Q1

Wanger Investments
Quarterly Letter

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1Q10 Preview

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Dear Sir/Madam:

Many of us were surprised by the strength and duration of the equity run-up. We still believe that the economy is improving, but remain quite worried about the long-term effects of high unemployment and bad real estate loans that remain on bank books. The risk is that investors are chasing returns. Bonds look really expensive and so do many categories of stocks.

Why Things Could Get Better in 2010:

- Real recovery continues to improve
- Benefits of real (non-stimulus related) U.S. competitiveness improvements
- Transition out of stimulus works without re-crash or inflation
- Cheap natural gas and other (surprisingly) inexpensive energy sources help to control inflation and provide economic assistance during the "real" recovery

Why Things Could Get Worse in 2010:

- Many under-collateralized commercial real estate conduit loans start maturing later this year — refinance risk is real
- Bad banks will deteriorate
- Unemployment stays bad and rapidly rising interest rates will end the party
- Transition out of government stimulus results in re-crash or inflation
- An "unexpected" oil shock occurs

Positioned for the Long-Term

At times like these, it's difficult to keep one's focus as a long-term investor. There is a huge amount of fear and uncertainty out there which leads to short-term thinking. Our job is to focus on the long-term and leave the market timing to market timers. I think the evidence is strong that we're working really hard to do that for you.

Growing the Firm

We are building a great firm here. We are privileged to have senior executive Tom Mulroy join us as COO. He brings more than twenty years of financial industry experience to our team. Don Scott, CEO of Wanger OmniWealth, is a force of nature and the best business partner a man could wish for. I continue to work with analysts Lee Wolf, Joel Hainsfurther, and Raja Vannela, as well as the staff of ACG, to evaluate investments, managers, and deals, each and every day. We have amazing advisors and some of the best friends around.

We couldn't be more excited. Email us at: info@wangerinvestments.com or visit us on the web at: www.wangerinvestments.com.

Best,
Eric Wanger, JD, CFA

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WANGER INVESTMENT MANAGEMENT

WANGER OMNIWEALTH LIFE ENRICHED

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From The Desk of Eric Wanger:

Income Taxes, Apollo 13, and Duct Tape

Eric Wanger

April of 1970 was an amazing time in American history: Richard Nixon was President, American Motors introduced the Gremlin, the Beatles officially disbanded, China launched its first satellite on the back of a Long March rocket, and the U.S. invaded Cambodia, inciting waves of protests throughout the country.

It was also almost forty years ago that an amazing dialogue took place between Astronaut Jack Swigert of Apollo 13 and mission control: In Mission Control, capcom Joe Kerwin asked, “Have you guys completed your income tax?” For Jack Swigert, the question brought a sudden pang of apprehension. From space came the words, “How do I apply for an extension?” “Things happened real fast down there,” Swigert continued, “and I do need an extension.”

Chaotic times seem to produce inflation, which may be our long-term destiny too -- but probably not in the short-term.

Kerwin tried to control his laughter, but Swigert wasn’t laughing. “I didn’t get mine filed,” he told Kerwin. “I’m really serious. I may be spending time in a another quarantine besides the one they were planning for me,” Swigert said, referring to the post-mission period of medical confinement. But just then, Flight Director Glynn Lunney offered words of reassurance: “American citizens out of the country get a 60-day extension on filing,” Lunney radioed, and added wryly, “I assume this applies to you.” (Source: www.space.com with special thanks to Chicago’s Adler Planetarium, America’s oldest planetarium.)

Given that labor has become one of the most expensive economic inputs in the American economy, it is also easy to believe that American companies using American labor have become more competitive over the past few years relative to many other developed countries.

It wasn’t until later in the famous flight that Swigert said, “Houston, we’ve had a problem,” which would come to symbolize NASA at its heroic, stoic best. An oxygen tank exploded in their spacecraft, ripping portions of it to shreds. Suddenly, their plans to walk on the moon became a fight for survival while returning to Earth. One of the most interesting aspects of the Apollo 13 rescue was the way that Houston and the astronauts had to scrape together and reuse a random assortment of spacecraft systems, parts, and even battery charges to get back to Earth alive. The movie included some wonderful footage, showing everyone involved using duct tape to piece together the various and sundry spaceship parts necessary to keep the astronauts alive long enough to return home.

Never Trust Anyone Over 30

There is a feeling in the air that America is in chaos. It’s as if we invented chaos, mistrust of government, huge, seemingly irretrievable schisms between the left and right, the rich and the poor, and the capitalist and the unionist.

The period surrounding 1970 was a time of extraordinary social stress. Rioting took place in urban neighborhoods, American soldiers deployed to kill and be killed in the Vietnam War, police and anti-war protestors exchanged bullets, and the famously anti-communist President Richard Nixon desperately tried to keep the whole thing from blowing apart.

Whether you were over or under thirty in 1970, I suspect you thought the world was coming to an end. My mother claims that in the late sixties she took me on the roof of our building to watch the bright lights caused by burning Chicago neighborhoods. In truth, I don’t remember. Things do seem irreparably chaotic right now, but they did then too. And it wasn’t the first time by any stretch of the imagination. An honest accounting of U.S. history shows that America has always been full of internal strife. Yet, despite it all, we somehow emerged with our battle-tested ideal of the dignity of the individual sufficiently intact to get the train back onto the rails.

Chaotic times seem to produce inflation, which may be our long-term destiny too -- but probably not in the short-term. Despite the inflationary effects of trillion dollar deficits, huge trade imbalances, and foreign wars, we aren’t necessarily on the brink of inflation. Housing has gotten cheaper and food prices don’t appear to be increasing mercilessly (an interesting conversation). Additionally, we are awash in unexpectedly cheap natural gas, driving down the value of coal and other major home heating and electricity generation inputs. As long as we don’t have a major oil shock, we might dodge the inflationary bullet for the near-term. In fact, over the next year or two, there are people who are seriously worried about a stalled deflationary scenario or even a Jimmy Carter-esque stagflation, if you throw in runaway oil prices.

Given that labor has become one of the most expensive economic inputs in the American economy, it is also easy to believe that American companies using American labor have become more competitive over the past few years relative to many other developed countries. Productivity is defined as something like the ratio of economic output measured in dollars per unit of human employment input measured in time. Based on this definition, it is easy to intuit that American productivity has soared over the past few years. This should ultimately return us to economic growth, at least in the areas of our economy which have not been overly lawyered.

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Income Taxes, Apollo 13, and Duct Tape (Continued)

What Will Get us Back on the Rails?

Some of the trends that are the most nervous-making are also the most critical. For example, the rise of the developing world and immigration are two of the most important factors in America's long-term strength.

The rise of the developing world and immigration are two of the most important factors in America's long-term strength.

The developing countries will clearly grow the fastest. Albeit from a relatively small base, the developing world—as demonstrated by its platinum selling rock stars India and China—is going to continue to put annualized GDP growth numbers north of five percent on the scoreboard for a long time. The middle class in India is about as big as the entire population of the United States. And only one-in-six citizens of the planet is from India! As long as one doesn't put too much stock in the published numbers, those nations are virtually guaranteed to produce more and more consumers for the goods and services America is best at producing: Energy, protein-rich diets, health care, and entertainment. But like investing in the United States a century ago, there are vast fortunes available to those that can pick the winners—but the devil will take the hindmost.

Immigration is the other factor that is going to save us. Immigration is the phenomenon where people leave their lives behind to come to America to work, receive an education, survive, or obtain a better family life. Millions of people even risk their lives and liberties to come to this country in order to participate in our economy, often working the hardest and most unpleasant jobs our economy has to offer. Could this country function without immigrants? No. Not now and not ever. Without new immigrants our low birth rate would put us in line to be the next Russia, Japan, or even Italy; countries that are failing to sufficiently replenish their populations.

Could this country function without immigrants? No. Not now and not ever.

Despite the bad press, developing nations and immigration are the best long-term prospects for the United States' economy. The developing world is hard at work creating economic participants. Further, immigration into the U.S. is creating a younger generation capable of taking care of an aging America in its dotage.

To a wealthy American eager to balance capital protection, current income, and growth, it is more important than ever to have "true" diversification. By this we mean taking advantage of the enormous growth opportunities available throughout the world, while maintaining a portfolio of assets that will not travel in "lockstep" during booms and busts. A portfolio which is truly diversified will attempt to balance total return (total return = unrealized gains in valuation + cash flows), risk of loss, liquidity, and correlation. Thus, true diversification also means looking at a world of investments that is much broader than merely stocks and bonds, which have proven to be much too correlated as the world's economies and markets grow together. The world may seem like it's falling apart, but it isn't the first time and it won't be the last. Apollo 13 is an apt metaphor for 1970s America and may also apply to America in 2010; they held it together and so can we. Apollo 13 is one of most gripping stories of heroism and bravery in the history of human space exploration. And while one must marvel at the creativity and backbone of the men and women in the ship and those guiding them back on Earth, one must never forget the ultimate lesson of Apollo 13: Never, ever, go anywhere without duct tape.

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

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Family Office Corner – By Don E. Scott:

When Do You Tell the Kids?

About the wealth, that is... Before I answer that question, it makes sense to lay some ground work. Some of this will seem obvious, but that doesn't mean that the issues always get the attention they warrant. In any event, I have been working with very wealthy families for almost 30 years. The question I am almost always asked is essentially: How do we not screw up the kids (or grandchildren) with this much money?

The Privileges that wealth provides can help shape a full life in ways most don't get to experience.

Double Edged Sword

Like it was yesterday, I remember my experience with a particularly wealthy family client. Notwithstanding that I was 22 years old and fresh out of college, it only took a few months to see the situation clearly. I had an interesting vantage point since I didn't come from money. I was an outsider looking in. I worked hard and knew I had to create whatever success I was going to achieve in life. That wasn't the case for the family's youngest son, who was two or three years older than me. I got the differences then and understand them better now. He seemed to have everything he could ever want. However, it was clear that his future would be fraught with struggle and disappointment. It was.

To paint this picture, let's start with some notion of the typical middle class kid. His or her life is full of challenges. Values, education, boyfriends, girlfriends, questions like "what do I do with my life," work ethic, skills, opportunity, the economy – the list goes on and on. Inject a lot of money and what happens? "Rich kids" face most of the same challenges as everyone else. However, like it or not, they have to overcome an additional set of issues that most people simply would fail to understand. Wealth adds powerful dynamics that are *both good and bad*. The good includes less financial pressure, access to unique experiences, a great education, the opportunity to take career and financial risks, and lots of choices. The bad includes—well, it's those same things.

We must all lead by example. Said better, our children and grandchildren will develop from the examples we set for them.

Don't get me wrong, wealth is a beautiful thing. Somebody put in years of dirty hard work to create it. The family deserves to enjoy the benefits. However, "taking off the pressure" had better be done carefully. I'd rather have too much pressure to succeed than not enough. The privileges that wealth provides can help shape a life in ways most don't get to experience. However, the kid had better understand the cost of those things and how you earn the right to them.

Building Blocks

The starting point for families with wealth is not much different than for other families. It's about being good parents and teaching values. This can be harder and even more important when wealth is present. We had all better get our arms around those values and, whatever they are, make sure that we firmly instill them within our children. One client of mine has a family mantra, "Smiths don't lie and Smiths don't quit." In our family, we have really focused on stressing the importance of work ethic. I have been saying to my girls since they were little, "we really work hard in our family." Young people must learn that hard work is necessary for good things to happen in their lives. It is very hard to undo a sense of entitlement.

We must all lead by example. Said better, our children and grandchildren will develop from the examples we set for them. What we do has a much greater impact than what we say. Ultimately, those fundamental values are where it all starts. There isn't much chance of success without these strong building blocks.

Not to be Taken Lightly

What more should I do to prepare my children and grandchildren for the unique circumstances in which they find themselves? The answer is "a lot!" All parents want to raise their children to become productive adults with their own sense of achievement and self-worth, and who possess the skills and knowledge to handle their particular life situations. When substantial wealth is present, this becomes much more challenging. Unless we focus on the impact of wealth on our children and grandchildren and act accordingly, their chances for long-term personal success will drop dramatically.

This topic is much too complex to do justice with a few paragraphs. This article isn't intended to include a great deal of "how to." *Raising Financially Fit Kids*, by Joline Godfrey, is a great book. Her firm, Independent Means, is an outstanding resource which we tap to help us advise our clients. I suppose everyone by now has read *Outliers: The Story of Success*, by Malcolm Gladwell. I found it to be incredibly interesting and another valuable background piece.

Answer the Question

I started with the question "when do you tell the kids" and then took the discussion back to matters that might seem most applicable to young children. Whether your offspring are 8, 16, 24,

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When Do You Tell the Kids? (Continued)

The kids aren't stupid, and being honest and open with them will likely have a positive impact.

or 32, the facts remain the same. The points I am trying to make are valid no matter the ages or paths our children are on. All of us would no doubt like to go back in time and redo a couple of those building blocks. However, it is never too late to take action as warranted. Whether a kid is 16 or 32, there is certain knowledge that is required in order to optimize success. There are effective steps to be taken to develop that knowledge.

The answer to the question is probably "now." I understand that it's not that simple. I am not suggesting that you provide a 12-year old with your audited fair market value balance sheet. However, I am recommending that you talk about the matters surrounding the impact of wealth. We can't pretend they don't know. They know – maybe not the details, but they know. The kids aren't stupid, and being honest and open with them will likely have a positive impact. Too much secrecy can backfire. We had better be talking about the advantages of wealth and about the hard work it takes to obtain it. We had better talk about the responsibilities of stewardship, about giving back, family dynamics, how to choose an advisor, and much more.

Wealth is a blessing that exists because somebody took risks and put in the long hours to make it happen. Making it happen for the next generation involves a lot more than trust and estate planning. That is the easy part. It's about passing on values, knowledge, and skills. If success is having wealth be a positive force in the lives of our children and grandchildren, those are the keys.

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

Ralph Wanger Reports:

Don't Flense My Quantum

Ralph Wanger

New technology means new words, and new acronyms, and if you are following energy stocks you better know the difference between a jack-up and a semi-submersible, and what MWD means.

Lots of people, some of them CFA's, use technical words from science or mathematics that sound fancy - but the words are used with meanings that are very different from the original.

For all of us language is an essential tool. Most of us have to write reports or give oral presentations all the time. You can gain a competitive advantage by using language well. I ran the Columbia Acorn funds for 35 years, and spent a lot of time writing quarterly reports. I tried to make the reports interesting and humorous, and developed a favorable reputation and a marketing advantage by doing so. Part of my success was due to competing in an easy league; the number of mutual fund shareholder letters that are interesting to read is a small number.

Language is constantly evolving. Words about computers and the Internet are being added to the dictionary, while obsolete words disappear. If you had to read *Moby Dick*, you saw the word "flensing" used by whalers, but nobody flenses now like they did in the good old days. Although "liposuction" comes close.

New technology means new words, and new acronyms, and if you are following energy stocks you better know the difference between a jack-up and a semi-submersible, and what MWD means. But my complaint in this essay is about the misuse of words.

Realtors are nice folks, many of whom are going through hard times now, due, of course, to the bear market in housing and commercial real estate. Sometimes realtors can be a nuisance by trying too hard to get business, but what bothers me is their misuse of language. For many years they have inverted the simple terms "bid" and "offer." We all know the dictionary definition that is universal in financial markets; a buyer "bids" and a seller "offers." Realtors invert this and tell potential purchasers, "I think if you offer $600,000 for the house we can buy it."

That misuse of the language pales compared to the latest stupidity using the well-defined term "short-sale" to refer to something else altogether, essentially a "sale at a price lower than the mortgage balance." Make up a word for that if you like, but don't steal a word that means something else altogether.

Our own colleagues are not immune from sloppy word usage. One example is "health inflation." ("CFA Institute Financial News Brief," March 23, 2010.) There is no question that health care spending rises every year. Productivity in health care has risen enormously. As an example, cataract surgery, fifty years ago, was a difficult surgery that required a lengthy hospital stay in which the patient's head was immobilized. The surgery was not done frequently because of the cost, discomfort, and high failure rate. Today, cataract surgery is an outpatient procedure, and three million cataracts are treated every year in the U.S. The cost per operation has dropped dramatically, while the total cost of all cataract surgery is probably a lot higher than fifty years ago. Calling this "health inflation" is an imprecise word. Fifty years ago, almost no financial analyst worked with a computer while today we all do. So we spend a lot of money on computers and data feeds. Fifty years ago, we didn't. None of us call that "computer inflation."

Lots of people, some of them CFA's, use technical words from science or mathematics that sound fancy – but the words are used with meanings that are very different from the original. One such is "exponential," by which most users mean "a whole lot more than before." What the word really means is "changing by a constant percentage."

The formula can be written $x=a(1+g)^t$ where a is the original value, perhaps "sales in 1990," t is the number of years, in this case 20, x is "sales in 2010," and g is the "growth rate." If g is a substantial positive number, say 15% (.15), then over 20 years sales will have grown 16.4 times, a spectacular increase. However, if g = -.05, sales will only be 36% of 1990 levels, a disaster, but still an exponential change. So "exponential" really means "steady," not "huge." If you want to describe a large increase in sales, the short and clear word is "big."

"Parameter" is a peculiar word. Most people remember high school geometry and remember the word "perimeter" (that means the sum of the lengths of all the sides of a polygon), so they use "parameter" to mean "boundary." A parameter is actually a quite technical term that describes something that is in between a constant and a variable. For instance, if you are using a dividend discount model to predict the return on a group of stocks, you could make a spreadsheet with a risk premium of 3% and get an answer. Then you could re-run it with a risk premium of 4%, then 5%. You are using risk premium as a parameter. Since so few people know that, you are better off not using the word "parameter" at all.

"Quantum leap" or "quantum jump" today means an unusual and important transition. This is the exact opposite of the original meaning. Great physicists such as Max Planck and Albert Einstein discovered the quantum at the beginning of the 20th century. Scientists of the time were working on the problem of smallness – if you cut something in half, such as a flask of hydrogen or a beam of light, you get a smaller amount of hydrogen

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Don't Flense My Quantum (Continued)

or energy, but its essence is unchanged. If you keep chopping, will it be a smaller amount indefinitely, or is there a limit where eventually it can't get smaller? In 1900, this was a lively question, but over the next decade the atom and the quantum were proved to exist. In the case of hydrogen, you eventually get down to a single atom, and if you try to chop the atom (not so easy), you get some particles that are no longer hydrogen. The same idea works for energy; if you split a beam of light repeatedly, you eventually get down to a single piece of energy that cannot be sliced, and this very tiny thing was named a "quantum." A quantum jump happened when an atom absorbed a quantum of energy in its electron shell. The excited electron then has another quantum jump as the quantum is radiated away. This absorption and radiation of quanta is the smallest event that occurs in the universe and also the most common, so there are God-knows-how-many trillions of quantum jumps in our sun every second. Is it not amazing that in common speech the word for the smallest and most common event that exists is now the name for an important and rare event?

Some words don't get completely reversed by misuse but get altered. There is a fine old Chicago slang use of the word "clout." The rest of the country started using it to mean "the ability to get something done." There is already a perfectly good five letter word that means "the ability to get something done." The word is p-o-w-e-r. "Clout" was designed by Chicago politicians to describe something subtler. Clout means "access to power with the ability to get the fellow with the power to do you a favor." An example: "I want you to meet my buddy Charlie. He has clout with the property tax assessor; I think he can fix your problem."

So, when you write, try to avoid misleading words, clichés, and ambiguous phrases. Humor has its place -- if you are not good at humor, cut a cartoon out of a magazine and paste it into the report. Your report is wasted if the target reader hits the Delete Key half-way through because your document is too boring.

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

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Bill Andersen:

Short-Term Recovery Tempered by Long-Term Concerns

The first part of the year has presented lots of evidence that a good cyclical recovery is underway. Employers in numerous industries reported that they have started to hire again. One recent survey showed that job demand grew in 17 of 20 economic sectors and in 21 of 23 job categories. There is also evidence that consumer spending is increasing, at least in the luxury and higher end sectors. The recession probably ended sometime last summer, a few months after financial markets turned up, which is right in line with the historical average over the past 100 years.

Enormous legacy problems remain from the previous cycle and the response to the financial crisis.

At the same time, enormous legacy problems remain from the previous cycle and the response to the financial crisis. In the U.S., the federal and state governments face huge, open-ended fiscal deficits, unsustainable and unfunded promises made to future retirees, and high levels of unemployment. The situation is worse in Europe, where Greece, a member of the European Union and a participant in the Euro, has been forced to suffer the humiliation of a bailout by the International Monetary Fund (IMF). This is something generally reserved for bankrupt third world nations and shows that developed nations are subject to the same laws of economics as the rest of the world. (Some may recall that England received an IMF financing package in the early 1970s.)

It is easy to confuse the short-term positive outlook with the longer-term negative one, when in fact they aren't inconsistent.

It is easy to confuse the short-term positive outlook with the longer-term negative one, when in fact they aren't inconsistent. The economic recovery reflects the normal cyclical characteristics of the global economy which have been observed for years. Companies over-invest and then retrench. Consumers overspend and then pay off debts. Markets shift from periods of optimism to pessimism and back.

Each cycle is different, of course, and what clearly differentiates this cycle is that this recovery is taking place during a period where extremely serious long-term challenges with no obvious solutions linger. As Reinhart and Rogoff have pointed out in their excellent book, *This Time is Different*, history suggests that countries which incur huge debt levels generally end up defaulting on them in one way or another, either through non-repayment or through inflation. They provide ample and convincing evidence of this.

On the other hand, there have been cases where high debt levels haven't led to this result. Following World War II, the United States had a debt to GDP level of 120%, higher than today and higher than that of Greece before its financial crisis. Throughout the next generation, this debt level was paid down to more manageable levels. Similarly, in the late 1970s the U.S. experienced inflation of up to 13% and interest rates higher than that. A combination of a Republican president and a Democratic chairman of the Fed helped solve those problems. There are all sorts of reasons why those periods differ from the current one, but it still shows what could happen.

A mini industry has evolved to capitalize on negative economic thinking. Last week at the annual Milken Global Conference, a debate was held between Mike Milken and Nouriel Roubini. Roubini, a professor and former IMF economist who now has a successful consulting firm, has become one of the chief proponents of the negative long-term view. To his credit, he was one of the first to point out the evolving problems in the housing market, several years before they became apparent to most others. While that was a great call, he has remained very negative even in the face of evidence supporting a recovery. Roubini, who has a vampire like quality, has in our opinion a sort of caricature view of the U.S. which is common to many Europeans. This view holds that the U.S. is past its prime and lacks the political and economic will to face and overcome great challenges. While it's certainly easy to see how someone could have this impression by reading the papers or watching cable television, the United States' long-term track record of successfully addressing large problems shouldn't be discounted.

On the other side, Milken proposed numerous solutions, some more practical than others, but always with an eye towards solving, rather than lamenting over policy challenges. On the practical side, Milken proposed some common sense changes to entitlements programs which would have a profound impact on the long-term outlook. On the more optimistic side, he points out that if Americans could get back to their average weight in 1960, the country could save $1.3 trillion per year in health care costs. For those interested, the debate can be viewed at (http://www.milkeninstitute.org/events/gcprogram.taf?function=detail&EvID=2122&eventid=GC10) the Milken Institute website.

The evidence that the economic recovery is underway is well documented. Financial markets have returned to value ranges which make security selection the key to good performance. Leadership in dealing with longer term structural issues will most likely come from the U.S.—hopefully soon.

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

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Lee Wolf:

Push-Button Alpha

About once a week, as I approach the lobby elevators at 401 N. Michigan, I'm delighted to see someone already in the elevator. Most likely this stranger isn't going to offer me a piece of chocolate cake or be my future wife; to the contrary, this person is rampantly pushing the "close door" button as I approach. While some may deem this rude, I interpret it as a happy reminder that alpha is still waiting to be found.

Many worker-bees of 401 N. Michigan have figured out that, during business hours, the elevators run on timers. The doors close when the timer runs to zero and a floor has been selected. Perhaps the button-pusher example is more an issue of human need for control (or at least perception thereof). Whatever your opinion of why this behavior takes place, I maintain that most human action is incomprehensible, which may offer the most warming explanation as to why bad taste is ubiquitous. The more important point is that button-pushers exist in many forms, in many places, and at the same watering holes as alpha. Also important is the idea that button-pushing is a learned behavior. But this is not the same type of learning error as if someone has been taught that the color "blue" is what the rest of us call "orange." Button-pushing is an expression of inappropriately drawn conclusions that are consolidated and then repeated as a heuristic. The idea that redundant human actions still exist is a strong corollary to suggest market inefficiency.

The idea that redundant human actions still exist is a strong corollary to suggest market inefficiency.

Is it reasonable to suggest that the Harvard and University of Chicago MBAs running big companies are susceptible to this kind of inefficiency? I believe business leaders make the same kind of errors as everyone else—the mistakes just sound more complicated. The recent economic crisis is a perfect example of miscalculation. Most firms were aware of the extreme event risk that began to materialize in 2007, but chose not to adjust. I suspect it feels unnatural to form a business plan around extreme events, especially when the risk/reward for doing so is out of balance. Combine that discomfort with performance goals focused on sequential rather than annual periods and eventually you trip from running too fast. The perception of risk control changed from a necessity to an expense item. A lot of firms that needed a lifeline in the last few years have closed their doors.

For every firm that went out of business in a downturn I assure you there was a surviving firm that either burrowed chestnuts for a long cold winter, changed direction and moved to Florida, or both.

The mere existence of a business cycle is informative of human repetition. Why doesn't the economy simply grow at 1%-3% per year with businesses entering and exiting markets at a more predictable pace? There are a lot of reasons why the business cycle graph looks like a wave instead of a straight line, but for every firm that went out of business in a downturn I assure you there was a surviving firm that either burrowed chestnuts for a long cold winter, changed direction and moved to Florida, or both.

The reality is that some things change and some things don't. Holding all factors constant, people today still succumb to the old adage of acting the same, but expecting a different result. If anything, I would suspect that attention span and memory have worsened over time. On January 5, 2010, the front page headline of the *Wall Street Journal* read, "The Hidden Benefits of Exercise." It appears that even mainstream publications have low expectations, restating the obvious as though it were new information.

In 2010 people are still mammals. Our abilities vary but our mistakes are of a similar nature. One thing that clearly differentiates us from primates is the ability to challenge inconsistencies, which is the reason I felt empowered to push the "close door" button when I came to the office on a Sunday—and guess what? It worked! As an analyst, it is my nature to evaluate what, if anything, has changed. In 2010 and beyond, I am quite certain that learning errors of the past will be repeated, albeit in a slightly different flavor. One constant in error, however, is alpha. Until the time comes when the world stays exactly the way it is, you'll find me in the Wanger office elevators pushing buttons.

Lee Wolf, *Securities Analyst,*
Wanger Investment Management, Inc.

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Investment Write-up:

Houston American Energy Corp. (NASDAQ: HUSA)

Investing in natural resource exploration sounds risky. Enough of these companies go bust that it makes sense to approach with caution. Imagine sitting across the table from a CEO with 30 years of oil industry experience who described his small company as a pure play oil exploration and production company in Colombia. The company, he continued, has property adjacent to one of the largest developed oil finds in Colombia and has drilling rights, which, if successful, could mean production of hundreds of millions of barrels of oil. After spreading out a two-dimensional seismic graph that covered our entire conference room table, he pointed to a multicolored area and, to paraphrase, stated: "You see this structure? This is almost identical to the structures adjacent to us that are producing greater than 10,000 barrels of oil per day. After completing seismic shooting of only 25% of our property we have identified 12 similar structures." I left the meeting wondering if the story was too good to be true.

John Terwilliger, the CEO of Houston American Energy Corp. (HUSA), isn't a flashy executive fresh off of Wall Street's production line. If anything, he appeared disheveled: the monogrammed initials on his shirt were off-centered, his tie was from a 1980s music video, and he had a tan that looked fresh from a nice long vacation. In short, Mr. Terwilliger is a genuine business operator. Evaluating geologic structures in foreign countries isn't the business of polished executives, it's a place for explorers and calculated risk takers. I like the idea of a CEO who gets out of the office, is involved in the operation of his business, and maintains a lean staff and low operating costs.

After fully evaluating the company we felt comfortable with the following opinions:

- We think the company is legitimate and their assets exist. Sell-side research analysts and independent geologists confirmed the existence of meaningful geologic structures.
- The assets are adjacent to other significant discoveries.
- Management has a history of successful exploration and production in the same geopolitical area.
- The Colombian government is supportive of natural resource exploration and production.
- We believe that earnings from current production are nearly sufficient to fund exploration activities.
- HUSA's future exploration activities, if successful, have very significant upside potential. We think the potential rewards justify the risks.
- The company has existing development partnerships with significantly larger and more experienced companies.

On a conference call several weeks ago, John Terwilliger outlined the progress of seismic shooting in the CPO-4 block. In one to two weeks we expect additional comments from the sell-side as earnings are released and we get more visibility on the CPO-4 seismic data; in mid-June we expect comments from the company announcing further progress on the 3-D seismic shooting in CP0-4 and in mid-July we expect to receive production information from two additional wells being drilled in the Serrania block. In December the company plans to drill its first two wells in the CP0-4 block. Also looming in the background is the Hupecol partnership assets which could be sold at any point, netting anywhere from \$20M-\$40M to HUSA. In our opinion, HUSA is an undervalued small cap company with exposure to an area that has generated significant interest from large cap exploration and production players.

Despite a volatile stock chart, we believe that the upside potential of hundreds of millions of barrels of oil distributed to approximately 31 million shares translates into a potentially significant return on investment.

Lee Wolf, *Securities Analyst,*
Wanger Investment Management, Inc.