Q1 Wanger Investment Quarterly Letter

Dear Sir/Madam:

What Are We Thinking About This Quarter?

Eric Wanger Admires a Truly Great Rant

Ralph Wanger Reminds Us of the Dangers of Aureodigititis

The Great Recession

The world is beginning to end at a decreasing rate. It is still ending, but the rate at which it is ending appears to be slowing -- which passes for good news on Wall Street.

Impressive federal stimulus spending and dramatic interest rate spreads are coaxing the banks back into lending. While credit is still not easy, those with good credit can now borrow again -- and that is a big deal. The overnight repo market (interbank lending) is functioning again, meaning that, if nothing else, the U.S. banking system has taken a step back from the brink of imminent disaster. Hopefully, we can now get back to the business of managing a slow, painful global recession.

Inflation or Deflation?

With all of the stimulus funds hitting the economy it's easy to hit the inflation-expectation panic button. But even if these policies create long-term inflation, what about right now?

In the near-term, prices will almost certainly go down. It's hard to imagine that the prices of energy, housing, or food could bounce back from their broad-based decline much before the end of summer. Furthermore, it's hard for us to see domestic unemployment rates improving until at least the end of the year. There are still more layoffs to come.

Retail sales, commercial real estate, and food prices have probably not seen 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.

Of course, we may prove wrong, but the odds seem to be in our favor.

How to Invest in this Horrible Climate

There are many signs that the worst is over. It is doubtful that there will be any more world-class failures on the scale of Lehman or AIG. On the other hand, we can still expect waves of layoffs and more forced asset sales, especially in commercial real estate.

We maintain our position that patient investors can still make money by focusing on quality, valuation, and yield. The best investors will find ways to capture all three.

As long-term growth investors we demand to be "paid to wait" as the markets recover over time.

We may see the current rally continue or lose its steam quickly, but over the next year at least, the theme will be volatility. We're going to be on a roller coaster for awhile.

Big Plans in the Works...

First we started the Long Term Opportunity Fund to capture misunderstood opportunities in small public shares. Next we started the Income and Growth Fund to provide current income for investors with some inflation protection. We "registered" the firm with the SEC to allow us to manage a wider array of strategies and to reach out much more broadly to make our service offerings known to the public. *Stay tuned! There's a lot going on here!*

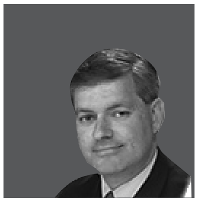
Yours,
Eric Wanger, JD, CFA

In This Edition

Q1 | Wanger Investment
Quarterly Letter

From The Desk of Eric Wanger:

Just a Little Rant (I Promise)



Eric Wanger, JD, CFA

Lehman, UBS, Bear Stearns, Refco;
Madoff, Bayou, Stanford, Pequot;
Country Wide, American Home Mortgage;
AIG, Merrill, Citi, BofA, UBS...
Anybody up for a good rant?

Dust off your Little Red Books, it's that time again.

Let's rant! We just went through a huge financial bust and busts always make Wall Street look like an evil clubhouse for crooks, lazies, crazies, and dupes. This one was no exception: Bankers, once again, are greedy parasites, and their lawyers, we are reminded, are crooked scumbags. (Any good rant should include a diatribe against greedy bankers and crooked lawyers.)

Free Trade: In one word, ...exploitation, veiled by religious and political illusions, ...naked, shameless, direct and brutal exploitation.

Now that's a rant!

This most recent bubble was as exceptional as its bust. An extraordinary amount of wealth was created and then destroyed. I've not been disappointed with the quantity or quality of rants in the press. Every editorial page and blog is bursting at the seams with moralistic homilies. Crooked bankers and sold-out fiduciaries grace every page.

America is not over and the free market is not dead. Did we collectively screw up? Yes. Did we get drunk on debt and leverage? Yes. Did we honestly think that there were really enough millionaires to buy all those million dollar condos? Maybe. But this has happened before and it will happen again.

The history of finance is filled with booms and busts and the crooks and robber barons that have come to symbolize them. There is a whole literature on this topic. My personal favorites include the sections of *A Random Walk Down Wall Street* by Burton G. Malkiel that deal with famous securities scams as well as a relatively obscure little book from the 1980's called: *Other People's Money: The Rise and Fall of OPM Leasing Services* by Stephen Fenichell. (Note: These works are not technically rants. They employ facts, often correctly.)

Why does the world need investment bankers? Because there are some things even lawyers won't do.

The Greatest Rant Ever

Some might expect that my vote for the greatest rant ever would come from the literature of the great depression. It took the American public decades to regain its trust in Wall Street after the bubbles and busts surrounding 1929. (and the cacophony of screw-ups that extended the misery) Yet the greatest rant in history may be one produced in the nineteenth century by Mr. Karl Marx and Mr. Frederick Engels. *The Communist Manifesto* of 1848 was a really kick-butt rant against Capitalism and its greedy bankers and crooked lawyers. Sample some of it in English:

> *The bourgeoisie, wherever it has got the upper hand, has put an end to all feudal, patriarchal, idyllic relations. It has pitilessly torn asunder the motley feudal ties that bound man to his "natural superiors", and has left no other nexus between people than naked self-interest, than callous "cash payment". It has drowned out the most heavenly ecstasies of religious fervor, of chivalrous enthusiasm, of philistine sentimentalism, in the icy water of egotistical calculation. It has resolved personal worth into exchange value, and in place of the numberless indefeasible chartered freedoms, has set up that single, unconscionable freedom -- Free Trade. In one word, for exploitation, veiled by religious and political illusions, it has substituted naked, shameless, direct, brutal exploitation.*

Now that's a rant!

Eric Wanger, JD, CFA, President of
Wanger Investment Management, Inc and Portfolio
Manager, Wanger Long Term Opportunity Fund.

Postscript: A Plea to the Obama Administration

There is no law that can eradicate greed or make fraud more of a crime. There is no law that will restore our trust in the financial system. Please remember the disaster that is Sarbanes-Oxley. Our system became great by choosing to regulate disclosure, not by trying to legislate common sense.

Clearly, we need to increase the level of disclosure and transparency demanded of certain markets and instruments. Likewise, we need to re-integrate certain areas of our financial system which (who) successfully evaded scrutiny in the past.

Fraud is already a crime. And stupidity, unfortunately, can never be one.

Q1 Wanger Investment Quarterly Letter

Ralph Wanger Reports:

OFHEO, Whistlejacket and Aureodigititis

Ralph Wanger, CFA

So Mr. Market was doing so well, and then he went broke. I know most of us have been confused and frightened by events the last two years. It is hard to make a coherent narrative about the 2008 crash. All the evidence says, "Everybody done it" in the spirit of Murder on the Orient Express.

There was a lethal combination of greed and carelessness at every point in the financial system, including commercial banks, investment banks, insurance companies, monoline insurers, hedge funds, private equity funds, real estate brokers, stock brokers, government agencies, politicians, and speculators. It is very hard to make sense of all this because there are just too many villains and no hero. One important thing to remember for next time -- if you are around next time -- is that bear markets have a clear purpose: to humiliate and ruin the reputations of everybody. The higher the reputation, the further it will fall. People such as Alan Greenspan, Sandy Weill, Jack Welch, Bernie Madoff, and even Warren Buffet are examples of business and financial titans who have been reduced to microtitans like the rest of us.

It is very hard to make sense of all this because there are just too many villains and no hero.

The failure of government to predict or prevent the crash is scary. An especially frightening part is that a common idea to improve the economy is to add more regulations. The Fed kept credit easy way too long. Sarbanes-Oxley did enormous damage to the U.S. leadership role in finance, but had no effect whatsoever in preventing terrible financial chicanery. The SEC just went missing for the last three years and enforced nothing. Fanny Mae and Freddy Mac strongly encouraged the deterioration of quality in home mortgages. The agency set up specifically to audit Fanny and Freddy (the clumsily named OFHEO) did sound the alarm in 2004, but the congressional committee told them to shut up, and they did. The Greek hero Orpheo was able to accomplish his aims through the beauty of his music and singing, suggesting that the OFHEO might do better to file their next report as an operatic aria or a hip-hop video rather than a boring accounting report. How does a boom-and-bust cycle happen?

The failure of government to predict or prevent the crash is scary.

One of the few people whose reputation has improved over the last three years is the late economist Hyman Minsky. He did a neat job of explaining how a boom and bust cycle is self generating. Imagine a few quarters of unremarkable activity. A period of quiet stability will not remain so, for after a couple of years, some of us financial geniuses will realize that buying lower quality bonds will create much better portfolio performance while others will buy high-beta stocks on margin. In a couple of more years a speculative boom will be roaring, followed eventually by tears. The speculative boom can last a long time, so there is an irresistible urge to join in. For instance, in 2002, the respected Standard Charter Bank of London brought out a $20 billion dollar SIV named Whistlejacket. (I leave to the reader, the pleasure of googling who Mr. Whistlejacket was.) The S&P declared the senior bond tranche to be AAA, and buyers of that paper had a good yield for five years. As you remember, a native uprising in Mortgageland broke out in 2007. In August of 2007, a Standard Charter spokesman calmed fears by saying that, "Whistlejacket is not in trouble, and we are quite comfortable." Six months later the fund had collapsed and was in receivership. It is now being liquidated. If you are carrying a yellow marker, the part of the paragraph to highlight is, "When a banker has to tell you he'is not in trouble, he is in trouble."

What is going on that makes us all Minsky marionettes in a period of euphoria? The cause is not economic theory or economic irrationality. It is a disease. A highly contagious and very hard to cure disease that, if untreated, leads to certain financial ruin. The name of this dreaded illness is Aureodigititis, the golden finger disease. I will now describe a typical case history, using a false name to protect the patient's privacy. However, you can find out what this patient looks like easily enough by walking into the bathroom and looking into the mirror.

Pat, a young CFA, works for a mutual fund manager. In June, Pat studies Aardvark Industries, and after two weeks of revising spreadsheets on the computer, crosschecks with other analysts and outside sources, finally concludes it's worth buying. She goes in the trading room, points at Aardvark on the screen, and says, "Buy 20 thousand shares market not held." One month later, the stock is up 15%, and the director of research for the first time smiles at her.

Continues on the next page

Q1 | Wanger Investment
Quarterly Letter

OFHEO, Whistlejacket and Aureodigititis (Continued)

In August, Pat goes to work on Beefsteak Mines. It is in the same industry as Aardvark, so she can crunch the numbers more quickly, and she gets a good thorough job done in four days. Back in the trading room, she points to Beefsteak on the screen and says, "Buy 30 thousand up to 25 and a half." Beefsteak goes up too. The director of research invites Pat to his office, and compliments her on her progress as an analyst, and even hints there may be a special bonus for her this year.

In September, Pat hears a street story about Corncob Industries. Corncob is going to report better than expected earnings in three days. Pat does not have time to do a lot of work on it, but she puts together a one pager cut-and-pasted from the brokerage report, points to the screen and says, "Buy 50 thousand Corncob, market not held." Sure enough, the good earnings are reported, and the stock jumps. It is now clear to Pat that she is not just an ordinary analyst, she is certainly the best in her firm, and speaking modestly, one of the best in the country.

When the volunteer from the Aureodigititis Foundation calls, give generously.

Now she realizes that it is not grinding through 10-K's that made her great. She is so in tune with this market that she can skip the analytic drudgery. The secret is in her finger; her success has been in pointing it at the right line on the Bloomberg screen. She can test this out.

She heard a good story about Dogbone Bank at a party on Saturday, so she points her finger at the screen and buys a position. It works fine. Pat now has a full-blown case of Aureodigititis, the disease of the golden finger. She now believes herself to be a Master of the Universe.

All those years of college, three springs wasted in CFA class, and endless hours of looking at footnotes in annual reports have paid off. Her magic finger has given her Superhero status that the world is starting to recognize. She has a two-minute interview on CNBC to prove her star quality.

At this juncture, I started seeing Pat less frequently because she quit her job at the mutual fund and moved to Greenwich to work for a small but well regarded hedge fund. I did talk to her once, three months afterwards, when she said, "Oh hi, things are really great here. My fund is up to three billion in assets and I think I can take home $20 million this year the way things are going. Yes, Marvin left me. He couldn't stand my late hours, but I don't mind, my career is going really well. Sorry I can't chat longer, but Singapore is opening in 10 minutes."

Four weeks later, Pat called me at 10pm. Her voice was agitated. "Eggplant Industry has just dropped from 32 to 23 because the CFO resigned. My source in Tokyo says that everything is fine and that this is the buying opportunity that I've been waiting for. Do you think it's okay for me to double up? My prime broker is happy to lend me the money."

I advised her, "Follow your finger, its been working great." I figured Pat had but a few weeks left.

You know how to finish this story. Pat has sold the house in Greenwich, is broke, divorced, and unemployable. Another tragic victim of the dreaded Aureodigititis.

Don't let this happen to you! Help yourself and join me in helping others. When the volunteer from the Aureodigititis Foundation calls, give generously. Remember that the Golden Finger of today is the Fickle Finger of Fate tomorrow.

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

Bill Andersen:

How Capitalism Used To Work

Your manager lives in a suburb about thirty miles north of Chicago. Over the years, some well known residents built beautiful homes there along Lake Michigan. Less known, but far more plentiful, are the perfectly nice, but much less grand homes which make up most of the town. These homes were historically owned by managers, professionals, and independent business owners.

In 1993, your manager purchased his first home -- a four bedroom colonial on a tree lined street near a school. The home was built in the early 1960's. Next door was a similar one which had been built around the same time. In a discussion with a neighbor one day, I learned that the home next to ours had previously been owned by the president of United Airlines. I found this striking. Thirty years ago, the president of one of Chicago's leading companies lived in a home which today would sell for under a million dollars.

This is how capitalism used to work. The homes on the lake were owned by people (or their heirs) who took risks with their own capital in order to earn their fortunes. They generally were innovators in technology, marketing, or finance. They faced the potential for loss as well as gain. When they were successful, they made huge fortunes. When they failed, they often lost everything.

Contrast this with the mind-set of many CEO's today. The bulk of their compensation generally comes from stock options, so the potential exists for gains but not losses. When options don't work out, the strike prices can be reset at a lower level. If an executive performs really poorly, there is generally a nice severance package waiting at the door.

How did we get to this point, where the "hired help" was living in mansions along with the entrepreneurs? In the 1970's, many American businesses were thought to be lazy and under-managed. There are many reasons why companies become less creative and less entrepreneurial: A poor business environment, lack of an activist shareholder base, and an old-boys club approach to competition, to name three. CEO salaries were low by today's standards, but so were expectations.

This changed in the 1980's when buyouts began to shake up the establishment. Entrepreneurs and innovative financiers showed companies that if they failed to perform they were subject to losing their jobs. The old system was under attack. Two of the rallying cries of this period were "create shareholder value" and "align the interests of management and shareholders." This movement was a key aspect in the renaissance in American business which began in the early 1980's.

Along the way, however, the original idea of aligning shareholders' interests with management was co-opted through the combined efforts of complacent boards, uninvolved shareholders, and an army of compliant compensation consultants. It would be interesting to study whether or not there has been a correlation over the past 20 years between CEO compensation and profitability. My guess is that there wouldn't be any, especially given the collapse of the financials in the past year.

The level of entitlement among some executives has reached remarkable levels. In many cases those who worked for failed financial firms have argued that they are entitled to large payouts despite their firms' collapse on the grounds: 1.) it wasn't their fault, 2.) their division had a good year, and 3.) they will go work somewhere else otherwise. These claims are in most cases dubious. Imagine a worker at the now bankrupt General Motors who argued for a bonus with similar claims: "my bumper assembly line had a great year, productivity was up, accidents were down, and we controlled costs. I deserve a raise."

Capitalism has been -- and will continue to be -- an amazing engine of economic growth, creativity, and entrepreneurial initiative. As Gary Becker points out, it has done more to lift people out of poverty in the past 30 years than anything else. However it is also true that market economies break sometimes (governments break too, of course, probably more often). The response of policy makers cannot be to sit frozen when the failure of market mechanisms is causing substantial harm to the world economy. This doesn't mean all ideas to fix the system are good, just that they aren't all bad either.

In Ayn Rand's classic novel *Atlas Shrugged*, the story is told of an epic battle between those who move society forward and those who live off the spoils. Ms. Rand is now often cited by so-called free market advocates who are critical of some of the financial market reforms which are being proposed. What these people miss is that the executives who have lived off shareholder largess over the years are like the villains of her novel, not the heroes. With apologies to those who haven't read the book, John Thain was no John Gault.

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

Q1 | Wanger Investment Quarterly Letter

Lee Wolf Joins Wanger Investment Management, Inc.

We'd like to welcome Lee Wolf to Wanger Investment Management, Inc. as a Securities Analyst. His responsibilities include researching and monitoring investment opportunities for the Wanger Long Term Opportunity Fund and the Wanger Income and Growth Fund.

Previously, Mr. Wolf was an Associate Analyst at Broadpoint Capital where he was responsible for coverage of the medical technology sector. In this role, the majority of his analysis concentrated on medical device companies in the orthopedics, diabetes, biologics, and neurology spaces. Prior to that Mr. Wolf served as a Private Wealth Manager at Ameriprise Financial and Linsco/Private Ledger. Mr. Wolf has a B.A. in Finance from the University of Illinois at Urbana-Champaign and is currently a level II candidate in the Chartered Financial Analyst program.

Irene Moy
Director of Operations

Jim Cahn Moves On

After nearly two years of hard work, Jim Cahn has decided to move on. We want to thank him for his concentration and dedication. We wish him the best. He has agreed to continue working with us as an Advisor.

Thanks Jim!

We appreciate your efforts! Best of luck from all of us!!

Wanger Investment Management, Inc.

401 N. Michigan Ave,
Suite 1301
Chicago, IL 60611

Phone: (312) 245-8000
info@wangerfunds.com
www.wangerfunds.com