Q4 | Wanger Investment Quarterly Letter

Dear Sir/Madam:

What Are We Thinking About This Quarter?

Eric Wanger Explains How a Credit Crunch Becomes a Credit Crisis

Ralph Wanger Reports on Bernie the Goniff

The Great Recession

Unfortunately, the world is still ending. GDP here (and nearly everywhere else) continues to drop rapidly. Current government numbers make a period of near-term deflation a real possibility. Deflation, the great bogeyman of the modern central banker is here: wages, commodities, asset prices, imports, exports and corporate earnings are all coming down at the same time. Unemployment is surging and credit is hard to get. "The Great Recession" is in full swing.

Despite impressive federal stimulus and dramatic interest rate spreads, banks are still not lending. As a result, the credit "crunch" is rapidly turning into a full-fledged credit "crisis." Read on. We have a lot to say on this topic.

How Long Until We Get There?

When will we see the bottom? That's the question everyone is asking. Obviously, we can only guess. Certainly, in the near term we will watch prices go down. It's hard to imagine that the prices of energy, housing and food could finish a broad-based decline before the end of summer unless governments step in to jack up prices. It's hard for us to see domestic unemployment bottoming out at least until late summer. Retail sales, commercial real estate, and food prices have yet to see their ultimate lows.

We expect that 2009 will be a net deflationary year, but that prices will start to go up again by late 2009 or early 2010.

How to Invest in this Horrible Climate

Patient investors can still make money by focusing on quality, valuation and yield. The best investors will find ways to capture all three: *Quality* means investing in firms that will grow and thrive in the long run. Such firms will find ways to use the current environment to become leaner, meaner, acquire control of valuable assets at fire-sale prices, rationalize costs and use patience and skill to leave their competitors in the dust. *Valuation* means investing with a disciplined approach to "buying well." Value-style investing is back with a vengeance. Simply put, value investors say, "show me the money." Invest based on dividends, yields, cash flows and earnings. *Yield* means getting paid current income to own securities. Even long-term growth investors should demand to be "paid to wait" for the markets to rebound. How? By cashing dividend and interest checks until the market--at its own time and on its own pace--rewards yield investors (when spreads eventually come in) by trading effective yield for capital appreciation.

What Happens Next?

When prices are done going down, they will go up again! We can't be sure whether all this massive federal stimulus will ultimately result in *inflation* (prices up, growth positive) or *stagflation* (prices up, growth nil). But we are confident that we will eventually see one of the two.

Yours,
Eric Wanger, JD, CFA

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From The Desk of Eric Wanger:

The Great Recession: Credit Crisis

Eric Wanger, JD, CFA

The biggest tragedy of this year may be the good companies taken down by the lack of available credit.

The biggest tragedy of this year may be the good companies taken down by the lack of available credit. Unless we can meaningfully address the credit crisis in the US (and most of the rest of the world), we will soon see good, solvent companies fail because they cannot refinance good, performing loans to continue their operations. The banking system is in disarray. Both the banks and their customers have responded with wave after wave of layoffs. But it won't be enough to repair shattered bank balance sheets. With or without "mark to market" accounting, many of the biggest banks in the country are operating on equity ratios so slim that they would be considered "busted" in ordinary times.

This is no mere credit "crunch." And not even the most die-hard free-marketer can simply refer to this situation as "creative destruction." There is no way we are going to get through this one without a significant injection of public money. How for example, will commercial real estate firms continue to operate without a well functioning debt market? Even the best managed operators use significant leverage and have a frequent need to "roll paper." We've already seen the auction rate securities and commercial paper markets freeze up over the last 6 months which played havoc on working capital.

But what is an ordinary credit "crunch" and why is this situation different? Why has it become a full fledged credit "crisis"?

What is a Credit Crisis?

Let's start with the term credit "crunch." It's a slang term which means:

An economic condition in which investment capital is difficult to obtain. Banks and investors become wary of lending funds to corporations, which drives up the price of debt products for borrowers….Credit crunches are usually considered to be an extension of recessions. A credit crunch makes it nearly impossible for companies to borrow because lenders are scared of bankruptcies or defaults, which results in higher rates. The consequence is a prolonged recession (or slower recovery), which occurs as a result of the shrinking credit supply. (Source: *Investopedia*)

Such a credit crunch is considered to be a manageable part of any meaningful economic trough. It's not fun, but it is a necessary part of a healthy capitalist economy. Credit gets more expensive and marginal projects get put on hold; the free market is applying appropriate checks and balances, creative destruction, the discipline of the market, etc. Eventually, demand for credit falls and rates come down, allowing the cycle to eventually repeat.

A credit "crisis," however, is a slang term for a severe, unmanageable version of a credit crunch. A credit crisis is a situation in which the tightening of credit and the ability of firms to ride out the economic downturn goes well beyond the ability of normal market forces (and central banks) to nudge the system back in the right direction.

That seems to be where we are right now. But why aren't the banks lending? Didn't we just inject hundreds of billions of dollars into the banking system?

Why is this Happening?

The man on the street will tell you that too many banks made too many bad loans, that the government was too lax in enforcing its rules, and that too many Wall Streeters got drunk on leverage. That all seems to be perfectly true. But what about the "Troubled Asset Relief Program" or "TARP"? At least $350 billion were already "injected" into US banks to prop up shaky balance sheets and get the banks to lend—with more on the way.

Banks are faced with a fundamental problem. Despite very attractive lending spreads, despite weak balance sheets, and despite short term deflation which actually increases the "real" profit for lending money, banks are simply terrified to loan money in an environment filled with riskier and riskier credits. Who knows who will go bust next?

Spreads may be high, but credit risk appears crippling. Rapidly climbing default rates make lending a very tough game for a solid bank. Weak banks simply don't want to play. Credit standards have gone up, interest rates have gone up and the "price" of credit has gone up in every form. But despite seemingly huge spreads available to anyone willing to lend, good companies will still go wanting.

No, this one really is different.

The textbooks explain how the history of banking and credit is interwoven with the history of economic cycles, macroeconomic sine waves with frequencies that can span decades. Such expansions and contractions are nothing

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The Great Recession: Credit Crisis (Continued)

new. As far as we know, they've existed as long as people have participated in credit or lending anywhere. The milder parts of the wave (lower amplitudes) are generally called "the business cycle" and the big ones (high amplitude) are called "booms and busts." The peaks and troughs have many names: highs and lows, easy credit and tight credit, optimism and pessimism, greed and fear, etc.

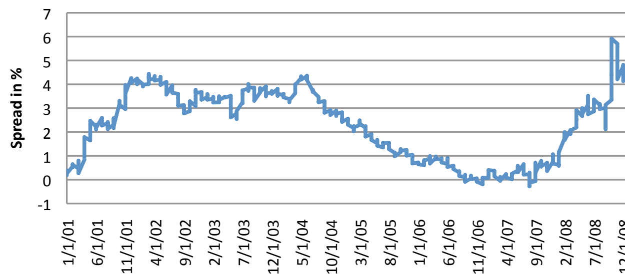
One key feature of these cycles is that they are irregular and unpredictable, both in magnitude and duration. Many statistical tools have been developed to measure them (GNP, GDP, CPI, M1, M2, unemployment rate, etc.) and many regulatory and governmental tools have been developed to try to mitigate their rampages (central banks, reserve ratios, government lending/borrowing, wealth redistribution, various forms of fiscal stimulation, etc.) Yet the business cycle is still considered as basic to capitalism as fleas to a dog.

But this credit crunch has broken out of the amplitude range we associate with a normal, even deep trough. This crisis starts with the "popping" of the biggest housing and credit bubble in history. America's home prices are down by more than 21% since their peak in 2006. (Source: Case-Schiller Housing Index) Many analysts expect another 10% drop across the country, which would bring the cumulative decline in nominal house prices close to that during the Depression. Worldwide losses on debt originated in America (primarily related to mortgages) is expected to exceed $1.4 trillion. Statistics from third quarter, 2008 showed that $760 billion had been written down by the banks, insurance companies, hedge funds and others that own the debt. The IMF's "base case" is that American and European banks will shed some $10 trillion of assets, equivalent to 14.5% of their stock of bank credit in 2009. (Source: Economist and IMF)

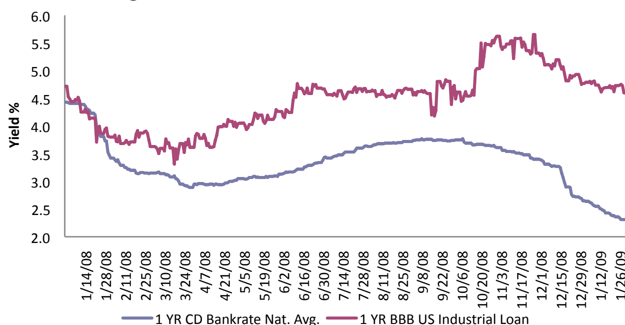
It's going to take a long time to get ourselves out of this one. But nearly every pundit we see has come to the same conclusion: This banking crises cannot be solved without public money. Whether we choose to continue recapitalizing banks through brute-force federal investment or use some RTC-style "bad bank" scenario, decisive government action will be required to minimize the damage to the economy. This one really is different.

Eric Wanger, JD, CFA is President of Wanger Investment Management, Inc & the Manager of the Wanger Long Term Opportunity Fund.

10 Year AA Industrial Rate less USD Overnight LIBOR



Funding Rates vs. Loan Rates



It's Not the Credit Spreads: A bank generates loan profits from the "spread" or difference between the interest it pays on deposits and funding sources vs the interest it receives from lending. Banks can currently make plenty of money loaning money to customers that will pay it back. (Source of Data: Bloomberg)

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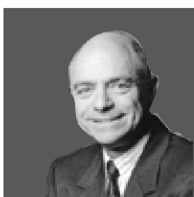
Ralph Wanger Reports:

Bernie the Goniff



Ralph Wanger, CFA

Every day you look at the newspaper Bernard Madoff is there, down jacket, baseball cap, and sheepish grin. Wow, is he famous! He combines Al Capone, John Wilkes Booth, and Hitler in badness, while still looking like your uncle Marvin. Why is this harmless-looking old guy hogging the headlines?

The first answer is — duh! — that he stole a lot of money. The papers keep using a $50 billion figure, but that is not a good estimate. The $50 B's came from Madoff's own mouth when he was being arrested, but here we have a bozo who never gave anyone a correct number in thirty years, and there is no reason to think that he changed into a truth-teller with this one.

Why do we obsess about Madoff?

But all the perceived losses could be near $40 billion.
The Madoff operation seems to have almost no funds left. Where did the money go? The Madoff family lived very well, shuttling between New York City, Palm Beach, and Cap d'Antibes, but not any more luxuriously than many other rich folks. He may have spent $3 million a year or so, but not enough to chew up even one billion in his lifetime.

A lot of the money was paid out to his customers, who used their Madoff "investment" as their cash reserves, and took out money regularly or occasionally. Since Madoff was faking trading but not doing any, all the cash outflows were fed by new money coming in the door. Just guessing, a billion dollars a year of payouts for twenty years makes $20 billion, half the missing bucks.

The Stalin Rule: Uncle Joe said, "One death is a tragedy, a million deaths are a statistic."

The other big chunk of money was from profits that were reported to clients but never existed at all. This was hard for folks to believe, because they were getting trade confirmations and monthly statements in the mail, a rude shock to find all of this fictional. Guessing again, if Madoff was telling people they were making 10% returns on a notional $10 billion in assets, and did this for twenty years, that would generate $20 billion in phony profits.

The two pots, $20 billion money paid out and $20 billion profits add up to $40 billion--about the size of the total fraud. So the disappearance of the funds is not really a mystery. Certainly the investigation now going on will add a lot of entertaining insights on the mechanics of the swindle.

What has to be explained still is why this scam is so fascinating. Madoff is not a big part of the economic problem. How can I say that? Look at some more numbers. Bernie blew $40 billion, an enormous sum, but total market losses (real estate, stocks and debt) are on the order of $40 trillion.

No one can grasp exactly what $40 trillion actually is, but one can calculate that it is 1000 times more than $40 billion. So if Madoff is one-tenth of one percent of the total losses, he is not a big part of the problem, only a teeny detail.

Why do we obsess about Madoff?

- Crooks are Cute: Robin Hood, Jesse James, John Gotti, and Ken Lay (Enron) are mythical figures that get movies made about them. Madoff fooled the rich and the brilliant for decades, a dramatic and ironic movie-to-be.
- Scapegoat: There are too many villains in the crash, and no heroes. Some of the villains are very important players in politics, banking, business, and piracy, and it is convenient to ignore them and pick one guy to focus attention on.
- Elders of Zion: The bad guys and the victims are Jews, and stories about Jewish bankers and speculators find a ready audience.
- Schadenfreude: Did you hear about poor Mrs. G? Yes, the woman who wouldn't come to your birthday party because she was traveling in Nepal. Well, she's broke now and…
- Behavioral Finance: Mentally you had your money divided into three layers. One was for safety, cash and high grade bonds. The second was long-term equity investment in mutual funds and hedge funds. The third tranche was for speculation and trips to Las Vegas. But your Madoff money was in the safe pool, the "Jewish T-bills". Losing the safe pool is more disconcerting than losing the same amount in the risk pool.

Ralph Wanger, CFA, is Senior Advisor to Wanger Investment Management, Inc.

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Bill Andersen:

Q4 Review: Putting a TARP over the Problem

The beginning of the fourth quarter saw the closest thing to a collapse of the financial system we've seen in 70 years.

Goldman Sachs and Morgan Stanley both became banks, thereby qualifying for government assistance. With that, the era of the independent, Wall Street investment bank came to an end. The new era will be dominated by large, government regulated (and partially owned) commercial banks.

The S&P 500 was down -21.9% for the fourth quarter. It was an historic period in financial markets in just about every way, including market volatility, the collapse of credit markets, government intervention, forced selling and negative returns. We will review this briefly, and then focus on how the current situation affects investors seeking income.

The crisis which had been building for over a year, reached a new height when investment bank Lehman Brothers failed in September. Lehman's debt and other securities were held by all sorts of investors, including banks, money market funds, hedge funds and foreign institutions. The failure set off a modern day bank run, with one of the oldest money market funds "breaking the buck" and rumors that supposedly sound financial institutions such as Morgan Stanley and Goldman Sachs were in trouble. When AIG failed several days later, the government had little choice but to step in and guarantee its obligations. AIG, a venerable insurance company, had gone to hell in just the past couple of years by putting on huge amounts of leverage and then writing hundreds of billions of dollars of insurance on the debt of companies like Lehman.

With markets virtually frozen at the end of September, the U. S. government announced the Troubled Asset Relief Plan, or TARP. The original idea of the plan was to help to recapitalize the financial system by purchasing the so-called toxic assets held by banks, brokers and other troubled financial institutions. The purchases were to be implemented by a "reverse auction." The plan was funded with $700 billion. On Sunday evening September 30, the Treasury held a conference call for the financial community to describe the plan. Towards the end of the call, someone asked how long the plan would take to implement. The answer was that the plan would be implemented over the next several weeks. The financial community was clearly looking for something much sooner, and over the next two weeks the markets crashed, with price declines of 20-30%. At this point the plan was overhauled and used mostly for direct investment in financial institutions.

Unlike financial crises of the last 30 years, this one has had a profound impact on economic activity. Earnings results for the fourth quarter were very weak, especially for economically sensitive companies like autos, steel, etc. Furthermore, the performance of economies outside the U. S. has been even worse, putting an end to idea that these countries could "de-link" from the U. S. The current recession/depression will be the biggest one in several generations.

Strategies for Income Investors

In seeking income, investors may be well advised to select companies with defensive business models which offer solid yields. The current depression in global economic activity threatens the dividend paying power of many companies. In fact, January, 2009 was the worst month for dividend cuts since at least 1956, which was when Standard and Poor's started keeping records. Investors may also want to focus on companies with minimal exposure to commodities, and which employ modest, if any, leverage.

Over time, equities have provided good hedges against inflation, much more so than bonds. This should still be an important consideration for investors. While inflation has been moderate to negative in recent months, it is very possible this will prove temporary. One need only look at the record debt which is being used to finance government bail out and stimulus programs to see the potential for this to occur. The soaring price of gold, silver and other "store of value" commodities shows investors concerns about this.

Despite solid fundamentals, many income bearing instruments performed poorly in 2008. We believe this is due to the manic behavior of investors during times like these. To illustrate, consider the premium which investors required to hold yield generated by equity securities in pipeline companies compared to government bonds. In July of 2007 at the market peak, markets required almost no premium for the extra risk. Six months ago, the risk premium was around 3 percent, which was around the historic norm. Recently, the premium rose to 7 percent, higher than any recorded level. Have these securities become riskier? Possibly, but in our view not by nearly as much as the market would have us believe.

With credit spreads and risk premiums at record levels, we believe it is a prudent time for investors to consider defensive, dividend paying shares. While it would be foolish to try to call the bottom, we think income investors currently have the potential to be "paid to wait" until the inevitable recovery in the economy and financial markets arrives.

William R. Andersen, CFA is the Portfolio Manager of the Wanger Income and Growth Fund

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Investment Write-Up: Understanding Closed-End Funds
Advent Claymore Convertible Security and Income Fund (NYSE: AVK)

Closed-end funds often get a bad rap, especially after the binding-up of the auction rate securities market; however, this oft neglected asset class can sometimes provide interesting opportunities for both current income and capital appreciation. Closed-end funds are the cousins of the "open-end" fund, aka the mutual fund. Closed-end funds raise capital through an IPO, (initial public offering) just like an operating company "going public." These investment companies then operate along their particular mandate purchasing and managing investment securities. Shares of closed-end funds trade on the secondary market just like a publicly trade stock or bond.

A feature of closed-end funds is that they have to publish their assets in their public filings. This creates the opportunity for analysts to compare the value at which the fund trades in the public market (Market Cap) and the market value of the assets the company holds (Net Asset Value or NAV). Generally, the shares trade at a slight discount to NAV, accounting for management fees and various perceived risks. However they can also trade at NAV or above, especially if the manager is believed to have particular skill or the asset class is difficult to invest in directly.

Historically, when the equity of the closed-end funds has traded at a large discount (30% or more) to NAV, the equity of these companies has proven to be a good investment. We saw such discounts in the 4th quarter of 2008. Such a gap can emerge in a variety of settings, but clearly emerged in the panicked selling of the fourth quarter of last year. This drove the market prices of many closed-end funds down well below NAV and simultaneously drove up their dividend yields, The holdings of many closed-end funds, such as those trading convertible bonds, bank debt, or high yield went into in free fall.

One specific example is the **Advent Claymore Convertible Security and Income Fund (NYSE: AVK).** During December, 2008, this closed-end fund provided exposure to convertible bonds at a 30% discount to replacement cost. We like convertible securities a lot right now because many are fundamentally undervalued due to forced selling by hedge funds. The characteristics of convertibles are very interesting in this market with such securities yielding between 10% and 15% while allowing investors to participate in an eventual recovery of equity prices.

Even as the market continued its decline in January of 2009, the assets held by AVK and other closed-end funds rose as total panic returned to ordinary fear. Markets responded by closing the gap between the equity price and the NAV; i.e. the shares went up.

We continue to find closed-end funds interesting and overly maligned. Despite the near-total pessimism in the markets right now, there still exist opportunities for diligent investors to make money and boost returns.

The reference to the closed-end fund does not represent a general recommendation to purchase or sell this particular security. Past performance is not necessarily indicative of future returns. Inherent in any investment is the possibility of loss, including all capital invested.

James L. Cahn

Wanger Presents: "Why Dividends? Why Now?"

Given current market conditions, we understand that many investors are reluctant to dive head-first into the equity markets. We sympathize with those sentiments and, as a result, Wanger is hosting a series of luncheons which feature Bill Andersen delivering a presentation entitled "Why Dividends? Why Now?"

In his presentation entitled "Why Dividends? Why Now?" Bill discusses current market conditions and shows that, even in the bleakest of times, there still exists opportunity. Studies show that attempting to time the market—especially during periods of extreme volatility—does not work. Bill speaks about the use of dividend-paying equities as a way for investors to receive an income stream from their portfolios. Many investors typically use equities solely for capital appreciation and often overlook the powerful income component that some equities offer.

If you would like to receive a complimentary copy of this presentation or are interested in attending one of our future luncheons please contact **Michael Kelnosky** at (312) 245 8000 or *michael@wangerfunds.com*.

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