First Quarter, 2011

Q1 | Wanger Investments Quarterly Letter

WangerInvestments.com
WangerOmniWealth.com

1Q11 Preview

Dear Sir/Madam:

While the U.S. is growing and unemployment is creeping down, economists remain nervous about U.S. growth. Having said that, housing is still cheap and it is unlikely that oil prices can retain their middle-eastern-revolution levels of risk premium. Food and other commodities have soared, but Americans seem more concerned with the price of gasoline.

What Do We Think About the Markets?

Are we bears? That's probably too strong of a statement. However, the share price run-ups of the last six months are now harder and harder to justify.

Thus far the U.S. has avoided broad based inflation. It is certainly true that food, fuel, and many industrial input prices have risen dramatically in a short time. However, housing is cheap and wages are not under upward pressure. Given the magnitude of our national debt (and the damage we are doing to our currency), it will take both skill and luck to dodge the inflationary bullet.

The dollar has nowhere to go but down over the long run, just as interest rates have nowhere to go but up; but inevitability does not require swiftness. The dollar often serves as the "tallest midget" despite our wholesale attempts to destroy its value on every front.

There are loud squabbles in Washington regarding budget cutting measures. But, simply put, unless we are able to muster the political will to cut back the health care promises we have made to the elderly of the future, we will never save the Trillions (notice the "T") required to make a meaningful dent in the long-term problem. Likelihood of real change coming out of Washington? You make the call...

Stocks

Now that we have seen the first cracks in the recent bull market in equities, it seems likely that large cap names will outperform small cap stocks, especially for the riskiest and most frothy names. Let's hope the ride is gentle.

Bonds

Bond investors looking for investment grade yield opportunities still have little to find in these markets. Federal policy is still explicitly aimed at expensive bonds and low yields. This is a gift to banks at the expense of the populace.

As you know, we have developed an Alternative Fixed Income Portfolio specifically designed to replace bonds. Interest rates may not soar tomorrow or the next day, but anything that can't last forever must eventually stop. And that means that bond prices are at risk. Given the yields we currently see, how much ordinary bond risk is really worth taking? Ask us about it. It's really cool!

Commodities

When the barber, doorman, and taxi driver know that certain assets can only go up in price, its time to be very, very nervous. That's how we feel about many energy and non-energy related commodities. $110 is not the natural market equilibrium price for oil at this time. It will be a bumpy ride, especially if mid-eastern bad guys do things to disrupt supply, but it is hard to imagine that prices won't be coming down at least in the near-term. Likewise, corn and farmland prices cannot continue to make millionaires out of American farmers forever.

We continue to grow and thrive. Our multi-family office group continues to bring high-touch services to a rapidly increasing group of prominent families much too used to getting pawned off to the call center of their bulge-bracket wealth management firms. For more information, 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

In This Edition

WANGER INVESTMENT MANAGEMENT

WANGER OMNIWEALTH LIFE ENRICHED

Q1 | Wanger Investments Quarterly Letter

From The Desk of Eric Wanger:

Oil, Drugs, and Social Networking

Eric Wanger

Our analyst team recently attended Global Hunter's "land based drillers" conference, an overview of industry economics that included presentations by four firms that own, lease, staff, and operate land based oil rigs. These are relatively small public companies that provide contract drilling services for clients that need gas and oil wells drilled. As one might expect, there was a lot of discussion about the prices of gas and oil. The price of oil was (is) impressively high based on a dramatic increase in middle-east unrest, heavy speculation, and big money flows looking for a place to invest. Likewise, the price of natural gas was (is) impressively low.

Crude Oil (WTI) & Natural Gas Prices: December 2008 — May 2011

Source: Bloomberg

Nobody ever said it was work for wimps. But it pays really, really well. Here is a job that doesn't require a high school diploma that can start at over $50,000 per year.

Some of the more interesting things we learned:

- Few in attendance believed that oil could maintain its (then) current $110-120 per barrel price levels for very long, believing that such high prices represented short-term speculative bets and middle-east risk premia, not underlying demand or supply issues.
- On the flip-side, these same analysts seemed to think that $60-$70 is about as low as oil can legitimately go at this point given actual supply and demand conditions.
- Relatively conservative balance sheets are in fashion among this crowd. While capital is plentiful and available to these land drillers, they are terrified of taking more money than they can put to work right away. The last crash was so severe that it "put the fear of God" into their CFOs. None of these smaller land drillers are willing to get "overbanked" again.
- Natural gas is once again a fuel of choice for electricity generation, especially in parts of the country (such as the Northeast) that have under-invested in nuclear power and can't safely and cleanly burn coal.
- As one might expect, the gas rig count continues to drop while oil seeking projects are exploding in number.

Admittedly, that's all pretty mundane stuff. Competent, interesting, possibly useful, but certainly dull. Dry as dust.

Want something a bit more interesting? What did every single senior executive in the room mention as his number one concern after trying to get and retain customers? Every management team in the room agreed: Finding and keeping competent employees is the toughest problem they face. The reason? Rampant drug use!

They were complaining about the rampant, recreational use of cocaine, methamphetamines, heroine, and other hard-core, addictive illegal drugs among unionized workers earning solid middle-class wages.

Rampant Drug Use

Working on an oil rig is a tough job. It's dirty outdoor work. It's hot. It's cold. It's wet. It's icy. Nobody ever said it was work for wimps. But it pays really, really well. Here is a job that doesn't require a high school diploma that can start at over $50,000 per year. Furthermore, hard working, experienced rig crew members can make in excess of $100,000 per year if they are responsible and can manage others.

Obviously, these companies have to maintain a zero tolerance posture on drug abuse. Their people are operating heavy machinery in tough outdoor conditions. The equipment is heavy and prone to difficulties. Injury is common and safety is a constant concern. Yet, in a world where populist politicians regularly complain that American workers can no longer get a decent job without a fancy education, I am listening to a bunch of senior corporate officials telling me that they can't find a sufficient numbers of workers that will come to work straight and sober for $50,000 per year.

Admittedly, there's not much to do for fun on your days off, but that's hardly a new problem. When did bored, lonely, and recently-paid oil, gold, coal, timber, or cattlemen ever behave like Eagle Scouts on their personal time? The highly paid "suits" at the conference were not complaining about whiskey or venereal disease among the lowly, poorly paid, or disenfranchised. They were complaining about the rampant, recreational use of cocaine, methamphetamines, heroine, and other hard-core, addictive illegal drugs among unionized workers earning solid middle-class wages.

Continues on the next page

Q1 Wanger Investments

Quarterly Letter

Oil, Drugs, and Social Networking (Continued)

One official told us that merely announcing mandatory drug testing dramatically lowered his job application rate. Another told us that his firm went to hair follicle testing because urinalysis only caught marijuana abuse and was too easy to fool by people using methamphetamine or cocaine on their days off.

Americans demand drugs — lots of drugs. So it is a basic law of economics that there will be huge efforts put into supplying drugs to Americans — and the current policy regime keeps it so profitable that it is worth killing people for the right to sell drugs. It was no different with oil, booze, or even newspapers back "in the day." People beat and even killed each other competing for the right to own the channels of distribution.

It was no different with oil, booze, or even newspapers back "in the day." People beat and even killed each other competing for the right to own the channels of distribution.

Basic economics guarantees that as long as Americans are willing to pay high prices for drugs, illegal or not, nearly infinite effort will be put into meeting that demand. No honest free-marketeer can deny this fact.

In 1931, Aldous Huxley wrote *Brave New World*, a science fiction novel rooted in social commentary ("Praise Ford!"). He foresaw our future in his eerie utopia with our entire population continually popping state-sanctioned recreational narcotics. In his world, psychotropic drugs were a tool of political control as much as of psychic self-medication. But as far back as 1931, he saw taking pills as part of the fabric of our society.

What we think about energy and other commodities:

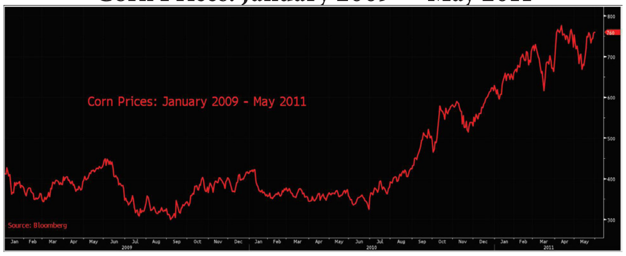
In the long-run, the price of oil will keep ramping higher, but the short-term will inevitably see the same zigzaw pattern we have always seen. In the short-term, the price is as likely to head back down to $70 per barrel as it is to jump back up above $110. Many oil and gas stocks have or will become cheap again after coming off huge bull-market run-ups. Stocks like Double Eagle Petroleum (DBLE) and Venoco (VQ), for example, can be purchased at or below the value of their proven hydrocarbon reserves. It might be awhile before these stocks peak again, but it's hard to argue with tangible asset value.

Is drug use really so bad that it is doing meaningful damage to our economy. Yes, unfortunately, it is.

America continues to be awash in coal. But Americans, at least right now, universally despise this abundant natural resource. Why aren't we investing in the technology necessary to burn coal cheaply and cleanly? I'm sure the answer is political. In any case, high quality coal is expensive and dirty coal is cheap. And coal is expensive to export to the countries clamoring for supplies of it. Unfortunately for us, coal stocks are hard for us to buy, because they are so cyclical and momentum driven.

Food prices have soared. Droughts in China and other Asian regions have caused significant food shortages. Weather problems have coupled with market distorting subsidies (such as America's Ethanol subsidy for corn farmers) to create the wealthiest American farmer we've seen in a long time. One result, American farm land is selling for huge prices, maybe even at "bubble" levels. We are hard at work looking to invest in things that wealthy farmers want to buy.

Corn Prices: January 2009 — May 2011



Source: Bloomberg

Lastly, there is another tech-bubble under way. This time it's the social networking companies like Facebook, GroupOn, LinkedIn, and others that are acting like the proverbial cow jumping over the moon. Are GroupOn and LinkedIn going to be Googles or Alta Vista? Are they going to be Yahoo's or NeXTs? Hard to tell. But I doubt any of the investment banks will return any of their hefty fees when we find out.

Eric Wanger, JD, CFA

Q1 | Wanger Investments
Quarterly Letter

Ralph Wanger Reports:

Mr. Jones Saves the USA, Twice

Ralph Wanger

It was no accident that TARP put money into the banks by buying preferred stocks.

The lesson for us is that there is some predictability even in very scary events, such as the 2008 crash. Mr. Bernanke immediately went to the Jesse Jones playbook and the banking system reacted in the same way.

Jesse Jones (1874-1956) is today just another man vanished into the anonymity of history, a fate that awaits almost all of us. His name, however, still lives in Houston and throughout the Texas area due to his generous philanthropies. In 1937, he set up the Houston Endowment, the largest private foundation in Texas. The business schools at Rice University and Texas Southern University are named in his honor. The Houston Symphony plays at Jesse H. Jones Hall. The Jesse H. Jones Rotary House Hotel serves patients and family members at the M. D. Anderson Cancer Center. Jones College of Communication, of the University of Texas at Austin, Baylor University's library, the list is extensive.

Mr. Jones did not start out as a rich guy. He was born on a tobacco farm in Tennessee and never went to high school, let alone one of the universities that now have his name on a building. I am sure that everyone reading this article went to high school and way beyond, and that's a very good thing. Self-made men like Jones had to come up the hard way. Abe Lincoln and Cornelius Vanderbilt rose to the top but, most such men never got very far. But Jesse prospered through hard work, built a reputation for honesty and fair dealing, and learned to judge human character rather than how to solve partial differential equations. At the age of twenty-four, Jesse was sent to Houston, Texas to manage an uncle's lumber yard. He soon started his own lumber yard, and then moved into real estate, then commercial construction, and then banking.

In 1908, Jesse built a new office and printing plant for the Houston Chronicle and swapped the buildings for a half-interest in the newspaper. After a while he owned the whole newspaper and kept the title of Publisher for the rest of his life. By 1914, his business and political skills enabled him to get federal funding for the Houston Ship Channel. That waterway made Houston the major port city it remains today.

The Reconstruction Finance Corporation (RFC) was set up in late 1932 under President Herbert Hoover. Hoover appointed Jones to the board even though Jesse was a Democrat, albeit conservative in the southern tradition. When Franklin Roosevelt was inaugurated president in March 1933, he promoted Jones to Chairman of the RFC, the key financial agency of the New Deal. In 1940, Jesse was appointed Secretary of Commerce, and served until 1945. He was 71 when he left government service.

The RFC made thousands of loans, but had few losses, with most programs returning small profits for the government. The agency people were hard-working and scandal-free. Mr. Jones built and ran a gigantic agency with skill, judgment, hard work, and honesty for thirteen years, and no one has ever done it better.

Saving the Banks

The Great Depression cascaded downwards in 1930, 1931, and 1932. In March of 1933, as Roosevelt was being inaugurated president, the American banking system completely broke down, and for ten days there was a "bank holiday." A special session of Congress was called, and a bill was passed authorizing the RFC to invest in the preferred stock or capital notes of banks. The RFC adopted a triage strategy. Class A banks were sound banks that needed no help. Class C banks had no capital left and were left to reorganize or liquidate. The RFC put money into the Class B banks that had impaired capital but had enough good assets to be worth saving. The RFC performed most of its program by buying preferred stock in the banks. At the time it was estimated that the banks could take about twenty years to retire the RFC's preferred stock holdings. In fact, the banks got back the preferred much more rapidly than that. The bank rescue program saved thousands of banks. There were some losses to the government, but the overall principal payments and dividends allowed the RFC to make a small profit on the total program.

The Troubled Asset Relief Program (TARP) that was begun in 2008 was designed in part by Ben Bernanke, the Fed Chairman and economist who had specialized in studying the Depression. It was no accident that TARP put money into the banks by buying preferred stocks. The banking system reacted similarly, retiring the preferred stock as quickly as they could, so that again the banking system survived and the government made a small profit. That is not including the rescue attempts for Fannie Mae and Freddie Mac. That will take hundreds of billions of dollars to wind down.

The RFC was then involved in making agricultural loans to prop up the farm sector, loaned a billion dollars to 89 railroad companies, rescued some mortgage banks, a number of insurance companies, and financed many infrastructure projects.

The lesson for us is that there is some predictability even in very scary events, such as the 2008 crash. Mr. Bernanke immediately went to the Jesse Jones playbook and the banking system reacted in the same way.

Continues on the next page

Q1 Wanger Investments Quarterly Letter

Mr. Jones Saves the USA, Twice (Continued)

The "killer app" for rubber was the first great personal transportation boom of modern times, the bicycle.

Between 1870 and 1930, rubber consumption grew at an 8% annualized rate, an extremely rapid increase over that long period of time. Nevertheless, rubber that sold for $3.00 a pound in 1893 was selling for 3 cents a pound in 1932.

The RFC also financed many infrastructure projects: The San Francisco Bay Bridge, the Pennsylvania Turnpike, the Colorado River Aqueduct that carried water from the Colorado River to Los Angeles, and the Brooklyn-Battery Tunnel were some of the many RFC-funded public works. Did these projects help end the depression? Shlaes Sprinkel and other conservative scholars think the RFC loans merely displaced other capital, and the depression didn't end. Perhaps, but I think the banking rescue was important, and also rubber.

Rubber

We are going to discuss the rubber industry. The reason for the apparent interruption to the RFC story will become clear as we progress. The rubber industry today has few companies in it and I suspect that few of us deal with portfolios that have more than one percent weightings in the group. Nevertheless, the modern world could not exist without rubber. Nobody in the developed world had heard of rubber until the middle of the 18th century when explorers returned from Brazil with some samples. They discovered it was bouncy (the Mayan civilization in Mexico used rubber balls in games). Some of this ancient sport tradition still exists. When in Oaxaca a few years ago, Leah and I watched two teams of local people throwing rubber balls across a field, in a game that seemed to have very few rules but was marked by cheerful enthusiasm.

Some Europeans discovered that a lump of the stuff could erase pencil marks and so the English called it "rubber." Mr. MacIntosh figured out that if he took a thin sheet of rubber and attached it to cloth, he could make a waterproof garment. Waterproof shoes were also produced. Rubber was not really useful, because in hot weather it got soft and runny and in cold weather it got brittle. In 1839, Charles Goodyear invented vulcanization that stabilized rubber enough for general use. It was quickly used for hoses, shoes, and finally tires.

The "killer app" for rubber was the first great personal transportation boom of modern times, the bicycle. The bicycle required much more tonnage of rubber than had previously been shipped, and the price soared. Rubber in 1890 was made from the sap of the rubber tree, found in the Amazon basin. These trees grew wild in the forest so workers went from tree to tree with axes, bowls, and buckets, tapping the trees and delivering the liquid latex for processing. If this sounds like a slow, primitive process to you, you are right.

The price of rubber went from a few pennies a pound to $3.00 a pound in 1893. In 1893, $3.00 represented the wage of a locomotive engineer or a hard rock miner for a twelve hour shift. So a bicycle tire was a valuable item. There may have been Robber Barons in American Industry, but there were certainly Rubber Barons in Brazil. The city of Manaus, way upstream in the Amazon jungle, became a boom town with extravagant mansions and a $10 million opera house that still exists today.

Opera House In Manaus, Brazil

Hunting around the jungle to find individual wild rubber trees wastes a lot of time. The inefficient Brazilian industry was a pothole on the road to progress. It was solved by the Englishman Henry Wickham, when he smuggled a sack of rubber seeds from Brazil to London in 1876. The Brazilians were furious but couldn't do anything about it. Rubber plants were then shipped to Ceylon (now Sri Lanka) and the Malay states (now Malaysia). Plantations were developed in the mid-1890s in response to the high Brazilian prices. The new rubber plantations were successful. The rubber trees liked growing in Southeast Asia just as well as they had in Brazil and the plantation workers were much more efficient that the Brazilians. A number of the plantation companies sold stock to the public. The rubber price came down from the 1893 peak but was still satisfactory, and then the automobile started a new demand for rubber. Prices started to rise. There was a fine story in the New York Times (Feb. 28, 1910) headlined, "British Public Mad over Rubber Stocks: Speculation in Plantation Shares — New Issues Snapped Up." The price of rubber was lofty again in 1909 and punters expected it to go much higher. Surprisingly, it didn't, and the speculators were erased.

The sap of a rubber tree can certainly be considered an agricultural commodity, but it doesn't act like one. If you are growing corn, wheat, or soybeans, you can get a crop every year. That means that if this year's soybean prices are high and corn prices are low, that next year you can switch soybean acreage to corn

Continues on the next page

Q1 Wanger Investments Quarterly Letter

Mr. Jones Saves the USA, Twice (Continued)

But you cannot run a modern economy, let alone fight a war, with rubber... So how come we won? Jesse Jones and the RFC saved the day.

and damp the price cycle. A rubber tree takes seven years from planting to become a productive tree, so a high price in 1902 will encourage the planting of new trees, but then it takes seven years before the supply increases. Obviously that will amplify any upswing in prices. Then when the supply from the new plantations hits the market, prices will drop rapidly, but production will stay high. A newly producing rubber tree will continue its productive life for about 30 years without very much maintenance expense, so excess supply stays in the market. One would expect rubber prices to bounce around with these economics and this has been proved. Between 1870 and 1930, rubber consumption grew at an 8% annualized rate, an extremely rapid increase over that long period of time. Nevertheless, rubber that sold for $3.00 a pound in 1893 was selling for 3 cents a pound in 1932.

The Malayan planters were very happy with their new plantations, but just as the English in Malaya had stolen market share from Brazil, the Dutch were able to start their own rubber plantations on Sumatra and other isles of the Dutch East Indies (now Indonesia). In addition to plantation rubber, local farmers started planting rubber trees as well. Abundant supplies made the 1930s awful for rubber producers. Then in 1942, the Japanese captured both the Malay States and the Dutch East Indies. The Allies had to fight WWII without new supplies of rubber. But you cannot run a modern economy, let alone fight a war, without rubber. Every jeep, truck, tank, and airplane needs tires, gaskets, hydraulic hoses, fan belts, and so on. So how come we won?

Jesse Jones and the RFC saved the day. In 1940, it was already clear that rubber supply was a critical problem. In June of 1940, Congress gave the RFC the authority to stockpile rubber and tin. The RFC, working closely with the U.S. tire manufacturers, bought all of the rubber that was available on the market through a new subsidiary, the Rubber Reserve Company. The stockpile by the beginning of 1942 amounted to 630,000 tons, a large quantity compared with the 1939 consumption for the U.S. of 900,000 tons. The rubber stockpile was essential but not sufficient. New rubber supplies had to be created, in size and quickly. But how?

Synthetic rubber had been invented by German chemists as early as 1882 and the Germans produced a low quality synthetic during WWI. In 1929, I.G. Farben, a giant German chemical company, invented modern synthetic rubber, made from the petrochemicals butadiene and styrene. This was an important invention, because the Germans knew that in a European war the British Navy would blockade rubber supplies. The U.S., of course, assumed that Southeast Asian rubber would always be available, and ignored the problem until 1940. American rubber companies had been doing lab work on synthetic rubber, but there were no commercial scale factories. A new industry had to be built in the U.S., in a very short period of time.

Jesse Jones made a written request to FDR in September 1940 asking for permission to invest $100 million in new synthetic rubber plants. FDR, not impressed, agreed to only $25 million. Jones made plans to spend $40 million anyway. Getting all the rubber and chemical companies to pool patents and cooperate with their competitors was difficult until Pearl Harbor, but after that patriotism caused them to cooperate fully, and the program went ahead at high speed. The $40 million budget jumped to $400 million. The rubber program solved all its predictable technological and political problems, and it worked. In 1944, production exceeded 700,000 tons. (The German program had started a decade earlier, of course, and German chemical technology was by far the best in the world. But the peak in German synthetic rubber production was in 1943, at only 109,000 tons.)

The Soviets also had a synthetic rubber program, but its production was probably less than the Germans. The U.S. sent experts to Russia to see if Russia could help the U.S. in any way but the delegation was refused entry into any Soviet rubber factories.

So, the war was won, and Jesse Jones and the RFC deserve enormous credit for foresight and energy creating this war winning industry. The synthetic rubber plants were controlled by the government until 1955, at which time the factories were sold to private companies.

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

Q1 | Wanger Investments Quarterly Letter

Family Office Corner – By Suzanne Carrier Campion:

Do I Really Love My Kids That Much?

Working with your advisors to strike an appropriate balance and figure this out is paramount and we advise to plan conservatively for the future.

The change in the law provides great impetus to think about whether or not you want to explore the options it presents you.

In a way, until now the estate tax law has saved us from having to make decisions about how much money to give our children while we are still around. If you have already transferred a great deal of wealth to your heirs, you probably formed a complicated trust or partnership structure or paid substantial gift taxes. Now, the government has given us a new opportunity, placing the responsibility squarely in our laps.

The recently passed Tax Relief Act of 2010 allows for a $5 million Gift Tax and Generation Skipping Tax (GST) exemption and a $5 million Estate Tax exemption for each individual. To the extent you use your Gift Tax and GST exemption during your lifetime, you would not have any Estate Tax exemption remaining at death. Each individual receives a total of $5 million of "exemptions." However, if you do not utilize the exemptions during your lifetime, the balance can be "carried over" to your spouse. Anything above this amount will be taxed at a top rate of 35%. One of the challenges of this new provision is that our friends in Washington have only made it available for the next two years, after which, it's anybody's guess as to what will happen.

NOW WHAT? On the one hand, do you really want to hand over that kind of money to your children or grandchildren now? On the other hand, do you want to lose the opportunity to take advantage of this potentially temporary tax bill?

Most of our clients undertake significant estate planning with their attorneys and accountants. While we certainly see some meaningful lifetime gifting, much of it actually occurs at death. This tax bill may encourage clients to rethink the timing of their gifting strategy.

WHAT ABOUT ME? Before taking any action to comfort younger generations financially, be sure that you are well taken care of for the balance of your lives. We have seen situations where, through the goodness of their hearts, clients have passed a great deal of their wealth to their children and grandchildren during their lives and something unforeseen happened. As a result of that event, the patriarch and matriarch ended up not having what they needed, and in the worst of situations, the children were unwilling to support their parents. Working with your advisors to strike an appropriate balance and figure this out is paramount and we advise to plan conservatively for the future.

THEN COME THE KIDS… For those who would like to take advantage of this "window of opportunity," here are some considerations:

- At what age would you consider it appropriate for your heirs to have access to some of your wealth?
- Are there restrictions you would put in place regarding the use of these funds?
- Would you like to protect your assets from future spouses/failed marriages?
- What kind of assets would you like to gift to your heirs?
- Are all of your heirs capable of handling this wealth in a responsible manner?

Don't get me wrong, we support gifting to younger generations as early as you deem appropriate. Why, you may ask? If you give your ten year old a hundred dollars today and it remains invested, all of the appreciation is in his/her estate, not yours. As a result, you avoid paying any gift or estate tax on the capital appreciation. The math is easy.

BUT I LOVE CONTROL! You say… The good news is, if you think you might consider gifting to your heirs within the next two years, it does not necessarily mean that you have to lose total control over the assets. Legal vehicles exist which enable you to give the gift while still directing the investments; determine when your heirs receive access to the assets; continue to have a say in the business; and maintain influence over other important factors. Given the low interest rate environment and this new opportunity, we, in conjunction with your other advisors, will assist you in examining and determining the best approach for you and your family in structuring these gifts.

WHAT IF MY GRANDSON/DAUGHTER ENDS UP BEING A @#*!$? Our guess is that your family is probably familiar with trust structures (and if not, you should be) so you likely know how flexible they can be. While we do not advocate demanding that your heirs become CEOs of "this" or graduates of "that" in order to benefit from granddaddy's good fortune, families find their own unique ways to encourage good citizenship.

WHAT'S NEXT? You have likely taken the first step by at least establishing a will and a revocable or living trust. The change in the law provides great impetus to think about whether or not you want to explore the options it presents you. Please use this as an opportunity to reengage us, your estate attorney, and your accountant. Valuations on certain assets remain relatively low and this window recently opened. There is no time like the present. And hey, a conversation about this does not commit you to anything. Creating a financial model for various scenarios is easy. Have fun with it and spread the love (even if you want to control the love)!

Suzanne Carrier Campion, *Office Managing Director,*
Wanger OmniWealth, LLC

Q1 Wanger Investments Quarterly Letter

Bill Andersen:

Ideas On Selecting An Investment Advisor

Investors who picked top performing hedge fund managers in 2007 soon saw their portfolios suffer losses which will take years to recover.

Managers who can identify high quality companies and value them intelligently may not outperform every year but they are unlikely to blow up, and their results over time should be good.

Conservative author William F. Buckley once said he would prefer to be governed by the first 2,000 names in the Boston phone book than by the 2,000 professors on the Harvard faculty. His comment was meant to point out that common sense, wisdom, leadership skills, and good temperament are often not directly associated with the sorts of intelligence found in academia.

Thomas Sowell of the Hoover Institution at Stanford uses the following to illustrate a similar point: He defines intelligence as the combination of intellect and judgment. Expressed algebraically: Intellect + Judgment = Intelligence. He points out that a little bit of algebra results in the following: Intellect = Intelligence – Judgment. In other words, being smart without possessing judgment can lead to problems.

Investors looking to select an investment advisor are presented with a difficult task. There are plenty of advisors around with impeccable academic credentials. Top degrees in business or law are a dime a dozen in our industry. Picking an advisor on this basis might seem like a good idea, but investors run the risk of running into the problem which Buckley and Sowell warned about. You can easily end up with an advisor whose pedigree is more impressive than his investment ability.

Alternatively, investors could pick an advisor based solely on their track record. This is not the worst idea in the world, but it can also lead to problems. Investors who picked top performing hedge fund managers in 2007 soon saw their portfolios suffer losses which will take years to recover. The same could be said for investors who got into tech stocks during the internet bubble. Picking an advisor based on this criterion alone can lead to chasing good performance at the wrong time.

There are a number of other strategies which could be employed. Some suggest picking the lowest cost producer and investing in an index of stocks. This strategy is based on the so-called "efficient market theory" which, despite being refuted by market reality time after time, still has many supporters. To its credit, at least this strategy will keep an investor from spending too much on investment advice which provides little value.

Another strategy is the so-called "best of breed" approach. Investors in this camp hire an investment advisor to select other investment advisors. The idea is that by picking the best advisors in each asset class you will get an optimal portfolio. The problem with this approach is that it assumes that the advisor at the top of the pyramid actually has the ability to select top managers consistently and that there is a structure in place which will allow him to do this. A further weakness is that investments are often chosen from traditional asset classes which have already performed well rather than those which will perform well in the future. Commodities and emerging markets are examples of asset classes which investors moved into after they had significantly appreciated.

No investment category in recent years has generated more excitement than Emerging Markets. After being universally despised during the financial crisis several years ago, investors jumped back into them in 2009 and 2010 as the fundamentals were quick to turn around after the recession. With interest rates low and the developed economies struggling, these markets became a one way bet in the minds of many investors. In fact we had lunch in London last fall with a hedge fund investor who argued that there was no need to hedge emerging market investments because the asset class had such a high degree of something he called "embedded alpha."

During the technology bubble of the late 1990s, Warren Buffett wrote a famous article in Fortune. He was being criticized by many for having missed the technology boom. In his article he wrote (and we are writing from memory) that investing wasn't just about who had the latest technology or who was growing the fastest. Rather, it was about identifying quality companies who could maintain their market share and earn good returns on capital. Emerging markets investors would do well to keep this in mind today. There is no doubt that the development of economies such as China, India, and others is one of the great economic events of our time, and that many fortunes will be made. But this isn't the same as saying that these markets are a one way bet, or that all the companies in these countries will thrive. Most listed companies in the developing world are far from the model Buffett described. They earn low returns on capital, have little pricing power, and are often dependant on cheap labor, which history shows is not a long-term sustainable advantage.

Investors would do well to keep this advice in mind when picking an advisor as well. Managers who can identify high quality companies and value them intelligently may not outperform every year but they are unlikely to blow up, and their results over time should be good.

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

WANGER INVESTMENT MANAGEMENT

WANGER OMNIWEALTH LIFE ENRICHED

Investment Write-up:

inContact, Inc. (NASDAQ: SAAS)

inContact, Inc. (SAAS) provides cloud-based (hosted) call center solutions and also resells basic telecommunication services. In 2005, SAAS made a strategic decision to focus exclusively on growing its call center solutions business, developing a hosted software solution and transitioning into a "Software-as-a-Service" (SaaS) business model. The company derives the majority of its software revenues from its automatic call distributor (ACD) and interactive voice response (IVR) products. SAAS has positioned itself to benefit from the evolution of the call center market away from capital intensive, on-premise solutions towards hosted, decentralized call centers. The company's customers prefer to deploy a hosted solution and avoid the high fixed costs associated with on premise call centers. This trend should continue for at least the next five years due to the strong value proposition of hosted solutions, which reduce capital spending requirements and have a lower total cost of ownership than on premise solutions.

Over the past several years, SAAS focused on building out its distribution capabilities by forming partnerships. The company is a premier partner of salesforce.com (CRM) and has many other important channel partners, including Agent Alliance and Astadia. These strategic relationships, combined with the company's internal investments in sales and marketing, should help generate strong brand awareness. SAAS continues to hire more salespeople and these efforts are starting to pay dividends, as the company experienced a record number of new contract wins in the software segment in both Q2 2010 and Q3 2010 and posted year over year growth in new contract wins in Q4 2010 and Q1 2011. The company also posted 96% year over year growth in bookings in Q4 2010 followed by 91% growth in Q1 2011. We expect SAAS to continue to capture market share as it grows its direct sales force, leverages its distribution relationships, and builds on its growing brand awareness.

We like the transition to a SaaS business model, as this should provide a strong recurring revenue stream going forward. Additionally, as software revenues continue to grow, the overall gross margins of the company should improve. Revenues in the legacy telecom business experienced unsettling declines for six consecutive quarters before experiencing sequential growth in the first quarter of 2011; the telecom business generates solid cash flow to help finance growth within the software segment.

In the near-term, we expect SAAS to lose money, as they face a near-term trade-off between profitability and investing in sales, marketing, and other areas of the business that will drive future growth. However, they should start to experience some significant software revenue growth in the second half of 2011, stemming from new customers they won in recent quarters. (It takes 5-6 months to recognize any revenue from a new customer.)

We believe that 2011 is an extremely important year for SAAS as it will provide the company with an opportunity to execute on their investments in sales and marketing and show solid revenue growth in the software segment. Management stated on their last earnings call that they expect year over year software revenue growth between 25%-30% in Q4 2011. If SAAS can successfully grow its top line, we expect management to scale the business and achieve profitability in the long-term.

SAAS Stock Price: January 2009 — May 2011

Source: Bloomberg

While we like SAAS as an investment idea, we continue to monitor several key risks. Software revenue growth has slowed, the company's balance sheet is not great, and competition from larger, better capitalized players such as Cisco (CSCO) could emerge if they deem the space very attractive. SAAS also historically has not operated profitably. We view the company's ability to sell as a key risk and are closely monitoring revenue growth within the software segment.

Despite these risks, we believe that SAAS is well positioned to grow and unlock value for shareholders. The company has a solid technology portfolio, continues to grow its sales force, and also continues to capitalize on and increase the number of strategic partnerships to strengthen its distribution infrastructure. SAAS operates in a niche market which we expect to experience strong secular growth over the next several years. With investors hungry for "cloud" companies and "Software-as-a-Service" business models, SAAS could eventually become an attractive acquisition target. This is a growth stock, and it is not cheap, but we expect big things from inContact over the next few years, as we think the future prospects for this company are very bright.

Joel Hainsfurther, *Senior Associate Investment Analyst, Wanger Investment Management, Inc.*