going forward. In fact, since 2000, U.S. Consumer Price Index (CPI) has increased less than 3% per annum, while oil prices are up almost 12% per year. In 2009, many commodity prices more than tripled from their March lows, while CPI increased by 500bps from peak to trough. The disconnect between commodity prices and consumer prices is a function of differences in spare capacity. Continued increases in productivity, significant investments in capital equipment, and a large pool of unemployed workers have created a capacity overhang which many economists point to when discussing the outlook for finished goods pricing. While that may be true, the distinct lack of spare capacity in commodities and the continued upward pressure on the marginal cost of supply has resulted in and, we contend, will continue to result in material increases in long-term commodity prices. Thus, while collateral interest has historically been a critical component in the returns generated by commodity investors, the outlook going forward is far less clear.

Commodities vs. Equities

When comparing the potential returns generated by commodities with those of natural resource equities it is important to recognize that commodities themselves do not create value – they simply fluctuate in price. However, natural resource equity strategies offer investors two unique sources of return: 1) the ability to invest in companies that create value independent of commodity prices, and 2) the ability to gain exposure to commodities that are not traded on futures exchanges and are not typically owned in diversified equity portfolios.

Natural resource companies with low-cost advantaged assets can create value irrespective of changes in commodity prices because of their positions on the supply cost curve. Furthermore, this value compounds over time to the benefit of the long-term investor. While natural resource stocks may go up and down with movements in the underlying commodity price over short periods of time, they track changes in net asset value over longer periods of time. As a result, share prices can materially outperform commodity prices for those advantaged natural resource companies with low cost assets that consistently grow net asset value across a commodity price cycle. The ability of a natural resource company to create value is a key point of differentiation between commodities and natural resource stocks.

In his book *Pioneering Portfolio Management*, David Swensen highlights the importance of this source of returns when comparing commodities with other real asset investments:

Unlike commodity indices, which give investors simple price exposure, well-chosen and well-structured real assets investments provide price exposure plus an intrinsic rate of return. For example, oil and gas reserve purchases in the past two decades generated low double-digit rates of return above and beyond the return from holding period increases in energy prices. Price exposure plus an intrinsic rate of return trumps price exposure alone...Pure commodity price exposure holds little interest to sensible investors.

As a result of the value created by advantaged natural resource companies, natural resource stocks have outperformed commodities across the cycle. Furthermore, the owner of advantaged assets has outperformed both the commodity and the underlying natural resource indices, which are comprised of both advantaged and disadvantaged natural resource companies. The table below shows how the stocks have outperformed commodities and how portfolios focused on advantaged natural resource companies, such as RS Global Natural Resources Fund, have outperformed both the commodity and the underlying natural resource indices across a commodity price cycle.

Exhibit 14. Performance Comparison (as of June 30, 2010)				
Global Equities	1 Year	3 Year	5 Year	10 Year
MSCI World Index (MSCIWI)	10.77%	-10.94%	0.61%	-0.53%
Commodities				
S&P GSCI Commodity Index (GSCI)	-5.43%	-12.45%	-8.13%	0.90%
Dow Jones-UBS Commodity Index (DJ-UBS)	2.75%	-8.36%	-1.32%	4.41%
Reuters/Jefferies CRB (RJ-CRB)	3.55%	-5.26%	-0.40%	5.86%
Natural Resources Equities				
RS Global Natural Resources Fund, Class A				
Without Sales Charge	20.96%	-5.49%	6.90%	14.46%
With Sales Charge	15.20%	-7.02%	5.87%	13.91%
S&P North American Natural Resources Sector Index™	13.43%	-6.89%	5.70%	7.65%
MSCI World Commodity Producers Index (MSCI WCP)	2.42%	-8.91%	5.24%	8.48%
MSCI Commodity Related Equity Index (MSCI CRX)	15.65%	-2.53%	10.50%	12.94%

Past performance is not a guarantee of future results. Performance returns for periods of less than one year are not annualized.

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 total gross/net annual operating expense ratios as of the most current prospectus for the Fund, Class A shares are 1.50%/1.45%. The net expense ratio reflects a contractual expense limitation which will continue through 4/30/11. The performance quoted "with maximum sales charge" reflects the current maximum sales charge of 4.75% that became effective on October 9, 2006. 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. A "deferred sales charge," also known as "back end load" or "CDSC," is incurred when liquidating an A share purchase over \$1 million, for example, before a specified holding period. 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. Performance results assume the reinvestment of dividends and capital gains. Current and month-end performance information, which may be lower or higher than that cited, is available by contacting RS Investments at 877-500-2388 and is frequently updated on our Web site: www.RSinvestments.com.

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In addition to the returns related to owning resource companies with advantaged assets, natural resource equity strategies also offer investors exposure to many commodities that are not traded on futures exchanges and are not typically owned in equity portfolios, including water, metallurgical and thermal coal, iron ore, potash, salt, aggregates, liquefied natural gas, power (from various generation sources including wind, solar, hydro, nuclear, and natural gas), phosphate, timber, and industrial gases, to name a few. Many of these commodities are impacted by factors not directly related to economic activity including seasonal weather changes, land usage, global dietary standards, population growth, and technology. In addition, prices for these commodities are not distorted by institutional fund flows into and out of the commodity futures market. As a result, real asset strategies can be aided by the diversification benefits associated with investing in the producers of those commodities that are not investable through either actively or passively managed commodity vehicles and are not typically owned in more diversified equity portfolios.

Finally, while we believe that long term commodity prices will continue to rise due to the lack of spare capacity and the maturation of the producing assets, in the event that commodity price inflation does not materialize, the unique return streams generated by advantaged natural resource assets would provide a compelling offset to the simple volatility offered by an investment in commodities.

Portfolio Impact

Empirical evidence suggests that a long-term allocation to natural resources equities within a real asset strategy has provided investors with superior real risk-adjusted returns relative to a direct investment in commodities futures. In addition to providing exposure to long-term commodity price trends, natural resource equities also provide investors with the two unique sources of return outlined above. The table below shows the risk-adjusted returns and down-market correlations of the various commodity and natural resource equity indices and RS Global Natural Resources Fund over the past 10 years.

Exhibit 15. 10-Year Performance Comparison of Natural Resource Equities and Commodities (Jan. 1, 2000–Dec. 31, 2009)						
	Cumulative Return	Annualized Return	Annualized Standard Deviation	Sharpe Ratio	Sortino Ratio RF MAR	Down Market Correlation to MSCI World
Global Equities						
MSCI World Index (MSCIWI)	2.34	0.23	16.51	-0.16	-0.21	1.00
Commodities Futures						
S&P GSCI Total Return (GSCI)	63.69	5.05	25.20	0.09	0.13	0.38
Dow Jones UBS Commodity Index Total Return (DJ-UBS)	99.12	7.13	17.34	0.25	0.36	0.33
Reuters/Jefferies CRB Total Return (RJ-CRB)	137.17	9.02	17.83	0.35	0.51	0.37
Natural Resources Equities						
S&P North American Natural Resources Sector Index (NANRSI)	141.46	9.22	23.41	0.27	0.41	0.63
MSCI World Commodity Producers Index (MSCI WCP)	161.95	10.11	20.16	0.36	0.54	0.63
MSCI Commodity Related Equity Index (MSCI CRX)	255.30	13.52	23.27	0.46	0.68	0.68
RS Global Natural Resources Fund (Net)	357.12	16.41	23.70	0.57	0.88	0.49

Past performance is not a guarantee of future results

Using data from above, we constructed two types of portfolios, one blending diversified equities with commodities and the other blending diversified equities with natural resource equities. Exhibit 16 shows the risk-adjusted returns and down-market correlations for those blended portfolios and highlights the significant improvement in returns related to using natural resource equities instead of commodities. In fact, over the last 10 years, adding natural resource equities to an existing equity allocation, instead of commodities, would have resulted in a material improvement in risk-adjusted returns, as measured by the Sharpe or Sortino Ratio, with no meaningful impact on correlations with the equity markets during downturns.

Exhibit 16. Impact on Portfolio Risk-Adjusted Returns						
Commodities	Cumulative Return	Annualized Return	Annualized Standard Deviation	Sharpe Ratio	Sortino Ratio RF MAR	Down Market Correlation to MSCI World
MSCIWI and GSCI 85%/15%	12.28	1.14	-0.95	0.07	0.09	-0.04
MSCIWI and DJUBS 85%/15%	13.33	1.24	-1.26	0.07	0.09	-0.03
MSCIWI and RJCRB 85%/15%	16.55	1.52	-1.25	0.09	0.12	-0.03
Natural Resources Equities						
MSCIWI and NANRSI 85%/15%	16.04	1.47	0.25	0.09	0.12	-0.02
MSCIWI and MSCI WCP 85%/15%	16.95	1.55	-0.10	0.10	0.12	-0.01
MSCIWI and MSCI CRE 85%/15%	22.96	2.05	0.36	0.13	0.17	-0.02

The Blended Portfolio Returns shown are hypothetical and do not represent results for actual investment vehicles. These hypothetical returns were achieved by weighting the monthly returns of the MSCI World Index (85% weight) and the commodity index, natural resources equity index. The returns do not reflect management or administrative fees of any kind. The returns also do not reflect any transactions costs associated with re-balance activity. Results assume the reinvestment of all dividends.

Conclusion

Most of the benefits commonly associated with owning commodity indices have been a function of interest rates and the significant backwardation in futures curves that once characterized over-supplied commodity markets. These dynamics have changed as commodity fundamentals have shifted. Increases in commodity prices today are driven less by supply shocks than by low spare capacity and the rising cost of supply.

As a result, correlations between commodities and equities have changed as well. Commodities have become much more correlated with equities, particularly in down markets, which is exactly when diversification becomes paramount. Although supply shocks may result in brief periods of negative correlation, changes in commodity prices are being driven more by changes in demand, which are highly correlated with changes in GDP and the equity markets. Therefore, we expect down market correlations between commodities and equities to remain elevated and to be a less meaningful point of differentiation with natural resource equities.

The shift in fundamentals has also impacted future price expectations, as best illustrated by the changes in the forward curves. If, in fact, the marginal cost of supply for commodities continues to rise and futures curves remain in contango more frequently than in the past, we believe that natural resource equities will continue to outperform commodities and thus will continue to provide a better hedge against longer-term inflation.

Finally, natural resource equities offer two unique and meaningful sources of returns that cannot be captured through direct investments in commodities and which typically are not exploited in diversified equity strategies. First, advantaged natural resource companies can create value independent of commodity price and this value compounds to the benefit of the long-term shareholder. Second, natural resource equity investors can invest in the producers of a number of attractive commodities that are not traded on futures exchanges. These sources of return allow natural resource equities to offer much more attractive risk-adjusted returns than commodities while also providing additional diversification benefits to investors. These return streams typically are not exploited by diversified equity managers and therefore are not usually captured within an existing allocation to the broad equities market. If commodity inflation does not occur, the unique returns associated with low cost commodity producers provide an offset to the simple volatility offered by a direct investment in commodities.

Many long term investors use allocations to real assets to protect the purchasing power of their assets as opposed to defending against temporary price spikes. The data suggests that natural resource equities can be more effective than commodities for investors looking to create a permanent allocation to real assets as a means to diversify portfolios, protect against longer-term inflation, and improve expected risk-adjusted returns.

For these reasons, we expect real asset allocations to continue to evolve as more investors seek out those strategies that actually create value across a commodity price cycle.

As with all mutual funds, the value of an investment in the Fund could decline, so you could lose money. Investing in small-and mid-size companies can involve risks such as having less publicly available information, higher volatility, and less liquidity than in the case of larger companies. Funds that concentrate investments in a certain sector may be subject to greater risk than funds that invest more broadly, as companies in that sector may share common characteristics and may react similarly to market developments or other factors affecting their values. Investments in companies in natural resources industries may involve risks including changes in commodities prices, changes in demand for various natural resources, changes in energy prices, and international political and economic developments. Foreign securities are subject to political, regulatory, economic, and exchange-rate risks not present in domestic investments. The value of a debt security is affected by changes in interest rates and is subject to any credit risk of the issuer or guarantor of the security.

1 Source: Barclays Capital

2 The S&P Goldman Sachs Commodity Index (S&P GSCI) is used in this paper to illustrate the risk and returns of an investment in commodities. It is a composite index of commodity sector returns, representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully-collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets.

3 The Dow Jones-UBS Commodity Index (DJ-UBS) is used in this paper to illustrate the risk and returns of an investment in commodities. It is composed of futures contracts on 19 physical commodities. The commodities in the index are traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

4 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.

5 The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of June 2007 the MSCI World Index consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

6 The S&P North American Natural Resources Sector Index™ (NANRSI), which is not covered by the report of independent accountants, is a modified capitalization-weighted index of 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 and do not include any transactions costs, management fees or other costs. As of December 31, 2007 the strategy has changed its benchmark from the Lipper Natural Resources Fund Index to the S&P North American Natural Resources Sector Index because the S&P North American Natural Resources Sector Index is composed of securities of companies in the natural resources sector while the Lipper Natural Resources Fund Index is composed of mutual funds that invest in the natural resources sector.

7 The Thomson Reuters/Jefferies CRB (RJ-CRB) Index maintains broad diversification through 19 commodities representing all commodity sectors. Commodities are equitably distributed whenever feasible, though exposure to selected markets, in particular those within the petroleum sector, are modified to create a liquid and rational index.

8 The MSCI World Commodity Producers Index (MSCI-WCP) is an equity-based index designed to reflect the performance related to commodity producers stocks. The MSCI World Commodity Producers Index is a free float-adjusted market capitalization-weighted index comprised of commodity producer companies based on the Global Industry Classification Standard (GICS®).

9 The Morgan Stanley Commodity Related Equity Index (CRX) is an equal dollar weighted index based on shares of widely held companies involved in commodity-related industries such as energy (e.g. oil and gas production and oil field services and equipment), non-ferrous metals, precious metals, agriculture and forest products.

10 The Barclays Capital U.S. Aggregate Index is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues, rated investment grade or higher, and having at least one year to maturity. Unlike the Fund, the index does not incur fees or expenses.

11 The S&P GSCI™ Spot index tracks the price of the nearby futures contracts, not returns available to investors. At the end of every business day, the S&P GSCI™ is composed of the same proportions by weight of the underlying commodities and expirations as the portfolio represented by the S&P GSCI™ Excess Returns.

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