Q4 | Wanger Investment Quarterly Letter

Dear Limited Partner,

What Are We Thinking About This Quarter?

We're growing again! William Andersen has joined us in the role of Portfolio Manager. **Bill will join Wanger Investment Management as portfolio manager of the Wanger Income and Growth Fund. Bill brings a wealth of experience and insight. We couldn't be more excited.**

Welcome to Bill Andersen, the newest member of our firm

Ralph Wanger Reports on The Unreality of Wealth and The Forbes Fictional 15

What Are We Thinking About?

Well-coiffed heads continue to roll all over bulge-bracket America while presidential campaign debates on the war and abortion have taken second row to the economy. Last year's obsession with inflation has been replaced by new fears of a credit-crisis and recession. Will the rest of the world slow with the US or are the "linkages" loose enough to allow the other major economies to continue growing despite a US slowdown?

The headlines are devoted to economic analysis and impassioned pleas to the Federal Reserve and Congress for liquidity and stimulus. Our economy is coming out of a hard-drinking period, binging on cheap money and easy credit. The hangover won't be fun.

Apparently, neither massive government stimulus packages nor foreign wars represent "big government" or fuel for inflation. But it's an election year, so all *laissez-faire* bets are off. We can let the next President worry about stagflation and what to do about the "permanent" income and estate tax cuts, the latter of which are scheduled to expire in 2010 for just one magical year.

Sailing When The Winds Are Light

Ralph once said you can't really tell who knows how to sail until the winds are light. 2007 came in like a lion and went out like a lamb as sentiments for near-term growth in the US clearly soured. 2008 has already brought strong headwinds to equity investors with major indices off 10-20% from their recent peaks. By most measures, the winds are light, but this is exactly the kind of test we like, and we hope to prove our seamanship.

Markets like these favor a flexible approach to valuation, growth and value alike, a fundamental research based methodology and a long-term time horizon. We are beating the bushes for interesting opportunities made available by the recent market tumult.

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

Actually, 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. We are all about "Rising Stars and Fallen Angels" positioned to take advantage of long term trends. Valuations have come down and our job is to find those opportunities for you, our partners. Opportunities abound if you are willing to look for them.

Yours,

Eric Wanger, JD, CFA

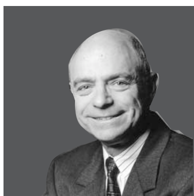
In This Edition

Page	Section	Title
Page 2	Ralph Wanger Reports	The Unreality of Wealth: Epistemology vs. Ornithology
Page 4	From the Desk of Eric Wanger	Come and say hello. We're on the 13th Floor
Page 5	Investment Write-up	Cypress Bioscience (CYPB)
Page 6	Wanger Investment Management Welcomes William Andersen	We welcome William Andersen in the role of Portfolio Manager of the Wanger Income and Growth Fund
	Bill Andersen	Income in a Turbulent Market
Page 7	Our Funds	Wanger Long Term Opportunity Fund II, LP Wanger Income and Growth Fund

Q4 | Wanger Investment
Quarterly Letter

Ralph Wanger Reports:

The Unreality of Wealth: Epistemology vs. Ornithology



Ralph Wanger, CFA

Below is a list of the Forbes Fictional 15. You may enjoy the challenge of trying to remember where these characters have appeared:

The Fictional 15:

1. *Scrooge McDuck*
2. *Ming the Merciless*
3. *Richie Rich*
4. *Mom*
5. *Jed Clampett*
6. *Montgomery Burns*
7. *Carter Pewterschmidt*
8. *Bruce Wayne*
9. *Thurston Howell III*
10. *Tony Stark*
11. *Fake Steve Jobs*
12. *Gomez Addams*
13. *Willy Wonka*
14. *Lucius Malfoy*
15. *Princess Peach*

I hadn't thought much about Scrooge McDuck over the last few years. He has waddled back into prominence by being designated "fiction's richest character" by Forbes magazine. He was assigned a net worth of $28.8 billion. This is not a particularly accurate figure, but Forbes estimates for the net worth of the richest 400 non-fictional people are subject to the same charge of quackery.

The whole enterprise seems highly suspect to me, because these characters are not really imaginatively rich. Number 13 for instance, Willy Wonka, is said to have $1.9 billion which is much less than the Mars family fortune, even though the Mars family has the disadvantage of having to manufacture real candy. Mr. McDuck, although prosperous for a non-mammal, is not quite as rich as Ingbar Kamprad, the Swedish founder of IKEA. One would think that it would not be that difficult to invent a character richer than a man who runs a furniture store.

When you read about the current financial crisis in America and realize it was caused by the diligent efforts of somewhat overeducated and vastly overpaid executives. This flock of MBA's discovered how to get rich by lending other people's money to home buyers who had neither the capacity nor the inclination to ever pay any of it back. Any essayist is bound by tradition to call this "Alice in Wonderland" logic. The problem with pinching metaphors from the Alice books is that it is too easy, "duck soup", one might say. However, Lewis Carroll wrote other quotable lines outside of the Alice books. One of them, Sylvie and Bruno, written in 1889, sold very few copies and is virtually unknown today, for cause. Its Victorian sentimentality is too syrupy Still, there are some bits of genius floating in the treacle.

One minor character, the Professor's Tailor, has an interesting claim to be the richest person in fiction. The following passage comprises everything that is known about this tailor:

> *"Come in!" (Says the Professor)*
>
> *"Only the tailor, Sir, with your little bill," said a meek voice outside the door.*
>
> *"Ah, well, I can soon settle this business," the Professor said to the children, 'if you'll just wait a minute. How much is it, this year, my man?" The tailor had come in while he was speaking.*
>
> *"Well, it's been a doubling so many years, you see," the tailor replied a little gruffly, "and I think I'd like the money now. It's two thousand pound, it is!"*
>
> *"Oh, that's nothing!" the Professor carelessly remarked, feeling in his pocket, as if he always carried at least that amount about with him. "But wouldn't you like to wait just another year, and make it four thousand? Just think how rich you'd be! Why, you might be a King, if you liked!"*
>
> *"I don't know as I'd care about being a King," the man said thoughtfully. "But it; dew sound a powerful sight o' money! Well, I think I'll wait--"*
>
> *"Of course you will!" said the Professor. "There's good sense in you, I see. Good-day to you, my man!"*
>
> *"Will you ever have to pay him that four thousand pounds?" Sylvie asked as the door closed on the departing creditor.*
>
> *"Never, my child!" the Professor replied emphatically. "He'll go on doubling it, till he dies. You see it's always worth while waiting another year, to get twice as much money!"*

As can be seen, the tailor has a note from the professor for 4000 pounds in 1890, and the value of the debt doubles every year. If these characters are still alive, and Carroll's characters don't have to be mortal, then the debt would now be an impressive sum, 4000×2^{118} pounds sterling. Since this number is many trillion times larger than all the known wealth of the universe, the tailor could claim to be the wealthiest character in fiction. The difficulty the tailor has, of course, is the same problem facing Citicorp, Countrywide, and Merrill Lynch. They have very large notional receivables but it has finally dawned upon them that much of the debt on their balance sheet is worthless. It is hard to judge, after reading even a great deal of Lewis Carroll's

Continues on the next page

Q4 | Wanger Investment
Quarterly Letter

The Unreality of Wealth: Epistemology vs. Ornithology (cont.)

works, exactly when the Professor's Tailor would have realized that this shabby academic could not pay 1000 pounds, let alone a sum of money larger than trillions of Scrooge McDuck's. There are some self-referential paradoxes in the case of a fictional character realizing that his fictional wealth is, well, fictional. There are some poems in Sylvie and Bruno which track the mental state of our credulous haberdasher, but these poems are mostly nonsense. The following verse is the closest hint we have to explain the tailor's paradox.

He thought he saw a Rattlesnake
That questioned him in Greek,
He looked again and found it was
The Middle of Next Week.
"The one thing I regret," he said,
"Is that it cannot speak!"

Sylvie and Bruno is nonsense and fantasy written by a real person under a false name. This is too good a business plan not to be used in modern finance. There was a hedge fund begun in 1996 called the Bayou Fund. It was begun by a stock trader from New Orleans who picked the swampy title in a pre-Katrina year. The Bayou founder believed that he could execute what was essentially a day-trader's long/short strategy, thus accumulating great wealth for his investors and for himself. His plan fell somewhat short in practice. He was doing pretty well at generating wealth for himself, because he owned the brokerage company that executed the incredible volume of trades generated, but the return to shareholders was grimly negative. The manager had the good sense to stop trading, but like the Professor, did not feel like paying off his obligation. Creative fiction saved the day. First, Bayou fired its legitimate auditor. Then they invented a new accounting firm with an address, nice stationery, but no employees. The CFO at Bayou had two phones on his desk, so that if a call came in on the blue phone, he would say "This is Mr. Marino of the Bayou fund. How may I help you?" and if a call came in on the green phone, he would say "This is Matt Richmond of Richmond Fairfield Associates. What can I do for you?" This system worked perfectly well. In 2003, for instance, Mr. Richmond published an audit showing a $25 million gain even though Mr. Marino knew that the fund had lost $35 million that year. The fund continued to bring in new investors because of their fine published results. In late 2005, the scheme unraveled and Mr. Israel, the portfolio manager and Mr. Marino, the duplicitous financier, both pleaded guilty to conspiracy and fraud charges. It is too bad the scheme ended so soon because in a few years "Matt Richmond" could have claimed more wealth than Willy Wonka. Would he make Forbes on the real or fictional list?

Computer games take place in a fictional virtual world, but human players can get entangled in them. In the game Second Life, players, using avatars, can do everything real people do, including business deals using "Linden Dollars". Some entrepreneurs set up banks, and encouraged innocent avatars to put in real-world dollars invested into Linden dollars. The Wall Street Journal (Jan. 23, 2008) reported in dismay that many of these banks have failed, causing the depositors to lose real money at an imaginary bank.

The line between fact and fiction is crossed and double-crossed by Forbes #11, Fake Steve Jobs. There is a real Steve Jobs at Apple. In 2006, a blog appeared, "The Secret Diary of Steve Jobs". The author posted himself as "Fake Steve Jobs", but after a lively search, was unmasked as Daniel Lyons, a Forbes senior editor. This reduces the concept to a mere inside joke at the Forbes office. The real Steve Jobs was quoted as saying, "I have read a few of the Fake Steve Jobs things recently and I think they're pretty funny." One may conclude, that if you have seen your wealth diminish in the stock market over the past few months, then perhaps some of your wealth wasn't really there in the first place.

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

Q4 | Wanger Investment

Quarterly Letter

From The Desk Of Eric Wanger:

Come and say hello. We're on the 13th Floor

Eric Wanger

Our new address:
Wanger Investment Management
401 N Michigan Ave
13th Floor
Chicago, IL 60611

Discover the many dimensions of terror that await you. Experience the sights, sounds and smells of fear as you journey through the nightmare that is the 13th Floor!

Some conspiracy theorists have suggested that the thirteenth floor in government buildings is not really missing, but actually contains top-secret governmental departments. (Wikipedia)

We are excited to announce that we are taking new offices at 401 N Michigan Avenue in Chicago, a lively building with great views of the Chicago River, the Wrigley Building and Navy Pier. The space is ample and will support our growth. Come and say hello---we're on the 13th Floor. We just hope that none of you suffer from *Triskaidekaphobia.*

You may be aware that there is a whole thirteenth floor "thing" out there. Thirteen is often considered an unlucky number (for reasons that are not that interesting) and the superstitious avoid it. Google the phrase "13th Floor." You'll be impressed by how much you get. Thirteens and thirteenth floors are practically a whole literary sub-genre. There are films, books, bands, clubs, etc. Thirteen is satanic. Thirteen is conspiratorial. Thirteen is kinky. Thirteen is horrific. Thirteen is psychedelic.

As a result, many office buildings and hotels have found something else to call that floor which is more than 12 and less than 14 floors above the ground. Some airlines have no thirteenth row of seats. No Grand Prix race car will ever hold the number 13. One European airline had to change its logo because it contained 13 dots. Apparently, starting as 13 colonies didn't hurt the United States. (Although it was pretty unlucky for the British).

Certainly other numbers can give you goose bumps. 4 is associated with death in certain Asian cultures and 7 can muster certain evil associations. But those other numbers are pikers and bush-leaguers when compared to thirteen. Clearly, no other office building floor can possibly compete with the thirteenth floor. A brief look at the genre revealed some real gems:

"Discover the many dimensions of terror that await you…. Experience the sights, sounds and smells of fear as you journey through the nightmare that is the 13th Floor!" (Jaycees of Huntington, IN)

The 13th Floor Elevators were a 1960's psychedelic rock band that told us: "Recently, it has become possible for man to chemically alter his mental state and thus alter his point of view (that is, his own basic relation with the outside world which determines how he stores his information). He can restructure his thinking and change his language so that his thoughts bear more relation to his life and his problems, therefore approaching them more sanely." (What were they smoking when they wrote that?)

A sci-fi film called the Thirteenth Floor came out in 1999. In it, a man investigates the murder of a computer wizard killed while testing his revolutionary virtual reality simulation of 1937 Los Angeles---only to uncover the truth — his own world of 1990s Los Angeles is itself a fabricated simulation, meaning that he himself is an artificially intelligent computer simulation" (I wonder if they were smoking the same stuff as the Thirteenth Floor Elevators...)

13th Floor is the name of a Christian Ministry group, because the 13th Floor represents "that place in ministry where people are afraid to go."

The 13th Floor, is a "Private Couples Group," Dallas' most exciting on-premise swinger's group "with special parties for couples, single ladies and select single men."

There is no 13th Law in the Code of Hammurabi. Apparently, it was bad luck then too. (Although being put to death for stealing the minor son of another doesn't exactly sound super-lucky.) If it makes you feel any better, our Graphic Designer, Renata Graw, tells us that in Shanghai the number 14 brings bad luck. And given that they have both 13 and 14 sensitive traveling there, some hotels go from 12 to 12A, 12B and then 15.

We're quite excited about our new digs and the luck they will bring us as we seek to deliver solid performance for our investors while growing and building a hard-working and talented firm.

Just remember, there are lots thirteens out there too: The original thirteen colonies, the age of Bar/Bat Mitzvah, the number of months in the lunar calendar, and more.

Eric Wanger, JD, CFA

Q4 Wanger Investment Quarterly Letter

Investment Write-up

Cypress Bioscience (CYPB)

Biotech firms, however, that run like businesses, not college laboratories, are of interest to the WLTOF. One such company is Cypress Bioscience (CYPB)

Our Senior Adviser, Ralph Wanger, doesn't have much love for biotech firms and for the most part neither do I. Just before Christmas, I visited biotech firms in and around San Diego. Each had a magic "molecule" developed by an extraordinarily smart scientist that solved some non-lethal, but widely troublesome problem in rats, and appears to work in humans, but causes heart attacks, strokes, etc. In a significant, but small number of test patients. Give the patient higher doses and they lose more weight, but what's causing the weight loss the drug, or the voices in the patient's head caused by the drug's hallucinatory side effects?

Many biotech firms aren't run like real companies; CFO's laugh off questions about cash flow and fortunes are made and lost by companies that have never sold anything. Biotech firms, however, that run like businesses, not college laboratories, are of interest to the WLTOF. One such company is Cypress Bioscience (CYPB), which is in the process of commercializing Milnacipran for the purpose of treating Fibromyalgia Syndrome (FMS).

CYPB's nineteen employees don't work to discover new compounds, but license existing compounds and find new uses for them. CYPB licensed Milnacipran, a drug widely used in the treatment of depression in Europe and Japan, in 2001 from Pierre Fabre for the treatment of FMS. Over the last 6+ years, FMS has demonstrated Milnacipran's efficacy and safety in treating FMS. CYPB partnered with Forest Laboratories (FRX), a firm known for successfully marketing CNS drugs, for distribution. CYPB will received up to $180 million in milestone payments from FRX, in addition to 15% of the revenue generated by the drug and reimbursement for co-promoting up to 25% of the targeted doctors.

FMS, not a recognized disease before 2001, is believed to affect 2-4% of the population worldwide, 90% of which are women. FMS disorder is characterized by wide spread muscle and joint pain as well as fatigue and insomnia. While some doctors believe FMS to be nothing more than aches and pains validated by the medical community as illness, others believe that FMS is literally the physical manifestation of depression. The FDA came down on the side of real illness when it approved Pfizer's (PFE) drug Lyrica for a FMS indication in 2007. Lyrica, unlike Lilly's (LLY) Cymbalta and FRX-CYPB Milnacipran only treats the physical pain of FMS, which means the market is still very much open for more robust FMS treatments.

By 2010 the total market for FMS related treatments could top $5 Billion annually. While Milnacipran will arrive late to the party (Lyrica is approved, Cymbalta will likely received a FMS indication in Q2 2008), we believe that market penetration in the mid-to-low teens is likely given the drugs best in class profile and that physicians will "rotate" in Milnacipran when the competing drugs fail or stop working for patients. The NDA for Milnacipran was submitted at the end of 2007 and we expect the drug to be approved towards the end of 2008.

CYPB is not without risk. The largest risk, besides the FDA rejecting the Milnacipran NDA, is that Management attempts to repeat its success with Milnacipran and in the process blows through the $177 million in cash the company raised in a dilutive follow-on offer. Management, we believe, is both smart and cheap, and therefore unlikely to make the mistake of taking on a risky compound just as CYPB is about to become a profitable company. Failure of Cymbalta to get its FMS indication from the FDA could be a blessing or a curse. If Cymbalta receives the indication for FMS, Cymbalta will beat Milnacipran to market by six months, and if Cymbalta does not get the indication, the failure will raise questions about the FDA willingness to approve FMS drugs. Additionally, launching a drug, like any product, is difficult although we believe FRX has the know-how to make Milnacipran a success.

A successful launch of Milnacipran will transform the company from a high risk biotech company, to a relatively stable annuity. Investors will either realize the value through a substantial dividend yield or, more likely, a buyout by FRX. Our conservative DCF scenarios of a successful Milnacipran launch puts the stock price in the high teens which provides WLTOF investors with the opportunity for substantial capital appreciation.

James L. Cahn

Q4 | Wanger Investment
Quarterly Letter

Bill Andersen: Income in a Turbulent Market

Wanger Investment Management welcomes William Andersen will join Wanger Investment Management, LLC as portfolio manager of the Wanger Tax Efficient Yield Fund.

William Andersen will join Wanger Investment Management as portfolio manager of the Wanger Income and Growth Fund. William Andersen worked for 17 years at Driehaus Capital Management, where he was manager of the firm's International Growth product. The product, which started in 1990, was one of the first international funds to focus on identifying fast growing companies overseas. Mr. Andersen eventually managed over $2 billion for mutual fund and institutional clients. He was also CIO-International, overseeing a team of 15 analysts, portfolio managers and staff and a member of the firm's management committee. He left Driehaus in 2003 to manage private portfolios, including a yield oriented strategy which now has a five year record. Mr. Andersen has a B.A. from Stanford University and an M.B.A. from the University of Chicago.

With the concerns and confusion in financial markets of the past few months, it's clear that interest rates in the U. S. are likely to be lowered at a good pace in 2008. (After all, no policy maker wants to be remembered as the one who was in charge when the economy fell apart.) Leaving aside the broader question of whether rate cuts will be successful in averting a recession or even whether we are, as George Soros has suggested, at the end of a 60 year cycle of credit creation which makes a recession in developed markets inevitable, there are nonetheless some asset classes which should benefit from the current phase of the interest rate cycle. I'd like to highlight three of these which are selling at reasonable valuations, have underperformed recently, and are likely to benefit from this environment.

There are some asset classes which should benefit from the current phase of the interest rate cycle. Three of these are selling at reasonable valuations, have underperformed recently, and are likely to benefit from this environment:

REITs
MLPs
Closed End Funds

Real Estate Investment Trusts have been around in the U. S. in their current form since 1960 and have been through many cycles. (For those unfamiliar with REITs, these companies operate under a special exemptions of the tax code which allows them to avoid paying corporate taxes as long as they pay virtually all of their earnings out as distributions to shareholders. They are required to operate primarily in the real estate sector.) These shares are rate sensitive for a number of reasons. First, they own real estate assets whose value is linked to interest rates. Second, they borrow money to purchase these assets, so the higher rates go the less cash flow, and vice versa. Finally, since a big part of the return from owning these assets comes from the distribution, investors tend to compare them to other yield oriented instruments.

Before the current cycle, REITs were last out of favor in the late 1990's, during the technology boom. At the low, quality REIT shares could be purchased with yields of over 8%. This yield was very attractive considering bonds at the time yielded between 5% and 6%. REIT investors got a premium yield, plus a decent growth rate thrown in for free. This situation persisted for several years, until the stock market collapse of 2000-2003. In order to prevent a long economic slowdown, interest rates were lowered rapidly to historically low levels. The high yields on REITs attracted attention by 2003 and the sector took off. The move was of course supported by the great performance of real estate during the period. By early 2007, the sector had nearly tripled (including distributions) and the valuation parameters had significantly changed. At that point, yields on the best REITs were under 4%, which was a discount to the government bond rate of just under 5%. (Comparing REIT yields to bond rates is not the only way to value REITs of course, but it does provide a good benchmark.)

In January of 2008, the situation has changed again. Since the peak last year, REITs have fallen by roughly thirty percent, reaching price levels of 2004. Interestingly, cash flows for the industry have grown 28% since that time. And the yield on bonds has fallen dramatically, now standing at 3.5%. Quality REITs now offer yields substantially above that benchmark for the first time in several years.

Another very significant development is the globalization of the REIT sector. While the U. K. and Australia have had well established property sectors for years, legislation to create REITs has been enacted more recently in Hong Kong, Singapore, Korea and other fast growing markets. Today Bloomberg lists 494 REIT securities in 20 countries worldwide. Only 181 of these are in the U. S.

The globalization of REITs is an important opportunity because real estate has generally performed best in

continues on the next page

Q4 Wanger Investment Quarterly Letter

Bill Andersen: Income in a Turbulent Market (cont.)

countries where wealth is being created. With developing economies growing much more rapidly than the mature ones, and with that trend likely to continue for a prolonged period (with the inevitable cycles) the potential for this sector looks bright. We would suggest a combination of a value oriented approach to real estate in mature economies combined with one more focused on growth in faster growing economies overseas.

Master Limited Partnerships are publicly traded Limited Partnerships which, like REITs are exempt from paying corporate income taxes as long as they pay out virtually all of their earnings as distributions to shareholders. Historically, this organizational structure has been widely used in the midstream energy sector, which includes operating pipelines, processing energy products and related activities. These fit the MLP structure well since they typically generate relatively stable cash flows and distributions to shareholders. Investors also like this format because depreciation and some other non-cash expenses can be passed on to MLP "unit holders", which creates a tax deferral. It is not unusual for 70-80% of an MLP's distribution to be tax-deferred.

Owners of midstream assets like this structure as well because the market places a higher value on assets which generate a current income. To illustrate, it is not uncommon for MLP's to trade at valuations (as measured by EV/EBITDA) of 10-12 times cash flow, compared to 7-8 times cash flow for traditionally structured assets. Owners have a further incentive since, under this structure they still receive a payment in the form of a general partner "split" from the operations of the assets. In sum, this structure has shown to be of value to both buyers and sellers. For this reason, it has grown remarkably in the past several years among both individual and institutional investors.

The sector experienced unusual volatility the past few months, with prices falling around 16% as MLP's, bonds and other instruments in which we have investments were caught up in the market volatility related to sub-prime lending. Due to good performance early in the year, the sector still showed a total return of 12.6% in 2007. Like REITs, these companies had also reached historically high valuation levels, and were trading almost at parity with government bonds. With the correction, the premium of over 2% has reappeared. Quality MLP's currently trade with yields of 6%-8%, with distributions expected to grow next year by 5%.

Closed End Funds. One other asset class to consider today is the purchase of fixed income oriented closed end funds which trade at discounts to their net asset value, or NAV. For more aggressive investors, we would suggest funds which employ some leverage. The thesis here is threefold. With a slowing economy, bonds should continue to perform well. (We acknowledge that bonds have already risen a lot and the upside could be limited.) Secondly, funds' internal cost of leverage will fall as it is tied to falling short term rates which may make it possible for them to raise their distributions. Finally, many good quality funds are trading at discounts to NAV of over 10% and with current yields of over 10%, which gives some cushion in holding these shares.

It is impossible to predict short term market direction or when a decline or rise will end. The three sectors discussed here share the characteristics of reasonable valuation, timeliness in terms of the interest rate cycle, and good current yields, which should provide some protection to investors.

Bill Andersen