

Q3

Wanger Investments Quarterly Letter

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3Q10 Preview

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DEAR SIR/MADAM:

During the third quarter ending in September 2010, equities clearly began a rebound, but remained highly volatile. Small cap stocks ran up in June (Russell 2000 Index up 6.79%), got pounded in August (Russell 2000 Index down 7.50%), and enjoyed a huge run in September (Russell 2000 Index up 12.30%). While we would love to get on the “everything is back to fine” bandwagon, it’s hard to ignore the enormous commitment to more federal stimulus as a possible explanation for this dramatic run-up in equities. And, frankly, such extreme volatility is not generally associated with clear-cut bull markets.

Some Strong Coffee

Volatility is once again the order of the day. While equities have been on a tear recently, overall market sentiment remains highly ambiguous. The U.S. government is back to “quantitative easing,” the euphemism for direct intervention in various debt markets. Essentially, the government floods the banks with cash, artificially driving down long-term interest rates. This has led to long-term concerns over the value of the U.S. dollar, which plunged during the third quarter. As the dollar depreciated, commodity prices took off, especially gold, which reached record highs. Concerns over the dollar and the health of the U.S. economy have diverted investors’ attention towards emerging markets. According to Bloomberg, the Sri Lanka stock market was up 111% YTD as of the end of September, beating Mongolia, which only returned 109.7%. At a P/E of 28, that’s some strong coffee. Drink it if you like, but watch out for the bubbles.

Positioning For the Long-Term

It’s gratifying to see that some of our favorite long-term ideas performed well during the quarter. Technology names have responded nicely to an environment of renewed takeover interest and hopes of a stabilizing economy. Asset rich oil and gas companies started to reflect their intrinsic values. The moratorium on deep water drilling in the Gulf has been lifted (sort of) and

we remain firmly convinced that oil companies will work hard to access the vast oil wealth stored below deep water.

U.S. Treasury securities will remain held-aloft by federal policy, despite a growing body of political objection. Treasury bonds will eventually fall off a cliff, however, we have no ability to predict how long that will take. As always, we are positioning ourselves for the long-term and not trying to time the market. We feel so strongly about this issue that we have launched an Alternative Fixed Income program for our clients.

Life at Wanger

The Alternative Fixed Income Strategy is designed to act as a bond replacement portfolio, targeting total return (growth + yield) with an extremely low correlation to the bond market (interest rates). Our goal is to provide solid current returns while positioning our clients to withstand the eventual (inevitable?) popping of the bond bubble.

Wanger OmniWealth, our multi-family office, multi-manager wealth management solution, continues to thrive and grow under the leadership of Don E. Scott and Suzanne Campion.

I continue to work with analysts Lee Wolf and Joel Hains further, our investment committee, and the good folks at Asset Consulting Group to uncover long-term investment opportunities. It has been a crazy year and the markets have been extremely volatile, leading most investors to adopt a short-term outlook. We reiterate that in times like these, it is essential to stay focused and think like a long-term investor. We are thinking like long-term investors on your behalf, and we are very excited about what the future holds.

Email us at: info@wangerinvestments.com or visit us on the web at: www.wangerinvestments.com or www.wangeromniwealth.com.

Best,
Eric Wanger, JD, CFA

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From The Desk of Eric Wanger:

Teflon, Rockets, and Pension Funds



Eric Wanger

In public life, Teflon is the "X factor" which separates the very good from the truly great.

Teflon is really cool: Nothing will stick to it. It's the slipperiest, slickest, most friction-free stuff around. The stickiest, messiest, gooiest mess slides right off. Teflon is used in industry whenever friction simply won't do. Because nothing sticks to it, its applications seem endless. In the pantheon of chemically engineered gods, Teflon stands near Zeus.

When a person is referred to as "Teflon," it means that nothing sticks to them in the political sense. Ronald Reagan was sometimes referred to as the Teflon president. He was such a masterful politician that he could jump fully clothed into a vat of pure nasty and climb out smelling like a rose. He dodged scandal after scandal, gaff after gaff, like some kind of Mohammed Ali of politics, floating like a butterfly and stinging like a bee. In public life, Teflon is the "X factor" which separates the very good from the truly great. Political careers are made and destroyed in the public forum, without a judge or a jury. Political teflon is that amazing ability to stand calmly and assertively while political opponents hurl chamber pots filled with shame and blame, only to watch it all slide off without leaving so much as a crumb on one's suit. And that, of course, brings us to the subject of public pension funds.



DuPont Inventor Roy Plunkett discovered Teflon in 1938. DuPont™ Teflon® fluoropolymer is one of the most slippery materials in existence and resists both heat and chemicals.

Had these fiduciaries operated in the private sector, they would have been fined or even jailed under ERISA.

It is well understood that public pension funds around the country are in a state of utter disarray. According to the Pew Center on the States, employees' public pension and health insurance funds were underfunded by more than \$1 trillion in 2008. Grossly negligent financial mismanagement, irresponsible return assumptions, and imprudent risk taking have combined with chronic underfunding to leave a swath of destruction in their wake. State governments around the nation have failed to stash away anything close to the amount of money their (often elderly) beneficiaries are owed. Had these fiduciaries operated in the private sector, they would have been fined or even jailed under ERISA. One study found that the average funding rate across the 59 city and state pension plans surveyed was 54 percent. Another study estimates that teacher pension systems across the nation are underfunded by \$484 billion. The Pew Center on the States rated state pension funds on a 4 point

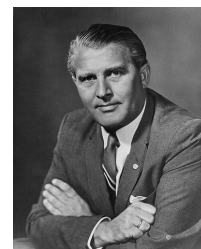
scale and gave *zero* points to Alaska, Colorado, Illinois, Kansas, Kentucky, Maryland, New Jersey and Oklahoma. In the private sector, there would be FBI raids, press conferences, and men in suits hiding their faces behind handcuffed wrists on the evening news.

But has anyone been punished because \$1 trillion (some estimates place it at \$3 trillion) has gone astray? No. Will anyone be punished in the future? It's doubtful, but the lawsuits have just begun to fly. Why? The individuals that approved the overblown rates of investment return are faceless, the committee members that approved the underfunded budgets have moved on, and the deficits are so big they have no meaning to the average person. The public debate has nowhere to go but to other issues—issues that can be used to win legislative seats, sway elections, enhance prosecutorial resumes, or buy voters with pork. That's Teflon in action. Despite the enormity of the crisis, there is nothing political for it to stick to so all of the blame and embarrassment will simply slide off.

Examine the current political debate regarding public pensions: It has been cleverly shifted to the *current* salaries and benefits currently being paid or promised to *existing* state and federal workers. That's clever sleight of political hand, but diverts us from the real issue. Teflon is at work and the taxpayers will be left to clean up the mess.

No discussion of teflon would be complete without acknowledging the most non-stick man of the last century, Werner Von Braun. Read Michael Neufeld's excellent biography of him. It's excellent and done to standards which should make the Smithsonian proud.

Werner Von Braun was a German rocket scientist straight from central casting. Remember Dr. Strangelove? Yeah, that guy. Von Braun was a founding father of U.S. rocketry; both ballistic missiles for war and the manned space program for peace. As



Portrait of Werner Von Braun.

one of the principle architects of our manned space program, he was the father of the Saturn V rocket (still the most impressive

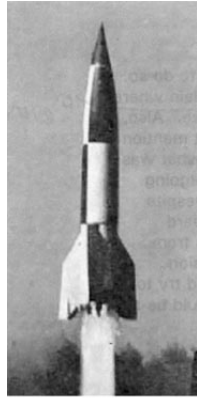
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Teflon, Rockets, and Pension Funds (Continued)

rocket in human history for my money) and the tall, handsome, blonde-hair, blue-eyed, German accented, face of the “dream of space” for a generation of Americans. His entire professional life was devoted to the dream of putting men into orbit and onto the moon. “I aim at the the stars,” he is famously quoted.



69b. German V-2 Rocket
(NMM)

But few Americans know the extent of his amazing and bizarre history: Within the space of a single lifetime, he was the pampered son of a German Baron; the Director of the Nazi’s Peenemunde rocket development site; the father of the infamous Nazi V2 ballistic missile; a “Colonel” in the SS; a recipient of the Fuehrer’s “Knight’s Cross” medal for service to the Reich; then, after choosing the United States over the Soviet Union at the end of the European war, a key player in the U.S. Army’s own ballistic missile program; a senior NASA administrator; an influential congressional lobbyist; a public face of the U.S. manned spaceflight program; a guest on Walt Disney’s television programs; and the father of the Saturn V rocket (which made the Apollo program possible and made it possible to put men on the moon). And, if Neufeld is correct, Von Braun was within days of receiving the Congressional Medal of Honor from the President before someone figured out that he had been personally decorated by Hitler! As Tom Lehrer famously sang, “*Nazi Schmazi, says Werner Von Braun.*”

So here is a man that was born in the greatest luxury known to pre-war Europe, spent the war eating good food, drinking good wine, and going to parties in a tuxedo (and wearing his SS officer’s uniform when required). He was a post-war “guest” of

the U.S. army, ultimately rising to the highest levels of the U.S. space establishment and its public face. He appeared on television and in print and he testified before Congress. He dined at the White House. He died a hero after helping to dedicate the Smithsonian Air and Space museum.

Teflon is thriving: Goldman Sachs will survive Congressional hearings and hundreds of millions in fines. Sarah Palin abdicated the governorship of Alaska in order to free up time for speaking tours and book publishing. Michael Jordan’s gambling? Bill Clinton’s perjury? Teflon people, truly non-stick humans.

But what of our public pension funds? If only Tom Lehrer were here: “Fiduciary, schmiduciary,” he would sing. Remember Peter Sellers in *Dr. Strangelove*? If one can learn to love the bomb, one can certainly learn to love huge deficits and the taxes we will have to pay to reinflate them. Real teflon is amazing stuff. It is so slippery it can help wash away the responsibility for the V2 ballistic missile. In the words of comedian Mort Sahl: “I aim for the stars...but sometimes I hit London.”

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

In politics, careers are made or destroyed in the public forum, without a judge or jury.

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Family Office Corner – By Don E. Scott:

The Ultimate Wet Blanket

I wanted to talk about prenups for a lot of reasons. As an advisor, it is a fairly interesting and highly challenging topic. Of course, our challenge is nothing compared to that faced by Mom and Dad. And, that is painless compared to the son's or daughter's uncomfortable foray into this land of competing logic and emotions.

With any financial aspect of our lives, it is always better to figure it out ahead of time.

Why?

There are a lot of reasons to care. First is the fact that over 50% of marriages end in divorce. There was a time when couples made the choice up front and that was that. Today, we live in a world of continuous choice. Choices are affected by many changing factors. So, your two kids will get married, and one will get a divorce. You don't know which one. If you are a parent, that is how you need to think about it.

Another reason to care about a prenup is that money does weird things to people. This is even more true for those that didn't grow up wealthy and suddenly find themselves a part of that world. Does someone choose to marry your child for the money? I hope not. Is the money some part of the equation? Of course it is. It's a part of who your child is – a part of the package. Can it become a bigger part later on, especially if things start to go south? You bet it can.

An unjust result is almost guaranteed without a prenup.

With any financial aspect of our lives, it is always better to figure it out ahead of time. In estate planning, for example, you spend so much paper covering situations that have a one in a thousand chance of ever coming to pass. However, you have to address them. You don't "not have a will" and then plan to figure it out once the person dies. Likewise, it is much easier to figure out division of assets and other such matters when the couple is not in the emotional throws of divorce. An unjust result is almost guaranteed without a prenup. That is a pretty strong statement, but I think it is true. If justice is in the eyes of the parties, it will only be a matter of how unfair.

It can also become important in connection with estate planning. Couples can go through years of marriage that is "sort of working" where Moms and Dads are never really sure if it will last. How many times have I seen that get in the way of estate planning that really needed to be done? Many.

Trusts and other such vehicles are not automatically 100% bullet proof. Nasty ex-sons-in-law or ex-daughters-in-law, with nasty lawyers, come at these things with a vengeance all the time. The "protected" assets may be safe. They may not be.

What?

A prenup is simply a contract that recognizes that A comes to the marriage with X and B enters the marriage with Y. A & B decide in advance how things will be divided in the event of a divorce. You have to think separately about what the parties bring into the marriage and what they accumulate or receive during the marriage. Different considerations apply to each group of assets.

It does not mean that A keeps everything, and that B is thrown out on the streets. Prenups can cover all sorts of things that are critically important to all parties. There are lots of details and we aren't well served to delve into all of them here.

How?

Now, I come to the point. Like most things, you have to talk about it.

1. Your children need to understand from the beginning this is just how it is. You DO NOT want to be in a situation where you have to try to convince them when they are all glassy eyed and care way more about what their true love has to say than about your opinions. (Of course, you can beat them over the head with the money card, but that isn't a lot of fun. There are better ways. Use the money card carefully.)
2. The future spouse needs to get it from early on. What a bad idea it is to spring it on them after they say "yes" to the proposal. I'd leak that story early on. If the relationship doesn't make it to the altar, no harm done. When that prospective daughter-in-law or son-in-law starts showing up for dinner, try leaving a well worn prenup laying on an end table in the family room. (OK, I know you are more tactful, but you get the point.)
3. The parents do need to be the heavies, in an appropriate way. I think the message should be, again, from early on: "This is how it will be. And, this is why." The future spouse will understandably come up with emotional reasons not to agree to a prenup. You don't love me. You don't trust me. What kind of way is this to start a relationship that will last forever? However, those are not valid reasons to put your child's current and future net worth at such high risk.

If we can put aside the emotions and look at the facts there is only one answer. We do need to carefully articulate the logic. We are doing this because Mom and Dad built the wealth, marriage statistics, personal experiences, estate planning, trusts —

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The Ultimate Wet Blanket (Continued)

Because the future is impossible to predict, it is necessary to plan for a worst-case scenario.

there are many facts that we can draw on to make a compelling case. Because the future is impossible to predict, it is necessary to plan for a worst-case scenario. Maybe the real point is that we need to get ourselves out of a very uncomfortable emotional place and into a more factual, logical place. Maybe, if it is easier for all of us to talk about it, it will be easier to get it done.

It's a bit ironic as I think about where we typically see prenups. In which situations do you think they most often appear? It's with those that have already been divorced. In second marriages, with big money at stake, prenups are the rule rather than the exception. At least that has been my experience. Consider those 50-year olds who are old enough to perhaps make better judgments and perhaps have better odds of not getting a divorce. They have been through the ringer before and tend to use a prenup.

On the other hand, in my experience the use of a prenup is really mixed with children. They are in their 20s, their emotions are running high, and they have little real experience upon which to make such critical decisions. They are the ones that need prenups the most. Unfortunately, they use them the least. I

understand the reasoning. I just don't believe it is justified.

Bottom line:

1. Really important
2. Uncomfortable topic that is often dodged
3. Focus on the facts and reduce the emotions
4. *This is very achievable if you approach it in the right way.*

I hope this is helpful. Thanks for reading!

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

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Wanger Investments Quarterly Letter

Ralph Wanger Reports:

Everything a Young Financial Analyst Should Know About Energy



Ralph Wanger

There is an old saying in Colorado that “whiskey is for drinking, but water is for fighting over.”

One can say that the water crisis and the energy crisis are interchangeable.

The BP oil disaster in the Gulf set a new world record in outpouring of rage from the media, the people, and Washington. Many investors dumped the stock, and BP dropped from 60 to 30. What should a financial analyst do? It's likely that BP will be a pretty good stock over the next few years from its current depressed level because negative PR can only abate at this point and BP still has a gigantic asset base and profitable operations, but make sure your boss thinks so too before you write a buy ticket.

Energy

The final plugging of the oil leak was done by drilling a “relief well” to intersect the messed up pipe. This sounds like just another routine project, but the technological capacity needed to drill this relief well is quite amazing. I used to follow the oil and gas industry as an analyst in the 1970's. In those days drill pipe routinely veered off course as the hole was drilled. If the drill bit ended up within 200 meters of its desired location that was considered just fine. The BP relief wells are intended to intersect an existing pipe, that means that the accuracy can be measured in centimeters. This is an extraordinary improvement in technology.

Most drilling activity in the United States is now shale formations such as the Marcellus in Pennsylvania. Many of the wells in shale formations are drilled as horizontal wells. The original bore hole is drilled vertically into the formation, and then the drill bit is turned 90 degrees so that it drills a horizontal segment that may extend 2,500 meters sideways. The same vertical hole can be used to drill several horizontal segments in various directions so that one well can gather gas from a very large area.

Deep water drilling and horizontal wells create profit opportunities as technology makes it possible to exploit these oil and gas deposits. But obviously they do not increase the total available energy resources of the planet.

Peak Oil

For many years, there have been a sizable number of geologists and analysts who believe that the oil fields of the world are close to peak production, and future annual production will decline. In March 2010, a paper was written at the College of Engineering Petroleum at Kuwait University. The model estimated that

the world's ultimate crude oil production would be 2,140 billion barrels, with 1,161 billion barrels remaining at the end of 2005 to be produced. The forecast was that world oil production would peak in 2014 at around 79 billion barrels per day. 2014 is soon. Despite the imprecision of this kind of forecast, this is a big deal, because even if the peak is in 2020 instead of 2014, that does not make any important difference in the history of the world. Any such peak is going to look bumpy and flattish and it's always hard to decide whether it's happened or not, but in any case, we can expect a big increase in the price of oil.

Water

There is an old saying in Colorado that “whiskey is for drinking, but water is for fighting over.” The majority of the earth's surface is covered by water, but we cannot drink it because the ultimate pollutant of water is salt. You can't drink the ocean. In February 2009, Leah and I participated in a visit to the Middle East organized by the Chicago Council on Global Affairs. One stop was in Riyadh, the capital and largest city of Saudi Arabia. Our status was “guests of the king” so we were treated, well, royally. We had an escort of soldiers in four Cadillac Escalades, one in front of our bus, one behind, and one on each side. They cheerfully blew their sirens and traffic scattered at our approach, treatment fit for an emperor. Riyadh is a city of five million in the desert. The nearest body of water is the Persian Gulf, 400 kilometers away. Luckily, energy is very cheap in Saudi Arabia. Sea water is processed in desalination plants using modern reverse osmosis technology, and then pumped through pipelines to the city. The third desalination facility has just been built and is beginning delivery. The consulting engineering firm on the new project is ILF, an Austro-German private company. The new line is expected to provide 950,000 cubic meters of potable water per day (that is 264 million gallons per day). The power required to pump the water is 270 megawatts.

Making sea water drinkable takes enormous capital investment and enormous amounts of energy. One can say that the water crisis and the energy crisis are interchangeable. One of the best ways to generate electricity is to let water fall from the top of the hill to the bottom of the hill through a hydro-electric generator. Alternatively, clean water can be produced from polluted or salty water by using electricity to run a desalination plant.

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Everything a Young Financial Analyst Should Know About Energy (Continued)

Sustainable Energy

Five thousand years ago most of the energy consumed by mankind was for food production. Sunlight, the basic renewable energy source, made farms work. Agriculture also required a lot of water. Early civilizations developed in river valleys such as the Yangtze, Indus, Euphrates, and Nile because that was where the water was. Irrigation systems required leadership, cooperation, and therefore government. Religions started in river valleys too. Early forms of agriculture lasted a long time. In 1776, Thomas Jefferson could look out the window at Monticello and see slaves working in the fields using horses and oxen as draft animals. King Sargon of Assyria saw the same scene 3,000 years earlier. Thomas Jefferson could not travel faster than the speed of a sailing ship or a trotting horse. He didn't even have Facebook. Neither you nor I can make a plausible claim to be smarter than Thomas Jefferson yet you think nothing of flying 1,000 for a business conference and flying home in time for dinner. The difference of course, was the Industrial Revolution. It was essentially about replacing the muscular labor of man and animals with water power and then coal. For the first time people consumed more energy than their great-grandfathers had. Material production took off first as people made money, science and education soon followed, so that libraries, museums, and concert halls multiplied as well.

The mining and burning of coal created pollution problems early on. The peak oil theory is an iteration of the peak coal theory. That was worked out by the English economist Jevons, in his book *The Coal Question* written in 1865. Jevons tried to calculate the amount of coal reserves in Great Britain and the growth rate of coal consumption. He concluded that coal production would top out in 50 years. As it happened, the maximum production from British collieries peaked in 1913, 48 years from the book's publication. If you think you can make a better 50-year projection for any economic variable, be my guest. Jevons made one important error when he assumed that the petroleum industry would never be an important energy source, even though Pennsylvania was producing commercial quantities of oil at the time he wrote *The Coal Question*. Nobody's perfect.

There are a limited number of candidates for the role of energy producer of the future. Coal is still the major source of electric power despite its emission of carbon dioxide. Sustainable energy people would like to live in a world where coal use goes down, not up.

It is likely that in ten years oil production will be no more than it is now and on the way down. Natural gas is an extremely important energy source for the next 50 years because there is plenty of gas that can be produced easily. Gas will be very important but in another century, gas too, may get scarce.

Nuclear power ought to do well over the next 50 years, because it is the one available technology with decent economics and no carbon dioxide emission. However there is still substantial political opposition to expanding nuclear, so I do not think that nuclear can expand fast enough to gain share versus other energy technologies. There is research work being done on nuclear fusion that would produce power without using uranium. That sounds good because uranium is also a depleting resource. The future of fusion power has been quite stable. Forty years ago, fusion researchers said that they would have a commercial fusion system in 40 years and today fusion researchers still say that they will have a workable system in 40 years. It would be a very good thing if fusion reactors could be invented. It is not an investable idea at this time.

There are some non-conventional oil sources that can be mobilized including tar sands and oil shale. Tar sands are commercial now in Canada and production will expand. Tar sand plants take a lot of capital and actually burn a lot of natural gas to extract the oil. Environmental damage by the industry is considerable. My best guess is that tar sands will be an important energy source in the future but will not produce more than 16 million barrels a day, which is only 20% of current world oil production. Oil shale has even worse problems in terms of capital costs and environmental damage, although if we get desperate enough, oil shale is available.

Now we get to renewable energy systems. These are hot items and fashionable to invest in. Included are hydro power, solar panels, windmills, biomass, and geothermal. These systems tend to have long range potential but short range problems. Let's go through them.

Hydro power, a well-known technology, is a reliable source of electricity and does not emit carbon dioxide. The problems with hydro power include a shortage of potential sites for new large hydro systems, high capital costs, and environmental negatives. As an example, the Mekong River in Southeast Asia was one of the relatively un-dammed major rivers. It passes through many countries: China, Burma, Laos, Thailand, Cambodia, and Viet Nam. Each of these countries would like to have more electric power, but there are major problems in getting these countries to cooperate on a rational development system. There will be damage. For instance, Cambodia has a very large freshwater lake, Tanle Sap, which is the best freshwater fishery in the world. Some of the plans in development threaten the survivability of this fishery.

Solar panels generate electricity and are being made by numerous companies around the world. The trick here is to increase the efficiency of the panels at an economically competitive level. So far, coal fired electricity is much cheaper than solar, so much so, that large government subsidies are required to keep solar in the game. Germany is an interesting example. Germany is not

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Thomas Jefferson could not travel faster than the speed of a sailing ship or a trotting horse. He didn't even have Facebook.

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Everything a Young Financial Analyst Should Know About Energy (Continued)

The same problem of disappearing government subsidies affects wind as well.

a good place to use solar panels because from October through March sunshine is unusual. After lengthy travels in Germany, my wife and I made up a curse. If someone aggravated us, we cursed them with “May you become a bathing suit salesman in Berlin!” However Germany had installed more solar panels than anyplace else because the government paid enough of a subsidy to make it work. Now most governments around the world are in fiscal crisis and Germany is planning to dramatically reduce its solar subsidy. That would reduce orders for solar panels in Germany by 100%. Other countries also scratched their subsidies. That suggests that solar stocks should be traded from the short side.

Windmills have some of the same characteristics as solar. High capital costs, free energy costs, and unreliable output. Not everyone loves them. Ted Kennedy was renowned for the obstacles put in the way of a proposed wind farm offshore Cape Cod. And he was a fervent environmentalist until someone suggested putting up a wind farm that could be seen from his living room window in Hyannis. The same problem of disappearing government subsidies affects wind as well.

Geothermal falls under the comprehensive list of energy sources and seems to work well if you have an available site, but there are only a few good sites in the world. The best site in the United States is Yellowstone Park and I do not think the American people are ready to turn Yellowstone Park into an industrial park.

Biomass has always been an important source of energy. Many underdeveloped societies burn wood or dung. The biggest application of biomass has been ethanol converted from corn. You can run a vehicle on ethanol or an ethanol-gasoline mix.

The catch is that production of ethanol takes as much fossil fuel energy as the ethanol contains (fertilizer, diesel fuel, and distilling). And it is widely believed that the ethanol industry is not economically viable but it must be considered part of the farm subsidy program. You may remember that biomass stocks were very hot for a couple of years and then crashed.

Wiser

Sustainable energy issues are very important to me. I have contributed substantial time and funding to the Wanger Institute of Sustainable Energy Research (WISER), at Illinois Institute of Technology in Chicago. WISER will support sustainable energy research and train engineers to apply the solutions which have been developed. It would be wonderful if you think that the sustainable energy question is crucial and contribute time and money to an institution of your choice.

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

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Wanger Investments Quarterly Letter

Bill Andersen:

Investing Internationally For Institutional Investors

Whatever your view about the recovery in the United States and Europe, there is no doubt that Asian economies have seen a classic “V” shaped recovery.

International equity investments are generally made by institutional investors for some combination of the following reasons: portfolio diversification, access to outstanding companies headquartered outside the U.S., or exposure to developing economies which are expected to grow more rapidly than the U.S. Each of these reasons may help investors reach their objectives, but each, in our view, can also lead investors to make poor decisions which won't improve their returns. In the case of diversification, the globalization of financial markets in the past 20 years may have reduced the incentive to invest globally for this reason. As we all know, financial markets are closely linked to each other now and in many cases act more like one big stocks market than fifty or so individual ones.

Investors often cite exposure to emerging markets as a key reason for investing internationally. While this idea has merit, an important question is how this is to be implemented. International benchmarks are composed almost entirely of mature, as opposed to emerging markets, with Japan, England, and Germany being the largest. Investors may choose an emerging markets benchmark, but these are highly volatile, which may lead investors to make small allocations that don't have a meaningful impact on overall performance, or conversely to over-commit and then make poor asset allocation decisions following a period of sub-par performance.

There are several themes currently at play in international markets. The first is the strong economic recovery seen in the developing nations of the world, particularly in Asia. Whatever your view about the recovery in the United States and Europe, there is no doubt that Asian economies have seen a classic “V” shaped recovery. There is much talk currently about the potential for a speculative bubble in these markets. While it is certainly possible in the future, this isn't likely to happen in the near-term.

A second theme in our view is that high quality companies are currently undervalued following the recovery rally of the past 18 months, which focused on those companies which had been most affected by the crisis. As an illustration, we recently came across a list of ten valuation criteria used by legendary value investor Benjamin Graham to uncover investment bargains. Having just read a report on Johnson and Johnson, we evaluated the company using Graham's criteria. We found that at current levels, J&J appeared to meet nine out of ten criteria proposed by Graham. In essence, investors can purchase this company for the value of its current operations, paying nothing for the strong likelihood that it will continue its long term record of growth.

Much has been made of the sub-par recovery in the U.S. when compared to previous economic cycles. This has been seen most notably in employment figures, which have lagged far behind previous cycles. At the same time, corporate earnings for the second quarter have recovered strongly, and productivity figures for the U.S. are very good. It is possible the U.S. is in what we would call a “Productivity Recession,” which has hurt hiring in both the service and manufacturing sectors of our economy. Our definition of Productivity Recession requires some explanation. Over the past several decades a combination of rapid technological improvements and a growing supply of low cost labor from recently opened up economies led to a large number of jobs leaving the U.S., primarily in manufacturing. While this caused disruptions in many parts of the country, the overall job market in the U.S. grew due to a boom in other sectors including financial services, real estate, health care, and other primarily service sector jobs. This made sense to many economic observers since it seemed logical that economic development would lead the U.S. to move to a higher value added, service sector oriented economy while developing economies focused on manufacturing. Service sector jobs, the argument went, are higher paying, cleaner, and less cyclical and take advantage of our educated and creative workforce. Unfortunately this scenario ran into several problems during the current slowdown. First of all, many service sector jobs are actually in very cyclical industries which can shed jobs as fast as any manufacturing company. Financial services and real estate are two examples. Secondly, service sector jobs are not immune to the forces which led to a reduction in manufacturing jobs over the past 30 years, specifically, they can be shipped overseas and they can be replaced by technology. Outsourcing of service sector jobs has been seen for years with things like call centers and IT outsourcing, but it is certain to replace jobs in other sectors eventually. Technology improvements in the service sector occur at an astounding rate, which is one reason for the good productivity numbers the U.S. has seen. For years this was masked by the long-term secular growth in many service industries, but now that growth has stalled productivity gains are reducing the need for workers. This may explain why we have an economy in which many companies are profitable but where employment lags.

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

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Q3

Wanger Investments Quarterly Letter

Investment Write-up:

Durect Corporation (NASDAQ: DRRX)

On average, it costs about \$800 million to develop a new prescription drug. After the patent expires on a novel treatment, the molecular blueprint becomes publicly available. In this way generic reproduction becomes far less expensive—and if that molecule is synthetic (not commonly found in nature), it's even easier and cheaper to replicate. Furthermore, the Food and Drug Administration (FDA) is friendly to generic drug manufacturers by providing a fast track for approval that usually doesn't require clinical trials; the approval process for generics typically requires simple tests for bioequivalence. To the end-user, the economics of breakthrough drugs are often frustrating—these therapies are expensive, while generic medicines are much more affordable. From a business standpoint, the high economic rent that can be earned from a blockbuster drug leads some manufacturers to pursue the costlier and riskier business model of new drug development.

Durect Corporation (NASDAQ: DRRX) positions itself somewhere in-between breakthrough and generic by improving generic formulas for duration and efficacy. In other words, DRRX takes a generic drug that needs to be taken every day and adjusts the formula, allowing one dose to last for three days with better results. A key consideration in their drug development model is that they alter the generic formula enough that costly development and clinical trials become necessary. To lessen their business risk, DRRX has developed repeatable drug development systems which save time, money, and provide for meaningful profit opportunities. By focusing on medicines that treat similar indications, and have similar chemical compositions, DRRX is able to leverage their knowledge capital to simplify the process of bringing new drugs to market.

DRRX's SABER delivery system is a repeatable process for the creation of protein, peptide, and small molecule-based drugs. The process combines injectable generic drugs with DRRX's patented compounds. POSIDUR is one output of the SABER process. POSIDUR is a long-acting, local anesthetic (bupivacaine), designed to treat post-operative pain. The injection is administered at the time of surgery and provides for the extended release of bupivacaine for up to 72 hours.

Other controlled release products on the market generally provide pain relief for 24 hours. By providing ongoing relief, POSIDUR has the potential advantages of reducing the quantity of narcotic needed, resulting in fewer unpleasant side effects commonly associated with the more frequent dosing of fast acting solutions. POSIDUR is currently enrolling a phase III clinical trial in the United States, with data expected in the second half of 2011 and a New Drug Application (NDA) submission in the first half of 2012.

ORADUR is another repeatable system based on the SABER technology, but focuses on transforming short-acting capsules to extended release capsules. Remoxy is one output of this system and is the leading product in DRRX's clinical pipeline. Remoxy is a long acting capsule similar to the painkiller oxycodone, but is designed for extended relief for 12 to 24 hours. Remoxy also has the additional benefit of being abuse resistant. The gel based capsule prevents inhalation by even the most motivated users who find the potency drastically reduced when crushed and frozen.

The alternative oxycodone market where Remoxy competes is more crowded than the POSIDUR market. However, the aging U.S. population has generated more interest from large pharmaceutical companies to diversify and expand their pain management portfolios. Furthermore, the multi-billion dollar prescription pain market – a focus of much of DRRX's clinical pipeline – is growing. One recent instance of industry consolidation was the acquisition of King Pharmaceuticals (NYSE: KG) by Pfizer (NYSE: PFE). Notably, KG was (and remains) a development partner in Remoxy. Under the terms of this partnership, KG is responsible for the sales and marketing of Remoxy. DRRX will benefit meaningfully from the acquisition due to the much larger and experienced PFE sales force. Remoxy has completed Phase III study, with an expected NDA submission this quarter, and hopeful FDA approval by mid-2011.

For many investors, biotech investing can be a risk/return roller coaster and a painful waiting game for new products to move through the pipeline. Imagine the frustration of micro-managing the daily activities of a process that requires 10 years to complete! We are encouraged by the long-term commitment of senior management at DRRX, many of whom have been with the company for 10 years or longer. In DRRX we see an opportunity to attain biotech-like returns without the high risk profile or the waiting. From a clinical standpoint, we believe that the two key products (Remoxy – with NDA results in 6-8 months – and POSIDUR) have been meaningfully de-risked. Remoxy, on its own, has the ability to drastically alter the financial profile of this company. We are also impressed by management's attitude to "show us" instead of pumping a story that has lots of potential. Along with strong management, comes a slow (aka patient) clinical development program that is focused on fiscal responsibility.

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