

Q2

Wanger Investments Quarterly Letter

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DEAR SIR/MADAM:

2Q10 Preview

From the Desk of Eric Wanger
Eric Wanger discusses deflation fears
page 2

During the second quarter of 2010, the bloom came off the rose from the first quarter run-up. The markets were pounded, especially in May (Russell 2000 Index down 7.68%) and June (Russell 2000 Index down 7.88%) as the hopes of a rapid economic recovery faded into concerns about slow growth, lengthy unemployment, and even a double-dip recession.

and asset driven companies based on a strong conviction that over the long-term, oil prices will increase, irrespective of short-term fluctuations. In financials there continue to be interesting opportunities coming from a variety of ultimately healthy institutions.

Family Office Corner
Don E. Scott
Don E. Scott discusses some factors to consider before constructing your portfolio
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The Perfect Storm
The second quarter represented a perfect storm. The environmental crisis in the Gulf of Mexico (GOM) destroyed hundreds of billions of dollars of market capitalization while Europe threw the financials and bond market into chaos with unknown levels of looming sovereign debt on bank balance sheets. Things got so bad in Europe that the European Central Bank finally intervened. We are satisfied with the steps they have taken to prove to the world that the Euro will not fail, however, fears remain.

The Firm
Our suite of active strategies continues to grow. We remain committed to our philosophy and refuse to adopt a short-term mind-set, even in an environment where short-term thinking is extremely prevalent. The Wanger OmniWealth wealth management platform is growing well under the leadership of Don Scott and Suzanne Champion. This multi-manager, multi-family office style wealth management solution is proving extremely valuable to our larger clients, especially in times of such volatility.

Ralph Wanger Reports
Ralph Wanger creates some new rules for his empire
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Our View of the World
We are more optimistic than most about the prospects of the U.S. economy and the state of Europe, however, fear is clearly out there. Fears of inflation have turned into fears of deflation, especially in the short-term based on the widespread perception that banks are not lending and corporations and consumers are not spending. Let us stress that we are optimistic for the long-run and that, while people are anxious to forget the severity of the 2008 crisis, it is not something that we can recover from with one or two years of good behavior.

I continue to work with analysts Lee Wolf, Joel Hainsfurther, and Raja Vannela everyday to identify attractive long-term investments for our investors. We remain committed to our investment strategy and refuse to deviate from our proven investment process. We feel that now, more than ever, it is essential to keep the faith and think like a long-term investor - I know that we are, and we are extremely excited about the future.

Bill Andersen
Bill Andersen emphasizes the importance of liquidity in yield investing
page 9

We continue to see long-term value opportunities in such sectors as energy and financials. In energy, we look out on a three to five year time frame and we continue to favor service

Email us at: info@wangerinvestments.com or visit us on the web at: www.wangerinvestments.com or www.wangeromniwealth.com.

Joel Hainsfurther
Joel Hainsfurther presents an investment idea
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Best,
Eric Wanger, JD, CFA

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From The Desk of Eric Wanger:

Fear is In the Air



Eric Wanger

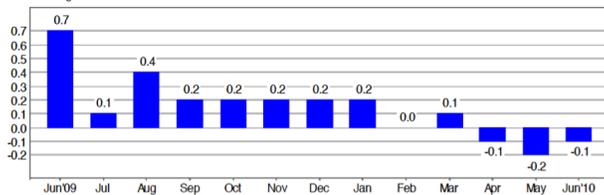
On a recent research and marketing trip through the west, I was impressed by how much fear I saw. Investors of every level of sophistication and experience were terrified, deeply afraid of where the markets might go. The irony is that no one I talked to could agree on what to be afraid of. Some were terrified of an impending stock market crash; some of a double-dip recession; some of the weight of future taxes; some of a socialist revolution; some of the religious right; some of anti-immigration vigilantes; some of pro-immigration scofflaws; some of the wars; some of the terrorists; some of the impending hyperinflation; and some of deflation. Wait, what was that last one? Deflation?

It's true: Deflationary fears have been making the headlines lately. But unless you have been following Japanese economics it's unlikely you have thought much about deflation or even know exactly what it is. During the second quarter of 2010, the consumer price index went negative for three months in a row, and there is no reason to think the trend is over. This scares economists and policy makers, because deflation often comes right along with recessions, and tends to extend periods of unemployment, excess capacity, and sluggish development. But what exactly is deflation and why should we be nervous about it?

In deflation, the real value of money increases while you sleep. How can that be bad?

One way to think about deflation is as a generalized glut of everything.

Chart 1. One-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted, June 2009 - June 2010



Source: Bureau of Labor Statistics, CPI News Release, Consumer Price Index, July 16, 2010.

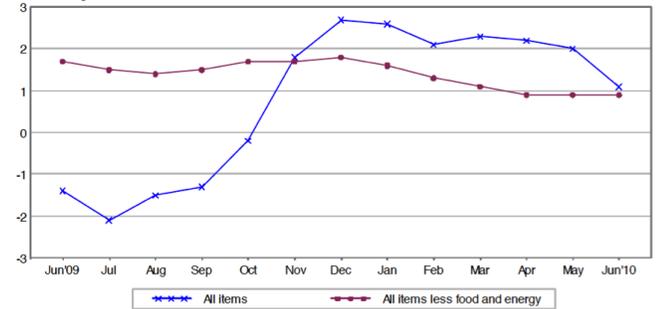
Definition of Deflation

In economics, deflation is a decrease in the general price levels of goods and services. As one might expect, this is the exact opposite of inflation. Deflation occurs when the rate of change in general market prices goes negative (i.e. the inflation rate falls below zero percent). So saying we're in a deflationary period is exactly the same thing as saying we're experiencing a negative inflation rate.

For people used to inflation, deflation seems a bit upside-down. In deflation, the real value of money *increases* while you

sleep, allowing one to purchase more goods and services tomorrow than with the same amount of money today. Over time, deflation actually increases the purchasing power of the money in your pocket. But that sounds great. So how could anything that good be bad for us?

Chart 2. 12-month percent change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted, June 2009 - June 2010



Source: Bureau of Labor Statistics, CPI News Release, Consumer Price Index, July 16, 2010.

Negative Effects of Deflation

Unfortunately, our way of life works a lot better when the economy is growing. Deflation is correlated with (although not necessarily caused by) recessions. This includes the Great Depression. One way to think about deflation is as a generalized glut of everything. In a deflationary environment, there seems to be "too much" of everything available for purchase, rental, or hire. Thus, there is no need to buy equipment, hire employees, or borrow money. In a deflationary world, the only way to compel a buyer to buy is to lower prices because there is simply too much of everything already in the marketplace. While this is obviously an oversimplification, it is easy to imagine a no-growth world in which people have as much housing as they want to buy, firms have as many employees as they wish to hire, and banks have more available capital than customers want to borrow.

Deflation also means that credit will cost more than it first appears. Real interest rates will exceed nominal interest rates, creating a sort of invisible increase in a loan's actual interest rate. For example, if deflation averages 10% per year (like certain periods during the Great Depression), a loan would have to be paid back in dollars costing 10% more each year. So even if nominal interest rates are quoted very low, it can be quite expensive to borrow money. In an inflationary world, loans actu-

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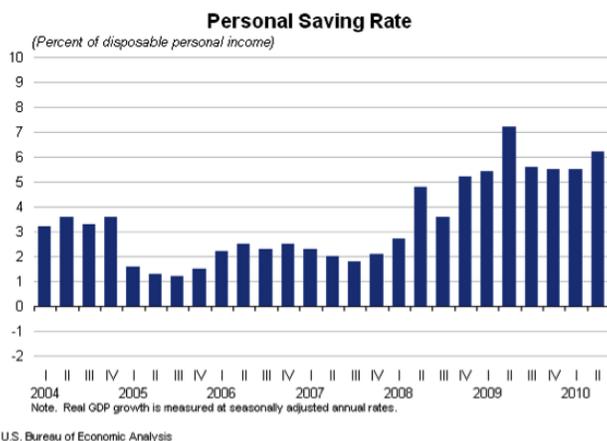
Fear is In the Air (Continued)

ally cost less than they appear because one can pay them back with dollars worth less than at the beginning. In a deflationary environment, this benefit gets turned upside down. And if credit is expensive, individuals and firms will not find it worthwhile to borrow money to build, expand, and invest.

The realization by consumers and firms that a dollar tomorrow might actually be worth more than a dollar today creates a strong incentive to save and not spend. And in a consumption driven economy, that is bad news for people making or selling houses, refrigerators, ski trips, and country club memberships. Right now, the U.S. personal savings rate is higher than it has been in a long time, reaching over 6% in the second quarter. The good news is that people are acting more responsibly with their money: People have much less credit card debt, are borrowing less for homes, and are generally saving more money. The bad news is that our economy still needs to reflate from the last few years of economic slowdowns. A bit of wanton spending wouldn't be so bad for the economy right now. FYI, that's not just "liberal claptrap." It was Milton Friedman who famously suggested fighting deflation by dropping money from helicopters!

In a deflationary environment, borrowers have to pay back loans with more expensive dollars.

A bit of wanton spending wouldn't be so bad for the economy right now.

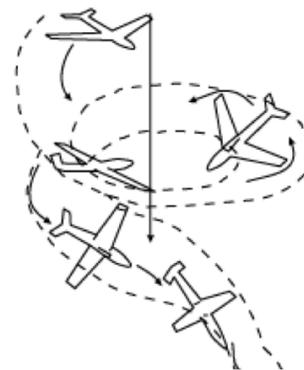


Scaring the Children

The ultimate deflationary boogey-man is the deflationary spiral. In this situation, price decreases lead to lower production by firms. Lower production leads to lower wages. Lower wages lead to lower economic demand. And lower economic demand leads to further price decreases. This vicious cycle is like the "flat spin" of an airplane. There is little the pilot can do but watch helplessly as he slowly and elegantly spins down into the ground. Some economists believe that the Great Depression was a deflationary spiral, caused or exacerbated by particular policy mis-

takes, resulting in a decreased money supply and a generalized glut of everything.

It is common economic wisdom that a better response to looming deflation is to flood the economy with increased money supply and to engage in *quantitative easing*, a policy wonk's term for all of the various ways the government can stimulate money supply growth and increase aggregate demand.



An Illustrated Dictionary of Aviation, edited by Bharat Kumar, McGraw-Hill Companies, Inc.

Central banks, starting with our Federal Reserve, use short-term interest rates (like the overnight federal funds rate) as their primary lever to stimulate lending, which increases the money supply in the economy. This would generally be expected to get the economy moving again. But what happens when the interest rate is already zero? What if there is nowhere lower to go? This is not an imaginary scenario. The Fed Funds rate is effectively at zero in the U.S. right now.

According to Gauti Eggertsson, an economist at the New York Fed, the old Keynesian school taught that the economy could become stuck in a *liquidity trap*, a scenario in which the government is effectively out of meaningful stimulus options. Eggertsson defines a liquidity trap as "a situation in which the short-term nominal interest rate is zero." The theory was that once interest rates reached zero, the money supply could no longer be stimulated, creating an economic death spiral. Luckily, modern economists are no longer that bleak. Eggertsson, discussing the modern view of the liquidity trap, states:

The modern literature, in contrast, emphasizes that, even if increasing the current money supply has no effect, monetary policy is far from ineffective at zero interest rates... According to the modern view [of the liquidity trap] outlined above, monetary policy will increase demand at zero interest rates only if it changes expectations about the future money supply, or equivalently, the path of future interest rates.

Source: Eggertsson, Gauti B. "Liquidity Trap." *The New Palgrave Dictionary of Economics*. Second Edition. Eds. Steven N. Durlauf and Lawrence E. Blume. Palgrave Macmillan, 2008. Viewed online at the New York Fed website at: <http://www.newyorkfed.org/research/economists/eggertsson/palgrave.pdf>.

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Fear is In the Air (Continued)

Ironically, this idea means that expected inflation cures deflation! Even if short-term interest rates are at near-zero levels, the expectation for future inflation can stimulate aggregate demand by incentivizing individuals and businesses to borrow, spend, and invest in growth. They might as well spend money now since their dollars will be worth less in the future.

As then Federal Reserve Governor (and current Fed Chairman), Ben Bernanke said in 2002, "...sufficient injections of money will ultimately always reverse a deflation."

Over the last two years, we have witnessed the fed funds rate go nearly to zero, direct support for big bank balance sheets, direct participation in the bond and MBS markets by the Treasury, and direct transfer payments to the states. Policy makers claim that all of this "quantitative easing" kept us out of the abyss. True pessimists believe that, despite all this, the U.S. economy will slouch down into a period of stubborn deflation as banks aren't lending again and businesses and consumers aren't spending.

Everyone is Afraid of Something

In an inflationary world, people shop at lunchtime because their paychecks won't go as far by dinner time. However, in a deflationary environment, your money will be worth more at dinner and even more at breakfast tomorrow. The problem with deflation in a modern economy is the cost of borrowing goes up, the value of collateral goes down, and individuals and businesses are incentivized to save rather than spend. This is clearly not a good way to create jobs and generate economic growth.

On one side, we have those concerned about deflation, fearing that widespread price declines, oversupply, and general delevering will continue to be a powerful disincentive to bank lending, corporate spending, and economic growth. This group believes (with plenty of evidence to back up their concerns) that the U.S. may become stuck in a no-growth, oversupplied, over-labored, quagmire in which the only way to put land, labor, or capital to work is by lowering prices.

On the other hand, we have people ultimately terrified of inflation and taxation. This group believes (with plenty of evidence to back up their concerns) that the U.S. will slingshot out of this recession into a period of horrible inflation, the ultimate bust of the dollar, and a raging thirst for taxing everything in order to pay for the ballooning national debt and entitlement programs.

The irony is that in some important sense, the two groups need each other. If the only way to get out of deflation is the expectation of inflation, then the deflation fearing policy makers need people to expect inflation. Likewise, the only way to cool inflation is if people expect things to cool off.

That's the riddle for policy makers, and maybe it's why so many smart and experienced people can disagree so profoundly as to what the future holds. Fear is overwhelming us right now, but it is unclear what to be more afraid of: The inflation, monetary debasement, excessive debt, and rising interest rates scenario we were afraid of last year, or the stalled, deflationary, no-growth economy that many are afraid of now. Luckily, I think, we're afraid of both.

It is often said that the world of finance cycles endlessly between fear and greed. We are definitely doing fear right now. Fear and risk aversion are clearly in style this season. Growth and risk taking are clearly out of style. Everyone is afraid of something right now - but nobody can seem to agree on what to be afraid of.

Our advice: Keep your head and don't panic. A temperate middle course is generally the right answer, especially in times like these. Long-term investors will see many excellent opportunities over the next year. But it will take patience to resist bad deals along the way, and even more patience to allow the long-term seeds to blossom.

Eric Wanger, JD, CFA *President*,
Wanger Investment Management, Inc.

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Family Office Corner – By Don E. Scott:

2010 Investing for High-Net-Worth Families

Many investors are concerned about their ability to maintain their lifestyles and level of wealth, in real terms, over a long period of time.

At Wanger OmniWealth, we work at the intersection of life and wealth. That intersection falls within the individualized family offices we provide to our high-net-worth clients. On one hand, that means coordinating with CPAs in connection with tax returns, helping reduce estate taxes and managing related matters, and about 100 other things. Our objective is to simplify our clients' lives and enable them to spend their time the way they want. We seek to optimize our families' lives, financially and otherwise.

We also serve as our clients' investment consultant. We are responsible for developing and implementing strategy for them. This is where asset allocation theories, access to the right resources, economic and market views, and individual client needs and behaviors all come together.

Each new family that comes to us has their particular sets of circumstances and concerns. These are perhaps more challenging than ever before. Many of these concerns, as interpreted through our decades of experience and current views of the world, are summarized below.

- 2008 through March 2009 eroded many personal balance sheets by around 35%. The scariest part was that we didn't really know when or how it was going to end.
- 2009 through the first part of 2010 went up like a rocket. Investors gained a false sense of optimism very quickly.
- May and June 2010 came along and caused us all to realize that we have a long, difficult road ahead.
- Many investors are concerned about their ability to maintain their lifestyles and level of wealth, in real terms, over a long period of time. They expect to live a long time and would like to leave more behind to their heirs and charities than they currently have.
- Very wealthy individuals are routinely selling vacation homes and cutting back. Most of what we have seen isn't dramatic and it's not always absolutely necessary. One might argue it is curtailing prior excesses to some degree. However, these actions speak directly to their feelings about the future.
- Investors really don't know what to do. Most of the non-clients we meet are pretty much invested as they have always been. Query: How has that worked out over the last 10 years? Further, many investors sold out either partially or in total when the market crashed. The majority of those don't know how, when, or if to get back in the game.

With that in mind, here are a number of considerations. Let's call this re-engineering your future. Unfortunately, we're all forced to address this reality in one of the most difficult times we've ever seen.

1. Start at the beginning: People tend to do things backwards. I'd start with a good balance sheet and ask myself, "what is all of this for? What do I need to accomplish with it over the next X number of years?"
2. Focus on cash needs: How much do you need to spend each year? There are a few problems here. Some people tend to underestimate. They don't consider that they buy a new \$80,000 car every year or two, make annual gifts, give to charity, remodel their homes, etc. and they don't leave enough cushion. The second challenge is that many families spend more than they should.
3. Think again about spending: My experience is that it doesn't matter how much money one has, you can always out-spend your capital base. I have worked with clients that spent \$100,000 per month - pick a number. I am suggesting that for many this is the time to do a little soul searching and to make minor sacrifices. In this context, sacrifice is nothing more than choosing one priority over another.
4. Time to understand risk: Most people don't really understand risk until a portfolio depreciates by 40%. It is really important to understand what would happen to your net worth if the Dow went to 8,000, for example. I don't think that will happen, but it certainly could.
5. Be realistic about return: There was a time when everyone seemed to expect 10% annual returns from their blended portfolios. Most portfolios don't have a chance at delivering those returns without carrying way too much risk. The tooth fairy died.
6. Who are we investing for? Should the objectives be centered on the senior generation, children, grandchildren, family foundation, or some combination thereof? There are probably pockets for each group that all necessitate different strategies. However, the answers to these questions are not always self-evident and not always properly analyzed.

My experience is that it does not matter how much money an individual or family has, you can always out spend your capital base.

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2010 Investing for High-Net-Worth Families (Continued)

However, for most investors the key is to not give up too much in the down markets. You can't figure that out once you are in a down market—it is too late.

Most importantly, perhaps, are things like knowing what your wealth needs to accomplish for you and why.

7. **Liquidity:** How much of the portfolio needs to be liquid? How concerning is it if certain components of the investment strategy cannot be turned into cash immediately? How much excess return should one expect for that illiquidity?
8. **Cash flow:** There was a time when this meant having enough in muni bonds to provide interest income to cover annual living expense needs. Nowadays, most investors tend to embrace a total return philosophy. That is, the risk and return characteristics should primarily drive the investment strategy as opposed to the cash flows associated with particular investments.
9. **Focus on risk first and return second:** This requires a great deal of discussion, modeling, and analysis. Both are important. However, for most investors the key is to not give up too much in the down markets. You can't figure that out once you are in a down market - it is too late. You have to prepare for this scenario when you think it is unlikely to happen. (And certainly if you think it is likely to happen.)
10. **Understand that you can reduce risk disproportionately to reducing return:** In the old days, if you were 30% muni bonds and 70% stocks you had a particular risk/return expectation. If you changed it to 40% munis and 60% stocks, or 50/50, risk decreased along with return. Today, we have a wide array of investment choices that blend into a portfolio designed to reduce risk substantially while reducing return potential much less.
11. **Manage risk and make money:** We are asked all the time, "How can you make money in these sorts of markets?" True, it is very difficult to generate positive returns in a year like 2008. However, over a cycle, even one like the last two and a half years, it is certainly possible to manage risk and earn a positive return. In fact, managing risk for severe downturns is a key driver of positive returns over the cycle.
12. **Get out of the box:** This doesn't mean take inappropriate risks. Quite the opposite. The old fashioned "retail portfolios" that we see are typically the ones carrying excess risk. By getting out of the box I mean to say that most high-net-worth investors need to rethink what they have been doing. The institutional world has been at least ten years ahead of the retail investors. It's time for high-net-worth investors to catch up.

I thought about calling this article, "Let's Start at the Beginning." We could have talked about particular investments or how you might build a portfolio. However, that's the middle, or perhaps the end. I wanted to share a few thoughts on how to work up to the portfolio construction process. Most importantly, perhaps, are things like knowing what your wealth needs to accomplish for you and why. It is extremely important that you are clear on the possible outcomes associated with building a strategy to accomplish your objectives. It's a lot tougher than in 1997. Avoiding failure becomes all the more critical. Creating success is always possible. It may just mean rethinking things from the beginning.

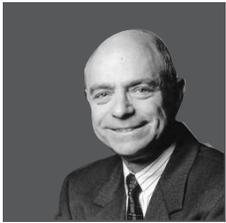
Don E. Scott, *Chief Executive Officer*
Wanger OmniWealth, LLC

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Ralph Wanger Reports:

Empire of Ralph



Ralph Wanger

The police confiscated the bikes of anyone not wearing a helmet. It seemed to work. I think we could do the same thing for people chatting on cell phones or texting while driving an automobile in my empire.

Forget about reading the financial services bill. It's 1,700 pages long, and I don't think I could bench-press it. These laws cannot be just, because there is no way that anyone has the skill or will to read them.

The U.S. political season is upon us, and the customary quantity of irrelevant flapdoodle has induced me to retire to my cabin in Colorado for the duration of the campaign. I've invested in some clever North Korean software that I have hooked up to the telephone so anyone calling with a political message or begging for campaign funds will be treated with a diabolical blast of sound which will render the caller permanently deaf. Be advised.

However, I've formulated a political platform for myself and am soliciting write-in votes for me as Emperor of the United States. Here are the main points of my 10-point platform:

1. All automobile companies will be summoned to a conference, and in 12 months they will make a decision. All the gas filler caps will be on either the right or the left side of the vehicle. The emperor does not have to pump his own gas, but this edict will keep loyal subjects from feeling foolish when they drive up to a gas station in a rental car.
2. We will adapt to the European 24-hour clock system. This solves the logic problem - for instance, what time is it after 11:59:59 a.m.? Is it 12:00 a.m. or p.m.? There is no logical solution to this problem, but it would easily be avoided by going to a 24-hour system. It would also simplify another problem. If there is a 3:00 p.m. conference call from London, when the heck are we supposed to get on the phone in Chicago? In addition, the calendar program on Microsoft Outlook makes it perfectly easy to schedule a golf game for 2:00 a.m., which would be less likely on a 24-hour clock. All electrical clocks and any device that shows the time, such as kitchen appliances, VCRs, HVAC systems, car clocks, alarm systems, and so on, will have a standard method for setting the clock. Ideally, clocks will automatically reset themselves. After all, it is the job of my clock to know what time it is without me having to tell it.
3. All electronic dinguses - be they cell phones, PDAs, iPods, Kindles, or Nintendo handhelds - will use the same voltage. They will all use a standard connector on the charger. Again, the industry will have 12 months to pick a sensible solution, and all nonstandard devices will be forbidden in my empire. The problem of standardizing electrical wall plugs, power voltage, and frequency across all countries deserves consideration but is too tough a job even for an emperor.
4. My next action will be to solve the energy crisis. The major cause of electric power wastage in the world is people leaving their computers on all the time. People leave their computers on all the time because they are using Microsoft Windows as an operating system, and Windows is notorious for taking so long to load that having highly paid people wait 15 minutes to get their PC up is much more expensive than leaving the dingus on all the time. I will use proper incentives to encourage Microsoft to reduce Windows loading time. In this case, the proper incentive is once a year to execute a Microsoft director until Windows loads in three minutes or less.
5. Next, I will solve the automobile safety problem. I was just in Saigon being attacked by fleets of motorbikes in constant flow throughout the city. The only way to cross the street was to stride boldly into the oncoming rush of motorbikes. They were good enough drivers that they would flow around you with perfect safety. I developed the mantra, "I am a rock in the river." If you moved your rock slowly and steadily at the same pace, one could cross unscathed. However, it was remarkable to see that all the drivers and passengers on these motorbikes wore helmets despite the savage tropical heat and humidity of Vietnam. I was curious as to how the authorities managed this feat and was told that the process is fairly simple. The police confiscated the bikes of anyone not wearing a helmet. It seemed to work. I think we could do the same thing for people chatting on cell phones or texting while driving an automobile in my empire. Police will simply tow your vehicle to the pound and let you walk home chatting as merrily as you please.
6. My next act will be to reverse a trend in the language. Television people for no particular reason started using "red states" for states that vote Republican and "blue states" for states that vote Democrat. This is obviously reversed, as even the producers of musicals know. In the successful musical "Les Misérables," the students attempt a revolution and wave a big red flag. The revolution fizzles because the working class doesn't show up. The libretto doesn't bother discussing the student's political platform, but the big red flag suggests it is socialist. Red has always been the color of the political left and blue the color of stability, so it only makes sense if the Democrats pick red.

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Empire of Ralph (Continued)

Publishing a 1,700-page law or not publishing a 1,700-page law has the same effect—no sane person is going to read it.

If the need to comply with my “conservation of law” rule has Congress searching desperately for old laws to repeal, I can think of no better place to start the search than the income tax code.

7. I would establish a new cabinet-level position called the Password Bureau. The American people are suffering under the tyranny of having 31 different passwords to open their various devices. Most people have solved the problem by using Post-It notes, which totally defeats the objective of having a secret password in the first place. There has to be an answer somewhere. The Password Bureau will solve the problem within five years, or all its employees will be executed. The use of proper incentives is very important.
8. I then will address the crisis of legislative logorrhea. Legislation, such as health care reform and financial services reform, is too long for anyone to read. Forget about reading the financial services bill. It's 1,700 pages long, and I don't think I could bench-press it. These laws cannot be just, because there is no way that anyone has the skill or will to read them. If you did try, you would find that on every page there is a paragraph amending some other federal law, and it is impossible to know whether these changes are minor technical fixes or important changes. Ancient oriental despots kept themselves in business by not publishing the laws. That way, their subjects could never know whether a planned action was legal or not, so the common people learned to be very conservative in their habits. Publishing a 1,700-page law or not publishing a 1,700-page law has the same effect - no sane person is going to read it. This includes members of Congress and senators. There are several good answers to the ever increasing caliber of our ordinances. The first will be a conservation principle: If Congress wishes to add 1,700 pages of law to the federal statutes, it must repeal 1,700 pages of old laws.
9. The next step will be a three-stage reduction in the allowable length of laws. The Torah, which contains 613 laws, does so in a snappy 248 pages and still has time for historical anecdotes, census figures, and creating the world. I think my imperial chancellor could write a change in the banking laws in fewer than 248 pages. Once we get used to laws not exceeding the length of the Bible, we can then get ready for a bigger leap: mandating that no law can be longer than the Constitution of the United States (including amendments). The Framers of the Constitution set up a whole new system of government in a dozen pages. That ought to be enough space to decide whether we need electronic medical records or not. The third level is stringent. Let us get the length of a law down to Lincoln's Gettysburg Address. Lincoln was able to deliver a powerful message with great rhetorical flourish and lasting impact. In a mere 272 words he gave the best speech ever made in the United States. The last length goal is the unreachable dream -

to get a law down to the size of a Twitter tweet. His objective is exceedingly ambitious but perhaps not impossible. Any of the Ten Commandments can be stated in a 140-keystroke tweet.

10. If the need to comply with my “conservation of law” rule has Congress searching desperately for old laws to repeal, I can think of no better place to start the search than the income tax code. Singapore, a city-state that was poverty stricken only 60 years ago, developed a very simple tax code similar to the code in Hong Kong. The maximum marginal rate is 20 percent. There is a short list of deductions, including deductions to incentivize citizens to procreate. Singapore today has per-capita income at U.S. levels, has a government surplus, and a fully funded social security system (thanks in part to incentives for procreation). The simplest form of management is to find out what works in the empire next door and copy it.

My final and most applauded edict will be to get the income tax form onto a postcard, as it is in Hong Kong.

All these edicts will make the reign of Emperor Ralph humane and prosperous. What's in it for me? Well, being above the law, I wish to do forbidden things. Number one, the law we have all been told to respect more than any other is the taboo on “disabling an aircraft lavatory smoke detector.” This is the only piece of an airplane that evokes this level of protection. Therefore, disabling one must be immensely pleasurable, and only the Emperor can perform this perverse act without risking the galls. After I have performed this forbidden deed, I shall write a memorial poem describing the flood of illicit exhilaration that accompanies the desecration of a sacred object.

So, in November, if you are voting in the United States, please write-in “Ralph for Emperor.” It is not a shoo-in, but I believe my program summarized above will elicit vast popular enthusiasm.

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

Q2

Wanger Investments Quarterly Letter

Bill Andersen:

Roadmap to Losses: The Coming Meltdown in Mezzanine Lending

With the demand by investors for high yields and a concurrent demand by private companies for capital, guess what has happened? A huge supply of mezzanine loan products has been created to fulfill the needs of both parties.

In seeking investment opportunities, investors are often called upon to trade prospective long-term returns for short term liquidity. Private equity, hedge funds, and real estate partnerships are all examples of asset classes where investors have been asked to commit their capital for a substantial period of time in exchange for returns which are presumably greater than they could obtain from more liquid investments. Yield oriented investors, who generally have a good selection of liquid investment vehicles, are also sometimes presented with illiquid investments which offer the potential for juicy returns.

One such area is so-called “mezzanine lending,” a form of finance which has been around for a long time. Mezzanine loans are typically unsecured loans made to privately held companies. The loans are junior to other debt issued by a company, but senior to equity. Because of their subordinated status, mezzanine loans generally have higher yields than senior debt, which is typically secured by plant and equipment, inventory, and/or a first call on a company’s cash flow. In many cases equity warrants are attached to mezzanine loans which give lenders the potential for increased returns. Lenders are attracted by the high yields, which are scarce in today’s economy. Borrowers like them because, in theory, they are less expensive than selling equity and don’t require all the rigorous terms of typical bank loans.

Which brings us to today’s situation. With today’s low yields on most fixed income instruments, investment companies have been hard pressed to develop products which offer substantial yields. At the same time, the credit crunch has made it difficult for all but a small number of investment grade companies to obtain loans on the terms which have traditionally been available to them. With the demand by investors for high yields and a concurrent demand by private companies for capital, guess what has happened? A huge supply of mezzanine loan products has been created to fulfill the needs of both parties.

Of course, there is nothing inherently wrong with this situation. At its best, the financial services industry exists to match those with capital with those who have productive uses for it. However, it is important to analyze the situation more carefully. For investors, the search for yield can lead them to make unwise decisions. While an opportunity exists to make loans to private companies at favorable rates, lenders must carefully scrutinize the trade-offs they face. Liquidity and credit quality are two important ones. Also, the inherent risk in lending to small private

companies on an unsecured basis should be considered. This problem may be exacerbated by the competition to make loans to the best quality companies in this space.

The situations of borrowers should be considered as well. Faced with a difficult time obtaining bank loans, private companies may be quick to take on debt from mezzanine lending funds and other investors. In many cases these loans are made by funds that seek to generate returns for their investors of 10-12% or more, after fees. This means the cost of this debt must be in the mid-teens to the actual borrower. How many private companies earn sufficient returns on capital to enable them to pay interest costs this high, much less repay principle in two to three years time as is often required in these loans? We don’t have a definite answer, but it is likely significantly less than the number which will be enticed by mezzanine finance promoters to accept such financing.

As the sub-prime lending boom showed, a financial product which matches willing buyers and sellers can grow for a long time, creating its own momentum and generating great returns for investors for a number of years. The problem is that eventually such trends collapse of their own weight as lending standards are lowered as more money flows into the asset class. Unfortunately for most mezzanine investors, by the time this happens it will be too late since they will be locked up in an illiquid investment.

Investors seeking income generally have an interest in liquidity, and our advice is to be very cautious in selecting income oriented investments where liquidity is not readily available. If investors follow this advice, then even if they make incorrect decisions they will at least have the flexibility to react to bad news rather than being locked up in a long-term investment from which there may be no exit opportunity.

William Andersen, CFA, *Portfolio Manager,
Wanger Income and Growth Strategy and Principal,
Andersen Capital Management*

Q2

Wanger Investments Quarterly Letter

Investment Write-up:

Perma-Fix Environmental Services, Inc. (NASDAQ: PESI)

Perma-Fix Environmental Services, Inc. (PESI) provides nuclear, engineering, and industrial waste management and consulting services. The company engages in the treatment, storage, and processing of nuclear and low-level radioactive waste material. PESI's unique asset portfolio includes sites in or adjacent to major Department of Energy (DoE) facilities as well as the only commercial facility in the United States permitted to treat radioactive Polychlorinated Biphenyls (PCBs). PESI also owns another exclusive permit as its Northwest facility (at Hanford) is the only commercial facility in the U.S. permitted to accept transuranic waste. PESI is poised to benefit from secular environmental cleanup trends, including the cleanup of contaminated sites and the treatment of radioactive materials, and from the large amount of stimulus funds allocated towards projects which fall under PESI's area of expertise.

PESI, long-recognized as a leader in the treatment space, expanded into on-site work in the fourth quarter of 2008 when it became a sub-contractor to CH2M Hill on a contract to complete on-site work at the DoE's Hanford site. The contract lasts for five years and has a five-year renewal option that we expect will get exercised; the contract should generate about \$35 million in annual revenues for PESI. While on-site work is lower margin work than treatment work, PESI can leverage its presence at a site to drive incremental waste to its facilities for treatment. The Hanford contract enables PESI to display its capabilities and build its resume so that it can win more on-site work in the future. PESI's continued expansion into on-site work should further enable the company to simultaneously grow its treatment revenues. The Hanford contract essentially provides the company with a source of recurring cash flows which it can use as a foundation to grow the company.

PESI's unique permits provide the company with some additional attractive opportunities. The permit to treat radioactive PCBs provides the company with the exclusive opportunity to serve a market that, while extremely difficult to quantify, could provide a \$100--\$300 million revenue opportunity in the future. We also believe that the transuranic waste market could eventually provide up to a \$100 million revenue opportunity as well.

PESI continues to upgrade its facilities and expand its capabilities. The company is currently working on installing a railroad at its Hanford facility. This will reduce transportation costs for the DoE and other customers and make it easier for the company to accept shipments of higher activity waste streams that cannot easily be transported on the road.

PESI stands to experience significant margin expansion over the next several years. In addition to maintaining a largely fixed operating cost structure, PESI has recently focused on treating more complex, higher activity waste streams which produce better margins. In May of 2010 the company successfully demonstrated its ability to treat tritium, a high activity waste stream that is prevalent at the DOE's Savannah River site. The DoE shipped seven drums of tritium to PESI's Oak Ridge, Tennessee facility towards the end of 2009. In the second quarter of 2010, PESI finished treating the initial seven drums and, while the timing of DoE shipments remains nearly impossible to predict, over 30 additional drums of tritium remain at Savannah River and PESI has positioned itself to benefit from this.



PESI's Oak Ridge, Tennessee facility.

PESI continues to execute and grow its cash flows. We believe that the stock is extremely attractive at current levels. However, PESI is a long-term name that requires patience from investors; it is impossible to predict when the company will receive shipments of waste from DoE sites. We believe that as this trend continues to play out over the long-term that PESI will be a big winner. We also think that the company is an attractive acquisition target for another player in the environmental services space. PESI has significantly improved its balance sheet over the last year and has positioned itself for what we believe will be an extremely bright future.

Joel Hainsfurther, *Securities Analyst,*
Wanger Investment Management, Inc.