

Yielding to Dividends

Finding dividend-paying companies with the added ability to create equity value is an uphill task. RS Equity Dividend Fund manager Ray Anello and his team of eight sector-specific fundamental analysts and two quantitative analysts employ a well-disciplined investment strategy to identify those individual companies that not only can maintain their current dividends, but grow them over time.

Q: What is your investment philosophy?

A: We are focused on well-positioned dividend-paying companies that have compelling business opportunities and the financial flexibility to grow earnings power per share, which results in rising dividends and equity value per share.

Q: What is a company indicating when it pays a dividend?

A: We believe that a regular dividend payout reflects a different dimension of a company's good financial health and management discipline. It lowers the company's overall business and market risk profile and projects a better balance sheet and higher predictability in earnings stream.

Q: What are the key elements of your investment process?

A: Our universe of 2,000 dividend-paying stocks includes foreign stocks, but our primary focus is US companies.

On an individual stock basis, we generate stock ideas by employing

quantitative screens and through our fundamental due diligence process. This process includes meeting with company managements, competitors, suppliers, sell-side analysts, and other industry experts. Once we determine which ideas are worthy of more intensive fundamental analysis, we seek to answer one key question: How can this company create equity value?

All stocks in the portfolio are analyzed thoroughly by our team of eight fundamental analysts and portfolio manager. Together we set upside/downside twelve month price targets.

There are three key indicators included in our quantitative screens - the free cash flow yield, dividend yield and dividend growth.

We believe free cash flow yield indicates financial flexibility for the creation of earnings power per share. In the portfolio we emphasize companies with a track record of dividend growth. In fact, over 80% of the existing portfolio has stocks that have



RAYMOND ANELLO is a portfolio manager with 19 years of investment management experience. Since November 2003, Anello has been the lead portfolio manager for an institutional account that follows the same strategy as the RS Equity Dividend Fund (REDAX) which was launched on July 31, 2007.

Over the course of his career, Anello has served as an analyst focusing on key sectors of the economy, such as energy, utilities, telecom, basic materials, healthcare services, media, and transportation, building a proven track record of stock selection

grown or are expected to grow the dividend by at least 3% in the following year.

While dividend yield is important to us, growing earnings power per share and sustaining and increasing dividends is our primary focus.

Q: Could you highlight your fundamental due diligence process?

A: The key factors we assess are the company's two to five year business opportunities, management's track record, the competitive position and the financial flexibility of the company. By financial flexibility we mean a strong balance sheet and free cash which can help support equity value creation.

We estimate earnings and dividend growth in setting our upside/downside twelve month target. This helps determine timing and position size.

Q: Can you give some examples of how research process has translated to stock picks?

A: Halliburton is a good example. It is one of the biggest oil-field management companies in the world with a yield that increased to 1% last year. Around 60% of their earnings are generated in North America and 40% from

their international business. One of the goals of the company is to grow their international business which has been growing over 20% per year recently. This is being accomplished through internal development, acquiring new technologies and adding new products or services to their worldwide distribution system. The company expects to make on average \$1 billion in acquisitions per year with a focus on international operations.

Halliburton management is also fine-tuning their earnings leverage. They exchanged shares of KBR (formerly their Engineering and Construction subsidiary) to shareholders enabling the retirement of more than 8% of outstanding shares. Their balance sheet is strong and they are in the middle of a \$5 billion stock buyback. By early next year, they will have retired 25% of their shares outstanding. We estimate that adds about 30 or 40 cents per share to their earnings power. In addition, Halliburton should generate about \$2 billion in free cash flow per year over the next couple of years. They have over \$2 billion of cash on the balance sheet and under \$3 billion in debt so they have got very good financial flexibility to grow in the international market and complete the buyback.

Q: How do you go about portfolio construction?

A: We are an all-cap fund. Currently about 50% of the portfolio is in large cap stocks defined as greater than \$10 billion market capitalization.

Our benchmark is the Dow Jones Dividend Select Index (DJDVY) an index consisting of 100 dividend-paying

companies. The Index identifies its holdings largely based on historical dividend yields and dividend growth. Our portfolio differs substantially from the Index, given our forward looking focus. We currently have positions in about 15 of these 100 stocks and 50 holdings in total that are not equally weighted. We monitor and actively manage our exposure vs. the Index looking at various relative sector weights. Position size is based on our confidence in the valuation components that we look for – the yield, yield growth, earnings power growth and the risks involved. Our largest position is about 5% of the portfolio, our smallest about 0.5%.

Q: Generally, what is your turnover both in names and in dollar amount?

A: As long-term investors, we have the ability to use volatility to our advantage. We trade to maintain our best risk-adjusted portfolio with a focus on our long-term goals. This approach has resulted in turnover statistics in the 150%-200% range. However, the name turnover is less than that. In a given year, it is probably more like 60% or 70%, reflecting our longer-term view.

Q: Any small cap names worth mentioning?

A: We recently bought a small-cap company called B&G Foods, a manufacturer and distributor of shelf-stable foods like pickles and baked beans. B&G Foods had been an unusual security, as it was a hybrid of equity and debt. At first, we avoided it as it sent confusing signals, and the debt aspect was unattractive. However, the company decided to convert all of the hybrid securities to common stock.

“We search for well positioned dividend paying companies that have the financial flexibility to grow earnings power per share, leading to rising dividends and equity value per share.”

The initial dividend was around 6%. Our consumer sector analyst Kristin Ketner-Pak thinks that management's track record is solid, the dividend is well covered and the balance sheet is strong. Some of their bigger competitors such as Kraft and ConAgra are downsizing. A small company like B&G can create equity value by acquiring brands that have not been focused on and invest and grow these brands.

Q: What are your buy and sell disciplines?

A: The biggest catalyst for us to sell a stock is when relative valuation becomes less attractive to other stocks in the portfolio or our watch list. Our goal is to improve the overall risk/reward of the portfolio. For example, we are finding good relative values in the REIT, MLP, and Utility sectors (dividend centric stocks which are most interest-rate sensitive). These sectors have all gone through healthy corrections. To fund these purchases we trimmed/sold some of our existing positions. The driving force was incrementally positive risk/reward relative to some of our existing holdings.


The net effect was an increase in our current yield, now roughly 4.3% and up about 90 basis points since June 30th.

Buying and selling decisions are also based on our long-term focus of a company's expected performance over the next two to five years. We sell a stock when the company fails in our expectations or dividend growth starts to slow.

Q: How do you mitigate portfolio risk?

A: We classify the portfolio into three main categories - dividend centric, non-cyclical and cyclical stocks. These classifications enable us to actively manage our portfolio risk. We try to find the best risk-adjusted valuations within these three categories.

Within the cyclical category, it's our belief that we are late in the basic materials cycle and the stocks are generally not attractive. We believe that the information technology sector is relatively more attractive driven by the long-term secular growth in broadband, wireless, and software. Consequently we are overweight technology and underweight basic materials relative to the index.

Figuring out what the market is assuming is also important in tackling risk. Earlier this year we felt that the market did not appreciate interest rate risk. This led us to underweight dividend centric stocks. Recently the market went through a sharp fear driven correction caused mostly by the subprime debt fallout. The market extrapolated this into a major crisis and many cyclical stocks not directly related to consumer mortgages were penalized. This caused us to take a fresh look at the two to five year outlooks and make any necessary adjustments to our risk-adjusted price targets. We took advantage of this market volatility, adding to stocks that have good opportunities to create equity value and grow dividends. We bought these stocks at what we feel are very attractive prices. 

RS Equity Dividend Fund

Symbol	REDAX
Website	www.rsinvestments.com
Address	RS Investments 388 Market Street Suite 1700 San Francisco, CA 94111
Tel. No.	816-843-8083
Inception	07/31/2007

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$1,000

FEES AND EXPENSES

12b-1 Fee	0.25%
Net Expenses	1.35%
Total Expenses	1.40%
Management Fee	0.60%
Max Redemption Fee	0.00%

PORTFOLIO MANAGER

Ray Anello	07/31/2007
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Data through: 06/30/07

Source: Company Documents; Lipper

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