

Q1

Wanger Investment Quarterly Letter

DEAR LIMITED PARTNER,

What Are We Thinking About This Quarter?

Ralph Wanger Reports on How the World Really Works

Things Are Going Great

Things are going very well here at Wanger Investment Management, in fact, they're going great: The Long Term Opportunity beat its benchmarks during first quarter by more than 5% and our new fund, the Income and Growth Fund, was officially launched on April 1st. Want to know more? Give us a call or check out our website: www.wangerfunds.com.

Yield in an Inflationary Time

You, our investors, asked for an investment vehicle that provided reliable yield while offering some protection from inflation. The Wanger Income and Growth Fund is open for business under the skillful hand of portfolio manager Bill Andersen. If you're an accredited investor and wish to learn more about Bills's thinking regarding current income and inflation protection, please contact us.

Economy is Not Out of the Woods Yet

2008 came in like a bear and, thus far, has overstayed its welcome. And

all but the most optimistic "permabulls" see a long trudge ahead for the US economy. Q1 took some major indices off 10-20%, knocking the stuffing out of many funds and managers. (*This is why we hedge the WLTOF.*)

The bulls may say that the worst of the crisis is over: The Fed has pumped enough liquidity into the financial markets, the dollar has bottomed, and the huge write-offs have all been taken. Unfortunately, we're not quite that optimistic. While we may have put the worst of the sub-prime crisis behind us, the global financial system still has to unwind a lot of leverage. As of this writing, interbank lending is still at a standstill with auction-rate securities frozen from illiquidity. Massive contingent liabilities in credit insurance derivatives are still looming over the balance sheets of bulge bracket banks and hedge funds. And inflation—well, the CPI is already at 4%. Do you think it's coming down soon? We don't.

Catastrophe or not, we are not yet done with this credit-crisis. Hopefully, we've avoided a full-on recession.

Good Hunting

For long term purposes, this is our kind of market. We are always on the hunt for high quality and yield rich companies at excellent valuations.

Markets like these favor a flexible approach to valuation, growth and value alike, a fundamental research based methodology and a long-term time horizon.

It's a Great Time to Invest

There is no shortage of things to be worried about. But for us, it's a call to action. Valuations are down and yields are up. Our job is to find those opportunities for you, our partners. Opportunities abound if you are willing to look for them.

This is a great time to be nimble, aggressive and activist.

Yours,

Eric Wanger, JD, CFA

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**Ralph Wanger Reports:
How the World Works**



Ralph Wanger, CFA



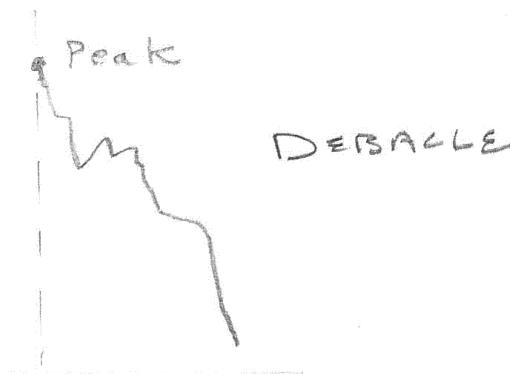
What can you do in a Debacle? Not much. If you own stocks, you can sell some, but rarely enough. If you are running a business, there is not much you can do, because events move so rapidly you can't fix anything. The best you can do is try to elbow your way into the lifeboat ahead of me.

Here is a useful chart. It is useful because it can be used for lots of different reports, such as:

- Value of my house
- Earnings per share for our company
- Price of my favorite stock
- Expected value of my bonus

There are two main parts of the chart:

We will start with the last half, because we are all too familiar with it.



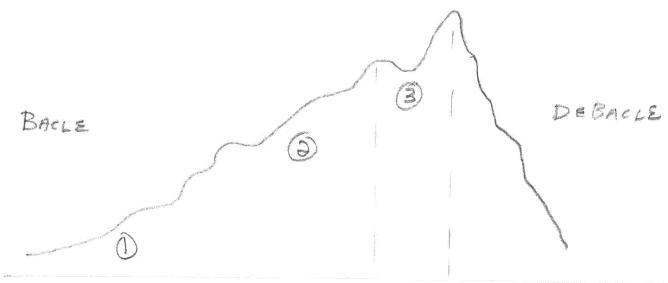
This part of the chart depicts a sudden, steep fall from a peak, that some would call a Collapse, or a Crash, but today we are going to use the more sonorous term, **Debacle!** Regardless of the terminology, a Debacle is unexpected, fast, destructive, and once you are in it, almost impossible to get out of. If you are a skier or a snowmobiler, you might agree this is a fair description of the dreaded avalanche.

Rule 1: The only practical way to survive an avalanche is to be somewhere else when the mountain decides to have one.

Before the Debacle, there is a longer period of general success and prosperity. The last part of this period can be called a Bubble, the bit before the Bubble considered a Boom, and so on, but there has not been a comprehensive word the whole half-cycle until now, for from now on, we will call it the Bacle. Now we have a simple but complete cycle; Bacle followed by Debacle.

Can you avoid the Debacle by not entering the Bacle? Possibly so, but if we are talking about a stock market cycle, and you want to make a living as an analyst or portfolio manager; you have to play, and you should, for there is a lot of money to be made in a Bacle. To make money, and then keep it, we must dissect the structure of the Bacle.

Phase one of a Bacle is when prices are low, and there is not much going on, until a Good Idea Shows up. The Good Idea will spread and create profit and excitement, and eventually generate the whole cycle.



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How the World Works (Continued)

Rule 2: Every bad idea starts as a Good Idea

An idea that is a bad idea to begin with doesn't go anywhere. Your company compliance manual does not have to have a rule forbidding you to drop a cinder block on your foot. Only good ideas have staying power. For instance, when you go to a party, but feel intimidated by a large number of people you don't know, a glass of champagne is a fine way to help you relax, strike up conversations with the other guests, and even make some witty remarks. The first glass is a Good Idea. The second glass makes you even wittier, a trifle ribald perhaps, but your new friends certainly enjoy your stories. You get on the dance floor and discover you can still do some fancy steps, and wondrously, you are now sexually irresistible. Is a third glass of champagne still a Good Idea? Nope. You are entering the last stage of your Bacle, and it is time to switch to club soda or the Debacle will be swift and humiliating.

In the real world, in 2006, the mortgage industry went into stage 3, "Ponzi assets," in which underwriting standards virtually vanished.

The reasons you wanted to write these mortgages were only two:

1. House prices would keep rising rapidly because they always do,

2. We are going to sell the mortgage to someone else, so it won't be our problem.

Rule 3: Bacles have three parts.

Just as our cocktail party had three levels of intoxication, and chess games have three phases (opening, middle game, end game), Bacles have three parts too. My brilliant friend Paul McCulley (the sage of Pimco) describes three phases of investment in a Bacle. He in turn pinched the idea from the economist Hyman Minsky (1919-1996, Professor at Berkeley and later Bard). Minsky had three Bacle investment levels of interesting intoxication.

- 1) Hedged assets
- 2) Speculative assets
- 3) Ponzi assets

What do these three levels refer to? Now we all know all about the home mortgage business, so we will pick examples from mortgages. A "Hedged asset," is safe and old fashioned. You lend a buyer money to buy a house subject to a 20% down payment and verified adequate income on the buyer's part. You can make a decent return on the spread between your bank's cost of funds (say 3%) and the mortgage (say 6%). You have a secure investment because you have a trustworthy borrower whose home equity is worth more than the mortgage.

After a few years, mortgage defaults have been so low that your boss tells you the portfolio is too conservative. Profit margins are fine, but we are losing market share. We can grow faster if we relax standards and finance "Specula-

tive Assets." A speculative mortgage has a down payment of only 10%, and the house carrying costs relative to buyer's income is dangerously high, but a higher interest rate spread will cover the increased risk. Besides, house prices have been rising, even in foreclosure you won't take a loss.

Obviously, this is close to the peak, and Debacle looms.

One of Professor Minsky's insights into the process was to explain why stage one, "hedged assets," wasn't permanent. He showed that the cause of instability was stability! The stable profits made during stage one convince market participants that risks are very low, so taking on more risk means more profits—and for the next few years that is absolutely correct! The first phase of stable prosperity seduces us into level two and then level three which is unstable.

Rule 4: The Debacle is caused by the Bacle.

How can you tell you are in the third and final stage of the Bacle? One sign is that "everyone is doing it." I remember well the Internet Bacle. It was founded on a Good Idea (the Internet will change the way we live) but by 1999, it had gone clearly to the speculative stage. If you held back from buying the whimsical IPO's of the time, the scornful put-down was "You just don't get it!", making you feel that you were the only at the party not making out by the swimming pool. The Debacle was awesome.

Technical Appendix

The word-pair Bacle-Debacle will not withstand serious scholarly analysis, but so what? The "x: de-x" construction is growing in popularity. We all board airplanes, but apparently now we can Deboard them too.

Dewater your flooded basement. Deflate your economy. Decumulate your assets. These words really get used.

The game doesn't always work, though: What is Mentia? Vorce?....Is a good kid a Linquent?

One last thought: Beethoven is dead. Do you suppose he is decomposing?

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



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From The Desk of Eric Wanger:

Time to Invest: It's The Call of the Small



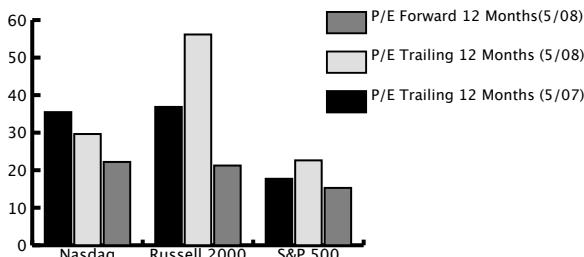
Eric Wanger

The Long Term Opportunity Fund buys shares in very small public companies, looking for capital appreciation over the Long Term. We reduce risk through hedging and embrace an activist approach to investing in small companies. Our results this quarter, have demonstrated the strength of this approach.

If you're very, very quiet, you can hear it, an entire universe of very small public companies crying out in the night:

"Help us! Long Term investors, come help us! Come buy our shares! We're unloved because we're small and cheap because we can't be margined or shorted easily. Many of our very small brethren are starved for cash or stuck without research coverage—but not us. We're profitable, rapidly growing, or have great dividend yields. Many of us have cash rich balance sheets with no debt. We're the healthy ones. Our valuations are affordable for the first time in years. Long Term Investors come save us! Help us, Long Term Investors! You're our only hope."

This, my friends, is the Call of the Small. Long term investors should be greedily looking at small public companies in the US. Valuations have come in, timing is right, and the universe is generally unloved.



Stay away from the little companies with too much debt—financing will be tough and expensive for awhile. Stay away from companies that sell designer genes to one-year old children—the consumer will feel a pinch for awhile.

Valuations are Good
 Valuations of very small firms are very good right now. Many have been dumped simply because their market capitalizations fail to meet some arbitrary limits. Silly? We think so. One way of measuring this is Price to earnings ratios, the price investors are willing to pay for trailing (actual) or future (estimated) earnings. Despite earnings expectations coming down, forward P/E ratios on smaller public companies (Russell 2000) have come down significantly since the beginning of the year, more than the shares medium sized (Nasdaq) or large firms (S&P 500).

Small Company growth is especially cheap. Some of our favorite small growers are firms like Amerigon (ARGN), ClickSoftware (CKSW), Cybersource (CYBS) and Stratasys (SSYS). Patient long-term investors can buy the +20% growth of these cash rich, debt free growers for nearly half the price of only one year ago.

As prices come down, yields come up. Where can you get dividends (some north of 10%) from solid small companies—firms that are going to survive and thrive? Ituran (ITRN), Mortgage Financial (MFA), Redwood Trust (RWT) and Enerflex (EFX) are some of our recent picks. Financials? What? Yes, it's true: Not all financials are created equal. We look at the balance sheets. You'd be surprised what you can find if you are willing to overlook the "smallness" factor.

The Timing is Good

It is popular to say that the current financial crisis is really about the repricing of risk. In our world that means that the "Equity Risk Premium" is being repriced. The ERP is an abstract concept which represents the amount equity investors demand to be paid (in the form of dividends or capital appreciation) above equivalently risky debt. (The CAPM formulation uses beta and the risk free rate to compute ERP). The equity markets plunged during Q1 as equity investors demanded more reward for the risks they were going to take owning equities. Nowhere was this more pronounced than in the area of very small stocks. Small caps vs large caps? Clearly, small caps have taken in on the chin.

The Space is Unloved

When a universe is hated, quality gets cheap too. Very small company stocks are clearly hated right now. And despite the prejudices against this asset class, many of these companies are cash rich, will continue to grow well and even pay dividends. Some of them represent extraordinary values trading at PEG ratios well below 1 and PE ratios below 10 times. But it is definitely the time to look for high-quality, solidly growing small public companies. Remember, the time to invest is when they are cheap, not when they're expensive!

Now is the time for the Long Term Opportunity Fund to put money to work. It's the right time to answer the Call of the Small.

Do you hear it? Above the hue and cry of unemployed Manhattan Investment bankers hoofing apples and pencils on the streets of Manhattan—it's not some Steve Martin comedy routine, go ask Alice, it's the Call of the Small.

Eric Wanger, JD, CFA



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Investment Write-up

Schadenfreude: Profiting from Panic

If there was a single word to describe 2008 so far it would be:

Schadenfreude, loosely translated as “taking pleasure in the pain of others.” Jim Cahn describes how the WLTOF has been taking advantage of the situation.

We were buying in these panicked markets, a strategy which contributed to the fund’s Q1 performance.

Leveraged funds use statistical models to make themselves feel better about taking risky bets. While the bad news in Q1 could be accounted for in their models, the market swings resulting from fear and panic could not. As a result many firms were forced to sell assets into a markets with few buyers, further depressing prices.

The collapse of Carlyle Capital was a textbook example of this phenomenon, providing excellent buying opportunities in its wake. Carlyle Capital borrowed money to buy agency backed mortgage bonds. With the help of generous lenders, the fund ended up with leverage of 32:1 (\$700 million in equity vs. \$21.7 billion in assets), which is the equivalent of buying of buying a \$1,000,000 house with a \$32,250 down payment. On March 6, 2008 Carlyle Capital got a public call from their lender saying they wanted a larger down payment. Carlyle had to sell assets to raise capital, but with the news the agency markets liquidity dried up; there were too fewer buyers even at reasonable valuations. As a result, prices dropped further, which in turn caused the banks to push harder, leading to more forced sales and lower prices.

Why is this interesting to investors in the Wanger Long Term Opportunity Fund (WLTOF)?

WLTOF invests in firms with small market capitalizations. From a risk management perspective, we take great care to ensure liquidity for our investors, but small stocks tend to be less liquid than larger ones. The upside is that our investors capture the higher expected returns demanded for investing in less liquid securities. The downside is that when there is a liquidity crisis, such as the market has been experiencing, these small stocks are disproportionately affected. The short term decline in prices may affect the WLTOF’s month to month returns, but in the long term WLTOF benefits from these forced sales by buying equities in good companies at better than reasonable prices. During the first quarter we hunted for value.

Regional banks appeared to offer an opportunity. Regional banks have been particularly hit by the liquidity crisis and will likely offer investors substantial opportunity for capital appreciation as we return to a more “normal” liquidity environment. Picking regional bank stocks, how-

ever, is like picking used cars; it’s difficult to know which one is going to be the lemon. To gain exposure to financials WLTOF invested in two public firms: **MFA Mortgage (MFA) and Anworth Mortgage (ANH)**, whose strategies are similar to Carlyle Capital, but with greater discipline on the use of leverage. MFA and ANH, like banks, offered the opportunity for capital appreciation from the normalization of the liquidity environment and a steepening yield curve (i.e. borrow for the short term, lend for the long term and collect the spread), but with fewer murky questions on credit and solvency.

Prior to Carlyle Capital’s collapse, ANH and MFA were unattractively priced based on price/book and dividend yield metrics. As Carlyle Capital neared collapse the agency-treasury spreads jumped 10%, and speculation circulated that haircuts (i.e. down payments) would be raised, the result was that the prices of MFA and ANH collapsed; for instance, ANH market value fell 39% from March 4th to March 14th. WLTOF began building a position once the prices had fallen meaningfully below book and we had confirmed with many of lenders to Mortgage REITs that haircuts were not jumping to 10%, but being more reasonable adjusted to the top end of the 4%-5% range.

Between March 14th and March 20th the panic passed and liquidity returned to the market; the agency-treasury spread declined more than 25% from the peak and the share price of ANH rose 44%. The WLTOF continues to hold both ANH and MFA and believes investors will benefit from additional capital appreciation as short term rates continue to fall and spreads revert back to more normal levels.

Investment managers are paid to intelligently take risk. Over the long term, investors in WLTOF will benefit from being a buyer of illiquid securities during times of panic when others are forced to sell.

James L. Cahn



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Bill Andersen: Crises and Recessions Linked?

William Andersen is the portfolio manager of the Wanger Income and Growth Fund, our newest portfolio.

In the past 50 years there have been just two recessions which lasted over a year.

Financial markets have calmed in recent weeks and there are some signs the financial crisis may be in its later stages (though, there are plenty of danger signs too). But will this crisis will bring about a big economic slowdown? While there is pretty much a 100% correlation between financial crises and predicted recessions, the correlation with actual slowdowns is much less direct. During the author's career, crises have occurred in 1987, 1990, 1994, 1998, 2000-2001 and 2007-8. Each was accompanied by predictions of a major recession, but this only occurred twice (so far) and each of these recessions was rather shallow lasting just eight months.

In considering the link between financial crises and recessions, I'd propose looking at the following factors:

Size of the crisis. One thing which distinguishes the current situation is its sheer magnitude. By all measures, the current credit crisis is huge. The write-downs by major financial institutions, the failure of a major Wall Street firm, the stimulus by the Fed and the bailout of the securities industry combine to make this the most important financial crisis in a generation. This would argue for a bigger than usual likelihood it could have a meaningful impact on the economy.

Nature of the crisis. Some crises seem to cause more problems than others. During the past 20 years, for example there have bee several crises set off by over-valued equity markets. Despite predictions, they didn't result in major slowdowns. Debt crises overseas (Russia ('98), Mexico ('94), Brazil ('70's) were also fairly well contained. Currency crises (Asia '98) were also contained as well, although the locals may not agree. On the other hand, the U.S. commercial real estate slowdown in the early 1990's did impact the economy. The current residential real estate slowdown may have a similar effect.

Potential for additional problems. Whenever there is a crisis, there is a tendency to predict that it will escalate. This time is no exception; the bears have some good points. Certainly the problems seen in residential real estate could be extrapolated to other areas of consumer lending like credit cards and autos. Huge amounts were also lent to finance private equity buyouts over the past few years. Guess who holds these loans? If you answered the same institutions who owned all the sub-prime debt you are correct. The concern is that the system is vulnerable now and another crises would be hard to deal with.

Fed Policy Errors. The Fed has a colorful history of turning financial crises into economic recessions or worse. It is widely believed that Fed tightening after the stock market crash in 1929 tipped a weakened economy into what became an economic debacle. Fed policy in the 1970's helped turn a commodities boom into a generalized inflation (inflation reached 13% in 1980) which was followed by a severe recession as the new chairman Volker reversed course and inflation was contained. During the Greenspan era the Fed was generally successful in containing financial crises. The "formula" was essentially to supply ample liquidity to the financial system during times of crisis. Unfortunately, too much money can also cause rising prices and a declining currency. This may be the time that the formula doesn't work. If so, policy makers will be in uncharted waters.

Other Factors. Financial crises don't take place in a vacuum. In the current case, I think a big positive is the remarkable growth seen in developing economies like India, Brazil and China. This could mitigate the effect of the crisis. Keep in mind that in addition to exports, countries like Mexico, Brazil and Chile are commodity driven, and are benefiting from the boom in this sector. And Asian economies like China and Korea have growing domestic markets. Exports are still holding up as well. Figures from Korea recently showed exports still very strong, with Asia and Latin American growing and the U. S. slowing.

Long Term Cycle. Analyzing long term cycles is notoriously difficult, and potentially useless: Get a 50 year cycle wrong by just 10% and a forecaster's career can suffer a big setback. That said, the global economy has seen 26 years of remarkable growth in earnings, stock prices, GDP and most any measure you can think of, including debt. Even our own system of economics has undergone a boom and been adopted virtually worldwide.

It is easy for investors to become too negative at points such as these. The evidence regarding the current situation and future expectations is mixed. At the very least, markets may have a substantial rebound as excess pessimism is unwound. At best, the positive factors noted above will continue and the negatives will eventually be worked through.

Bill Andersen, CFA

