

Q3

Wanger Investment Quarterly Letter

DEAR LIMITED PARTNER,

What Are We Thinking About This Quarter?

Ralph Wanger Reports on A Sticky Mess

Bill Andersen explains "Why Dividends, Why Now"

Yep, It's the End of The World Now

If you've been reading this newsletter, you know we have been calling for the end of the world for a while--and, there is little doubt that it has come! If you're not afraid yet, it's probably time to consider it. When both the heads of Treasury and the Federal Reserve are scared the entire US banking system is crashing, it's probably time.

Read on. We have a lot to say on this topic.

Is "De-Risking" Really a Word?

We are currently facing down a potential financial crisis unseen since the great depression. How many investment banks, commercial banks, hedge funds and large corporations are, in fact, insolvent, assuming they had to mark their assets to market?

Everyone has stopped lending. The banking system has, at least for the moment, ground to a halt.

The most euphemistically minded among us coined the term "de-risking" to describe the current phenomenon. The rapid decline in asset prices

and jump in default rates have forced a kind of universal margin call, forcing everyone to sell liquid securities, dump risky bets, raise cash to meet redemptions and barricade the doors against vast bad "insurance" bets, including the infamous credit default swap.

While the great investment banks were levering up their proprietary trading books to the proverbial 30x, there was free money for all and no risk was too risky. Now the bottom has fallen out and no risk is worth taking. In fact, given the danger in some of the biggest money market funds, even "cash" is suspect.

The Long Term Opportunity Fund

We are sharpening our pencils to raise quality, bring down PE's and increase dividend yield.

Given our three-to-five year investment time horizon, this is rapidly becoming our kind of market. We took our lumps in Q3, for sure, but continue to believe it's our job to stay invested and not retreat to cash. We are already seeing unprecedented long-term valu-

ations and yields on higher and higher quality investments.

The Income and Growth Fund

We believe that high-quality dividend paying equity securities are one of the best ways to ride out the storm. None of us can time the bottom, but that doesn't mean we can't get paid to wait. The Income and Growth fund is designed to provide reliable current yields in concert with long-term growth. We are hard at work seeking out the highest quality "hybrid equity securities," hunting for firms with solid businesses that won't be likely to cut their dividends if times stay rough.

We're so excited about this strategy that we're giving speeches throughout the country. Read Bill's piece in this newsletter. I think you'll be intrigued.

Yours,

Eric Wanger, JD, CFA

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Wanger Investment Quarterly Letter

From The Desk of Eric Wanger:

Volatility: A Good Year This Afternoon



Eric Wanger, JD, CFA

It is almost certain that volatility levels will have to calm down before the stock market can establish some kind of bottom and ultimately start to recover. In the meantime, prepare for a wild ride.

The most remarkable aspect of this year has been the “no place to hide” phenomenon that has made just about every kind of investor look foolish. With a small number of impressive exceptions, nearly every form of fund and every class of investor has taken it on the chin in 2008.

The incredibly rapid erosion of prices in almost every asset class has been accompanied by extraordinary volatility. This meant that investors have had to get the timing right in addition to the investments themselves. That’s how the commodities traders and market neutral strategies managed to get zapped.

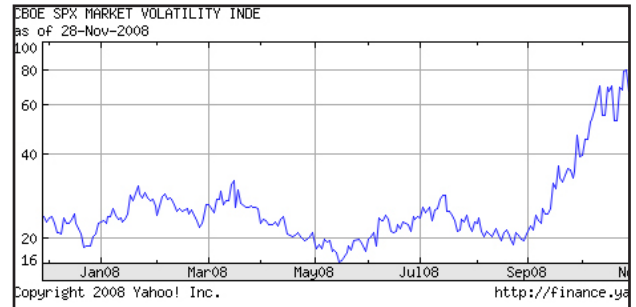
No Place to Hide

Recall that in late June the price of oil, and in fact most major commodities, began a sudden and large plunge in price from their previous frothy heights. A barrel of oil hit nearly \$150 at the peak and promptly dropped nearly by a third in a matter of a few weeks. Likewise, steel, gas, potash, coal, and many others fell in lockstep. As a result, commodities, which had been the great soaring bull story of 2008 plummeted back to earth. Similarly, shares of big investment banks, commercial banks, and brokerages such as Lehman, Merrill, Wachovia, Washington Mutual, and, yes, even Goldman Sachs, came to be traded as serious bankruptcy risks, sometimes exhibiting intra-day volatilities in excess of 50%.

Any manager that wasn’t clubbed by the unbelievably rapid drop in asset prices, could easily have gotten whacked by the unprecedented increase in market volatility. The volatility index for the S&P 500 ran up to record levels, whipsawing traders and causing the prices of options to skyrocket. This made many common hedging strategies extremely expensive in the short term (including ours).

There appears to be a correlation between bear markets and spikes in volatility. This bear market is no exception. Volatility got so high that major indices started experiencing more than 10% intra-day swings. We started telling a joke around our firm: “We had a good year this afternoon.”

It is almost certain that volatility levels will have to calm down before the stock market can establish some kind of bottom and ultimately start to recover. But in the meantime, prepare for a wild ride.



The Bailout at the End of the World

There seems to be little doubt that the end of the world has come, at least in the sense we have been referring to it in this newsletter. We are now in a full blown credit “crisis” with major global banks teetering on the edge of solvency. Many forms of credit have essentially dried up with more disasters to come. Broad government interventions are virtually guaranteed to continue at unprecedented levels. And to add to the fun, the crisis is now indisputably global in nature. I’m writing this one day after President Bush signed (the revisions) to the *Emergency Economic Stabilization Act of 2008*, authorizing the Secretary of the Treasury to establish “TARP,” the much discussed Wall Street bailout. TARP is *The Troubled Assets Relief Program*, the \$700 billion dollar federal relief program, authorizing the Treasury to bolster up the banking system. The legislation is well intended. It’s stated purpose is to keep more of us in our homes and to keep as many banks as possible from folding.

Whatever TARP ultimately turns out to mean, a few things seems clear: The text creates the opportunity for the Treasury to save the financial world---it guarantees nothing. The coming months will witness the creation of a new federal bureaucracy with a huge checkbook. Secretary Paulson and his successor will attempt to reliquify, recapitalize, and “reconfidence” a system eaten by poorly understood termites. What will the Government actually buy? Who will they actually buy it from? What will they pay for it? Under what terms? These are the trillion dollar questions.

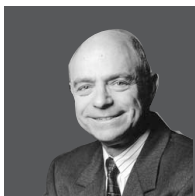
Eric Wanger, JD, CFA



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Ralph Wanger Reports: A Sticky Mess



Ralph Wanger, CFA

On January 19, 1919, for causes never completely determined, the tank collapsed, and a tsunami of sticky, sweet molasses filled the neighborhood.

The future remains a sticky mess. The straight-down drop in the market may be over, but a lot of complex events lie ahead, and a balanced hedged portfolio seems like a good idea.

The Sticky Collapse

What went wrong? A short twelve months ago, everything financial was in a sweet spot; with the stock market back to its 2000 high (S&P500 at 1540). The sub-prime mortgage pool was leaking a little, but most people did not expect a flood.

Ninety years ago, on a non-descript industrial street in the north end of Boston, everything was quiet as well. The dominant structure was a huge tank, fifty feet tall and ninety feet in diameter, filled with two million gallons of molasses... The tank was made out of steel plates riveted together. It leaked a little bit, but that was fine with the locals, who collected the leaking molasses to take home. Then, on January 19, 1919, for causes never completely determined, the tank collapsed, and a tsunami of sticky, sweet molasses filled the neighborhood.

The cliché, “slow as molasses in January” didn’t apply. The sticky mess flowed at 35 miles per hour, knocking down buildings and breaking the columns of the Boston Elevated Railway. Twenty-one men and women were killed as well as many horses, and 150 people were injured. It took 87,000 man-hours to clean up the sticky, stinking mess.

When I entered MIT in the early 1950’s the first engineering formula I was taught was to calculate “hoop stress” – how much force was produced in the walls of a tank full of liquid. MIT was only a mile from the molasses tank, and the disaster was still an important memory. The unsound molasses tank had been designed and built by poorly-trained men, and one result of the tragedy was new regulation of construction, mandating engineers to design and inspect structures.

This is all a fine metaphor for the sub-prime mortgage mess, a gooey mess that overwhelmed Fannie Mae, Freddie Mac, WaMu, Indy Mac, Bear Stearns, Lehman Brothers, Wachovia... (At least this time no horses were drowned.) The investigations have already begun, and additional regulations will show up soon. After the Boston Molasses Disaster, the local residents filed one of the first class-action lawsuits, and after three years the United States Industrial Alcohol Company paid a large settlement. One should not

rule out the possibility of litigation in regard to the Sub-Prime Disaster.

I am writing this on October 14, 2008. The government has just announced a massive program to support bank solvency, causing a welcome rally in the market after a week of terrifying declines. The government action is well thought out and seems to have bipartisan support. The European governments have announced a similar package, a fine example of international cooperation. The threat of a cascading flood of monetary molasses drowning the world banking system has likely been averted.

Thank is all to the good, but not completely satisfying. The jarring bear market, that has hurt housing, the debt markets, and stocks, has turned a lot of smart, confident money managers into panicky, helpless fools in the molasses, unable to either swim or float.

The Markets

There are three good things that have happened to the stock market.

1. The bank bailout is a big help.
2. The price of oil has dropped nearly in half from the high.
3. Stocks and bonds have already dropped as much as they do in an average bear market.

The future remains a sticky mess. The straight-down drop in the market may be over, but a lot of complex events lie ahead, and a balanced hedged portfolio seems like a good idea. The U.S. economy is not fixed yet. The real problems have been housing, and then the debt market. The stock market has really been only a residual.

Unleveraging

If a person, or company, or bank, has got too much debt, it has a problem. We will call the overextended entity *Beefsteak Securities*. When they built up debt, this is called using leverage. We can do a very easy bit of arithmetic to show how this works. This example will be oversimplified but perhaps helpful.

Continues on the next page



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A Sticky Mess (Continued)

But because they had to mark down the remaining assets, their net worth was cut in half. The leverage did not go down, it went way up.

Beefsteak Securities Balance Sheet:	
Assets:	
1000 shares Acme Fireworks @ \$20	\$20,000
Liabilities:	
\$19,500 in debt owed to Megabank	\$19,500
Net Worth:	
\$500 in net worth (Assets-Liabilities)	\$500

We will define leverage as debt divided by net worth:

$$\text{Leverage} = \$19,500 / 500 = 39x.$$

Leverage of 39x is high, and so Mr. Beefsteak decides to reduce it. He sells 300 shares of Acme at \$20 and pays down debt by \$6000:

When everyone tries to deleverage, no one can.

Beefsteak Securities Balance Sheet:	
Assets:	
1,000-300 = 700 shares @ \$20	\$14,000
Liabilities:	
\$19,500-\$6,000=\$13,500 in debt in debt	\$13,500
Net Worth:	
\$500 in net worth (Assets-Liabilities)	\$500

$$\text{Leverage} = 13,500/500 = 27x$$

Mr. Beefsteak has accomplished his goal. Leverage has been reduced from 39x to a more manageable 27x.

The deleveraging program succeeded because Beefsteak was able to sell assets at a price on the books. However, in the real world today, many asset holders are trying to reduce leverage,

all at the same time. What happens? If everyone is trying to sell at the same time, the sale might be made at \$19.75 instead of \$20, so:

1. The sale of 300 shares of Acme raises only \$5,925.
2. The assets must be "marked to market." *That means, the remaining shares in Acme Fireworks will be marked down from \$20 per share to \$19.75 per share. Marking an asset to market means recording its value at the most current available market price.*

Beefsteak Securities Balance Sheet:	
Assets:	
1,000-300 = 700 shares Acme Fireworks @ \$19.75	\$13,825
Liabilities:	
\$19,500-\$5,925=\$13,575 in debt	\$13,575
Net Worth:	
\$500 in net worth (Assets-Liabilities)	\$250

$$\text{Leverage} = \$13,575 / 250 = 54.3$$

On one hand, by selling 300 shares at \$19.75 instead of \$20, Beefsteak only gave up \$75 ($\$0.25 \times 300 = \75) from the previous example. But because they had to mark down the remaining assets, their net worth was cut in half. *The leverage did not go down, it went way up. When everyone tries to deleverage, no one can.*

Bait and Switch

Now we can understand why Paulson and Bernanke persuaded Congress to pass a \$700 billion package to buy investments from the banks, but now have changed the deal to buy preferred stock instead. If you look at the Beefsteak balance sheet it should make sense that increasing the net worth by selling stock reduces leverage much more effectively than by selling investments.

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



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Bill Andersen:

Income from Equities

Investment advisors will be faced with a serious dilemma in coming years as a huge demographic group moves towards retirement.

Investment advisors will be faced with a serious dilemma in coming years as a huge demographic group moves towards retirement. In the next 15 years, the majority of the post World War II “baby boom” generation will reach their mid 60’s...a group of roughly 40 million people. This will greatly affect many parts of the economy including social security, Medicare and other government services.

The challenges faced by this generation in retirement planning will be significantly different from previous generations. Most importantly, life expectancies have expanded significantly. As Ross Perot has pointed out, the original actuarial assumptions of the Social Security program were roughly based on a retirement age of 65 and a life expectancy of 66. While, of course, there were many Americans who lived much longer, as a whole there was not a great need for long-term planning for retirees. Furthermore, investors more frequently were participants in “defined benefit” retirement plans, under which responsibility for retirement investing was assumed by the employer.

The retirees of tomorrow face a different situation. First, they are statistically likely to live substantially longer than those in the past. This has many implications, with the long-term impact of inflation being perhaps the most significant. Secondly, most retirees now have their assets in a combination of individual retirement accounts (IRA’s) and some sort of “defined contribution” plan through their employer. The difference is that the responsibility and risk for making investment decisions now falls directly on the employee. Thirdly, this is all happening after a generation-long bull market in financial assets which saw the Dow Jones average rise 15 fold over a 25 year period. It is certainly possible that the returns from financial assets in coming years will be significantly lower than in recent years. As Ralph Wanger has pointed out, there have been significant periods in the past where the stock market has provided meager returns. In the last century, the Dow Jones average stood at roughly 100 in 1905 and was at the same level 38 years later. Similarly, the Dow stood at 1000 in 1967 and was actually lower than that level when the new bull market began in 1982.

While it is not our intent to forecast stock prices, prudent planning would certainly involve considering a scenario of prolonged poor returns from equities. What would be the proper course of action under such a scenario?

Prudent Planning, Not Market Timing, Is Key

As Ralph Wanger has pointed out in a 2007 article in the CFA digest, the expected return from stocks can be broken into two components: the income component and the growth component. In selecting securities, investors may look for stocks with good expected total returns, but the mix between the two types of returns is likely to be affected by their personal circumstances. Each component of growth has its own important characteristics. The growth component is particularly attractive due to its ability to compound tax free until a security is sold. Managers can presumably be counted on to make wise decisions regarding the reinvestment of capital, the results of which accrue to long-term shareholders. When securities are sold, the increase in value is taxed at the capital gains rate, which is usually lower than the rate on ordinary income. The disadvantage of this portion of the return, of course, is that it is highly uncertain in the short term. As Warren Buffet has said, “In the long term the stock market is a weighing machine, but in the short term it is a voting machine.” The short-term returns may be impacted by many factors, both related and unrelated to the company. While this isn’t a big problem for younger investors, it may present a significant issue for those who depend on their investment for income to meet everyday expenses.

The income portion of the return has the advantage of being substantially more predictable than the growth component. Numerous studies have shown that companies are highly resistant to reducing or eliminating their dividends, and can be expected to set dividends at a rate at which they are sustainable. A key disadvantage of the income portion of the returns is that it is taxable each year, although the rate is currently favorable in cases where double taxation would apply. Some other asset classes, such as publicly traded master limited partnerships, may qualify for favorable tax treatment. As investors move towards retirement, they are likely to focus on the income portion of the return more than the growth component. Equities such as REIT’s and MLP’s (for which the income portion of the return accounts for 60-70% of the total) may be more appropriate than many common stocks with low yields and highly variable total returns.

William Andersen, CFA is Director of Research and the Manager of the Wanger Income & Growth Fund.



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Wanger Investment Quarterly Letter

Investment Write-up

Thinking Outside the Style Box: ES and ADG

These companies share important common attributes: limited exposure to business cycles, strong ability to generate cash and unique assets capable of producing high ROE's.

ES's Clive, Utah low level radioactive disposal site is the only site that the majority of nuclear materials users can use for disposal.

ADG is a failed military roll up that expects to complete the sale of its remaining non-ammunitions business by the end of 2008. The munitions business currently has \$190 million backlog with a 10% EBITDA margin.

Breaking away from the drama of the market is difficult, but it is in times of great turmoil when the best opportunities can be found. Q3 presented Wanger Investment Management, Inc. with opportunities to purchase companies with great assets at discount prices. Two new investments added to the portfolio are **Energy Solutions (ES) and Allied Defense Group (ADG)**. These companies share important common attributes: limited exposure to business cycles, strong ability to generate cash, and unique assets capable of producing a high ROE. In addition, both companies are poised to benefit from important longer term trends: ES will take advantage of the growth of the nuclear industry and ADG will benefit from the transition to lighter, more mobile militaries around the world.

Since its IPO on 11/15/2007, ES has traded at an average PE of 22. We like the company but not that much. ES's Clive, Utah low level radioactive disposal site is the only site that the majority of nuclear materials users can use for disposal. Low level nuclear waste (Class A to be specific) includes everything from the lab coat a radiologist might wear to the dirt under the site of a former nuclear power station. ES is almost the only game in town, with 82 of the 104 operating nuclear power plants in the US having "life of plant" contracts with ES for the disposal of their Class A waste. Margins on disposal are an impressive 50%, so the growth comes by driving more waste into their dump. Each nuclear plant must have a fund set up at its inception for decommissioning at the end of life and ES's central growth strategy has involved figuring out how to tap these funds. For example, ES was awarded the contracts to fully decommission 2 large reactors in Zion, IL. As part of this strategy ES has asked the Nuclear Regulatory Commission (NRC) to allow the trust funds to be used for partial decommissioning ("large component removal"). While this change in regulation is expected, it hasn't occurred fast enough to generate the expected revenue in 2008, causing analysts to talk down 2008 EPS, thereby setting up 2009 to be a record year. Such attractive margins and limited capacity have attracted the interest of other waste-handling companies, but the barriers to entry are impressive. Valhi (VHI) subsidiary, WCS, has been working for more than ten years to obtain a permit for a similar site in Texas, but continues to run up against a series

of challenges. The regulatory delay, along with the market conditions, caused the stock price to fall by 64% YTD (as of 9/30/08), bringing the current PE down to 11, and providing an opportunity to buy.

ADG is not an obvious buy at first glance. ADG is a failed military roll-up that expects to complete the sale of its remaining non-ammunitions business by the end of 2008. Looking at the company more closely, ADG's remaining subsidiary, MECAR SA, produces differentiated munitions, with a solid back log, a tested management team, a deeply rich customer base and almost no debt. The munitions business currently has a \$190 million backlog with a 10% EBITDA margin. The backlog will be realized over a 12-14 month period and continues to build. Given the current market cap of \$50 million we estimate that this firm is conservatively trading at 2.6x 2009 EBITDA. The backlog is real and securitized with deposits. The largest customer in the backlog is the Saudi Arabian government which primarily uses 90mm rounds in its tanks and mortars, of which ADG is the only manufacturer. Other customers include the governments of Morocco, Bahrain, Tunisia, Kuwait, and Jordan. ADG also has advanced 105mm round technology that allows the smaller shell to perform similarly to the 120mm round, which is the current standard in the US military. The military's goal to build a lighter and faster army has led them to realize that the 120 mm guns are too heavy. As a result, the smaller 105mm round weapons have been designated by the military for use in the General Dynamics Stryker vehicle - an exciting development for ADG. In addition, ADG formed a joint venture with the much larger Alliant Technologies to redistribute each other's products. We believe the JV could be a first step towards an eventual buyout of ADG. We also like that the tangible PPE assets of ADG's MECAR unit in Belgium - externally appraised at 10-15m Euros - limits the downside. By completing the sale of the GMS unit, ADG is now out from under a series of bad financing deals that almost brought this great, small company down. We expect ADG will continue to grow or be purchased.

While these markets continue to be challenging, we at Wanger still see tremendous opportunities.

James L. Cahn



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Wanger Investment Quarterly Letter

Bill Andersen Presents:

"Why Dividends? Why Now?"

As you can see from the articles in this newsletter, Wanger Investment Management has a high amount of conviction in its strategies. Given current market conditions, we understand that many investors are reluctant to dive head-first into the equity markets. We sympathize with those sentiments and, as a result, Wanger is hosting a series of luncheons which feature our Director of Research, Bill Andersen, delivering a presentation entitled "Why Dividends? Why Now?"

Bill has received a good deal of praise for this presentation, with many participants finding his points to be both timely and relevant in this economic climate. In his presentation entitled "Why Dividends? Why Now?" Bill discusses current market conditions and shows that, even in the bleakest of times, there still exists opportunity. Studies show that attempting to time the market--especially during periods of extreme volatility--does not work. Bill speaks about the use of dividend-paying equities as a way for investors to receive an income stream from their portfolios. Many investors typically use equities solely for capital appreciation and often overlook the powerful income component that some equities offer. Carefully chosen income-producing securities serve as the cornerstone for the Wanger Income &

Growth Fund and more and more investors are looking to this strategy as a way to ease back into the markets.

Here is a list of the venues where Bill will be delivering this presentation during the third and fourth quarters:

November 6, 2008 - The Arts Club, Chicago, Illinois

December 3, 2008 - SF Ferry Building, San Francisco, CA

December 9, 2008 - Deer Path Inn, Lake Forest, Illinois

If you would like to receive a complimentary copy of this presentation or are interested in attending one of our future luncheons please contact Michael Kelnosky at 312.245.8000 or michael@wangerfunds.com.

Michael J. Kelnosky, Director of Distribution

A New Look for: www.wangerfunds.com

During these times of economic crisis and financial uncertainty, some investment management firms might stifle communication with their clients while they scramble to make sense of the chaos. At Wanger, we believe that now is precisely the time when our clients want to hear from us and so we have taken steps towards increasing the amount of and the frequency of our proactive communication.

As part of this initiative, Wanger Investment Management has revamped its website: www.wangerfunds.com. Although this project required a great deal of time and effort on the part of many, we believe that the end result made that all worthwhile. The site now offers a more comprehensive look at the firm, with pages devoted to the Wanger team, philosophy, and strategies, as well as increased information about the firm itself. The website also offers a Wanger news section which features archived

newsletters, video clips and other commentary written by the Wanger Portfolio Team. Throughout 2009, visitors will find a more consistent stream of information, so we would urge you to visit our website often.

Most importantly, the website was designed with our clients, both current and prospective, in mind. We hope that you will take the time to visit the website and offer suggestions and feedback regarding its design and content. We view this website as a work in progress and will not stop working on it until our clients are satisfied. Please feel free to forward any specific feedback or suggestions to Michael Kelnosky at michael@wangerfunds.com.

Michael J. Kelnosky, Director of Distribution



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Wanger Investment Quarterly Letter

Wanger Long Term Opportunity Fund II, LP

The Wanger Long Term Opportunity Fund II, LP seeks long-term capital appreciation for its limited partners by investing in small companies. Our strategy is to capture the benefits of private equity style investing with the enhanced liquidity of registered securities. Creative and well-positioned small companies can generate large returns by taking part in discernable and significant long-term opportunities. The WLTOF invests in firms in which solid management teams create value and take market share with unique, innovative and competitive products positioned to benefit from important domestic and international trends.

The manager believes that a disciplined, research driven investment philosophy combined with a “growth at a reasonable price” approach to security valuation is best suited to tap the potential of very small stocks. By exploring the small end of the market capitalization spectrum, the Partnership searches for opportunities in this generally overlooked and underfollowed asset class, one that relatively few Wall Street analysts are paid to understand. The WLTOF is relatively concentrated (generally under 30 securities) and employs an investment strategy designed around detailed investment research and stock picking. The manager has selected a “net long” strategy to take advantage of the clear upward bias in the equity markets. The fund employs a hedging strategy designed to limit significant losses without overpaying for such “insurance.”

Wanger Income and Growth Fund

The Wanger Income and Growth Fund seeks to generate a total return that is in excess of high quality bond returns by investing in yield-oriented securities with potential for growth of income and capital appreciation. The fund was designed to meet the needs of baby-boomers who are approaching retirement and seeks to address the demographics of extended life-spans which require longer term investments with good yields and growth potential. The fund is for investors seeking a compounded source of current yield and income with lower volatility than available from traditional equities. The benchmark is a blended index composed of 50% S&P 500/50% Lehman Aggregate.

The fund can invest in any publicly traded asset class, domestic or international, but the following have provided the best opportunities to date: Master Limited Partnerships, Real Estate Investment Trusts, Closed End Funds at Discounts to Net Asset Value, Convertible/Preferred Securities and High Yielding Debt and Equities. Securities are valued on a fundamental basis and use investment criteria which include the following: Above average dividend yields, records of consistent and growing dividend payments, overall fundamental histories and prospects, conservative capital structures and timely exposures to economic cycles and commodity prices or other cyclical factors (*e.g.* real estate).

If you have any questions or comments regarding your existing investment or further contributions, please contact us at (312) 245-8000, email us at info@wangerfunds.com, or visit our website www.wangerfunds.com.

Wanger Investment Management, Inc

401 N Michigan Ave, 13th Floor
Chicago, Illinois 60611

Phone: 312.245.8000
Fax: 661.459.2328

Email: info@wangerfunds.com
Web: www.wangerfunds.com

