Q2 | Wanger Investment Quarterly Letter

Dear Sir/Madam:

What Are We Thinking About This Quarter?

Eric Wanger discusses the trashing of the Efficient Market Theory

Ralph Wanger discusses the link between America's military and economic power

Death Takes a Holiday

Markets were up nicely in Q2 and there are (finally!) murmerings of an eventual recovery. It's nice to get a break from the relentless stream of bad news. Sobering stuff, but it certainly feels better to worry about the Fed's stimulus program than about how many hundreds of thousands will lose their jobs this month. Is the rally sustainable? We'd like to know too.

Where Are We Now?

The U.S. economy is in a complex place. Things are clearly getting better, but it's impossible to really know. We are cautiously optimistic but are taking a trust-but-verify approach to investing. Banks are still sick, but grudgingly starting to lend. Bond issues are back and capital is starting to flow again—but expect to fill out a lot of forms if you want a loan. The days of easy lending are definitely over.

The "new normal" is really the old normal again: Get used to life without heady stock market and real estate profits supplementing our salaries and unsustainable spending habits. Household savings rates are higher than they have been for decades. And, yes, paying down your credit card bill counts as saving!

Where's the Growth?

As the quarter ended, we saw many firms reporting higher profits on lower revenues. Obviously, this can only happen if expenses decrease faster than revenues. Theoretically, we should all want responsible corporate management teams cutting costs if revenues are shrinking. Profitability is good. However, an entire domestic economy full of firms cutting costs will have a sluggish time returning to growth. If you want to see growth, look back to China and its Asian neighbors. Huge amounts of stimulus are definitely taking hold. Hopefully, the Chinese haven't merely swapped an export crisis for an eventual banking crisis. Only time will tell.

Our Kind of Market

We're definitely in a "stock picker's" market, an environment that should play to our strengths. "Active" managers such as ourselves need to demonstrate that we can consistently produce better returns than raw passive indices. It takes a lot of work, but that's exactly what we're here to do.

We started the Long Term Opportunity strategy to capture misunderstood opportunities in small public shares while hedging against major downswings in the market. Next we started the Income and Growth strategy to provide current income with some inflation protection. Things are exciting here.

Take a look at our numbers, they're really good! Email us at **info@wangerfunds.com** or visit us on the web at **www.wangerfunds.com**.

Stay tuned! There's a lot going on here!

Yours,
Eric Wanger, JD, CFA

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From The Desk of Eric Wanger:

Trashing EMH: Sometimes a Cigar is Just a Cigar

Eric Wanger, JD, CFA

"The incredibly inaccurate efficient market theory was believed in totality by many of our financial leaders, and believed in part by almost all. It left our economic and government establishment sitting by confidently, even as a lethally dangerous combination of asset bubbles, lax controls, pernicious incentives and wickedly complicated instruments led to our current plight. 'Surely, none of this could be happening in a rational, efficient world,' they seemed to be thinking. And the absolutely worst part of this belief set was that it led to a chronic underestimation of the dangers of asset bubbles breaking." --Jeremy Grantham

In the wake of the recent economic turmoil, it has become fashionable to trash the philosophical underpinnings of our financial system. One of the most universally reviled ideas is the Efficient Markets theory:

The efficient market hypothesis—long part of academic folklore but codified in the 1960s at the University of Chicago—has evolved into a powerful myth…The theory holds that the market is always right, and that the decisions of millions of rational investors, all acting on information to outsmart one another, always provide the best judge of a stock's value. That myth is crumbling. --The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street By Justin Fox.

It's not obvious where this idea that "the market is always right" came from exactly, but it's not part of the Efficient Markets Hypothesis ("EMH").

Professor Eugene Fama, in a 1970 paper, defined EMH as "the hypothesis that security prices at any point in time 'fully reflect' all available information." "Efficiency" is an abstract concept describing the rapidity and thoroughness with which market prices come to "reflect" (another abstract concept) whatever information is available. In other words, the more completely and instantaneously that market participants use the information they possess, the more "efficient" the market.

EMH, as it is known to finance geeks, seems too esoteric to be worth hating. Yet so do the differences between Sunni and Shiite Islam or Catholicism and Protestantism and lots of people have died over those rather technical differences. It seems that ideas, even very abstract ones, can become doctrine. People are funny that way.

In its most literal form, EMH is actually quite counterintuitive. Under "strong" EMH, for example, it would be impossible for a trader to take advantage of any "mispricings" because they could not, by definition, exist. That is what Fama (*et al.*) meant when they said that an efficient market fully reflects all information.

It's easy to understand why economists, mathematicians, and finance theorists found this idea valuable. Like Freud's Theory of the Unconscious, Darwin's use of Natural Selection, or Galileo's demonstration that the sun really is in the center, EMH provided a fresh way to look at the world, opening up an entirely new area of intellectual and philosophical development. However, just like these ideas, time has turned the authors of EMH into saints and their writings into creeds. Ultimately EMH came to be preached, not discussed, leaving little room for doubt or debate. That's how it was taught to me, too.

The attacks on the EMH are really attacks on the students and teachers of EMH who have risen to power in finance and government. EMH has come to stand in for the arrogance of hedge-fund managers, mortgage brokers, and the risk managers at Lehman, Bear Stearns and AIG. That's why people bash it: Our brightest finance students just bankrupted the country. Yet, EMH is just an idea, and ideas don't do much damage by themselves:

It's ridiculous to blame the financial crisis on the efficient market hypothesis. If you are leveraged 33-1, and you're holding long-term securities and using short-term indebtedness, and then there's a run on the bank—which is what happened to Bear Stearns—how can you blame that on efficient market theory? --Burton Malkiel quoted in Poking Holes in a Theory on Markets by Joe Nocera, June 5, 2009.

Eugene Fama wrote: "Though we shall argue that the model stands up rather well to the data, it is obviously an extreme null hypothesis. And, like any other extreme null hypothesis, we do not expect it to be literally true." That's hardly the position of a zealot.

So even if Sigmund Freud never actually said, "sometimes a cigar is just a cigar," Mark Twain did say, "I smoke in moderation. Only one cigar at a time."

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

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Ralph Wanger Reports:

American Power Goes Sub-Prime

Ralph Wanger, CFA

The story we have all been reading:

The financial crisis and the depression that followed have had dramatic effects on the fiscal position of the United States. Federal deficits for the foreseeable future will be in the trillion dollar neighborhood, and that is a more expensive neighborhood than most CFAs can afford. As these deficits accumulate, the federal balance sheet will deteriorate, so in a decade government debt outstanding will reach 100% of GDP. The buyers of this flood of debt—China, Saudi Arabia, Russia, and other big exporters to the U.S.—are already getting publically nervous about buying all this dollar-denominated paper. Economic theory suggests that the dollar will depreciate, requiring the Treasury to pay high interest rates to place all this debt. Businesses and consumers will be taxed at very high rates in order to offset the deficit. The U.S. economy will not be able to recover and grow in a time of stagflation.

There is a second part of the story that has not been talked about much yet, but will be soon: Foreign policy!

This negative scenario has been presented in many articles.

Yet, there is a second part of the story, one that has not been talked about much, but will be soon: Foreign policy!The United States has had a muscular foreign policy for a century and has been victorious in three major wars. We were a late but decisive factor against imperialism in World War I, the victor on two fronts simultaneously against Fascism in World War II, and then we outlasted Communism in a 70-year "Cold War" (although Korea and Viet Nam were uncomfortably hot for those involved).

One can claim that the conflict between Islam and the West has been going on for 14 centuries, and not showing any signs of ending.

Today the United States and its allies are battling Islamist militants and have deployed major armies in Iraq and Afghanistan. These two fronts have involved American casualties, so there is a natural emphasis on Iraq and Afghanistan, but in addition there are a couple of dozen countries fighting Islamist rebellions of various sorts and sizes. One can claim that the conflict between Islam and the West has been going on for 14 centuries, and not showing any signs of ending.

Can we pay for our wars without borrowing money from other countries? All wars are expensive, and as technology makes every soldier more capable, the cost per soldier goes up. Here is what has happened to jet fighter planes:

PLANE	INTRODUCED	UNITS	COST each (mil.)
F-22 *Raptor*	2005 *Iraq*	187	$ 137.5
F-4 *Phantom*	1960 *Viet Nam*	5,195	$ 2.4
F-86 *Saber*	1947 *Korea*	9,860	$ 0.2

The F-22 program became so expensive that Congress recently stopped it. I suppose nobody could think of a target worth attacking if there was a 1% risk that we could lose a $137.5 million airplane in the process.

The logical limit on a weapons procurement program was in *Star Wars*, the Death Star planet destroyer, procurement quantity: one, despite having tax revenue from hundreds of planets. The unit cost was, of course, astronomical.

The United States of America can no longer afford to fight a war without borrowing the money for it.

The countries that have the money—China, Saudi Arabia, Russia, etc.—have their own foreign policy agendas. We would have to negotiate loans from people who may well oppose our policies. The Europeans, who controlled most of the world in 1914, lack the financial strength and the will to exert power in the world. They argue that using diplomacy is much more civilized. I suppose that diplomacy is more civilized, but diplomacy has not impeded the Iranian nuclear program -- heck, it hasn't even worked against the pirate kids in Somalia. Diplomacy works best with a carrier group sailing nearby.

If our creditors have veto power over our military power, we will end up like Switzerland but with sicker banks. Financial weakness means military impotence. Examples of countries that suffered this weakness include: Great Britain after the Great War; the Ottoman Empire in the 19th

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American Power Goes Sub-Prime (Continued)

century; China in the 19th and early 20th century; and The Confederate States of America (C.S.A.) from 1861-65.

I was at a party in early July and saw a middle-aged Asian couple sitting by themselves. I went over to their table and introduced myself. I was pleased to meet the Japanese Ambassador to the United States, Fujisaki-san, and his wife. We had a very friendly chat because my wife Leah's parents were saved from certain death at Auschwitz by the Japanese consul in Lithuania, Sempo Sugihara. Fujisaki's grandfather was also a Foreign Service officer, posted in Czechoslovakia, and a friend of Sugihara. I asked the Ambassador about the financing of the Russo-Japanese War of 1904-05. Japan, a few small islands, was at war with the whole damn Russian Empire, and no one gave Japan much of a chance. Surprise! The Japanese Army and Navy performed with skill and valor, and was winning on the battlefield, but their country was out of foreign exchange, and so could not finance the war. The New York investment banking firm, Kuhn, Loeb, & Co., saved the situation by underwriting $260 million in Japanese bonds, allowing Japan to continue to fight. (The Russians were out of money too, but cut a deal with a French bank.)

The consequences of that loan were complex and far-reaching. Japan was able to do well on the battlefield but felt screwed by the Portsmouth Peace Treaty dominated by Teddy Roosevelt. Proud of their martial spirit but angry at the European and U.S. nations that patronized them, Japan was set up for its aggressive policy of the 1930's, climaxing at Pearl Harbor. The Russians, on the other hand, felt humiliated by their battlefield defeat. The realization of Romanoff incompetence generated popular disgust with the Tsarist regime, and encouraged the various left-wing revolutionary parties.

An All-American story of war finance was, of course, the Civil War. The Confederate States and the Union had identical technology at the start of the war, and the Confederacy raised a spirited army with excellent generals such as Stonewall Jackson and Robert E. Lee. The Southern cavalry was better. The North had a much stronger navy and better artillery. The Union had a bigger population and superior manufacturing and railroad systems, while the South was agrarian, and Dixie capital was invested in slaves, not lathes. A typical statistic: miles of railroad track were 30,000 in the North, only 9,000 in the South. War financial ability had a similar ratio favoring the Yankees, and the Federals had a far superior banking system. The C.S.A. ended up printing money to pay their bills, resulting in hyperinflation and economic collapse. The Confederacy hoped that the North did not have the stomach for a long, bloody, and costly conflict, but when Lincoln persuaded the North to pay the price of victory, the Southern cause was doomed.

To repeat the lesson, without financial independence, you cannot be the hegemonic power.

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

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Bill Andersen:

Same Situation, Different Result

In 1977 Tom Watson walked up the 18th fairway at Turnberry, a stroke ahead of Jack Nicklaus in one of the most famous golf duels of all time. He hit a seven iron within two feet of the hole and made birdie to win the championship. Thirty two years later, Watson again enjoyed a one shot lead in the final round of the British Open at the same course. As most everyone knows by now, he hit his second shot a little too strong and bounced it over the green. He ended up with a bogey on the hole and subsequently lost the tournament. Two seemingly identical situations resulted in completely opposite outcomes.

In 1929, financial markets collapsed globally. In the ensuing years, a series of poor monetary policy and world trade decisions, along with numerous unsuccessful attempts to stimulate the U. S. economy, resulted in a global depression. Following the crash of 2008, many are predicting a similar result for the global economy in the coming years. But just as Tom Watson experienced a different outcome at the British Open last month, it is very possible that the results for the economy will be much different this time around.

One of the most important differences between now and 1929 is the strong economic activity coming from the world's developing economies. In the 1930's, places like India and China were poor, rural economies with economic and political systems which made substantial growth almost impossible. India was still under colonial rule while China and Brazil were both in the midst of severe political turmoil. When the slowdown came in the developed world, these economies succumbed as well. Today these economies, while still poor and rural, are committed to market economies and are growing very rapidly even as the developed world slows. Statistics from the International Monetary Fund show that since 2005, China has accounted for over 70% of the global increase in oil and coal production. The Chinese economy is predicted to grow by over 7% this year. While some may question the accuracy of figures coming from the Chinese government, it is clear that their economy is doing better than much of the world.

Another difference from the experience of the 1930's has been the policy response, particularly in terms of monetary policy. It is generally agreed upon that following the stock market crash of 1929, the Fed made a policy error by tightening after the crash, which made the situation worse. Contrast this to the current situation where central banks globally have loosened monetary policy in almost every way imaginable. There is no guarantee, of course, that this will be successful, but the outcome is likely to be quite different from the 1930s. China, for example, has gone on a stimulus and monetary binge. According to *Grant's Interest Rate Observer*, M-2 money supply is up 25.7% from a year earlier. Their local stock market has risen over 60% and bank lending has doubled. While this certainly creates some long term concerns, for now the situation appears to be positive.

In the U.S., a healthy re-pricing of risk seems to be in place. A recent conversation with a senior banker reveals that most credits are being substantially re-priced as they come due, with a return to a "prime plus" pricing model rather than the "prime minus" one which didn't work out so well. With less capital available and more rational pricing, our view is that bank lending and credit investing generally should be profitable for some time to come. As we have said before, we favor the master limited partnership sector, where investment grade companies can still be purchased with high single digit yields and reasonable expectations of growth.

None of the above is meant to present a sanguine view of the current economy or its prospects. Policy makers face many challenges and the outcome of their decisions is uncertain precisely because they have never been tried before. That said, the short term prospects for global growth are better than after the previous great crash, and the downward spiral which seemed likely just a few months ago seems to have been postponed and possibly averted.

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

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Investment Writeup:

Zenith National Insurance (NYSE: ZNT)

On a daily basis the analysts at Wanger are presented with unique investment opportunities, many of which tell a good story, but lack the "special sauce" that makes the story worth repeating. From a fundamental standpoint, we have seen an increase in the number of companies that appear to be cheap when valued on a P/E or Enterprise Value multiple; however, we have not experienced an equivalent increase in the number of companies in which we would like to invest. This begs the question: How can investors distinguish between a "value trap" and a stock that adds alpha? We believe that a recent addition to our portfolio — Zenith National Insurance Corp. (ZNT) — exemplifies a value play with the right amount of dislocation.

Zenith sells workers compensation insurance to small and medium-sized businesses, primarily in California and Florida. While many of their larger competitors have an appetite for a broad range of underwriting, we were attracted to Zenith's focus on industry specialization and customer service. In contrast to life insurance, where actuarial tables are more straightforward, the assessment of workers compensation risk requires industry specialization. We believe Zenith's focus on the agriculture and manufacturing industries is intelligent, but also necessary, given the higher risks associated with jobs in each respective industry.

Higher workers compensation risk translates into higher premiums, but Zenith does not compete on price. On the front end, a business will pay more for workers compensation coverage with Zenith than with its competitors; however, the business will reduce its overall costs in the long-run. How is this possible? After underwriting policies for a customer, Zenith will visit the client with the aim of educating and training employees and management. Over time, Zenith's goal is to reduce the risk profile of its customers, which translates into less risk, reduced premiums, and lower total costs.

Independent insurance brokers (that we spoke with while conducting channel checks) who sell Zenith's policies know them as a company that scrutinizes each customer carefully—rejecting the majority of applicants. We are also encouraged by the ongoing service that Zenith provides, which is another important differentiating factor for high risk employers. For example, California's state workers compensation plan is one of only a few insurers willing to underwrite high risk policies; however, a worker who gets his hand caught in a machine would prefer to avoid a customer service experience akin to the department of motor vehicles.

On the surface, Zenith appears to have struggled over the last few years, with revenues down roughly 32% since 2007. Currently, the less favorable pricing environment and a volatile investment backdrop create additional challenges for the company. Based on 2009 estimates, Zenith is trading at a P/E ratio of approximately 80. But before you ask me if I wear a bicycle helmet, please try to think of Zenith as one part insurance company and one part investment company. Behind the premium revenue is a substantial reserve account that has been put in place to pay claims as they become due. If, on average, it takes three to four years for Zenith to start receiving claim requests, they will have ample time to invest and create additional shareholder wealth. Similar to their underwriting style, Zenith's reserve account has been managed conservatively, generating income for the common shareholder to the tune of an 8% dividend yield. Additionally, the company trades at a 12.5% discount to book value, which is composed mostly of the reserve account (and a small, manageable amount of debt). We believe their dividend is sustainable and are satisfied with the outcome of our dividend discount model valuation.

Zenith's revenue decline in recent years can be explained in part by macroeconomic pressures and in part by management. To the extent that management is responsible for the decline, we believe the downturn was intentional. In a downward pricing pressure environment some companies make compromises on their underwriting standards, aware that their loss ratio will increase, but in the spirit of achieving greater investment returns on their reserve account—a disaster waiting to happen. Zenith is focused on long-term sustainability and their declining revenues speak more to a disciplined business plan than a short-term vision.

As a cyclical play, we believe Zenith will survive and is well-poised for growth during a macro recovery. Fur-

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Zenith National Insurance (NYSE: ZNT) (Continued)

thermore, premium pricing and book values are cyclical in the workers compensation industry. Zenith's peers are currently trading at an average of 0.9x book value, but have a long-term historical average of 1.4x book. At 0.875x book, we believe Zenith has limited downside. Additionally, we have already seen early signs of premium price increases in California. Significantly higher combined ratios across the industry signal that further price increases are on the way—leading to higher profitability. Price increases and multiple expansion should provide healthy tailwinds as the company regains momentum in a recovery. Until then, we are content spending time with the strong dividend yield and excellent management team.

Lee Wolf *is a Securities Analyst for Wanger Investment Management, Inc.*

Irene's Corner:

Comings and Goings

Joel Hainsfurther Joins Wanger Investment Management, Inc.

We'd like to welcome Joel A. Hainsfurther 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 interfacing with investment professionals to help expand distribution of Wanger Investment Management's proprietary strategies.

Previously, Mr. Hainsfurther served as an Editorial Intern and Contributor at the *Diplomatic Courier* where he wrote articles covering a wide range of foreign policy issues. Mr. Hainsfurther graduated cum laude from Lake Forest College with a B.A. in politics; he graduated with honors in the politics major, received distinction for his senior thesis on post-9/11 U.S. - Iranian relations, and was the 2009 recipient of the Solly A. Hartzo Award in Politics. Mr. Hainsfurther served as an intern at Wanger Investment Management for a year prior to joining the firm full time in June 2009.

Raja Vannela Joins Wanger Investment Management, Inc.

We'd like to welcome Raja S. Vannela to Wanger Investment Management, Inc. as a Securities Analyst. His responsibilities include quantitative analysis and software development.

Previously, Mr. Vannela served as a Software Analyst at Accenture Services Pvt. Ltd, in India, where he worked on financial software development. Mr. Vannela graduated from the Birla Institute of Technology & Science in Pilani, India with a B.A. in Economics and is currently pursuing his Masters in Mathematical Finance from the Illinois Institute of Technology. Mr. Vannela is currently a Level I candidate in the Chartered Financial Analyst program.

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