# Charlie Munger's Wesco Financial Corporation Annual Letters 1983 - 2009

Many thanks to P.H. for access to the database so that I could share these letters. Also thanks to Mr. O and O.O. for all their support.
I hope everyone benefits from Charlie's wisdom as much as I have.
- David Hoang

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# WESCO FINANCIAL CORPORATION

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Annual Report 1983

Form 10-K Annual Report 1983

# WESCO FINANCIAL CORPORATION

## LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated ordinary operating income (i.e., before all net gains from sales of securities, mortgages and important fixed assets) for the calendar year 1983 increased to $8,507,000 ($1.20 per share) from $7,221,000 ($1.02 per share) in the previous year.

Consolidated net income (i.e., after net gains from sales of securities, mortgages and important fixed assets) decreased to $10,553,000 ($1.48 per share) from $11,502,000 ($1.62 per share) in the previous year.

Wesco has two major subsidiaries, Mutual Savings, in Pasadena, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts):

| | Ordinary Net Operating Income of | | | | |
|---|---|---|---|---|---|
| **Year Ended** | **Mutual Savings** | **Precision Steel Businesses** | **All Other Ordinary Net Operating Income**[1] | **Net Gains on Sales of Securities, Mortgages and Important Fixed Assets**[2] | **Wesco Consolidated Net Income** |
| December 31, 1983 ... | $3,046 | $1,622 | $3,839 | $2,046 | $10,553 |
| Per Wesco share .... | .43 | .23 | .54 | .28 | 1.48 |
| December 31, 1982 ... | 3,482 | 327 | 3,412 | 4,281 | 11,502 |
| Per Wesco share .... | .49 | .05 | .48 | .60 | 1.62 |

(1) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings' headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan subsidiary.

(2) The 1982 figures include $6,706,000 or $.94 per Wesco share of net securities gains realized throughout the consolidated enterprise, offset by a loss incurred on sale of mortgage-backed securities of $2,425,000 or $.34 per Wesco share. The 1983 figures relate entirely to such net securities gains. All figures are net of taxes.

The foregoing breakdown (of the same aggregate earnings) differs somewhat from that used in our audited financial statements and press releases, which follow standard accounting convention. The supplementary breakdown of earnings is furnished because it is considered useful to shareholders.

### Mutual Savings

Mutual Savings' ordinary net operating income of $3,046,000 in 1983, represented a decrease of 12.5% from the $3,482,000 figure the previous year. In both years such ordinary net operating income, while economically real and probably of at least average quality as reported savings and loan industry incomes go, was below the top quality possible because such earnings came from income tax savings obtained through inclusion of Mutual Savings in the consolidated income tax return of a parent corporation. Earnings so derived from income tax savings are not of the top quality possible because they have less cushion in reserve against future adversity than earnings from ordinary operating income on which income taxes have been paid in full in cash at the highest corporate rate and are recoverable from the I.R.S. in the event of future operating losses.

Separate balance sheets of Mutual Savings at yearend 1982 and 1983 are set forth at the end of this annual report. They show (1) total savings accounts rising to $203 million from $168 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a mortgage loan portfolio of about $106 million at the end of 1983, down 12% from the $121 million at the end of 1982. The mortgage loan portfolio at the end of 1983 bore a fixed average interest rate of only 7.48%, probably the lowest for any U.S. savings and loan association and far below the average interest rate which now must be paid to hold savings accounts.

The capital-rich, mortgage-loan-interest-rate-poor position of Mutual Savings came from (1) success many years ago as a construction lender at above-average interest rates, plus (2) sale in 1980 by Mutual Savings of all branch offices (except for one satellite office in a major shopping center across the street from the Pasadena headquarters) under terms where only the lowest-yielding mortgage loans from its large portfolio were retained, plus (3) drastic curtailment by Mutual Savings of mortgage lending following the sale of its branch offices.

Mutual Savings has remained profitable because the adverse effects from its low-yielding, fixed-rate mortgage loan portfolio are more than offset by favorable effects from its large shareholders' equity and a tax-equivalent yield on its marketable securities (utility preferred stocks, tax-exempt bonds and common stocks) considerably higher than that prevailing on the mortgage loan portfolio of a typical savings and loan association. The low-yielding, fixed-rate mortgage loan portfolio has shrunk from pay-backs at 8.5% per year over the last three years, and the shrinkage is expected to continue at about the same rate.

Mutual Savings has adapted in its own way to the dramatic changes which have occurred in recent years in interest rates and the regulatory structure of the banking and savings and loan industries. At Mutual Savings, as well as the rest of the savings and loan industry, the standard practice used to be to borrow short from savers while lending long on fixed-rate mortgages, to have high financial leverage for shareholders' equity and to grant mortgagors easy prepayment terms. The practice was profitable for decades but always involved something like a "hurricane risk," and the equivalent of a hurricane came in 1981-82 as interest rates rose to unprecedented levels and caused widespread losses. Results were good for shareholders before 1981-82 only because interest rates were stable or rose slowly as mortgage-loan portfolios steadily and rapidly expanded under a regulatory structure which both fostered growth and protected operating margins by requiring that on all insured savings accounts fixed rates be paid that were slightly higher than the low rates specified for banks. Thus a small deposit-attracting rate advantage over banks was given to savings and loan associations, while competitive pressure was dampened for both types of institution.

Although interest rates have subsided from the 1981-82 peak, the low and slowly changing interest rates of former years are plainly gone with the wind, as are the former government-decreed limits on interest rate competition for savings accounts and the favoritism for savings and loan associations over banks. But an agency of the U.S. government (F.S.L.I.C.) continues to insure savings accounts in the savings and loan industry, just as it did before. The result may well be bolder and bolder conduct by many savings and loan associations. A sort of Gresham's law ("bad loan practice drives out good") may take effect for fully competitive but deposit-insured institutions, through increased copying by cautious institutions of whatever apparent-high-yield loan and investment strategies seem to allow competitors to bid away their savings accounts and yet report substantial earnings. If so, if "bold conduct drives out conservative conduct," there eventually could be widespread insolvencies caused by bold credit extensions come to grief.

And if serious credit-quality troubles come to the savings and loan industry, they will merely add to troubles from the borrowed-short, lent-long-at-fixed-rates problem, which is far from completely removed, and which destroys shareholder wealth at startling speed whenever interest rates are rising rapidly, even when the credit quality of mortgagors or other borrowers is excellent.

Developing a short-term operating plan for Mutual Savings which would sharply increase its reported earnings next year would be a near-absolute cinch. For instance, savings accounts could be expanded greatly by paying a high rate of interest on "jumbo" deposits in $100,000 multiples, and proceeds plus cash equivalents on hand could be placed in long-term mortgages at a substantial current interest spread while, in addition, some origination fees could be "front-ended" into income. However, taking long-term risks into account, it is much harder to find a sound operating plan. Money is the ultimate fungible commodity. In the new order of things, an association is not only in a tough, competitive, commodity-type business on the lending side but also finds that, with decontrol of government-insured rates paid savers, every competitive association has virtually unlimited credit to fund increased lending, by paying premiums over interest rates generally prevailing on savings accounts. Under such conditions, when all risks are considered, including those created by that portion of competitors motivated primarily by short-term effects, it is quite naturally difficult to earn over a long period an attractive return on shareholders' equity. How could it be otherwise?

A few years ago, about the time Mutual Savings reacted to new conditions by curtailing lending, most other associations decided instead to keep lending aggressively but under new adjustable-rate mortgages under which some portion (but far from all) of the interest-rate-fluctuation risk is shifted to the homeowner. Despite widespread use of these new adjustable-rate mortgages, savings and loan industry earnings remain dependent to a material extent, as they always were, on an interest rate spread attributable to: (1) borrowing short while lending long, and/or (2) making loans which can be priced high enough to provide a profit only because they involve a very material credit risk, compared to the risk of owning government-backed securities of comparable maturity.

Under present conditions of strong competition from bold competitors accompanied by high interest-rate-fluctuation risk, the result tends to be that each year of reported attractive earnings occurs only in the absence of two now much more likely events: (1) sharply rising interest rates, and (2) widespread credit losses. Thus, each good year reported is a lot like the year when a Texas hurricane insurer reports satisfactory earnings because there have been no hurricanes. Mutual Savings has a considerable share of this uncomfortable position and will continue to have it. It has not yet developed a long-term operating strategy with which it is satisfied, and it continues to seek one. Just as Mutual Savings has been idiosyncratic in the past as it sold branch offices in 1980 (a practice now being adopted to some extent by other savings and loan associations and major banks), it will probably be idiosyncratic in the future. It will seek some non-standard way of rendering socially constructive service while operating with acceptable profits accompanied by an acceptable level of risk for shareholders' capital, likely gains considered.

Eventually, by maintaining unusual capital strength and liquidity, and by having a parent corporation which does likewise, Mutual Savings hopes to stand in particular favor with federal and state regulatory authorities and be in a position soundly to expand again, perhaps dramatically, and perhaps involving additional shareholder investment in Mutual Savings by the parent corporation.

As part of a program for the anticipated eventual sound expansion of the savings and loan business, Mutual Savings in 1983, without heavy promotion or advertising, consistently paid about ½% per annum more than most competitors on so-called "money market rate accounts" of moderate size. This type of savings account is repayable on demand without penalty and allows up to three withdrawals by check each month. Most of Mutual Savings' "money market rate accounts" are in the range of $10,000 to $100,000. Mutual Savings' practice of bidding up slightly for this one type of account penalized 1983 earnings to a small extent and caused the bulk of the reported $36 million growth in savings.

**Precision Steel**

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, it had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $1,622,000 to ordinary net operating income in 1983, up 396% compared with $327,000 in 1982. Most of the increase was caused by (1) generally improved conditions in the cold-rolled strip steel market, and (2) absence in 1983 of an unusual loss which occurred in 1982 from correction of a business mistake (in which the present chairman of Wesco personally participated), namely a venture in the measuring tool distribution business which with better judgment would not have been authorized.

Under the leadership of David Hillstrom, Precision Steel's businesses are now satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition. The improvement from disappointing performance in 1982 is welcome. No dramatic change is expected in 1984 in either direction.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now successful, contributing $7,605,000 to sales in 1983 at a profit percentage higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using liquid assets available.

## All Other Ordinary Net Operating Income

All other ordinary net operating income, net of interest paid and general corporate expenses, rose to $3,839,000 in 1983 from $3,412,000 in 1982. Sources were rents ($2,609,000 gross, including rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

## Net Gains on Sales of Securities, Mortgages and Important Fixed Assets

Wesco's aggregate special net gains, combined, after income taxes, declined to $2,046,000 in 1983 from $4,281,000 in 1982. The 1982 net gain consisted of $6,706,000 from sales of securities, offset by a loss of $2,425,000 from Mutual Savings' sales of mortgage-backed securities. There were no losses from sales of mortgages or mortgage-backed securities in 1983.

## Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others. As indicated in Note 2 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate cost at December 31, 1983 by about $29 million. In addition, Wesco's Pasadena office building block (containing about 1?5,000 net rentable square feet including Mutual Savings' space) has a market value substantially in excess of carrying value. The mortgage debt ($5,166,000 at 9.25% fixed) against this real property now exceeds its depreciated carrying value ($3,077,000) in Wesco's balance sheet at December 31, 1983. Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires some patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, common stock investments, both those in the savings and loan subsidiary and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in a very few companies. Through this concentration practice better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual consolidated net income to consolidated shareholders' equity, about 9% in 1982-83, is not yet attractive from the Wesco shareholders' point of view. Wesco, started as a savings and loan holding company in what became a very tough business, has been proceeding slowly under shortened sail instead of trying to make fast time by getting all canvas aloft. However, progress ultimately helpful to shareholders is not restricted to what shows up in the income account. Recent increases in balance sheet strength are expected to be useful in the future.

On January 26, 1984, Wesco increased its regular quarterly dividend from 13½ cents per share to 14½ cents per share, payable March 7, 1984 to shareholders of record as of the close of business on February 14, 1984.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. We invite your careful attention to these items.

**Retirement of Louis Vincenti**

Late in 1983 Louis Vincenti retired from Wesco on account of health. He had served 28 years, the last 10 years as Chief Executive Officer. Before joining Wesco, as a partner in Hahn and Hahn, he was one of Southern California's great attorneys. Before practicing law he had starred spectacularly as both student and athlete at Stanford.

Wesco had a net worth of about $5 million when he joined it in 1955. As he retires the net worth of Wesco is about $124 million, and, in addition, cash dividends of about $26 million have been paid out to shareholders over the years. The consolidated enterprise first made extraordinary profits as a construction lender, then went through the 1981-82 crisis period in the savings and loan industry reporting steady profits, paying dividends which increased each year, and piling up more capital outside the troubled savings and loan business as a start was made at diversifying sources of operating income.

The entire record was accompanied by much philanthropic and public service and service to the savings and loan industry by Mr. Vincenti. All who know him admire him, in whom generosity, acuity, diligence and a totally forthright manner are so happily joined. In a career of extraordinary length as well as distinction, he came to work before 7:30 each morning until very shortly before he retired at age 77.

There are not many men in the world like Louis Vincenti. Wesco has been a very fortunate corporation to be guided so long by such a man.

Mr. Vincenti's colleagues who replaced him are Charles T. Munger as Chairman and Chief Executive Officer of Wesco and Mutual Savings and Harold R. Dettmann as President of Mutual Savings. Mr. Munger also is Vice Chairman of Berkshire Hathaway Inc., 80%-owner of Wesco. Mr. Dettmann for many years served as operating manager next in line to Mr. Vincenti.

Charles T. Munger

Charles T. Munger
Chairman of the Board

February 3, 1984

# WESCO FINANCIAL CORPORATION

Annual Report 1984

Form 10-K Annual Report 1984

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1984 increased to $10,060,000 ($1.42 per share) from $8,507,000 ($1.20 per share) in the previous year.

Consolidated net income (i.e., after unusual operating income and all net gains from sales of securities), increased to $23,656,000 ($3.32 per share) from $10,553,000 ($1.48 per share) in the previous year.

Despite the high numbers reported, 1984 was a so-so year in terms of real gain in strength. While "normal" net operating income increased satisfactorily, total net income was swollen in a major way only because of an unusual item of operating income and the cashing in of some unrealized appreciation in marketable securities which had occurred in earlier years.

Wesco has two major subsidiaries, Mutual Savings, in Pasadena, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | "Normal" Net Operating Income of | | | | | |
|---|---|---|---|---|---|---|
| | Mutual Savings | Precision Steel Businesses | All Other "Normal" Net Operating Income(2) | Gain from Unrealized Appreciation in Forward Commitment of Mutual Savings to Buy GNMA Certificates | Net Gains on Sales of Securities(3) | Wesco Consolidated Net Income |
| December 31, 1984 . | $3,476 | $2,034 | $4,550 | $458 | $13,138 | $23,656 |
| Per Wesco share . . | .49 | .29 | .64 | .06 | 1.84 | 3.32 |
| December 31, 1983 . | 3,046 | 1,622 | 3,839 | — | 2,046 | 10,553 |
| Per Wesco share . . | .43 | .23 | .54 | — | 28 | 1.48 |

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings' headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan subsidiary.

(3) Includes $1,080,000 ($.15 per share), which, under different accounting treatment, might have been both (1) shifted to a different income category and (2) increased by $1,765,000 ($.25 per share). See "Unusual Income and Certain Accounting Quirks in 1984 Reporting" below.

The foregoing breakdown (of the same aggregate earnings) differs somewhat from that used in audited financial statements, which follow standard accounting convention as interpreted from time to time by Wesco's outside auditor. The supplementary breakdown of earnings is furnished because it is considered useful to shareholders.

Much of this letter is a word-for-word repeat of last year's letter with updated numbers. The repetition of wording occurs because it is believed (1) that the duplicated material remains correct and is worth repeating, and (2) that in Wesco's case any time and money required to change wording would be better spent elsewhere.

Parsimony, however, does not wholly predominate. So much kidding occurred concerning the 1960s automobiles in the old photograph of the Mutual Savings' building, which was used in last year's annual report to avoid incurring the cost of a new photograph, that the purse has been opened a little. Shareholders comparing the new photograph (on the inside front cover of this report) with the old will note that the trees have grown a lot in the intervening years. Fortunately, so has the value of the building. See the last section of this letter. The building, which works very well and attracts high quality tenants regarded as friends, is a constant reminder of the good sense of Louis R. Vincenti and Richard D. Aston, the Wesco executives responsible for its creation.

**Mutual Savings**

Mutual Savings' "normal" net operating income of $3,476,000 in 1984, represented an increase of 14.1% from the $3,046,000 figure the previous year. In both years such "normal" net operating income, while economically real and probably of at least average quality as reported savings and loan industry incomes go, was below the top quality possible because such earnings came entirely or partly from income tax savings obtained through inclusion of Mutual Savings in the consolidated income tax return of a parent corporation. Earnings so derived from income tax savings are not of the top quality possible because they can be impaired by future changes in tax laws and have less cushion in reserve against future adversity than earnings from ordinary operating income on which income taxes have been paid in full in cash at the highest corporate rate and are recoverable from the I.R.S. in the event of future operating losses.

Separate balance sheets of Mutual Savings at yearend 1983 and 1984 are set forth at the end of this annual report. They show (1) total savings accounts rising to $228 million from $203 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $95 million at the end of 1984, down 11% from the $107 million at the end of 1983. The loan portfolio at the end of 1984 bore a fixed average interest rate of only 7.63%, probably the lowest for any U.S. savings and loan association and far below the average interest rate which now must be paid to hold savings accounts.

The capital-rich, mortgage-loan-interest-rate-poor position of Mutual Savings came from (1) success many years ago as a construction lender at above-average interest rates, plus (2) sale in 1980 by Mutual Savings of all branch offices (except for one satellite office in a major shopping center across the street from the Pasadena headquarters) under terms where only the lowest-yielding mortgage loans from its large portfolio were retained, plus (3) drastic curtailment by Mutual Savings of mortgage lending following the sale of its branch offices, plus (4) profits in every recent year, no matter how high interest rates went.

Mutual Savings has remained profitable because the adverse effects from its old low yielding, fixed-rate mortgage loan portfolio are more than offset by favorable effects from its large shareholders' equity and a tax-equivalent yield on its marketable securities (utility preferred stocks, tax-exempt bonds and common stocks) considerably higher than that prevailing on the mortgage loan portfolio of a typical savings and loan association. The old low-yielding, fixed-rate mortgage loan portfolio has shrunk from pay-backs at 9.8% per year over the last three years, and the shrinkage is expected to continue at about the same rate. With portfolio shrinkage, loan credit quality problems have been reduced to a meaningless trace, because the old mortgages have large real estate equities supporting secured credit extended. And the foreclosed property on hand (mostly 22 vacant, largely oceanfront, acres in Santa Barbara) over a long holding period has plainly become worth considerably more than its $2 million balance sheet carrying cost.

It should be noted, however, that Mutual Savings' total mortgage loan portfolio did not, in substance as distinguished from accounting form, decrease in 1984 by the 11% mentioned above, determined by comparing audited year end balance sheet totals for loans. Mutual Savings has agreed to buy in 1986 U.S. Government guaranteed mortgage equivalents (GNMA certificates) at a price of about $19 million and has pre-funded this forward commitment by buying U.S. Treasury Notes maturing near the time the certificates will be purchased. After taking into account this forward commitment to purchase GNMA certificates, Mutual Savings' total mortgage loan portfolio has, in substance, *increased* by about 7% in 1984.

The 1984 increase in substance of mortgages owned reflects Mutual Savings' intention to keep at least 60% of assets in mortgages or mortgage equivalents, exactly as the Federal Home Loan Bank Board wisely exhorts the savings and loan industry to do if it expects to remain under a regulatory system separate from that of banks. And as a result of anticipated steady shrinkage through repayment of remaining old 7.63% mortgages, combined with purchases of new mortgages or mortgage equivalents bearing much higher interest rates, Mutual Savings expects in due course significantly to raise the average rate of interest on the entire mortgage loan portfolio, thus improving earnings so long as interest rates on savings accounts do not greatly increase. The GNMA certificates purchased for 1986 delivery at a price of about $19 million are expected to yield about 15% on such price, getting under way the process of "blending" the mortgage loan portfolio yield to a higher average level.

Mutual Savings has adapted in its own way to the dramatic changes which have occurred in recent years in interest rates and the regulatory structure of the banking and savings and loan industries. At Mutual Savings, as well as the rest of the savings and loan industry, the standard practice used to be to borrow short from savers while lending long on fixed-rate mortgages, to have high financial leverage for shareholders' equity and to grant mortgagors easy prepayment terms. The practice was profitable for decades but always involved something like a "hurricane risk," and the equivalent of a hurricane came in 1981-82 as interest rates rose to unprecedented levels and caused widespread losses. Results were good for shareholders before 1981-82 only because interest rates were stable or rose slowly as mortgage-loan portfolios steadily and rapidly expanded under a regulatory structure which both fostered growth and protected operating margins by requiring that on all insured savings accounts fixed rates be paid that were slightly higher than the low rates specified for banks. Thus a small deposit-attracting rate advantage over banks was given to savings and loan associations, while competitive pressure was dampened for both types of institution.

Although interest rates have subsided from the 1981-82 peak, the low and slowly changing interest rates of former years are plainly gone with the wind, as are the former government-decreed limits on interest rate competition for savings accounts and the favoritism for savings and loan associations over banks. But an agency of the U.S. Government (FSLIC) continues to insure savings accounts in the savings and loan industry, just as it did before. The result may well be bolder and bolder conduct by many savings and loan associations. A sort of Gresham's law ("bad loan practice drives out good") may take effect for fully competitive but deposit-insured institutions, through increased copying by cautious institutions of whatever apparent-high-yield loan and investment strategies seem to allow competitors to bid away their savings accounts and yet report substantial earnings. If so, if "bold conduct drives out conservative conduct," there eventually could be widespread insolvencies caused by bold credit extensions come to grief.

And if serious credit-quality troubles come to the savings and loan industry, they will merely add to troubles from the borrowed-short, lent-long-at-fixed-rates problem, which is far from completely removed, and which destroys shareholder wealth at startling speed whenever interest rates are rising rapidly, even when the credit quality of mortgagors or other borrowers is excellent.

The Federal Home Loan Bank Board, under its current Chairman Edwin R. Gray, shares Wesco's concerns. Wesco approves its attempts by regulation and by "jaw-boning" to limit follies to come from (1) sharing the U.S. Government's credit with optimistic new entrants to the savings and loan business, often coming from the real estate development and stock brokerage businesses, given ample scope to venture under widened investment authority, and (2) high financial leverage throughout the savings and loan industry, combined with continuing maturity mismatch of fixed rate assets and liabilities. Logic and history would suggest that Mr. Gray is right to pull on the reins, but this is an unpopular task since many powerful activity-cravers feel the bit and create political heat in opposition to even limited (and almost surely inadequate) financial discipline which would protect the federal deposit-insurance system by demanding a significant margin-of-safety factor in financial institutions, just as in bridges. Wesco is not optimistic either that the present rules of the savings and loan game will stand the test of time or that drastic changes in the rules will occur until huge future trouble comes, sooner or later.

Developing a short-term operating plan for Mutual Savings which would sharply increase its reported earnings next year would be a near-absolute cinch. For instance, savings accounts could be expanded greatly by paying a high rate of interest on "jumbo" deposits in $100,000 multiples, and proceeds plus cash equivalents on hand could be placed in long-term mortgages at a substantial current interest spread while, in addition, some origination fees could be "front-ended" into income. However, taking long-term risks into account, it is much harder to find a sound operating plan. Money is the ultimate fungible commodity. In the new order of things, an association is not only in a tough, competitive, commodity-type business on the lending side but also finds that, with decontrol of government-insured rates paid savers, every competitive association has virtually unlimited credit to fund increased lending, by paying premiums over interest rates generally prevailing on savings accounts. Under such conditions when all risks are considered, including those created by that portion of competitors motivated primarily by short-term effects, it is quite naturally difficult to earn over a long period an attractive return on shareholders' equity. How could it be otherwise?

A few years ago, about the time Mutual Savings reacted to new conditions by curtailing lending and financial leverage, most other associations decided instead to keep lending aggressively but under new adjustable-rate mortgages under which some portion (but far from all) of the interest-rate-fluctuation risk is shifted to the homeowner.

Despite widespread use of these new adjustable-rate mortgages, savings and loan industry earnings remain dependent to a material extent, as they always were, on an interest rate spread attributable to: (1) borrowing short while lending long, and/or (2) making loans which can be priced high enough to provide a profit only because they involve a very material credit risk, compared to the risk of owning government-backed securities of comparable maturity.

Under present conditions of strong competition from bold competitors accompanied by high interest-rate-fluctuation risk, the result tends to be that each year of reported attractive earnings in the savings and loan industry occurs only in the absence of two now much more likely events: (1) sharply rising interest rates, and (2) widespread credit losses. Thus, each good year reported is a lot like the year when a Texas hurricane insurer reports satisfactory earnings because there have been no hurricanes. Mutual Savings has a considerable share of this uncomfortable position and will continue to have it. It has not yet developed a long-term operating strategy with which it is satisfied, and it continues to seek one. Just as Mutual Savings has been idiosyncratic in the past as it sold branch offices in 1980 (a practice since adopted to some extent by other savings and loan associations and major banks), it will probably be idiosyncratic in the future. It will seek some non-standard way of rendering socially constructive service while operating with acceptable profits accompanied by an acceptable level of risk for shareholders' capital, likely gains considered.

Eventually, by maintaining unusual capital strength and liquidity, and by having a parent corporation which does likewise, Mutual Savings hopes to stand in particular favor with federal and state regulatory authorities and be in a position soundly to expand again, perhaps dramatically, and perhaps involving additional shareholder investment in Mutual Savings by the parent corporation.

Recent growth in savings accounts, considered on an incremental-effects basis, constitutes loss business, because Mutual Savings has incurred in interest and other expense more than it has received from employing proceeds in short-term interest-bearing investments far above regulatory requirements for liquidity. Moreover, some of the attendant expense may not have hit the books. In due course (starting in 1985) Mutual Savings, which with its large ratio of shareholders' equity to total liabilities imposes a virtually zero risk on FSLIC (the U.S. agency which insures safety of accounts in savings and loan associations), will be required to pay to FSLIC extra insurance premiums, based on Mutual Savings' gross size, to help fund FSLIC's protection of account holders in other savings and loan associations finally recognized as insolvent. In this process Mutual Savings, in effect, will retroactively pay extra interest-equivalent expense by reason of having attracted new savings. Mutual Savings' position at the moment is like that of a sober and careful automobile driver of 2000 miles per year, disadvantaged by his limited activity, yet forced to pay mutualized, standardized insurance premiums so long as he lives based on inclusion in a liability insurance pool (1) which is composed almost entirely of much worse risks, (2) which contains a considerable number of traveling salesmen previously convicted of drunk driving, and (3) which discovers liabilities, partly through institutional design, long after their occurrence. Deliberate growth in savings, under such conditions, reflects considerable optimism, perhaps Micawberish, that Mutual Savings will eventually have better ideas and opportunities and that its officers (including the Chairman) will make fewer of the sort of mistakes in which they participated in the past, leading to difficulties now decried.

The foregoing comments, designed to communicate reality for Wesco shareholders as it appears to Wesco management, should not be taken as criticism of FSLIC management. In recent years FSLIC management has bordered on heroic, considering economic and legal changes, political pressures, extraordinary work burden, novel problems and limited resources.

**Precision Steel**

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, it had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $2,034,000 to "normal" net operating income in 1984, up 25% compared with $1,622,000 in 1983. Such a sharp increase in 1984 profit was not anticipated and was largely attributable to (1) increased sales (up 20% to $55,098,000) and (2) some favorable quantity-order prices on steel purchased.

Under the leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition. The 1984 year could be a hard act to follow.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $8,589,000 to sales in 1984 at a profit percentage higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using liquid assets available.

**All Other "Normal" Net Operating Income**

All other "normal" net operating income, net of interest paid and general corporate expenses, rose to $4,550,000 in 1984 from $3,839,000 in 1983. Sources were (1) rents ($2,078,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

### Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $13,138,000 in 1984 from $2,046,000 in 1983. The large 1984 gains do not indicate special acumen or good fortune in 1984. It merely happened that in 1984 unrealized appreciation occurring in previous years was cashed in.

A $1,080,000 portion of 1984 securities gains, if a different accounting treatment had been used, would have been both: (1) shifted to a different income category and (2) increased by $1,765,000. See next section.

### Unusual Income and Certain Accounting Quirks in 1984 Reporting

Wesco's consolidated audited figures for net earnings contained in this Annual Report are lower by $1,328,000 in aggregate ($.19 per share) with respect to the nine months ended September 30, 1984, than the figures contained in Wesco's previously-issued quarterly reports covering such nine months.

The downward restatement of earlier reported earnings occurred because, after the close of the year, Wesco's outside auditor made an unanticipated interpretation of generally accepted accounting principles applicable to an unusual business transaction.

The unusual business transaction was cash paid by General Foods for transfer of General Foods' stock from Wesco to General Foods under a written arrangement with General Foods, specifying intention to create an exact dividend-equivalent, which kept Wesco's percentage ownership of General Foods the same at all times. Under such circumstances, income tax law quite naturally treats all proceeds of the in-form "sale" of General Foods stock as a dividend, which is the I.R.S. view as well as Wesco's view of the underlying economic substance. Last year, in a virtually identical case, Wesco's outside auditor approved, for the consolidated group of which Wesco is a part, financial statements including accounting treatment in conformity with in-substance dividend reporting to the I.R.S. and Wesco's 1984 quarterly reports of earnings followed this precedent with no objection. But, after much deliberation, the outside auditor's opinion early in 1985 came down in favor of treating the 1984 transactions with General Foods as sales instead of dividend-equivalents, except that income tax provision continued to be computed on the in-substance dividend basis.

From the Wesco shareholders' vantage point the result from the outside auditing decision made is that the error, if any, existing in the audited accounts by reason of the Wesco-auditor disagreement is now on the side of underreporting income. Wesco's audited net income for the full year 1984 is now lower by $1,765,000 ($.25 per share) than would have been reported if all proceeds of the 1984 business transaction with General Foods had been reported as unusual dividends or dividend-equivalents, following Wesco's view of substance. Either way, any income from the Wesco-General Foods business transaction is reported as "unusual" or from an irregular source (securities gains), and, either way, the 1984 year end balance sheet is exactly the same, except that in one case (Wesco's view) the after-tax balance sheet carrying cost would have been $1,765,000 higher for an identical number of General Foods' shares owned, with the $1,765,000 increase augmenting book net worth of Wesco.

While Wesco disagrees with its outside auditor on the accounting issue, Wesco can find something to applaud in (1) a de-emphasis of year-to-year consistency in search for an answer best in the auditor's latest view and (2) an auditor's favoring of a decision, where it has any doubt, which may err on the side of under-reporting income, considering a common tendency of corporate clients to favor decisions in the opposite direction.

Were Wesco running a national accounting partnership it would want a system where a high-ranked partner, free of business-retaining pressure, could reverse accounting decisions urged by field partners, so Wesco can hardly complain about the inconsistent messages from an audit-management system which forced Wesco in 1984 to change at year end quarterly income figures earlier reported. However, in this murky case, where we happen to know that one of the country's most eminent accountants agrees with the Wesco view, we must admit to minor irritation with the fates. Wesco makes special effort aimed at high-quality reporting to shareholders. (For instance, only with respect to competitively proprietary information, such as transactions in marketable securities, does Wesco consciously keep communication with shareholders to the legal minimum.) Thus when the audit quality-control system of its outside C.P.A. firm selects Wesco for forced restatement of numbers previously given shareholders, we feel much as if we were a duty-obsessed engineering student at Brigham Young University, accidentally tear-gassed by the national guard in a necessary program to control campus unrest.

The subject of this restatement of a small part of Wesco's earnings is covered at length here only because, much more often than not, it is a bad sign for shareholders when a full year-end audit decreases income reported as earned in previous quarterly reports. A full explanation is therefore appropriate.

The inconsistency between quarterly and final income figures is not the only accounting quirk in Wesco's audited 1984 financial statements. It seems odd, as highlighted above in the unconventional breakdown of earnings, that unrealized appreciation of $458,000 in a forward commitment to buy mortgage-equivalents was taken into Mutual Savings' income in 1984, which happened because the commitment was made in a futures market on a commodities exchange. A forward commitment to buy the same mortgage equivalents, made in some other manner, for instance by simple contract, would not, under the applicable accounting rules, result in the same unrealized appreciation's being reported as income. And, even though the unrealized appreciation is recognized as income in the 1984 earnings statement, shareholders must look deep into a footnote to the audited 1984 financial statements to find the only reference to the mortgage equivalents which produced the appreciation. The balance sheet standing alone discloses only short-term investments (U.S. Treasury Notes in this instance) the proceeds of which will be used in 1986 to close the forward commitment to buy the mortgage equivalents.

It also seems odd, in view of the substantial additional costs FSLIC membership will in the near future impose on Mutual Savings, that prepaid FSLIC premiums amounting to $3,146,000 are included in the audited consolidated balance sheet, without offset for anticipated new cost of sharing FSLIC liabilities. We do not object to the accounting convention at work. All complexities and interests considered, the accounting profession is doing all right by the civilization; the FSLIC relationship has long been a valuable asset in the savings and loan industry, with its mutualized nature of no practical adverse consequence; and both accounting and public-policy considerations disfavor quick invention of new accounting convention to anticipate in current financial statements future increases in burden from FSLIC membership by reason of facts already known.

But quirks (at least as diagnosed by Wesco) required (probably wisely, on balance) by accounting convention, do contribute to causing Wesco to break down and discuss its earnings unconventionally in its management letter and also to call shareholders' attention to audit footnotes. The use of both footnotes and letter is needed for a best-feasible understanding of economic reality as it appears to Wesco management.

It is recognized, of course, by most certified public accountants as well as by Wesco that audited statements alone, unless accompanied by a letter giving management's view of economic reality where inconsistent with the image created by accounting convention, is an improperly incomplete form of annual communication with corporate owners. There is a limit to the communication which properly standardized accounting can create, and Wesco's outside auditors (and its parent companies' auditors) over the years have been quite supportive of Wesco's approach to expanding numerate communication in the management letter, even though outside auditing jurisdiction.

Written arrangements creating the issue of unusual dividend-equivalent income, of the type which caused reporting quirks in 1984 as a result of transactions with General Foods, can hardly be expected to be made year after year. However, Wesco does anticipate, based on an agreement already signed, that in 1985 more of the same sort of transactions will occur with General Foods, probably somewhat smaller in aggregate amount than in 1984.

**Consolidated Balance Sheet and Related Discussion**

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing failure to acquire additional businesses because none are found available, despite constant search, at prices deemed rational when the interest of Wesco shareholders is taken into account.

As indicated in Note 2 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate cost at December 31, 1984 by about $13 million, down sharply from about $29 million one year earlier.

Wesco's Pasadena office building block (containing about 165,000 net rentable square feet including Mutual Savings' space) has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($5,182,000 at 9.25% fixed) against this real property now exceeding its depreciated carrying value ($3,069,000) in Wesco's balance sheet at December 31, 1984, and (2) substantial current net cash flow to Wesco after debt service on the mortgage.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires some patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, common stock investments, both those in the savings and loan subsidiary and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in a very few companies. Through this concentration practice better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 13% in 1982-84, (1) was dependent to a considerable extent on securities gains, irregular by nature, and (2) nonetheless leaves something to be desired from the Wesco shareholders' point of view. Wesco began life as a savings and loan holding company in what became a very tough industry in which the real value, as distinguished from the reported book value, of most shareholders' equity became impaired, particularly in 1981-82. Damaged along with the rest of its industry, Wesco has been proceeding slowly under shortened sail, while it assesses damage and repairs the ship, instead of trying to make fast time by getting all canvas aloft. However, progress ultimately helpful to shareholders has not been restricted to what has shown up neatly in the income account covering this period. Increases over recent years in both (1) aggregate reported shareholders' equity and (2) the percentage of such equity outside Wesco's savings and loan segment are expected to be useful in the future.

On January 24, 1985, Wesco increased its regular quarterly dividend from 14½ cents per share to 15½ cents per share, payable March 7, 1985 to shareholders of record as of the close of business on February 19, 1985.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T Munger

Charles T. Munger
Chairman of the Board

February 12, 1985



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# WESCO FINANCIAL CORPORATION

*Annual Report 1985*

*Form 10-K Annual Report 1985*

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1985 decreased to $8,347,000 ($1.17 per share) from $10,060,000 ($1.42 per share) in the previous year.

Consolidated net income (i.e., after unusual operating income and all net gains from sales of securities) increased to $51,541,000 ($7.24 per share) from $23,656,000 ($3.32 per share) in the previous year.

A highly unusual capital gain, of a not-likely-to-recur type, from disposition of General Foods stock caused most of the net income in 1985. The table below gives particulars.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1985 | | December 31, 1984 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income (loss) of: | | | | |
| Mutual Savings | $ 3,342 | $ .47 | $ 3,476 | $ .49 |
| Precision Steel businesses | 2,010 | .28 | 2,034 | .29 |
| Wesco-Financial insurance business— | | | | |
| Underwriting | (1,584) | (.22) | — | — |
| Investment activity | 1,225 | .17 | | |
| | (359) | (.05) | | |
| All other "normal" net operating income[2] | 3,354 | .47 | 4,550 | .64 |
| | 8,347 | 1.17 | 10,060 | 1.42 |
| Fluctuation in market value of GNMA futures contract | 1,671 | .24 | 458 | .06 |
| Net gains on sales of securities[3] | 41,523 | 5.83 | 13,138 | 1.84 |
| Wesco consolidated net income | $51,541 | $7.24 | $23,656 | $3.32 |

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.

(3) The 1985 figure includes a $34,363,000 ($4.83 per share) gain realized by Wesco on the sale of its General Foods Corporation common stock to Philip Morris Company in connection with the latter's publicly announced tender offer. See "Net Gains on Sales of Securities" below.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

## Mutual Savings

Mutual Savings' "normal" net operating income of $3,342,000 in 1985 represented a decrease of 4% from the $3,476,000 figure the previous year.

Separate balance sheets of Mutual Savings at yearend 1984 and 1985 are set forth at the end of this annual report. They show (1) total savings accounts rising to $269 million from $228 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, (4) a loan portfolio (mostly real estate mortgages) of about $83 million at the end of 1985, down 12% from the $95 million at the end of 1984, and (5) favorable effects of securities gains and other unusual gains and fluctuations, which caused net worth to decline only $4 million in 1985 despite payment of a dividend of $14 million to the parent corporation.

The loan portfolio at the end of 1985, although containing almost no risk of loss from defaults, bore a fixed average interest rate of only 7.60%, probably the lowest for any U.S. savings and loan association and far below the average interest rate which now must be paid to hold savings accounts. However, as the loan payoff pace intensified and interest rates declined sharply in 1985, the unrealized depreciation in the loan portfolio became approximately offset by unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks.

As pointed out in footnote 13 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($57.6 million at December 31, 1985) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, even pursuant to a plan of complete liquidation, for the $57.6 million in book value reported under applicable accounting convention, the parent corporation would receive much less than $57.6 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

There is, however, a buried plus value in Mutual Savings. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its $1.5 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 10 years in the course of administration of land-use laws. But we are optimistic that an end to the delay is near and that the Santa Barbara and Montecito communities will be very pleased with the development now likely to go forward. This development will contain 32 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

Balancing all merits and demerits, Mutual Savings, as it has been managed under present conditions by the writer and others, is no jewel of a business from the shareholders' point of view. Mutual Savings' good points are: (1) high asset quality and sound balance sheet; (2) a maturity match of interest-bearing assets and liabilities which makes risk of insolvency near zero, whatever happens to interest rates; and (3) a deserved reputation for high quality service to account holders, achieved at below-average cost to the institution in an efficient one-large-office operation, as distinguished from a many-small-branch-offices operation. Mutual Savings' bad points are: (1) all recent growth in savings accounts, considered on an incremental effects basis, has been loss business because interest and other costs incurred exceed income obtained by employing proceeds in short-term interest-bearing assets; (2) a burdensome position under the FSLIC account-insurance system causes payments of ever-higher amounts into the system to help bail out more venturesome savings and loan associations which become insolvent, with the payments being required despite the fact that Mutual Savings imposes almost no risk on FSLIC; (3) "normal" net operating income is below an acceptable rate of return on present book value of shareholders' equity, with such return reaching an acceptable level over recent years only with help from securities gains and other unusual items; (4) it would not be easy to leave the savings and loan business, should this course of action ever be desired, without a large income tax burden of a type not applied to corporations other than savings and loan associations; (5) the regulatory structure of the savings and loan business creates a competitive situation in which it is hard to make respectable profits through careful operations; and (6) management has not yet found an acceptable remedy for any of the previously listed bad points, despite years of trying.

Moreover, comparisons of post-1984 financial results for Mutual Savings with results for many other and more typical savings and loan associations in California leave Mutual Savings looking inferior, to put it mildly. As interest rates went down these other associations, which have greater financial leverage and operated less fearfully than Mutual Savings during former high-interest periods, came to have loan and investment portfolios which (1) now are worth more on average than book value and (2) now produce a high return on book value of shareholders' equity, after deduction of operating expenses and interest to account holders at present rates. Any Wesco shareholder who thinks Mutual Savings has any expertise in predicting and profiting from interest rate changes can look at the 1985 record and despair.

Despite the fact that some other savings and loan associations did much better after 1984 than Mutual Savings, and are now much better poised to report good figures for 1986, we plan to continue operating only in ways acceptable in our own judgment, anticipating as a consequence widely fluctuating and sometimes inadequate returns. In the future, however, Mutual Savings will make and purchase more loans. Now that Mutual Savings' old mortgage loans have declined in amount and increased in market value (the market value increase being caused both by a decline in generally prevailing interest rates and by a shortening of remaining loan life), new loans will be added as seems wise, with a target that 60% of assets be in housing-related loans. The first new direct loan in some time, an adjustable rate mortgage with no cap on future interest rate changes but with an extremely low "spread" for the lender, will shortly be closed. We are not at all excited by our prospects as we now make housing loans of this type, but we wish to get some renewal of direct mortgage lending under way.

With assets not employed in direct real-estate lending, Mutual Savings continues not only to make payments to FSLIC far in excess of fair charges for risks imposed on FSLIC but also to employ a large part of total assets in short-term loans to the Federal Home Loan Bank. These practices are pro-social but will continue to reduce profits.

Mutual Savings also continues to support the Federal Home Loan Bank Board in its efforts to change the present rules of the savings and loan business to augment average soundness of FSLIC-insured associations. We retain our opinion that the present rules, despite some improvement in 1985 through wise efforts of the Federal Home Loan Bank Board, are unsound, from the country's point of view. Too much latitude is allowed financial "swingers" to grow as they gamble, through use of account guarantees from FSLIC, an agency of the U.S. Government, while they offer whatever it takes in interest rates to attract more accounts.

With money being the ultimate fungible commodity, it seems to us that the rules create a super-competitive, commodity-type business, in which (1) economic law probably destines most careful associations, like other fungible-commodity dealers, to realize very modest returns on shareholders' equity over extended time periods, yet (2) good financial results can nonetheless usually be reported in each near-term period by managers-in-charge through aggressive deposit-expanding, lending and investing measures which increase risk, while (3) the importance and rewards of managers, who usually have little downside risk as owners, are tied mostly to institutional size and recently reported numbers. With managers mostly being non-owners, a sort of Gresham's law of competitive-yet-deposit-insured banking, "bad loans drive out good," tends to work with extra force as managers fear being left out of whatever activity allows competing managers to report high profits while bidding high for deposits. We see no reason for assuming that ethical, intelligent managers in the savings and loan industry are immune from effects similar to those which caused similar managers of all major U.S. banks to place significant portions of assets in now-regretted foreign loans, rather than stand apart from the crowd. If our diagnosis is correct, a lot of serious trouble lies ahead (perhaps far ahead) for U.S. savings and loan associations.

While present rules and practices have a positive side in causing satisfaction of almost 100% of demand for those housing loans which are sound at the prevailing interest rate, this accomplishment is accompanied by much unsound housing and other lending and by much unsound investment in "junk bonds" and other assets unsuitable for highly leveraged, federally insured, deposit-taking institutions. The system design in place would probably be a flunking design in an engineering course, where the emphasis would be on preserving the integrity of an essential system by a margin of safety, by being content with rules which (1) caused satisfaction of, say, only 95% of requests for sound credit extension and (2) forced more conservative conduct on banks and savings and loan associations.

The present design, we think, would probably also be a flunking design in a surgery course, where the wise practice is to remove some healthy cells along with cancerous cells, based on margin-of-safety principles. We hope we are wrong about the present design of the savings and loan system, but we fear increased, widespread adversity, ultimately reaching housing borrowers and would-be housing borrowers, whose interests we consider important. Any such adversity would probably be followed by changes in the rules. No doubt, our judgment as to the probable temporary nature of present savings and loan industry structure and practices has helped deter us from direct lending of a conventional sort which otherwise would have occurred. Our attitude, right or wrong, during recent tumultuous changes in the savings and loan industry, has been roughly that of the French grandfather who replied when asked what he did in the great revolution: "I got through." We also think something good could eventually happen to Mutual Savings because future trouble in the savings and loan business may create opportunities worth seizing.

## Precision Steel

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, the company had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $2,010,000 to "normal" net operating income in 1985, down 1% compared with $2,034,000 in 1984. Such a modest decrease in 1985 profit was achieved in spite of decreased sales (down 7% to $51,124,000).

Under the skilled leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $9,140,000 to 1985 sales at a profit margin higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using available liquid assets.

## Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco invested $45,000,000 in cash equivalents in a newly organized, wholly owned, Nebraska-chartered insurance company, Wesco-Financial Insurance Company ("Wes-FIC").

The new subsidiary Wes-FIC, then reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary without profit, 2% of the entire book of insurance business of the long established Fireman's Fund Corp. (listed on the NYSE).

Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1986 is expected to be over $60 million.

Wes-FIC's separate financial statements, covering the brief period of its existence, September 1, 1985, to December 31, 1985, are included on pages 29 and 30 of this Annual Report, and show that Wes-FIC experienced a small 1985 reduction in net worth, from $45,000,000 to $44,676,000.

We do not consider this four-month result to have significant predictive value with respect to the future. The price of insurance is rising, with price increases not yet fully reflected in 1985 numbers. Moreover, the financial statements are of questionable accuracy and could be wrong in either direction. It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Finally, Wes-FIC's initial financial statements have a disadvantage in that the period covered is short, making any use of the reported past cost-price ratio extra dubious as an indicator of any probable future cost-price ratio, due to the small size of the sample forming a base for projection.

It is entirely too soon to forecast future results for Wes-FIC, but Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

Wesco has high regard for John Byrne, newly appointed CEO and also a large shareholder and stock-option holder of Fireman's Fund. Mr. Byrne was an outstanding insurance company manager in his previous position as CEO of GEICO CORPORATION (38% owned, but not controlled, by Berkshire Hathaway), which improved enormously during his stewardship. Fireman's Fund's insurance business is intrinsically more cyclical and less-advantaged than GEICO's core insurance business, which has lower distribution costs from a different, "direct writing" distribution system. Thus Fireman's Fund's business will almost surely be much more difficult to improve permanently than was the case at GEICO. However, Mr. Byrne and other Fireman's Fund executives know all this very well, and, with improvement less spectacular than previous improvement at GEICO, Fireman's Fund and Wes-FIC could both prosper.

Industry-wide conditions, as well as managerial excellence, affect Wes-FIC's prospects under the reinsurance contract with Fireman's Fund. Large premium increases now going into effect throughout the casualty insurance business could provide some welcome tailwind effects, instead of the headwind effects of the period just ended, which was one of the worst in history.

We are pleased with our relationship with Fireman's Fund, which has a long and distinguished record, going all the way back to superb performance after the great San Francisco earthquake and fire, and which is affiliated with the even longer established American Express Company, one of the premier corporations in the United States.

However, Wesco's optimism about quality of Fireman's Fund, quality of this reinsurance contract, and possible short-term, industry-wide cyclical improvement, is tempered by a larger and longer view of the reinsurance business. That business has the defect of being too attractive-looking to new entrants for its own good and therefore will always tend to be more or less the opposite of, say, the old business of gathering and rendering dead horses, which tended to contain few and prosperous participants.

Troubles, losses, and insolvencies can come fast as the apparent attractions of the reinsurance business, including its seductive receive-pay-in-advance aspects, lure new entrants and encourage expansions by old occupants. The business was a disaster area in recent years, adversely affected by prices which would have been too low in a stable world, plus inflation, new judicial notions tending to augment insurance coverage beyond limits contemplated when policies were issued, and not-minor degradation of commercial behavior.

No doubt recent commercial behavior degradation, particularly noticeable in the reinsurance business on both sides of the purchase counter, was accelerated by general hardship, demonstrating once again the wisdom of Poor Richard's Almanac: "It is hard for an empty sack to stand upright."

Insurance company subsidiaries of Wesco's parent corporation, Berkshire Hathaway, long active in reinsurance, did continue proper commercial behavior during the recent period of industry-wide problems, but financial results from reinsurance were terrible. Thus Wesco shareholders are being led not only into an extra-hazardous place but also by people who met severe reverses on the last trip.

Is there any reasonable hope for Wesco shareholders that its reinsurance business, whatever its short-term merits, will provide an advantageous long-term journey? Yes, one reason for long-term optimism is present. With recent defaults by reinsurers causing everyone to worry more about quality in promisors, Wes-FIC and Berkshire Hathaway expect that their old-fashioned engineering-type attitudes and financial practices will help create for Wes-FIC an unusual, commercially-useful reputation for issuing trustworthy promises in one or more markets or submarkets wherein most buyers will accept nothing less. Thus, the absence of federal insurance for reinsurance liabilities may create for Wes-FIC a reputation based competitive advantage which is denied to Mutual Savings by FSLIC's support of all Mutual Savings' competitors through insuring their accounts.

## All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,354,000 in 1985 from $4,550,000 in 1984. Sources were (1) rents ($2,219,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

## Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $41,523,000 in 1985 from $13,138,000 in 1984.

The 1985 figure includes a big after-tax gain ($34,363,000) from sale of General Foods stock to Philip Morris Company. This gain contained a large amount of windfall profit. When Wesco made its investment in General Foods stock several years ago, because General Foods' executives seemed sensible and the stock was available in the market at a conservative price relative to its value as a share of ownership in a presumably ever-continuing independent entity, it was unprecedented and virtually inconceivable that a corporation the size of General Foods would ever be "bear-hugged" into selling out at an immense premium over the then prevailing market price for its stock. But that is what happened, wholly unpredicted by Wesco, in 1985 as old taboos eroded and the great American takeover game swept into new areas.

## Bowery Savings Bank

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested $100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested $9,000,000, other Berkshire Hathaway subsidiaries invested $12,384,000, and other unrelated investors invested the balance of the $100,000,000.

The terms of the FDIC assistance, which include income-assistance payments over many years to the newly organized bank, are extremely complex but can be fairly summarized as far from adequate to assure that the investors will make a profit. This is as it should be when $100 million buys a highly leveraged residual equity position in a $5 billion bank, albeit one with many sick assets.

Any minority position investment with such extreme financial leverage (in effect buying with a 2% down payment), involving a troubled company in a demanding environment, can fairly be called a venture capital type investment for Wesco. In our judgment the prospect for gain justified the risk of loss. The investment involves a small portion (about 5%) of Wesco's consolidated net worth. We consider it financially conservative to risk 3½% of Wesco's net worth (which is roughly the after-tax exposure involved) if we believe a hundred similar bets would, in aggregate, be almost sure to work out successfully.

## Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in Note 3 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate cost at December 31, 1985 by about $5 million, down sharply from about $13 million one year earlier.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($5,023,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($3,158,000) in Wesco's balance sheet at December 31, 1985, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 96% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires some patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 21% in 1983-85, was dependent to a very large extent on securities gains, irregular by nature. The recent ratio is almost certain to decline, quite probably very sharply. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to cause the recent ratio to continue. The business acquisition game is now crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And, as discussed earlier, the great contribution of 1985 securities gains to Wesco's recent return on shareholders' equity contained a big fluke element. Such fluke gain, rare in any event, tends to come to an investor like Wesco mostly as an unanticipated by-product of an obviously sound investment which does not require any fluke to work out well. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments then than now, and because prospects for above-average returns tend to go down as assets managed go up, it is now easy to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing Wesco marketable securities disclosed in the 1985 Annual Report, to diagnose (correctly) that the decision-makers are dry of good investment ideas.

Wesco is trying more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action. Moreover, the approach is being applied to no great base position. Wesco is sort of scrambling through the years without owning a single business, even a small one, with enough commercial advantage in place to pretty well assure high future returns on its capital. In contrast, Berkshire Hathaway, Wesco's parent corporation, owns three such high-return businesses.

On January 25, 1986, Wesco increased its regular quarterly dividend from 15½ cents per share to 16½ cents per share, payable March 6, 1986, to shareholders of record as of the close of business on February [illegible] 1986.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger

Charles T. Munger
Chairman of the Board

February 13, 1986

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# WESCO FINANCIAL CORPORATION

*Annual Report 1986*

*Form 10-K Annual Report 1986*

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1986 increased to $11,934,000 ($1.68 per share) from $8,347,000 ($1.17 per share) in the previous year.

Consolidated net income (i.e., after unusual operating income and all net gains from sales of securities) decreased to $16,524,000 ($2.32 per share) from $51,541,000 ($7.24 per share) in the previous year.

A highly unusual capital gain, of a not-likely-to-recur type, from disposition of General Foods stock caused most of the net income in 1985. The table below gives particulars.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1986 | | December 31, 1985 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income (loss) of: | | | | |
| Mutual Savings | $ 2,159 | $ .30 | $ 3,342 | $ .47 |
| Precision Steel businesses | 1,701 | .24 | 2,010 | .28 |
| Wesco-Financial Insurance business— | | | | |
| Underwriting | (1,469) | (.21) | (1,584) | (.22) |
| Investment activity | 8,084 | 1.14 | 1,225 | .17 |
| | 6,615 | .93 | (359) | (.05) |
| All other "normal" net operating income[2] | 1,459 | .21 | 3,354 | .47 |
| | 11,934 | 1.68 | 8,347 | 1.17 |
| Fluctuation in market value of GNMA futures contract | — | -- | 1,671 | .24 |
| Net gains on sales of securities[3] | 4,590 | .64 | 41,523 | 5.83 |
| Wesco consolidated net income | $16,524 | $2.32 | $51,541 | $7.24 |

(1) All figures are net of income taxes

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.

(3) The 1985 figure includes a $34,363,000 ($4.83) per share) gain realized by Wesco on the sale of its General Foods Corporation common stock to Philip Morris Company in connection with the latter's publicly announced tender offer

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

**Mutual Savings**

Mutual Savings' "normal" net operating income of $2,159,000 in 1986 represented a decrease of 35% from the $3,342,000 figure the previous year.

Separate balance sheets of Mutual Savings at yearend 1985 and 1986 are set forth at the end of this annual report. They show (1) total savings accounts rising to $282 million from $269 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, (4) a loan portfolio (mostly real estate mortgages) of about $79 million at the end of 1986, down 6% from the $83 million at the end of 1985, and (5) favorable effects of securities gains, which caused net worth to decline only $3 million in 1986 despite payment of a dividend of $7.5 million to the parent corporation.

The loan portfolio at the end of 1986, although containing almost no risk of loss from defaults, bore an average interest rate of only 7.48%, probably the lowest for any U.S. savings and loan association and about equal to the average interest rate which now must be paid to hold savings accounts. This, of course, leaves no net interest margin to cover operating costs. However, the unrealized depreciation in the loan portfolio is now more than offset by unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks. Such unrealized appreciation at December 31, 1986 was about $17 million.

As pointed out in footnote 14 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($54.8 million at December 31, 1986) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, even pursuant to a plan of complete liquidation, for the $54.8 million in book value reported under applicable accounting convention, the parent corporation would receive much less than $54.8 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

There is, however, in Mutual Savings, not only a buried plus value in unrealized appreciation of securities, but also a buried plus value in real estate. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its $1.6 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 11 years in the course of administration of land-use laws. But we are optimistic that delay will end in 1987 and that the Santa Barbara and Montecito communities will be very pleased with development into 32 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

The buried plus value in real estate is limited by the small number of houses allowed (32) and by the fact that only a minority of such houses (12) will have any significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, and landscaping. And, most important of all, various charges and burdens imposed by governmental bodies will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into 1987.

Balancing all merits and demerits, Mutual Savings, as it has been managed under present conditions by the writer and others, continues to be a mediocre business from the shareholders' point of view. Mutual Savings' good points are: (1) high asset quality and sound balance sheet; (2) a maturity match of interest-bearing assets and liabilities which makes risk of insolvency near zero, whatever happens to interest rates; and (3) a deserved reputation for high quality service to account holders, achieved at below-average cost to the institution in an efficient one-large-office operation, as distinguished from a many-small-branch-offices operation. Mutual Savings' bad points are: (1) all recent growth in savings accounts, considered on an incremental-effects basis, has been loss business because interest and other costs incurred exceed income obtained by employing proceeds in short-term interest-bearing assets; (2) a burdensome position under the FSLIC account-insurance system causes payments of ever-higher amounts into the system to help bail out more venturesome savings and loan associations which become insolvent, with the payments being required despite the fact that Mutual Savings imposes almost no risk on FSLIC; (3) "normal" net operating income is below an acceptable rate of return on present book value of shareholders' equity, with such return reaching an acceptable level over recent years only with help from securities gains and other unusual items; (4) it would not be easy to leave the savings and loan business, should this course of action ever be desired, without a large income tax burden of a type not applied to corporations other than savings and loan associations; (5) as explained in last year's annual report, the regulatory structure of the savings and loan business creates a competitive situation in which it is hard to make respectable profits through careful operations; and (6) management has not yet found an acceptable remedy for any of the previously listed bad points, despite years of trying.

Moreover, comparisons of post-1984 financial results for Mutual Savings with results for many other and more typical savings and loan associations in California continue to leave Mutual Savings looking inferior, to put it mildly. As interest rates went down these other associations, which have greater financial leverage and operated less fearfully than Mutual Savings during former high-interest periods, came to have loan and investment portfolios which (1) now are worth more on average than book value and (2) now produce a high return on book value of shareholders' equity, after deduction of operating expenses and interest to account holders at present rates. Any Wesco shareholder who thinks Mutual Savings has any expertise in predicting and profiting from interest rate changes can look at the 1985-1986 record and despair.

Despite the fact that some other savings and loan associations did much better after 1984 than Mutual Savings, and are now much better poised to report good figures for 1987, we plan to continue operating only in ways acceptable in our own judgment, anticipating as a consequence widely fluctuating and sometimes inadequate returns. In the future, however, Mutual Savings will make and purchase more loans. Now that Mutual Savings' old mortgage loans have declined in amount and increased in market value (the market value increase being caused both by a decline in generally prevailing interest rates and by a shortening of remaining loan life), new loans will be added as seems wise, with a target that at least 60% of assets be in housing-related loans. New direct loans aggregating $9 million were made in 1986, all adjustable rate mortgages with no cap on future interest rate changes but with an extremely low "spread" for the lender. In recent months the total of all loans on hand has risen as new loans made exceeded principal payoffs on old loans.

With assets not employed in direct real-estate lending, Mutual Savings continues not only to make payments to FSLIC far in excess of fair charges for risks imposed on FSLIC but also to employ a large part of total assets in short-term loans to the Federal Home Loan Bank. These practices are pro-social but will continue to reduce profits.

Mutual Savings also continues to support the Federal Home Loan Bank Board in its efforts to change the present rules of the savings and loan business to augment average soundness of FSLIC-insured associations and prevent recurrence of widespread insolvencies like those now bedevilling the industry.

**Precision Steel**

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, the company had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $1,701,000 to "normal" net operating income in 1986, down 15% compared with $2,010,000 in 1985. The decrease in 1986 profit occurred in spite of increased revenues (up 2% to $52,304,000).

Under the skilled leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $10,172,000 to 1986 sales at a profit margin higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using available liquid assets.

**Wesco-Financial Insurance Company**

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned, Nebraska-chartered insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $36.2 million was invested in January 1986.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1986 exceeded $67 million.

Wes-FIC's separate financial statements, covering the brief period of its existence, September 1, 1985, to December 31, 1986, are included on page 30 of this Annual Report, and show that Wes-FIC's net income for 1986 was $6,967,000 versus a small deficit ($359,000) for its first 4 months of operation in 1985. The 1986 net income figure included securities gains, net of income taxes, of $352,000.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicality of its business.

However, Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

We very much like our association with Fireman's Fund, a real class operation, and with Jack Byrne, its CEO, who displayed great integrity, intelligence and vigor in returning GEICO Corporation to glory before he took his present position.

### All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $1,459,000 in 1986 from $3,354,000 in 1985. Sources were (1) rents ($2,229,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level. The great decrease in interest and dividends received in this "other income" category was caused by the transfer of assets to Wes-FIC, where income is now classified as insurance income.

### Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $4,590,000 in 1986 from $41,523,000 in 1985.

### Bowery Savings Bank

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested $100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested $9,000,000, other Berkshire Hathaway subsidiaries invested $12,384,000, and other unrelated investors invested the balance of the $100,000,000.

The terms of the FDIC assistance, which include income-assistance payments over many years to the newly organized bank, are extremely complex but can be fairly summarized as far from adequate to assure that the investors will make a profit. This is as it should be when $100 million buys a highly-leveraged residual equity position in a $5 billion bank, albeit one with many sick assets.

Any minority-position investment with such extreme financial leverage (in effect buying with a 2% down payment), involving a troubled company in a demanding environment, can fairly be called a venture-capital type investment for Wesco. In our judgment, the prospect for gain justified the risk of loss.

This investment continues to be carried at cost in Wesco's accompanying financial statements, and we continue in guarded optimism regarding our position.

### Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in Note 3 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1986 by about $13 million, up modestly from about $5 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $23 million. As earlier noted, about $17 million of this unrealized appreciation lies within the savings and loan subsidiary.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($4,940,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($3,091,000) in Wesco's balance sheet at December 31, 1986, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 90% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 19% in 1984-86, was dependent to a very large extent on securities gains, irregular by nature. This recent ratio is almost certain to continue to decline, probably sharply, as it did in 1986. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to help much in the short term. The business acquisition game continues to be crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And future securities gains are likely to prove harder to come by for very simple reasons. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments then than now, and because prospects for above-average returns tend to go down as assets managed go up, it is now, early in 1987, even easier than it was early in 1986, to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing either (i) this virtual reprint of last year's letter or (ii) Wesco's marketable securities disclosed herein, to diagnose (correctly) that the decision-makers are now even more dry of good ideas than they were a year earlier.

The considerable, and higher than normal, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action. Moreover, the approach is being applied to no great base position. Wesco is sort of scrambling through the years without owning a single business, even a small one, with enough commercial advantage in place to pretty well assure high future returns on its capital. In contrast, Berkshire Hathaway, Wesco's parent corporation, owns a fair number of such high-return businesses.

On January 22, 1987, Wesco increased its regular quarterly dividend from 16½ cents per share to 17½ cents per share, payable March 12, 1987, to shareholders of record as of the close of business on February 20, 1987.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T Munger

Charles T. Munger
Chairman of the Board

February 13, 1987

P.E. 12-31-87

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# WESCO FINANCIAL CORPORATION



Annual Report 1987

Form 10-K Annual Report 1987

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1987 increased to $16,612,000 ($2.33 per share) from $11,934,000 ($1.68 per share) in the previous year.

Consolidated net income (i.e., after unusual operating losses and all net gains from sales of securities) decreased to $15,213,000 ($2.14 per share) from $16,524,000 ($2.32 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)(1):

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1987 | | December 31, 1986 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income (loss) of: | | | | |
| Mutual Savings | $ 2,895 | $ .41 | $ 2,159 | $ .30 |
| Precision Steel's businesses | 2,450 | .34 | 1,701 | .24 |
| Wesco-Financial insurance business — | | | | |
| Underwriting | (1,394) | (.19) | (1,469) | (.21) |
| Investment activity | 10,853 | 1.52 | 8,084 | 1.14 |
| | 9,459 | 1.33 | 6,615 | .93 |
| All other "normal" net operating income(2) | 1,808 | .25 | 1,459 | .21 |
| | 16,612 | 2.33 | 11,934 | 1.68 |
| Writeoff by Mutual Savings of prepaid FSLIC insurance premiums(3) | (1,935) | (.27) | — | — |
| Flood loss at Precision Steel | (672) | (.09) | — | — |
| Net gains on sales of securities | 1,208 | .17 | 4,590 | .64 |
| Wesco consolidated net income | $15,213 | $2.14 | $16,524 | $2.32 |

(1) All figures are net of income taxes.
(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.
(3) Necessitated by the Federal Home Loan Bank's elimination of the savings and loan industry's nearly $1-billion secondary insurance reserve, consisting of deposit insurance premiums prepaid to FSLIC, the U.S agency which insures accounts in savings and loan associations.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

**Mutual Savings**

Mutual Savings' "normal" net operating income of $2,895,000 in 1987 represented an increase of 34% from the $2,159,000 figure the previous year.

However, this "normal" figure of $2,895,000 for Mutual Savings' 1987 earnings is created by ignoring as abnormal an after-tax charge of $1,935,000 from writeoff of prepayments of deposit-insurance premiums. The premiums had been prepaid in previous years to FSLIC, the U.S. agency which insures accounts in savings and loan associations. Since FSLIC has been grievously impaired by widespread failure of insured associations and continues to be insolvent, and since its long-term source of support is collection of premiums which the savings and loan industry is *compelled* to pay, it may well be questioned whether FSLIC-related charges far in excess of past experience should on that account now be excluded from the "normal" as we do in this explanatory letter. Mutual Savings' position, relative to FSLIC, is like that of the owner of a concrete pier, mostly underwater, compelled to buy fire insurance on a pooled-rate basis with a group of oily-rag collectors, many of whom have already had but not reported their fires, with the result that no provision for such fires has yet been made in pooled-basis premium rates. Such an owner probably has not yet had his last unpleasant surprise from his insurance costs. Even so, we chose "unusual" classification for the FSLIC special charge in 1987, because it is not certain to be repeated.

Separate balance sheets of Mutual Savings at yearend 1986 and 1987 are set forth at the end of this annual report. They show (1) total savings accounts rising to $287 million from $282 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $139 million at the end of 1987, up 76% from the $79 million at the end of 1986.

The loan portfolio at the end of 1987, although containing almost no risk of loss from defaults, bore an average interest rate of only 8.38%, probably near the lowest among U.S. savings and loan associations, but up sharply from 7.48% at the end of 1986. There is now no significant unrealized depreciation in the loan portfolio, while unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks at December 31, 1987 was about $9 million.

As pointed out in Note 10 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($56.6 million at December 31, 1987) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, for the $56.6 million reported as book value, the parent corporation would receive much less than $56.6 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

Mutual Savings has not only a buried plus value in unrealized appreciation of securities, but also a buried plus value in real estate. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its $2.0 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 12 years in the course of administration of land-use laws. But, miraculous to report, grading is now actually under way on the property for an authorized development into 31 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

The buried plus value in real estate is limited by the small number of houses allowed (31) and by the fact that only a minority of such houses (11) will have any significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, and landscaping. And, most important of all, various charges and burdens, including heavy archaeological obligations imposed by governmental bodies, will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into 1988.

Mutual Savings is now a "qualified thrift lender" under the Federal regulatory definition requiring 60% of assets in various housing-related categories. Substantially all loans receivable have either short expected lives or bear interest rates which fluctuate with the market to 25% per annum or more.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, such spread is improving. Moreover, the disadvantage from inadequate spread continues to be offset to a considerable degree by the effect of various forms of tax-advantaged investment, primarily preferred stock. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock, with its fixed dividend and long life, will decline in value and not provide enough income to cover Mutual Savings' interest costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment to preferred stock is kept conservative, relative to the amount of its net worth.

All in all, Mutual Savings continues to be a mediocre business, albeit one which is both (1) improving slightly and (2) expected to produce an average return of at least 10% per annum on the after-tax proceeds which could be realized from its liquidation. And, of course, we are making needed loans in our community while we try to behave as if there were no federal deposit-insurance system. Such an institution may find a bigger role as the years go by.

**Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,450,000 to "normal" net operating income in 1987, up 44% compared with $1,701,000 in 1986. The increase in 1987 profit occurred in spite of only a modest increase in revenues (up 5% to $54,843,000).

The "normal" net operating income figure does not include the adverse effect of an after-tax charge of $672,000 from a flood loss following a severe rainstorm in August, during which nine inches of rain fell in a twenty-four hour period. We consider such a flood a once-in-a-hundred-years type of occurrence, and have no hesitation as we exclude the item from "usual" results in our explanatory letter.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1987 provided an extraordinary return even without taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

The good financial results have an underlying reason. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

**Wesco-Financial Insurance Company**

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $45 million was invested in 1986 and 1987.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1987 exceeded $73 million.

Wes-FIC's net income for 1987 was $9,468,000, versus $6,967,000 for 1986. The net income figures included securities gains, net of income taxes, of $9,000 in 1987 and $352,000 in 1986. Wes-FIC's 1987 net income benefitted by about

$1 million because of an unusual adjustment to its income tax provision caused by the Tax Reform Act of 1986.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicality of its business.

However, Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

**All Other "Normal" Net Operating Income**

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to $1,808,000 in 1987 from $1,459,000 in 1986. Sources were (1) rents ($2,272,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

**Net Gains On Sales Of Securities**

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $1,208,000 in 1987 from $4,590,000 in 1986.

**Bowery Savings Bank**

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested $100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested $9,000,000, other Berkshire Hathaway subsidiaries invested $12,384,000, and other unrelated investors invested the balance of the $100,000,000.

The terms of the FDIC assistance were extremely complex but can be fairly summarized as far from adequate to assure that the investors would make a profit. This is as it should be when $100 million buys a highly-leveraged residual equity position in a $5 billion bank, albeit one with many problems.

The investment continued to be carried at cost in Wesco's accompanying year-end financial statements, but it was sold, as part of a friendly acquisition of Bowery by a large and reputable company, on January 31, 1988, at an after-tax profit for Wesco of about $5 million.

Richard Ravitch was the organizing leader in the group which revitalized Bowery Savings Bank, acted as its CEO and negotiated its sale. We take this opportunity to doff our hat to him for a job well done. We have similar admiration for our other co-investors, particularly the Tisch family and Richard Rosenthal. Mr. Rosenthal was a former Salomon partner (see below) who died in a tragic air crash in the midcourse of our venture.

**Salomon Inc**

On October 1, 1987 Wesco and certain of its wholly owned subsidiaries purchased 100,000 newly issued shares of Series A Cumulative Convertible Preferred Stock, without par value, of Salomon Inc ("Salomon"), at a cost of $100 million. Salomon's primary business is transacted by its subsidiary, Salomon Brothers, a leading securities firm. Our investment was part of a $700 million transaction in which other subsidiaries of Berkshire Hathaway Inc., Wesco's parent, invested $600 million. Principal terms of the transaction include the following: (1) the new preferred stock will pay dividends at the annual rate of 9%; (2) each preferred share, purchased at a cost of $1,000, will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at $1,000 per share plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

At the stated conversion price of the preferred stock, a profit (subject to certain procedural requirements) will be realizable whenever, after October 31, 1990, the common stock of Salomon (listed NYSE) trades at over $38 per share. At the time of our commitment to buy the new preferred, the common stock of Salomon was selling in the low 30s. However, shortly after the ink dried on Wesco's new stock certificates, the October 19, 1987 "Black Monday" stock market crash occurred, which caused temporary but substantial operating losses plus a lowered credit rating at Salomon. Although Salomon, among securities firms, suffered only its rough share of the general debacle, its common stock at one time after the crash traded as low as 16⅛.

Fortunately, as the conversion privilege we had bargained for declined in value along with the price of Salomon common stock, interest rates also declined, which made our fixed 9% annual preferred stock dividend more valuable. We believe that, all factors considered, at December 31, 1987 our $100 million investment in preferred stock of Salomon was still worth about $98 million.

We much admire the way Salomon and its leader, John Gutfreund, are adjusting operations to cope with new and adverse conditions. They seem ahead of the game to us, compared with competitors, and they work from the sound base of an honored name, affixed to an organization deep in talent and known for hard work.

Berkshire Hathaway's Chairman, Warren Buffett, and the undersigned joined the board of Salomon on October 28, 1987, and are very pleased with the new association.

**Consolidated Balance Sheet and Related Discussion**

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated on the accompanying consolidated balance sheet, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1987 by about $6 million, down significantly from about $13 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $12 million. As earlier noted, about $9 million of this unrealized appreciation lies within the savings and loan subsidiary.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($4,850,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($3,164,000) in Wesco's balance sheet at December 31, 1987, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 15% in 1985-87, was dependent to a very large extent on securities gains, irregular by nature. This recent ratio is almost certain to continue to decline, probably sharply, as it did in 1987. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to help much in the short term. The business acquisition game continues to be crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And future securities gains are likely to prove harder to come by for very simple reasons. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments then than now, and because prospects for above-average returns tend to go down as assets managed go up, it is now, early in 1988, even easier than it was early in 1986, to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing either (1) this virtual reprint of last year's letter or (2) Wesco's marketable securities disclosed herein, to diagnose (correctly) that the decision-makers are now even more dry of good ideas than they were two years earlier.

The considerable, and higher than desired, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action.

Moreover, our approach is being applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway, Wesco's parent corporation, has a larger proportion of its intrinsic value in durable high-return businesses.

Some historical explanation for the current situation becomes appropriate here. When Wesco's parent corporation acquired control, Wesco's activities were almost entirely limited to holding (1) some surplus cash, plus (2) a multi-branch savings and loan association which had many very long-term, fixed-rate mortgages, offset by interest-bearing demand deposits. The acquisition of this intrinsically disadvantageous position was unwisely made, alternative opportunities considered, because the acquirer was overly influenced by a price considered to be moderately below liquidating value. Under such circumstances, acquisitions have a way of producing, on average, for acquirers who are not quick-turn operators, low to moderate long-term results. This happens because any advantage from a starting "bargain" gets swamped by effects from change-resistant mediocrity in the purchased business. Such normal effects have not been completely avoided at Wesco, despite some successful activities, including recent investment in General Foods.

Over the long term, a corporation like Wesco, with no significant proportion of intrinsic value in great businesses, is like a tortoise in a race of hares. And, as noted above, this particular tortoise faces the race with an unoriginal and conservative approach.

However, there are respectable precedents for our approach. The novelist Hardy, who believed that the natural outcome of ambition was getting clobbered, advocated the logical preventative of aiming low. And people known for outcomes far too good to have been expected by Hardy have mined a branch of the same vein. Consider this statement from Newton: "If I have seen further than other men, it is by standing on the shoulders of giants". And this from Mozart (as approvingly quoted by the distinguished advertising creator, David Ogilvy): "I never tried to compose anything original in my life".

It is occasionally possible for a tortoise, content to assimilate proven insights of his best predecessors, to outrun hares which seek originality or don't wish to be left out of some crowd folly which ignores the best work of the past. This happens as the tortoise stumbles on some particularly effective way to apply the best previous work, or simply avoids standard calamities. Anyway, we hope so. And so should recent purchasers of Wesco stock who have not only bet on a tortoise but also, by paying prices in the mid forties, given odds.

On January 28, 1988, Wesco increased its regular quarterly dividend from 17½ cents per share to 18½ cents per share, payable March 15, 1988, to shareholders of record as of the close of business on February 26, 1988.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger

Charles T. Munger
Chairman of the Board

February 26, 1988

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# WESCO FINANCIAL CORPORATION

Annual Report 1988

Form 10-K Annual Report 1988

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1988 increased to $23,564,000 ($3.31 per share) from $16,612,000 ($2.33 per share) in the previous year.

Consolidated net income (i.e., after unusual operating losses and all net gains from sales of securities) increased to $30,089,000 ($4.22 per share) from $15,213,000 ($2.14 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1988 | | December 31, 1987 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income (loss) of: | | | | |
| Mutual Savings | $ 4,694 | $ .66 | $ 2,895 | $ .41 |
| Wesco-Financial Insurance business | 12,094 | 1.70 | 9,459 | 1.33 |
| Precision Steel's businesses | 3,167 | .44 | 2,450 | .34 |
| All other "normal" net operating income[2] | 3,609 | .51 | 1,808 | .25 |
| | 23,564 | 3.31 | 16,612 | 2.33 |
| Gain on sale of interest in Bowery Savings Bank | 4,836 | .68 | — | — |
| Net gains on sales of marketable securities | 1,689 | .23 | 1,208 | .17 |
| Writeoff by Mutual Savings of prepaid FSLIC insurance premiums[3] | — | — | (1,935) | (.27) |
| Flood loss at Precision Steel | — | — | (672) | (.09) |
| Wesco consolidated net income | $30,089 | $4.22 | $15,213 | $2.14 |

(1) All figures are net of income taxes.
(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.
(3) Necessitated by the Federal Home Loan Bank's elimination of the savings and loan industry's nearly $1-billion secondary insurance reserve, consisting of deposit insurance premiums prepaid to FSLIC, the U.S. agency which insures accounts in savings and loan associations.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

**Mutual Savings**

Mutual Savings' "normal" net operating income of $4,694,000 in 1988 represented an increase of 62% from the $2,895,000 figure the previous year.

The high percentage increase in 1988 was partly fluke. The interest rate curve happened to be precisely adapted to Mutual Savings' needs during most of the year, and already, in 1989, net interest margins are impaired as short-term rates and intermediate-term rates have become more or less identical.

Moreover, these "normal-income" figures come from a decidedly abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1987 and 1988 are set forth at the end of this annual report. They show (1) total savings accounts rising to $289 million from $287 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $137 million at the end of 1988, down slightly from $139 million at the end of 1987.

The loan portfolio at the end of 1988, although containing almost no risk of loss from defaults, bore an average interest rate of only 8.70%, probably near the lowest among U.S. savings and loan associations, but up moderately from 8.38% at the end of 1987. Because the loan portfolio is almost entirely made up of instruments of short maturity or bearing interest rates that adjust automatically with the market, there is now less unrealized depreciation in the loan portfolio than the net unrealized appreciation in Mutual Savings' interest-bearing securities and public utility preferred stocks. That appreciation at December 31, 1988 was about $7.5 million.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, this "spread" improved last year. Moreover, the disadvantage from inadequate "spread" has been reduced in each recent year by the effect of various forms of tax-advantaged investment, primarily preferred stock and municipal bonds. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock and municipal bonds, with their fixed yield and long life, will decline in value and not provide enough income to cover Mutual Savings' interest costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment is kept conservative, relative to the amount of its net worth.

Mutual Savings remains a "qualified thrift lender" under the federal regulatory definition requiring 60% of assets in various housing-related categories. It plans to continue keeping substantially all loans receivable either with short expected lives or with interest rates that fluctuate with the market. All new variable-rate loans are "capped" at the 25% per annum level, which is over ten percentage points higher than the normal 2½-points-over-market "cap" offered by competing associations. Naturally, to gain this extra protection from interest rate increase, Mutual Savings "pays" by (1) getting lower "spreads" over an interest rate index, and (2) not being able to make loans in amounts desired.

As pointed out in Note 10 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($49.7 million at December 31, 1988) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold for the $49.7 million reported as book value, the parent corporation would receive much less than $49.7 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

Mutual Savings has not only a buried value in unrealized appreciation of securities but also a buried value in real estate. The foreclosed property on hand (mostly 22 acres at or near the oceanfront in Santa Barbara) has become worth over a long holding period considerably more than its $5.4 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 13 years in the course of administration of land-use laws. But, miraculous to report, grading, street and public utilities work is now nearly finished, and significant other construction work is now under way on the property for an authorized development into 32 houses interspersed with large open areas. Mutual Savings plans to make the development first-rate in every respect, and unique in the quality of its landscaping.

The buried value in real estate is limited by the small number of houses allowed (32) and by the fact that only about half of such houses will have a significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, landscaping, and non-standardized, environmentally sensitive adaptation of housing to the site. Also, various charges and burdens, including heavy archaeological obligations imposed by governmental bodies, will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into the present era. We have "given" a very large fraction of the value of our land to the County of Santa Barbara in exchange for permission to use it at all. In California these days such results are common, particularly in coastal areas.

The savings and loan association described in the foregoing paragraphs, quite different from most other associations for a long time, added a significant new abnormality during 1988. Mutual Savings increased its position in preferred stock of Federal Home Loan Mortgage Corporation (widely known as "Freddie Mac") to 2,400,000 when-issued shares. This is 4% of the total shares outstanding, the legal limit for any one holder. As this letter is written, all of these 2,400,000 shares have been issued and paid for. Mutual Savings' average cost is $29.89 per share, compared to a price of $50.50 per share in trading on the New York Stock Exchange at the end of 1988. Thus, based on 1988 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $49.5 million. At current tax rates the potential after-tax profit is about $29.2 million, or $4.10 per Wesco share outstanding.

Freddie Mac is a hybrid, run by a federal agency (the Federal Home Loan Bank Board), but now owned privately, largely by institutional investors. Freddie Mac supports housing primarily by purchasing housing mortgage loans for immediate transmutation into mortgage-backed securities that it guarantees and promptly sells. In the process Freddie Mac earns fees and "spreads" while avoiding most interest-rate-change risk. This is a much better business than that carried on by most (or indeed most of the top 10% of) savings and loan associations, as demonstrated by Freddie Mac's remarkable percentage returns earned on equity capital in recent years.

At Freddie Mac's current dividend rate ($1.60 per annum per share), Mutual Savings' pre-tax yield is only 5.35% on its $29.89 average cost per share. Post-tax, the dividend yield is only 4.4%. But Freddie Mac has a very creditable history of raising its earnings and dividend rate, thus contributing to increases in the market price of its stock. The market price increases because Freddie Mac's "preferred" stock in substance is equivalent to common stock. Here are figures for 1985-1989:

| Year Ended 12/31: | Earnings per Share | Dividends per Share | Year-End Market Price per Share | Freddie Mac's Return Earned on all Average Equity |
|---|---|---|---|---|
| 1985 | $2.98 | $ .53 | $ 9.19 | 30.0% |
| 1986 | 3.72 | 1.13 | 15.17 | 28.5 |
| 1987 | 4.53 | 1.10 | 12.13 | 28.2 |
| 1988 | 5.73 | 1.25 | 50.50 | 27.5 |
| 1989 (announced) | ? | 1.60 | ? | ? |

The above numbers are unusually good for a stock selling at only $50.50 per share at the end of 1988. We think the probable cause of substandard investor response is some combination of (1) lack of familiarity with Freddie Mac among investors and (2) fear that the federal officials who control Freddie Mac will mismanage it or not deal fairly with Freddie Mac's private owners, perhaps under pressure from Congress.

There is, of course, some risk that Freddie Mac will ruin its remarkable business by ignoring fiduciary duties to new private owners, or reducing credit standards, or making bets on the future course of interest rates. But we consider such outcomes unlikely. The tendency to consider them likely rests largely in those who think ill of federal officials because of the dramatic, multi-billion-dollar insolvency of FSLIC (the U.S. agency which insures depositor accounts in savings and loan associations). This reaction is natural as it becomes ever more clear that the final FSLIC insolvency was augmented by regulatory failure to intervene early to solve easily diagnosed problems which were getting worse at a rapid rate.

But FSLIC and Freddie Mac are two separate entities, and the circumstances affecting the business of each are radically different. As the world changed, the troubles of FSLIC had roughly the following history and causes:

(1) In its early decades, the savings and loan industry lived under a system ordained by legislation in the 1930s. Interest rates paid by both banks and

associations were fixed by law at low levels, but with (i) a deposit-attracting advantage of ¼% more per annum which could be paid by associations and (ii) tax advantages for associations, compared with banks. The interest rate controls were created to dampen competition in an effort to prevent recurrence of the widespread failure of deposit-taking institutions which had followed the aggressive banking practices of the 1920s. In return for the cartel-like advantages granted and federal deposit insurance, associations were required to concentrate assets in home lending and to be conservative in risking losses from nonrepayment of loans. The standard practice of associations was then to borrow short (by taking demand deposits) and to lend long (by making long-term mortgage loans at fixed rates). Associations lived on an approximate two-percentage-point "spread" between the mortgage interest rate and the mandated low interest rate on deposits.

(2) This system always had a built-in risk that interest rates would generally and sharply rise, in which case the government would be forced to raise interest rates on deposits in order to enable associations to hold deposits. Then associations would be squeezed into losses because they were hooked by contract to fixed interest rates on old mortgages. But associations accommodated this risk, during periods of low inflation and slowly rising, government-fixed interest rates on deposits, by continuously "growing their way" out of profit-margin trouble. Associations simply "averaged up" the rate of interest on the whole mortgage portfolio by making ever larger amounts of new mortgage loans at higher interest rates. The necessary continuous growth, despite mandated low interest rates for savers, was made possible, of course, by the ¼% per annum deposit-attracting rate advantage possessed by associations. The system contained much wise and constructive cynicism, akin to that of the country's founding fathers. The system's creators wanted associations not to cause losses to FSLIC, the federal deposit-insurer, while helping the citizenry by favoring housing. So, knowing like Ben Franklin that "it is hard for an empty sack to stand upright," the creators simply gave associations significant competitive and tax advantages that made it easy for executives to do well while doing right. Also, because the creators admired "cooperative," workers'-self-help models and, looking back at the excesses of the 1920s, feared losses from capitalistic ambition more than they feared inefficiency from a more socialized process, all federally-chartered and most state-chartered associations were "mutual" institutions. Such institutions are "owned" by depositors and are therefore not capable of making any shareholder rich. In the early decades, this system, relying on carrot as well as stick, was, like the FHA, one of the most successful systems in U.S. history. It did a world of good at a trifling cost.

(3) Naturally, the few state-chartered, shareholder-owned associations (including Mutual Savings, which was "mutual" in name only) in due course became more aggressive than their "mutual" brethren and used their government-mandated competitive advantage to make their shareholders rich. This process was aided by their emphasizing high-yielding tract-housing loans in the

faster-growing parts of the country during a long boom. And envy plus logic then caused many "conversions" of formerly "mutual" associations to shareholder ownership, which, featuring different incentives, increased managements' proclivity to endure risk in the hope of above-normal reward. The heavy-risk-taking attitude finally spread throughout a large percentage of the savings and loan industry, including formerly conservative "mutual" institutions that remained "mutual" institutions.

(4) But, eventually, the tendencies of government to escalate currency debasement and of interest rates to rise sharply with sharp inflation combined to reduce the prosperity of the savings and loan industry, now structured more to produce extra profit when much went well than to prevent loss when much went wrong. As interest rates rose, even associations holding only high-grade, long-term, fixed-rate mortgages suffered large losses. Most gamier associations became hopelessly insolvent.

(5) In this new high-interest-rate environment, it proved impossible for most associations to "grow their way" out of trouble. Suddenly, the former bank and association duopoly faced new competition from "money market funds" that paid higher interest and also provided check-writing privileges, as well as from U.S. Treasury obligations that were more conveniently available. Not only could deposits not be increased; they could not be kept from shrinking.

(6) To prevent continuation of deposit outflows, which then tended to cripple housing, legislators decontrolled interest rates on all savings accounts. Next, after an irrational delay, the legislators allowed housing lending at interest rates that fluctuated with the market, a wise practice long standard in England. Even so, many associations remained insolvent "basket cases," because interest rates that had ratcheted upward on liabilities were matched against fixed and outdated rates on assets. Less impaired but still solvent associations had difficulty maintaining adequate equity capital without the "edge" possessed by the industry in its early years.

(7) In this period of trouble it also seemed logical to Congress and state legislatures, responding to non-apposite use of "free-market" labels and requests from savings and loan operators, to try to relieve the financial pressure by "helping" associations make more money. The method used was revision of investment rules for associations so that they could attempt to widen "spreads" by engaging in much more risky and difficult-to-manage deployments of assets that promised high yields if everything worked right. Deposit insurance was retained.

(8) But the coexistence of deposit insurance, liberalized asset deployment rules, and uncontrolled rates of interest which could be paid to savers had terrible consequences. The new system (despite minor impediments from some new anti-growth rules) enabled almost any association, even if small and remote and run by a crook or fool, to expand fast and almost without limit. When any association could use the government's credit and also promise to pay as high an interest rate as was required to bring in any desired amount of savings, the only

remaining limitation on size was the requirement that a small percentage of savings be matched with net worth. This was not much of a problem for growth-minded associations. The government, accommodatingly, *reduced* the percentage of net worth required. And when, after this help, growth was so great that more net worth was required to meet the relaxed general standard, such net worth could easily be provided, on paper, for a long time during expansion. After all, it is child's play to make any bank or savings and loan association report high profits for a while, thereby rapidly augmenting reported net worth, by making loans (or other asset deployments) providing both (i) high initial interest or profit accruals and (ii) probable high ultimate but delayed losses caused by the risks assumed. There are always real estate operators willing to sign any sort of promise or make any sort of projection in exchange for cash. The real estate crowd is notoriously optimistic and also includes a significant fraction of people like those who caused Mark Twain to define a mine as "a hole in the ground owned by a liar." Also, good short-term results are often available, in modern times, from merely committing money to sound borrowers for a very long time at a fixed rate, thus substituting lethal risk from interest rate change for lethal risk imposed by bad credit quality. Using one or more of the short-term, high-profit-reporting strategies, many minor associations soon grew to gargantuan size, often paying stockbrokers (and other brokers) commissions to bring in the massive amounts of deposits desired. The practice of using brokers to gain deposits had a high correlation with later insolvencies.

(9) The new system included a "runaway-feedback mode," exactly what every wise engineer or businessman learns to dread. It could and did entice into inappropriate conduct not only those always prone to bad behavior but also some associations that had formerly been admirable but were now suffering from bad luck. Once you were a loser and insolvent, for any reason, and very likely doomed, the system still granted you an opportunity to risk as much you wished of the government's money (your money was gone) in some massive gamble, on interest rates or business outcome, that had a chance of returning you to health. And, if the first gamble didn't work, you could always "double up." Such were the "parlay" possibilities for losers.

The losers' "parlays" were, quite predictably, made much quicker to arrange and much grander in scope by the availability of brokers who were paid to solicit government-insured deposits at above-normal interest rates (not a hard sale). The result was right out of *Alice in Wonderland*. For perhaps the first time in the history of regulation of deposit-taking institutions, the government (in the wry words of John Liscio of *Barron's*) was creating widespread "runs of money *into* small problem institutions and in the process turning them into big problem institutions."

For initial winners, shrewd or lucky in making risky investments, the "parlay" possibilities were immensely better. One instant-centimillionaire savings-and-loan family tried to gild the lily under such winning circumstances. The association involved proposed payment to a family executive of total compensation pushing $10 million per year. Then, after government regulators objected, the family satisfied itself with ordinary compensation (including bonus and special retirement contribution) of a mere $5 million or so. But the reduced ordinary compensation was supplemented by a lion's share of a huge new "incentive" to pay attention to business. Executives were granted rights to buy at attractive prices options or other securities of "junk bond" issuers which were available to the association at those attractive prices only in return for purchase of "junk bonds". ("Junk bonds" are bonds with high interest rates and grossly substandard credit backing that banks are pretty well forbidden to buy under their less permissive regulatory system. In recent years a large proportion of "junk bonds" were issued to help finance highly leveraged acquisitions and restructurings of corporations fearing or suffering from "raids" by hostile-takeover artists. Current practice is for deposit-insured banks to finance the most secured portion of massive corporate debt, which portion is maximized to a point which makes bank regulators sullen and fretful but not mutinous. Then some deposit-insured associations [and others] take loan positions so junior to many layers of senior debt [including but not limited to debt to banks] that language is strained when one calls them "loan positions." This anomaly in the total regulation of insured institutions is made possible [along with many other anomalies] by the division of total regulation into four systems [state and federal systems for both associations and banks] with some systems further subdivided to provide additional Balkanization.)

Such extraordinary success, in turn, had runaway-feedback possibilities of its own as examples of "parlayed" success became more widely known and envied, an enlightenment aided by brokers earning commissions or "spreads" by selling risky investments. In many cases, the end of the rapidly spreading winner's "parlay" game has not yet come. All we know is that the early phases look like many a speculative bubble which, in due course, was followed by a big bust.

There were other important consequences of the "parlay" games made possible by coexistence of decontrol and deposit insurance. The high interest rates promised by associations trying to "grow their way" out of trouble, or bent on instant-centimillionaire glory, tended to "bid up" the prices paid for savings by less ambitious associations in the would-be-conservative category. These institutions were therefore almost forced to consider high-rate, high-risk assets, so that they might have some chance of obtaining a moderate margin over costs. And thus was born the suggestion of a new sort of Gresham's law for deposit-insured, unlimited-interest-rate banking: "Bad lending drives out good."

The basic problem underlying this new form of Gresham's law may be impossible to solve, given the probable legislative premises that virtually unlimited deposit insurance, uncontrolled interest rates, wide discretion in deploying assets, and long grace periods when trouble comes, are each sacred. The problem is grounded deep in the nature of things, in the principle that in a complex system you can never "do merely one thing." When one variable is maximized other variables often get minimized in an undesired way. In this case, in making money ultra-easy for everyone to get and invest in any amount and way desired, thus maximizing the availability of investable money, Congress changed the savings and loan system in a way that made it harder for associations to reloan the money safely at interest rates that covered costs. Congress thus minimized the opportunities for earning profits safely. As Garrett Hardin, the biologist, (or perhaps George Stigler, the economist) might say: "How could it be otherwise?" At any rate, the result as we observe it seems to be, roughly, that every form of savings and loan operation that is safe and simple, so that ordinary executives can manage it, avoiding both all net interest-rate-change risk and all net credit risk, will provide no net profit. Therefore every association that wishes to continue to exist is forced either to be remarkably prescient or to endure some combination of net credit risk and net interest-rate-change risk. This, in turn, makes normal earnings at strong associations like those of an earthquake insurer in a year when there is no earthquake. (Remember, upward fluctuations in interest rates on modern home loans are typically "capped" a mere 2½ percentage points over the mortgage interest rate prevailing when the loans were made.) Also, weak associations, guided by the less able, less honest, or less lucky, after exhausting shareholders' equity, tend to cause big losses to the government agency which insures savings accounts. These losses may exceed resources provided by deposit-insurance premiums.

Indeed, a government agency that tries to depend on 100% of its thinly capitalized deposit-insurance patrons being of above-average ability in unrestricted asset management, unrestricted in scale, would be "bonkers" not to expect large insurance losses. The system we now have is not "free market" economics. It is non-economics.

[At this point it is logical to inquire: If the foregoing reasoning is correct, why doesn't it apply to banks and why is the FDIC, which insures bank deposits, now in so much better shape than FSLIC? We think the answers are (i) that the fundamental reasoning does apply to banks, and we note that irresponsible bank lending, bank losses and FDIC losses all escalated dramatically after the installation of unlimited interest rates in a banking system already containing deposit insurance, and (ii) that the FDIC losses are, so far, lower than FSLIC losses for reasons including the following:

(a) the profit-shortage pressure has been lower at banks because of favorable momentum effects from the past, particularly including the banks' long monopoly in checking accounts, difficulties faced by would-be new entrants into banking, and traditional bank avoidance, through continuous repricing of loans, of most risk from interest rate change; and

(b) there is much tougher regulation, including better domestic-asset-quality controls, under the bank regulatory apparatus.

The second factor is particularly important. Tougher regulation clearly limits damage to the deposit-insurer. Indeed, if the toughness of bank regulation could be doubled and redoubled, so that it closed banks summarily when liquidating value of equity was impaired but not exhausted, like the clearing system of a stock or commodity exchange, little would remain of expectancy of deposit-insurer loss from idiosyncratic high risk taking. It does not follow, however, that banks, even under such toughened regulation, would refrain from forms of high risk taking which became so conventional that trouble, if it came, would sink everyone at once. Under such circumstances, the regulated have a tendency to appraise regulatory threat as a paper tiger. Banking institutions (perhaps wisely) believe that the regulator which must close all banks will close none. Something like this has already occurred with respect to unwise foreign lending, where the regulatory response would, very likely, have been much tougher if only one big bank had been involved. Instead, with virtually all big banks threatened by huge holdings of dubious foreign loans, bank regulators are now much tougher on domestic loans worth 70¢ on the dollar than on foreign loans worth 40¢ on the dollar.]

(10) All of the foregoing happened to coincide with a general nationwide increase in wheeler-dealer activity, often with a fraud component. In this environment the new system attracted precisely the wrong sort of people into the savings and loan business as if designed for this purpose. It would have been hard to invent a system more irresponsible than the one that allowed any half-plausible group to control a savings and loan charter carrying the right to use the government's credit in the prompt attraction of multiple millions, or even billions. This was the financial equivalent of distributing free machine guns in cocaine alley, and many billions of dollars of fraud losses naturally followed.

(11) There also was a grand collapse in oil prices, creating the worst depression since the 1930s in oil-production-dependent areas, which caused many conservative home loans to go into default. Thus, FSLIC would have suffered large (but probably not lethal) losses even if inflation and legislators had never changed the savings and loan system.

(12) To be sure, even under the new system some possibilities remained for regulators or accountants to stop some FSLIC hemorrhages earlier than they actually did. But the accountants were selected and paid by the associations and had professional loyalties to clients as well as concepts. They were understandably loath to enforce death sentences until the negative aspects of complex situations became abundantly clear. And the regulators were overwhelmed by horror cases, being suddenly given the working conditions and triage problems of a M.A.S.H. unit, while receiving modest salaries. Moreover, the medical analogy fits when stretched further. FSLIC was not allowed by Congress to take much appropriate early corrective action. Just like certain savings and loan managements, Congress did not want to face the consequences — for instance, increased taxes — of honest bookkeeping and rational action. Indeed, many legislators intervened directly with the Federal Home Loan Bank system to protect particular fools or crooks, or merely unlucky savings and loan operators, from unpleasant consequences of insolvency. Thus FSLIC was not only like a doctor working under M.A.S.H.-unit conditions but also like such a doctor

forbidden to cause new pain, however brief, or make any blood transfusions (as distinguished from promises regarding future blood transfusions).

(13) The final result for FSLIC could easily be a loss of over $100 billion in a continuously unfolding financial mess that is among the greatest in U.S. history. Even some recently "rescued" associations, with new owners, are likely to cause new FSLIC losses at some later time — losses caused by the speculative temperaments of new managements attracted by loose asset-deployment rules.

While the Federal Home Loan Bank Board failed to prevent the insolvency of FSLIC, that insolvency was probably unpreventable, given its macroeconomic origin and subsequent conduct of legislators. FSLIC's "rescues," although imperfect, were probably as wise as could be expected under M.A.S.H.-unit conditions with no new blood available. There is an O. Henry short story in which God treats as a false arrest the bringing before Him of a miscreant young woman and sends the Heavenly Policeman back to bring in the real culprit, the neglectful father who raised her wrong. So also with the FSLIC mess. The important miscreants are not the crooks and fools who are always with us or the overburdened industry regulators. The real culprits are the ignorant, self-absorbed industry executives and state and federal legislators who should have known better than to let the system be crafted as it was. They also should have acted earlier to correct obvious errors, instead of becoming accessories after the fact.

In retrospect, it is clear that some of the very worst behavior of all, in the years when the FSLIC mess was created, was that of the United States League of Savings Institutions. The League combined a blind loyalty to silly ideas with a blind loyalty to member associations — a loyalty which usually treated the admirable and the despicable as if they were just the same. Acting with such "loyalty to a fault", the League was an effective foe of proper regulatory and legislative response. We are ashamed to report that during the whole period Mutual Savings paid its League dues promptly and voiced little objection to League conduct. This paragraph is a minor effort at atonement.

By silence we acquiesced wrongly as the League took antisocial positions which it incorrectly believed consistent with the long-term interest of the savings and loan industry. Our future behavior will be a little better: If the League does not act more responsibly in the future, Mutual Savings will resign.

It does not follow, we think, from FSLIC's troubles that federal controllers are likely to ruin Freddie Mac. FSLIC was very sick from causes outside the regulators' control, whereas Freddie Mac is flourishing. And Congress, better later than never, is now plainly chary of further loosening, and in fact desires to tighten, asset quality standards in the savings and loan industry and its regulatory apparatus.

Freddie Mac is now regarded in the mortgage, mortgage-securities and debt-issuing markets as a virtually risk-free government agency, even though its obligations are not technically backed by the full faith and credit of the United States. With this enormous advantage, Freddie Mac's controllers can almost always get socially constructive and financially rewarding results, provided they refrain from taking significant risk of ruining Freddie Mac's credit. The annual dividend to private owners is peanuts, a small fraction of 1%, compared to the financing Freddie Mac provides to buyers of housing. The need for the dividend's safety and growth disciplines the system in exactly the right way. There is no reason to change course. Moreover, the right course, involving continued tough credit standards, has been clearly demonstrated by the recent terrible home loan experience in oil-production-dependent areas. Conventionally-sound home loans then went sour in massive quantities, despite having been made by wise and honorable lenders to home buyers with good jobs and loan-payment histories who made substantial down payments. Such experience reinforces the margin-of-safety principle required of highly leveraged institutions that guarantee credit. Just as bank credit standards remained sound for a long time after the horrors of the 1930s, home lending standards enforced by Freddie Mac may remain sound for a long time after the good-home-loan losses of the 1980s. If so, and if interest-rate-change risk is scrupulously minimized, Freddie Mac stock could be a good long-term investment for Mutual Savings.

Our discussion of reasoning regarding investment in Freddie Mac is an anomaly within the Berkshire Hathaway group. Normally, we do not disclose such reasoning. We fear bad effects on future investment buying or investment selling. (We also avoid display of our frequent mental inadequacies, but that is not the reason for the policy.) We depart from usual practice only because we have acquired a full investment position and we do not anticipate an increase in the legal limit which prevents us from buying more stock of Freddie Mac. Under these conditions, we are all for disclosure. But we are *not* recommending that Wesco shareholders purchase Freddie Mac stock. We never want to encourage Wesco shareholders to copy Wesco investments in their own personal accounts.

The first attempt at resolution by the federal government of the FSLIC insolvency will be made when new laws are enacted in 1989. The new laws will probably contain a combination of elements selected from the following list:

(1) sharp increase in deposit-insurance premiums payable to FSLIC;

(2) higher equity capital requirements for associations, with no credit for intangibles, and with prompt asset reduction required when the equity-capital minimum is breached;

(3) drastic reduction in investment powers to limit risky assets (including "junk bonds"), plus close monitoring of risk-prone associations;

(4) strict limits on annual growth of savings deposits;

(5) bans on use of brokers to bring in deposits;

(6) tougher accounting standards, including more bans on "front-ending" into reported income of fees paid in exchange for long-term commitments;

(7) tougher, more summary close-out procedures for associations, including those that are impaired but not insolvent;

(8) more insulation of regulation and close-out cases from interference by individual members of Congress;

(9) changes in control of regulation within the federal bureaucracy, aimed at toughening of regulatory practice, including more concentration of resources on obvious high-risk cases;

(10) a moratorium on approvals of new savings and loan charters; and

(11) more override of state law by federal law.

All the foregoing, except sharply higher deposit-insurance premiums, would clearly tend to reduce future FSLIC losses and should, as a minimum, be included in any half-sensible 1989 attempt to fix FSLIC. Payment to FSLIC of sharply higher deposit-insurance premiums would provide mixed results. On the one hand, FSLIC would get new revenue to help discharge liability from foolish insurance practices in the past. On the other hand, it is not clear how much net new revenue would be available. Sharply higher deposit-insurance premiums would also increase future FSLIC losses by increasing pressure on associations to acquire higher-risk assets promising the higher yields necessary to cover higher premiums. If deposit-insurance premiums are increased by ¼% per annum on total liabilities (which could happen) it will sound trifling and not very threatening to solvency. But associations' net worth, where it exists, is not owned by the government and may be withdrawn by its owners from the savings and loan industry. And, ignoring revenue from assets matching net worth, many associations now look at net profits vs. total liabilities at the rate of ¼% per annum as an unattainable dream. After all, the associations face aggressive competing institutions which either have lower costs, like money-market funds (which do not pay deposit-insurance premiums), or have more experience in maximizing safe yields, like banks. Starting from this not-so-hot competitive position and seeking not-so-obvious ways to stretch yields by ¼% per annum, many associations would, almost surely, be pressed into significant incremental losses. Others would quit the savings and loan business because of below-market returns being earned on shareholders' equity, and any equity capital withdrawn from the system would no longer "buffer" FSLIC against losses.

The would-be FSLIC fixers, as they set increased deposit-insurance premiums, will face the same basic question faced by a keeper of sheep. But, unlike the sheepkeeper, the government lacks knowledge to guide prediction of the point at which additional closeness of shearing will be contrary to the interests of the shearer. This leaves an important question: When you don't know for sure what the sheep can stand, how much safety margin do you leave before you set the shears, shear the whole herd, and send it forth to fare as it will?

The politics of the current scene seem to us to create more wishful thinking than sound thinking. We do not believe that the legislation adopted in 1989 will be likely to prevent recurrence of big trouble at FSLIC.

First, consider again the record of our modern legislators, the would-be FSLIC fixers. They started with a system designed to limit association insolvencies by both:

(1) protecting associations from full competition (a brutal force in a fungible commodity business, with money being the ultimate fungible commodity) and full taxes; and

(2) requiring associations to deploy assets in a very low-risk way.

Despite noting that this combination of carrot and stick kept the donkey under reasonable control for a long time, as it was designed to do after the insolvencies which followed excesses in the 1920s, the modern legislators actually removed the stick from the loss-control system in an attempt to compensate for the loss of the carrot. They also neglected, for a considerable period after interest rates of liabilities were unleashed, the obvious need to allow floating interest rates on home loan assets. And they acted, while they did this, as if they preferred to entice new thieves and megalomaniacs into coverage by federal deposit insurance and also to expand, as fast as possible, the operations of thieves and megalomaniacs already insured. Then, as FSLIC losses mounted, $10 billion or so at a time, the legislators delayed, and delayed, while going along with almost every form of foolish, paper-it-over expediency. And now, finally, we hear many cries for scapegoats in the "any one but me" category. We hear almost no cries for re-examination of assumptions (including re-examination in the form of (i) study of savings and loan systems which have worked better, like England's and (ii) consideration of alternatives such as forcing the private pension system, a huge savings pool which still possesses the carrot of tax exemption and can better bear interest rate crunches, to commit a share of assets to home loans, instead of high-turnover stock trading and the super-leveraging of corporate America, and (iii) consideration of other more extreme alternatives which fit modern facts). Instead, the first proposal, meeting tacit acceptance, is that any federal fix must qualify for mickey-mouse, off-budget accounting which will increase ultimate federal cost. This is not a fixing record which creates confidence in the fixers.

Second, consider the difficulty of the problem faced. As suggested earlier, that problem may well be a "lalapaloosa" which would not yield to the efforts of fixers much better than those we have. When you mix certain elements in a certain way you get sulfuric acid, wish it or not, and there are similar "impotency principles" in microeconomic systems. Under modern conditions it is quite conceivably impossible to create a deposit-insured savings and loan system, successful over the long term, which includes all the elements (for instance "capped" interest rates for borrowers in long-term loans) that a politically sensitive body will want to preserve. Thus the legislative fix attempted in 1989 may be only a more sophisticated version of the attempt of the rustic legislator, aiming at facilitation of education, who proposed a law rounding Pi to an even three. The derision of this example is aimed not so much at our legislators as at the normal working of the human mind. In the presence of complexity the ability to unlearn a once-successful idea is seldom found. Max Planck, the Nobel laureate, noted that even in physics, wherein the ablest of mankind are sworn as their highest duty to improve ideas to fit facts, you never really changed the minds of most of the old professors. Instead, the wide acceptance of correct new ideas had to wait for new professors who had less to unlearn.

Our views are that the problem faced is hard and that everyone has "unlearning difficulty." These views, of course, may have been shaped by our own thinking record. If the problem is not difficult, and if unlearning is easy, we would have difficulty excusing ourselves for the clobbering Mutual Savings took from interest rate change in the early 1980s.

If our predictions are right, Wesco shareholders can pretty well count on Mutual Savings being harmed not only in 1989 but also at a second and later time. In each case we will face both new deposit-insurance costs and reductions of investment powers caused by insolvencies of a type Mutual Savings never got near.

As legislative changes are made Mutual Savings is likely to be hurt by all three of the following:

(1) wise changes in laws;

(2) unwise changes caused by the problems being more difficult than contentious legislative bodies are able or willing to think through; and

(3) unwise changes caused by vindictive legislative reaction to the size of the mess.

We fear changes in the last category because we so often see verifications of the iron prediction (roughly recalled) of the Victorian prime minister: "Those who will not face improvements because they are changes will face changes that are not improvements."

At least as we operate it, Mutual Savings, ex its investment in Freddie Mac, continues to have mediocre long-term prospects.

**Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $3,167,000 to normal net operating income in 1988, up 29% compared with $2,450,000 in 1987. The increase in 1988 profit occurred in spite of a small decline in pounds of product sold. Revenues were up 14% to $62,694,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1988 continued to provide an extraordinary return.

The good financial results have an underlying reason, although not one strong enough to cause the results achieved in the absence of superb management. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago (for instance, Los Angeles) seek out Precision Steel's service.

It is not common that steel warehouses have results like Precision Steel's, even in a generally good year like 1988. What we have watched under David Hillstrom's leadership is boring, repetitive excellence, year after year. We love to see it and to be associated with him.

**Wesco-Financial Insurance Company**

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $45 million was invested in 1986 and 1987.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1988 exceeded $62 million.

Wes-FIC in 1988 began to write direct business, as distinguished from reinsurance. It is now licensed in Nebraska, Utah and Iowa, but it wrote only $412,000 in direct premiums, all surplus lines coverage (permitted for non-admitted insurers) in Alabama. Earned direct premiums were $108,000.

Wes-FIC's "normal" net income for 1988 was $12,094,000, versus $9,459,000 for 1987. The net "normal" income figures excluded securities gains, net of income taxes, of $6,071,000 (including $4,836,000 realized on sale of Wes-FIC's 9% equity interest in Bowery Savings Bank) in 1988, compared with only $9,000 in securities gains in 1987. These items are reported as "Net Gains on Sales of Securities," below. Wes-FIC's net income benefitted by about $260,000 in 1988, versus $1 million in 1987, because of an unusual adjustment to its income tax provision caused by the Tax Reform Act of 1986.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicality of its business.

Wesco continues to expect a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract. However, the Fireman's Fund contract ends with August in 1989, which will leave Wes-FIC with a "longage" of capital and a shortage of good insurance business. This is not a desired position, but there are worse ones.

**All Other "Normal" Net Operating Income**

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to $3,609,000 in 1988 from $1,808,000 in 1987. Sources were (1) rents ($2,436,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level.

**Net Gains On Sales Of Securities**

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $6,525,000 in 1988 from $1,208,000 in 1987. As noted above, $6,071,000 of these gains were realized in the Wes-FIC insurance subsidiary.

**Salomon Inc**

On October 1, 1987 Wesco and certain of its wholly owned subsidiaries purchased 100,000 newly issued shares of Series A Cumulative Convertible Preferred Stock, without par value, of Salomon Inc ("Salomon"), at a cost of $100 million. Salomon's primary business is transacted by its subsidiary, Salomon Brothers, a leading securities firm. Our investment was part of a $700 million transaction in which other subsidiaries of Berkshire Hathaway Inc., Wesco's parent, invested $600 million. Principal terms of the transaction included the following: (1) the preferred stock pays dividends at the annual rate of 9%; (2) each preferred share, purchased at a cost of $1,000, will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at $1,000 per share plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

At the stated conversion price of the preferred stock, a profit (subject to certain procedural requirements) will be realizable whenever, after October 31, 1990, the common stock of Salomon (listed NYSE) trades at over $38 per share. At the time of our commitment to buy the new preferred, the common stock of Salomon was selling in the low 30s. However, shortly after the ink dried on Wesco's new stock certificates, the October 19, 1987 "Black Monday" stock market crash occurred, which caused temporary but substantial operating losses plus a lowered credit rating at Salomon. Although Salomon, among securities firms, suffered only its rough share of the general debacle, its common stock at one time after the crash traded as low as $16⅝.

By the end of 1988 Salomon common stock was trading at $24⅛ after much constructive adjustment of Salomon's business to new conditions.

Salomon's credit as a potential source of preferred dividends and stock redemptions improved during its 1988 recovery, when generally available dividend rates on preferred stock were roughly stable. With Wesco's preferred stock now one year shorter in contractual duration, and its conversion privilege enhanced in value during the year, we believe that the fair market value of Wesco's investment was somewhat in excess of its cost, and that the aggregate amount of any such excess was not material to Wesco, at December 31, 1988.

Berkshire Hathaway's Chairman, Warren Buffett, and the undersigned joined the board of Salomon on October 28, 1987, and are very pleased with the new association.

**New Subsidiary**

At the close of 1988, Wesco acquired 80% of the stock of New America Electrical Corporation ("New America Electric") for a price of $8,200,000. Of this price $7,165,000 was cash paid to a liquidating trust for the former shareholders of New America Fund and $1,035,000 was a ten-year, 10% note payable to Glen Mitchel, CEO of New America Electric, who retains the 20% of New America Electric not acquired by Wesco. The pattern of this acquisition is getting to be a common one within the Berkshire Hathaway group, where we are willing to be an 80% owner in many a business we would not be in if we did not admire and trust people who retain the other 20% and are expected to continue to operate the business, with little help and no hindrance from us.

Glen Mitchel is a long-time friend and trusted and admired business associate of the undersigned, Wesco's CEO. Indeed, because Wesco's CEO and his family owned more of New America Electric than Wesco, our whole transaction was approved by the Wesco board with the recommendation and participation of Warren Buffett, CEO and major shareholder of Berkshire Hathaway Inc., Wesco's parent company. Mr. Buffett had no financial interest in New America Electric, and he, plus Messrs. Munger and Mitchel, all believed that $10,250,000 was a fair valuation for 100% of New America Electric at yearend 1988.

New America Electric is a manufacturer of various electrical products including switchgear, circuit breakers, lighting ballasts and starters and electrical equipment for marinas and mobile home and recreational vehicle parks. Its facilities are in Orange County, California.

New America Electric has a present book net worth of about $6,400,000, including over $2,500,000 in cash, and a long history of earning high returns on capital, but with current earnings reduced by conditions approaching those of severe price war. Fortunately, New America Electric is a very low-cost producer. Its size is not material (in accounting parlance) to Wesco; so we have not yet determined future reporting practice. At a minimum, essential information will be discussed each year in the Annual Report's Letter to Shareholders.

This acquisition became available to Wesco because Glen Mitchel preferred minority (20%) ownership of a Berkshire Hathaway group subsidiary instead of dominant 30% ownership in New America Electric, with all other New America Electric stock pretty well scattered through a new public offering, which was the alternative offered. We will try to deserve Glen Mitchel's confidence.

## Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1988 by about $54 million, up significantly from about $6 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $62 million. As earlier noted, about $57 million of this unrealized appreciation lies within the savings and loan subsidiary, and includes $49.5 million of appreciation in stock of Freddie Mac.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($4,751,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($2,937,000) in Wesco's balance sheet at December 31, 1988, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are seldom present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 10% in 1986-88, was dependent to a significant extent on securities gains, irregular by nature.

The considerable, and higher than desired, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric. Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action.

Moreover, our approach continues to be applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway Inc., Wesco's parent corporation, has a larger proportion of its intrinsic value in durable high-return businesses.

Some historical explanation for the current situation should be repeated here. When Wesco's parent corporation acquired control, Wesco's activities were almost entirely limited to holding (1) some surplus cash, plus (2) a multi-branch savings and loan association which had many very long-term, fixed-rate mortgages, offset by interest-bearing demand deposits. The acquisition of this intrinsically disadvantageous position was unwisely made, alternative opportunities considered, because the acquirer (including the signer of this letter) was overly influenced by a price considered to be moderately below liquidating value. Under such circumstances, acquisitions have a way of producing, on average, for acquirers who are not quick-turn operators, low to moderate long-term results. This happens because any advantage from a starting "bargain" gets swamped by effects from change-resistant mediocrity in the purchased business. Such normal effects have not been completely avoided at Wesco, despite some successful activities, including a large gain in 1985 from an investment in General Foods.

A corporation like Wesco, with no significant proportion of intrinsic value in great businesses, continues to be like a tortoise in a race of hares. And, as we have plainly demonstrated, this particular tortoise is not very sprightly.

On January 26, 1989, Wesco increased its regular quarterly dividend from 18½ cents per share to 19½ cents per share, payable March 7, 1989, to shareholders of record as of the close of business on February 10, 1989.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T Munger

Charles T. Munger
Chairman of the Board

February 24, 1989

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# WESCO FINANCIAL CORPORATION

Annual Report 1989

Form 10-K Annual Report 1989

The 1989 Annual Report of Wesco Financial Corporation included the following letter to Wesco stockholders from the Chairman of the Company.

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1989 increased to $24,414,000 ($3.43 per share) from $23,564,000 ($3.31 per share) in the previous year.

Consolidated net income (i.e., after unusual operating items and all net gains from sales of securities) increased to $30,334,000 ($4.26 per share) from $30,089,000 ($4.22 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1989 | | December 31, 1988 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income of: | | | | |
| Mutual Savings | $ 4,191 | $ .59 | $ 4,694 | $ .66 |
| Wesco-Financial Insurance business | 14,276 | 2.00 | 12,094 | 1.70 |
| Precision Steel's businesses | 2,769 | .39 | 3,167 | .44 |
| All other "normal" net operating income[2] | 3,178 | .45 | 3,609 | .51 |
| | 24,414 | 3.43 | 23,564 | 3.31 |
| Gain on sale of interest in Bowery Savings Bank | — | — | 4,836 | .68 |
| Net gains on sales of marketable securities | 5,920 | .83 | 1,689 | .23 |
| Wesco consolidated net income | $30,334 | $4.26 | $30,089 | $4.22 |

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

**Mutual Savings**

Mutual Savings' "normal" net operating income of $4,191,000 in 1989 represented a decrease of 11% from the $4,694,000 figure the previous year.

The decrease in 1989 was primarily attributable to a less favorable interest rate "spread" as cost of holding savings increased more than yield on loans and investments.

As usual, these "normal-income" figures come from a decidedly abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1988 and 1989 are set forth at the end of this annual report. They show (1) total savings accounts rising to $293 million from $289 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $154 million at the end of 1989, up slightly from $137 million at the end of 1988.

The loan portfolio at the end of 1989, although containing almost no risk of loss from defaults, bore an average interest rate of only 9.23%, probably near the lowest among U.S. savings and loan associations, but up moderately from 8.70% at the end of 1988. Because the loan portfolio is almost entirely made up of instruments of short maturity or bearing interest rates that adjust automatically with the market, there is now much less unrealized depreciation in the loan portfolio than the net unrealized appreciation in Mutual Savings' interest-bearing securities and public utility preferred stocks. That appreciation at December 31, 1989 was about $11.3 million.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, this "spread" improved again last year. Moreover, the disadvantage from inadequate "spread" has been reduced in each recent year by the effect of various forms of tax-advantaged investment, primarily preferred stock and municipal bonds. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock and municipal bonds, with their fixed yield and long life, will decline in value and not provide enough income to cover Mutual Savings' interest and other costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment has been kept conservative, relative to the amount of its net worth.

Mutual Savings remains a "qualified thrift lender" under the old federal regulatory definition (which ends June 30, 1991) requiring 60% of assets in various housing-related categories. It plans to continue keeping substantially all loans receivable either with short expected lives or with interest rates that fluctuate with the market. All new variable-rate loans are "capped" at the 25% per annum level, which is over ten percentage points higher than the common 2½-points-over-market "cap" offered by competing associations. Naturally, to gain this extra protection from interest rate increase, Mutual Savings "pays" by (1) getting lower "spreads" over an interest rate index, and (2) not being able to make loans in amounts desired.

As pointed out in Note 10 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($48.9 million at December 31, 1989) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold for the $48.9 million reported as book value, the parent corporation would receive much less than $48.9 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

Mutual Savings has not only a buried value in unrealized appreciation of securities but also a buried value in real estate. The foreclosed property on hand (mostly 22 acres at or near the oceanfront in Santa Barbara, acquired in 1966) has become worth over a long holding period considerably more than its $8.4 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 14 years in the course of administration of land-use laws. But, miraculous to report, eight houses, plus recreation facilities, are in various stages of completion on the property as part of an authorized development into 32 houses interspersed with large open areas. Mutual Savings plans to make the development first-rate in every respect, and unique in the quality of its landscaping.

The buried value in real estate is limited by the small number of houses allowed (32) and by the fact that only about half of such houses will have a significant ocean view. Additional limitation will come from high cost of private streets, sewage and utility improvements and connections, landscaping, and non-standardized, environmentally sensitive adaptation of housing to the site. Also, various charges and burdens, including heavy archaeological obligations imposed by governmental bodies, will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into the present era. We have "given" a very large fraction of the value of our land to the County of Santa Barbara in exchange for permission to use it at all.

The savings and loan association described in the foregoing paragraphs, quite different from most other associations for a long time, added a significant new abnormality during 1988. Mutual Savings increased its position in stock of Federal Home Loan Mortgage Corporation (widely known as "Freddie Mac") to 2,400,000 shares. This is 4% of the total shares outstanding, the legal limit for any one holder at the time the shares were purchased. Mutual Savings' average cost is $29.89 per share, compared to a price of $67.12 per share in trading on the New York Stock Exchange at the end of 1989. Thus, based on 1989 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $89.4 million. At current tax rates the potential after-tax profit is about $52.6 million, or $7.39 per Wesco share outstanding.

Freddie Mac, formerly created and long run by a federal agency (the Federal Home Loan Bank Board), is now owned privately, largely by institutional investors and is now governed by an independent board of directors. Freddie Mac supports housing primarily by purchasing housing mortgage loans for immediate transmutation into mortgage-backed securities that it guarantees and promptly sells. In the process Freddie Mac earns fees and "spreads" while avoiding most interest-rate-change risk. This is a much better business than that carried on by most (or indeed most of the top 10% of) savings and loan associations, as demonstrated by Freddie Mac's high percentage returns earned on equity capital in recent years. One ironic cause of the high returns is that this creation of federal regulators pays no deposit-insurance premiums as it replaces much of the former function of the savings and loan industry.

At Freddie Mac's current dividend rate ($1.60 per annum per share), Mutual Savings' pre-tax yield is only 5.35% on its $29.89 average cost per share. Post-tax, the dividend yield is only 4.4%, but this amounts to about 75% of the current after-tax yield from very high grade mortgages. Moreover, Freddie Mac has a very creditable history of avoiding significant loan losses and increasing its earnings and dividend rate, thus contributing to increases in the market price of its stock. Following are figures for 1985-1989:

| Year Ended 12/31: | Earnings per Share | Dividends per Share | Year-End Market Price per Share | Freddie Mac's Return Earned on all Average Equity |
|---|---|---|---|---|
| 1985 .................................... | $2.98 | $ .53 | $ 9.19 | 30.0% |
| 1986 .................................... | 3.72 | 1.13 | 15.17 | 28.5 |
| 1987 .................................... | 4.53 | 1.10 | 12.12 | 28.2 |
| 1988 .................................... | 5.73 | 1.25 | 50.50 | 27.5 |
| 1989 .................................... | 6.57 | 1.60 | 67.12 | 25.0 |

When Wesco's annual report went to press last year, Congress was midcourse in considering revisions to the savings and loan laws. But it was clear that associations were shortly to be "re-regulated" into some mode less likely to cause a fresh torrent of deposit-insurance losses, borne by taxpayers. Provoking that legislative action was a previous torrent of losses which now seems likely to exceed $150 billion. These losses were caused by a combination of (1) competitive pressure on the "spread" between interest paid and interest received put on associations and banks when federal deposit insurance is provided to entities free to pay any interest rates they wish in order to attract deposits, (2) loose asset deployment rules for associations, (3) admission and retention of crooks and fools as managers of associations without regulatory objection, (4) general real estate calamities in certain big regions, and (5) continuous irresponsible protection and enhancement of unsoundness by the savings and loan lobby and certain members of Congress beholden to the most despicable savings and loan operators.

The new laws, under the acronym FIRREA, were composed and enacted with a speed caused by congressional indignation. (A recent example of such indignation, employing remarkable comparisons, is provided by the words of Congressman Jim Leach: "[If certain allegations are true] Charles Keating is a financiopath of obscene proportions — the Reverend Jim Bakker of American commerce, given a license to steal by a bank board headed by the Neville Chamberlain of regulation — a cheerleader who saw little evil and thus spoke little truth.")

Mutual Savings modestly contributed to tough legislative action by resigning from the U.S. League of Savings Institutions, using a letter of resignation which drew widespread media attention despite its understated criticism. A copy of this letter of resignation is appended at the end of this letter to shareholders.

Mutual Savings, desiring to act responsibly, supported virtually all the law revisions made by FIRREA, even though many of them will hurt Mutual Savings' profits.

For example:

(1) In stages, by July 1, 1994, Mutual Savings (and its service corporation subsidiary) must dispose of:

 (a) High-quality public utility preferred stocks, having tax-advantaged dividend rates averaging about 10.8% per annum, with a carrying value of $41.4 million at yearend 1989, and a market value then higher by about $8.7 million; and

 (b) High-quality convertible preferred stock of Salomon Inc, bearing a tax-advantaged dividend rate of 9% per annum, with a carrying value of $26 million, believed to be below the amount which could be realized in the event of sale.

(2) In stages, by the same date, July 1, 1994, Mutual Savings must write down to zero, in computing net worth for regulatory purposes, its 2,400,000 shares of Freddie Mac, which

had a carrying value of $71.7 million at yearend 1989, and, as reported above, a market value then higher by about $89.4 million.

(3) All new asset commitments, fitting Mutual Savings' proclivities and tax position, are pretty well restricted to (a) housing loans (including indirect loans in the form of mortgage-backed securities) and (b) debt instruments of the U.S. Government or its agencies.

(4) In stages, designed to create compliance during a two-year period commencing July 1, 1991, Mutual Savings will have to increase "qualified thrift lender" assets by 10 percentage points to a 70%-of-assets level, using a new and more limited definition of such "qualified thrift lender" assets which, to our surprise, does not include Freddie Mac stock. If the new test had been in full effect at December 31, 1989, Mutual Savings would have complied by disposing of about $74 million of non-home-loan assets (including some cash equivalents) and placing the proceeds in home loans (including indirect home loans in the form of short-term mortgage-backed securities).

(5) Deposit-insurance premiums have been increased. Short term, Mutual Savings is protected by credits of a nonrecurring nature. But by the mid 1990s the new premium rates will reduce Mutual Savings' annual earning power by about $200,000 from the level which would have occurred if it were still paying at the 0.083%-of-deposits rate which was in effect for years, instead of the new rate of 0.23%. The adverse effect of the higher deposit insurance costs on percentage return on shareholders' equity is much lower at Mutual Savings than at almost all other associations, which suffer substantially. The cause of Mutual Savings' advantage is its much larger percentage of equity, compared to deposits. This is a "one-time" advantage related to one ratio; on an incremental dollar of savings Mutual Savings faces the same damage as everyone else.

These combined effects will reduce Mutual Savings' normal earning power. While conservatively operated, Mutual Savings has been scrambling through recent years in its own way, obtaining a modest success made possible largely by the wide variety of asset-deployment options available under pre-FIRREA law. Consequently, FIRREA will adversely affect Mutual Savings, however wise the new restrictions, public needs considered. Nevertheless, it is probable that Mutual Savings' normal earning power will not be much reduced in 1990 and 1991.

We predict this deferment of decline in normal earnings because:

(1) FIRREA's asset-mix effects are phased in, subject to wide regulatory discretion; and

(2) We anticipate that regulators will be wise enough to exercise their discretion to allow extra-strong associations, with easy-to-sell assets, the same forbearance which will be granted to weak associations with hard-to-sell assets.

If we prove wrong in our prediction about regulators, Mutual Savings' wisest alternative will probably be withdrawal from the savings and loan business and the related obligation to pay deposit-insurance premiums.

If, as seems likely, Mutual Savings stays in the savings and loan business, it will retain a business even more mediocre than before, with only two interesting near-term prospects:

(1) During the next few years, Mutual Savings is almost certain to make a pre-tax profit of a nonrecurring nature as it disposes of the Santa Barbara property it acquired through foreclosure in 1966; and

(2) Mutual Savings will retain prospects for gain from its Freddie Mac stock if, as anticipated, Freddie Mac pays ever-higher dividends and the price of the stock also rises.

Long term, Mutual Savings hopes to find within the savings and loan business some constructive, continuing role which is not dependent on either of the foregoing anticipated near-term prospects. Until the right long-term role is found, our policy is simply to "stagger through."

The FIRREA law revision, while greatly improving the savings and loan system from the taxpayers' point of view, took an approach which can fairly be described as "all stick and no carrot." This is no way to create felicity for the donkey, but we deserve our share of the beating because we were previously so passive in the presence of obvious error and evil. Moreover, the safety-enhancing features of the law revision fell short in one fundamental respect which leaves profits under pressure: banks and associations remain free, within wide limits, to attract government-insured deposits at any interest rate they wish, while they must resell the ultimate fungible commodity, the use of money, into a brutally competitive market. The resulting squeeze on interest-rate "spread" safely attainable, combined with normal competitive disadvantages of associations, leaves the average well-run association with a likely future which should not excite its owners.

The normal competitive disadvantages of the average association, compared with the average bank, now include the following: higher deposit-insurance costs, more confusing new regulation, and less experience and momentum in various important remunerative activities. As a result, even a superbly run conventional association, like the one owned by H. F. Ahmanson & Co., sells in the stock market at a much lower price-to-book-value ratio than a superbly run bank. And the average savings and loan branch office probably now offers more incremental value to an experienced bank than it provides to its present owner.

Moreover, the average association does not now compete only with banks. Also gathering "deposits" are the money-market funds which:

(1) pay no deposit-insurance premiums, saving 0.23% of deposits each year, compared to associations;

(2) are required to employ exactly no capital from profit-earning proprietors ("management companies" in fund parlance), while capital requirements for associations have been raised;

(3) have lower-cost regulation (from an understaffed SEC) than associations;

(4) maintain no expensive branch offices, although they provide check-writing privileges and accept frequent deposits, using fast, low-cost systems which are better adapted in many ways to the new order than the systems of the average association; and,

(5) as a result of all the foregoing advantages, have total annual costs (before proprietors' profits), as a percentage of assets, which are more than 50% lower than annual costs of the most efficient association.

Thus, the natural "almost-no-brainer," non-home-mortgage, deposit-gathering niche is now occupied by a competing, better-adapted new species. This leaves associations in roughly the position of the original rabbit-like mammals which lost ecological market share when the rabbit was introduced into Australia. The adjustable-home-mortgage niche may now provide a decent home for some large, extremely efficient loan originators like Home Savings, but, as we seem to say each year, we have not yet found for Mutual Savings a permanent lending niche which is attractive, as distinguished from bearable. In the mortgage business we thus constantly confirm Samuel Johnson's observation that: "Life is a state in which much is to be endured and little to be enjoyed."

Left in place in the revised savings and loan system is a significant (although much reduced) structural risk for the federal government as deposit insurer. Associations retain a considerable residue of temptation to act imprudently. The temptation, in response to the profit-pressure which is a natural consequence of the structure of the system, is the same one which caused troubles in the past: the temptation to seek an acceptable interest rate "spread," not available any other way, by bearing undue risk from either (1) mismatched maturities of loans and deposits or (2) losses through defaults of a gamier class of borrowers willing to promise extra-high interest rates. It is almost impossible to have asset deployment controls so tough that a bank or association can't look good for a while (and give the appearance of justifying higher compensation of management) as it takes risks which will in due course destroy its owners' equity and also cause deposit insurance losses. The "all stick" method of control is much better than nothing, but it is far from ideal when it is the exclusive method for prevention of losses borne by the deposit insurer. In contrast, when, long ago, the federal deposit insurer had low losses, the savings and loan system used both carrots and stick, so that the average savings and loan operator could do well without exceptional luck or ability. (The carrots were very low income taxation plus interest-rate controls which reduced cost of holding deposits while giving an advantage over banks in attracting deposits.) We think the present, revised system continues to impose more risk than taxpayers should bear, with high deposit-insurance costs contributing to the risk as well as compensating for it.

Housing is now less assisted than before by the existence of savings and loan associations. An example of the drift away from housing assistance is provided by FIRREA's new restriction preventing large loans to any one house builder. The new requirement is that an association loan no more than 15% of owners' equity to one customer, with exceptions permitted up to 30% for adequately capitalized associations with good records. The new requirement would have greatly reduced the profits and housing contributions of Mutual Savings in its early days when it concentrated resources in development loans while trusting only a few house-builders. And the new requirement now has the same general effect. It will significantly restrict availability of house-building loans in many regions of the country. This result demonstrates the impossibility of revising a complex system without undesired "by-product" effects. The first law of ecology and the first law of legislation are one and the same: "You can never do merely one thing."

Of course, a "by-product" of law revision sometimes helps, instead of hurts, some participant in a market. New "risk-based" capital requirements under FIRREA have such an effect, as they give associations new incentives to transfer monies they otherwise would have earned to Freddie Mac, through exchange of mortgages for credit-enhanced, mortgage-backed securities. (Although the securities then provide less income, they help satisfy regulatory capital requirements, because the securities require less owners' equity to hold.) This income-transfer effect should help Mutual Savings, through its large shareholding position in Freddie Mac.

**Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,769,000 to normal net operating income in 1989, down 13% compared with $3,167,000 in 1988. The decrease in 1989 profit occurred as pounds of product sold declined by 12%. Revenues were down less, by 5% to $59,440,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1989 continued to provide an extraordinary return on resources employed.

As we never tire of saying, the good financial results have an underlying reason, although not one strong enough to cause the results achieved in the absence of superb management. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago (for instance, Los Angeles) seek out Precision Steel's service.

It is not common that steel warehouses have results like Precision Steel's. What we see, year after year, under David Hillstrom's leadership is boring, repetitive excellence as he remembers a basic catechism emphasizing service of the highest quality. We hope to be associated with him for a long time.

**Wesco-Financial Insurance Company**

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $58 million was invested in 1986, 1987 and 1989.

The new subsidiary, Wes-FIC, reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Group. Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period ending August 31, 1989. The arrangement put Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results occurred only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invested funds from "float" generated. Wes-FIC's share of premiums earned in 1989, before contract termination, exceeded $37 million.

Upon contract termination, Wes-FIC returned to Fireman's Fund $15.6 million in unearned premiums, net of related ceding commissions, and retained assets of about $91 million offset by claims reserves which will be exhausted slowly over many future years. We regard the totality of Wesco's four-year participation in the Fireman's Fund reinsurance contract as having excellent prospects, all future claim payments considered. Wesco's ultimate parent corporation (and 80% owner) almost certainly did Wesco a favor in allowing Wesco's participation, as was planned at the time.

There was some good luck in the selection, years ago, of a termination date for the Fireman's Fund contract. The date, August 31, 1989, happened to be just before occurrence of both Hurricane Hugo and the San Francisco earthquake. There was some heavenly justice in this outcome, because Wes-FIC caught a share of hurricane losses within hours after the inception of the contract in 1985.

Wes-FIC in 1988 began to write direct business, as distinguished from reinsurance. It is now licensed in Nebraska, Utah and Iowa, but it wrote only $183,000 in direct premiums, almost all surplus lines coverage (permitted for non-admitted insurers) in Alabama. Earned direct premiums were $438,000.

Wes-FIC's "normal" net income for 1989 was $14,276,000, versus $12,094,000 for 1988. The net "normal" income figures excluded securities gains, net of income taxes, of $5,910,000 in 1989, compared with $6,071,000 (including $4,836,000 realized on sale of Wes-FIC's 9% equity interest in Bowery Savings Bank) in 1988. These items are reported as "Net Gains on Sales of Securities," below. Wes-FIC's net income benefitted by about $215,000 in 1989, versus $260,000 in 1988, because of an unusual adjustment to its income tax provision caused by the Tax Reform Act of 1986.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware of the inherent imperfections of Wes-FIC's accounting, based as it is on forecasts of outcomes in many future years.

Wes-FIC retains a "longage" of capital and a shortage of good insurance business. We see few present opportunities for sound expansion, but we expect more insurance writing in due course, made possible by fear that other insurers will become unable or unwilling to pay fair claims.

Effective January 1, 1990, Wes-FIC has begun to reinsure 50% of the book of insurance business (largely workers' compensation insurance) of Cypress Insurance Company, a wholly owned subsidiary of Berkshire Hathaway. Wes-FIC's share of premiums written is expected to approximate $8 million in 1990. We regard this reinsurance contract as worth having at Wesco, but it is not nearly as promising, per dollar of insurance written, as was the Fireman's Fund contract.

**All Other "Normal" Net Operating Income**

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,178,000 in 1989 from $3,609,000 in 1988. Sources were (1) rents ($2,518,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) earnings of New America Electrical Corporation. The decrease in this "all other" component of earnings in 1989 resulted primarily from transfer of assets, with their related incomes, to Wesco's insurance subsidiary to augment its capital position.

**Net Gains On Sales Of Securities**

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $5,920,000 in 1989 from $6,525,000 in 1988. As noted above, $5,910,000 of these gains were realized in the Wes-FIC insurance subsidiary in 1989, versus $6,071,000 realized in 1988.

**Convertible Preferred Stock of Salomon Inc**

On October 1, 1987 Wesco and certain of its wholly owned subsidiaries purchased 100,000 newly issued shares of Series A Cumulative Convertible Preferred Stock, without par value, of Salomon Inc ("Salomon"), at a cost of $100 million. Salomon's primary business is transacted by its subsidiary, Salomon Brothers, a leading securities firm. Our investment was part of a $700 million transaction in which other subsidiaries of Berkshire Hathaway Inc., Wesco's parent, invested $600 million. Principal terms of the transaction included the following: (1) the preferred stock pays dividends at the annual rate of 9%; (2) each preferred share, purchased at a cost of $1,000, will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at $1,000 per share plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

At the stated conversion price of the preferred stock, a profit (subject to certain procedural requirements) will be realizable whenever, after October 31, 1990, the common stock of Salomon (listed on the New York Stock Exchange) trades at over $38 per share. At the time of our commitment to buy the new preferred, the common stock of Salomon was selling in the low 30s. However, shortly after Wesco acquired its new stock certificates, the October 19, 1987 "Black Monday" stock market crash occurred, which caused temporary but substantial operating losses plus a lowered credit rating at Salomon. Although Salomon, among securities firms, suffered only its rough share of the general debacle, its common stock at one time after the crash traded as low as $16⅝.

At the end of 1989 Salomon common stock was trading at $23⅜, compared with $24⅛ at the end of 1988, after much constructive adjustment of Salomon's business to new conditions.

Salomon's credit as a potential source of preferred dividends and stock redemptions improved during its 1988 recovery, when generally available dividend rates on preferred stock were roughly stable. And during 1989 Salomon was a star performer, compared to most other securities firms. With Wesco's preferred stock now shorter in contractual duration, and its conversion privilege enhanced in value during the last two years, we believe that the fair market value of Wesco's investment was somewhat in excess of its cost, and that the aggregate amount of any such excess was not material to Wesco, at December 31, 1989.

Berkshire Hathaway's Chairman, Warren Buffett, and the undersigned joined the board of Salomon on October 28, 1987, and are very pleased with the association.

**Other Convertible Preferred Stocks**

In transactions similar to that which created our Salomon investment, Wesco and its subsidiaries during 1989 invested a total of $75 million in several new issues of convertible preferred stock. The common stock of all issuers is listed on the New York Stock Exchange. These transactions are briefly summarized below:

(1) ***The Gillette Company***
On July 20, 1989, Wesco's Wes-FIC subsidiary invested $40 million in newly issued shares of convertible preferred stock of The Gillette Company ("Gillette"). The stock provides an 8¾% annual dividend, must be redeemed by Gillette in 10 years, and is convertible into Gillette common stock at $50 per share. Warren Buffett, Chairman of Wesco's parent company, has joined Gillette's board of directors. Gillette has just introduced a new product, the Sensor razor, which will sell well because it provides significant improvements to the wet-shaving process.

(2) ***USAir Group, Inc.***
On August 7, 1989, Wes-FIC invested $12 million in the newly issued convertible preferred stock of USAir Group, Inc. ("USAir"). The stock provides an annual 9¼% dividend, must be redeemed by USAir in 10 years, and is convertible into USAir common stock at $60 per share.

(3) ***Champion International Corporation***
On December 6, 1989, Wesco and certain of its subsidiaries invested $23 million in a new issue of convertible preferred stock of Champion International Corporation ("Champion"). The stock provides an annual 9¼% dividend, must be redeemed by Champion in 10 years, and is convertible into Champion common stock at $38 per share.

While we admire the corporations and managements involved, we regard these investments in the aggregate as sound but not exciting. Few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations. Considering alternatives available when the investments were made, we were pleased to buy the stocks, but Wesco shareholders should expect no bonanza.

**New America Electrical Corporation**

At the close of 1988, Wesco acquired 80% of the stock of New America Electrical Corporation ("New America Electric") for a price of $8,200,000. Of this price $7,165,000 was cash paid to a liquidating trust for the former shareholders of New America Fund and $1,035,000 was a ten-year, 10% note payable to Glen Mitchel, CEO of New America Electric, who retains the 20% of New America Electric not acquired by Wesco. The pattern of this acquisition is a common one within the Berkshire Hathaway group, where we are willing to be an 80% owner in many a business we would not be in if we did not admire and trust people who retain the other 20% and are expected to continue to operate the business, with little help and no hindrance from us.

Glen Mitchel is a long-time friend and trusted and admired business associate of the undersigned, Wesco's CEO. Indeed, because Wesco's CEO and his family owned a higher percentage of New America Electric than Wesco, our whole transaction was approved by the Wesco board with the recommendation and participation of Warren Buffett, CEO and major shareholder of Berkshire Hathaway, Wesco's parent company. Mr. Buffett had no financial interest in New America Electric, and he, plus Messrs. Munger and Mitchel, all believed that $10,250,000 was a fair valuation for 100% of New America Electric at yearend 1988.

This acquisition became available to Wesco because Glen Mitchel preferred minority (20%) ownership of a Berkshire Hathaway group subsidiary instead of dominant 30% ownership in New America Electric, with all other New America Electric stock pretty well scattered through a new public offering, which was the alternative offered. We like causing such confidence and try always to deserve it.

New America Electric is a manufacturer of various electrical products including switchgear, circuit breakers, lighting ballasts and starters and electrical equipment for marinas and mobile home and recreational vehicle parks. Its facilities are in Orange County, California.

When Wesco purchased its 80% interest, New America Electric had a book net worth of about $6,400,000, including approximately $2,500,000 in cash and equivalents, and a long history of earning high returns on capital, but with current earnings reduced by an industry-wide price war.

Unfortunately, financial results in New America Electric's first year after acquisition are an embarrassment to us. In 1989, New America Electric earned only $168,000, after taxes (before adjustments under consolidated accounting convention incident to our purchase of stock), which is (1) only 2.6% on historical book value of shareholders' equity, and (2) only 1.6% on the price Wesco paid. After consolidated accounting adjustments, the total contribution of New America Electric to Wesco's 1989 earnings was even lower: only $59,000 (included in our earnings breakdown in the "all other normal net operating income" category).

The year-to-year earnings decline at New America Electric was a stunning 77%. Part of the earnings decline was caused by high expense incurred in consolidating previously scattered operations in a large, newly leased building. Other factors were (1) escalation of the price war accompanied by a 2.5% year-to-year decline in sales, (2) a ridiculous, unfair result in a lawsuit, and (3) at least one decision which, with hindsight, looks like an error.

New America Electric's 1989 troubles were limited to the income statement. Its balance sheet remained strong. For instance, at yearend 1989, despite major improvements of facilities and purchase of new equipment, the same amount of cash and equivalents was on hand as at the start of the year: $2.5 million.

We appraise the 1989 earnings decline as temporary. We think Glen Mitchel is tackling the problems with his usual skill and diligence. We are impressed with the new building and new equipment, which will both reduce costs and improve quality of products and service. And we admire not only Glen Mitchel but also his chief officers: Thomas Johnson, Jeff Mowry and Thomas Vogele.

We will be very supportive as operations are fixed. Our sharing of disappointing times without irrational panic is an entitlement for people who choose to make these 80%-20% deals with us. But we will not obscure, in reports to our shareholders, poor financial results, temporary or not, from any recent business acquisition. And we will be particularly anxious to highlight bad results, no matter how "immaterial" (in accountingspeak), in a case where Wesco's Chairman had an interest in the business acquired. If Wesco's shareholders don't hear much about New America Electric in the future, it will be success, not failure, which causes de-emphasis.

**Consolidated Balance Sheet and Related Discussion**

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1989 by about $98 million, up significantly from about $54 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $103 million. As earlier emphasized, about $101 million of this unrealized appreciation lies within the savings and loan subsidiary, and includes $89.4 million of appreciation in stock of Freddie Mac. In addition, there is about $29 million of unrealized appreciation in common stocks (mostly stock of The Coca Cola Company) held by Wesco's insurance subsidiary. Under a peculiar accounting convention applicable only to insurance companies this appreciation, after deducting income taxes which would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Wesco's Pasadena real estate comprises a full block containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings, which it would probably be wiser to destroy than improve. This real estate has a market value substantially in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,643,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($2,862,000) in Wesco's balance sheet at December 31, 1989, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 97% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. In fact, we are about to refurbish all the bathrooms, even though there is almost nothing wrong with them. (We have observed many recent instances of mismanagement at other buildings where managers prefer to paint the financial record, instead of the building. We try, with an occasional lapse, to stay a long way removed from such conduct, considering it contrary to both implicit obligation to tenants and long-run interest of the owner.) With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities. Following this practice, and to reduce interest costs, Wesco during 1989 paid off at par its $25 million of 10⅛% debentures due in June 1991, and issued $30 million of new 8⅞% debentures due in November 1999. The low interest rate on the new debentures was made possible by Wesco's AA+ credit rating.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity requires patience, at least for people like us, as explained below.

It is assumed by many business school graduates, and by almost all consultants, that a corporation can easily improve its outcome by purchasing unrelated or tenuously related businesses. According to this widely shared view, if only the obvious steps had been taken, if the right "mission statement" had been adopted and the right "experts" hired, then each railroad, instead of remaining bound in chains by new forms of competition and obsolete and hostile laws and union rules, would have become another Federal Express, another United Parcel Service, or even another brilliant performer in the mode of Emerson Electric.

Our experience, both actual and vicarious, makes us less optimistic about easy solutions through business acquisition. We think undue optimism arises because successful records draw too much attention. Many people then reason as I would if I forecasted good prospects in big-time tennis after observation limited to Ivan Lendl and Steffi Graf, or good prospects in the California lottery after limiting observation to winners. The converse is also true, only more so. Far too little attention is given to the terrible effects on shareholders (or other owners) of the worst examples of corporate acquisitions such as CBS-DuMont, Xerox-Scientific Data Systems, General Electric-Utah International, Exxon-Reliance Electric, Sohio-Kennecott, First Interstate Bancorp-Allied Bancshares, Arizona Public Service-MeraBank, USX-Texas Oil & Gas, Prudential Insurance-Bache, Mobil Oil-Montgomery Ward, General Motors-Hughes Aircraft, and Avon Products-Practically Anybody. The list ends here for want of space, not a shortage of additional examples. The acquiring corporations listed are great enterprises, honorably run. In fact, their greatness augments their utility as examples as they show how hard it is, even for managers promoted to power through meritocratic procedures at admired corporations, to advance by acquisition the interests of owners.

The full implications of the worst examples are lost, in part, because the conventions of corporate reporting cause managers to present data in a manner which obscures both facts and implications. Horrible results are obscured, and mediocre results are made to look fine. Techniques for masking the truth include (1) mixing bad or mediocre results into other good results which would have been much better, absent the mixture, and (2) taking several poor results off the stage at once through the "big bath" technique. The "big bath" technique, in turn, is often accompanied by some extraordinary gain elsewhere which is cashed on a time schedule designed for obfuscation. Or a loss is mixed into a "restructuring," adopting word usage which would explain Napoleon's outcome at Waterloo as a thoughtful strengthening of France.

As we appraise it, the corporate mode of "solving your problems by acquisition" far more often ends in the mediocre "follow-the-fad-of-the-year" record of a Peter Grace than in the wonderful record of a Dover Corporation. Nor does the avoidance of dubious methodology guarantee success. It is hard to win at the game, even if one (1) does not rely on the valuation judgment of outside acquisition "experts" paid per transaction recommended and closed, and (2) does not create the in-house equivalent of the outside adviser who must buy to thrive, namely the internal department which has no function except acquisitions and often bears a label including "planning," or even "strategic planning."

Perhaps more instructive than the rarity of good corporate acquisition records is the striking rarity of important acquisitions within the few good records. Most winners act as a wise baseball hitter would if permitted to pass as many pitches as he wished before swinging.

For instance, among the best acquisition records is that of Tom Murphy and Dan Burke at Capital Cities/ABC. Yet the major acquisitions, which accounted for more than 80% of ending economic value for continuing shareholders, occurred less often than once each two years. This slow pace occurred even though they were in full control, were (and are) two of the quickest learners and actors around, did all the important work themselves, and were located in the midst of a profit- laden and long-lasting communications revolution (television broadcasting) wherein rapid change churned out opportunities for the acute at an above-normal rate. (The writer has to believe that the opportunities seized by Murphy and Burke were recognizable only by the acute. This follows from the writer's participation in rejecting a television-station opportunity, long ago given by Murphy and Burke when they were barred by law from purchase. The price was less than one-tenth of present-day value.)

A particularly depressing lesson, for the action-prone, might also be extracted from the business acquisition record of Wesco's ultimate parent, Berkshire Hathaway. Over 24 years, Berkshire transformed a small, doomed New England textile enterprise into a large and diversified company, without ending up with many more shares outstanding. Yet if you removed from Berkshire's record the six most significant acquisitions, extracting occurrences averaging one every four years, the record would not now be mentioned here, or anywhere else.

It has always been easy (indeed, one attracts scores of helpers) to make disadvantageous business purchases in a hurry with corporate cash. And it has been even easier to cause disadvantage if one is unwise enough, like General Electric in the Utah International merger, or Xerox in the merger with Scientific Data Systems, not to be super-sensitive to the probability that any attainable stock-for-stock merger will transfer more intrinsic business value than is acquired. On the other hand, advantageous business purchases, not involving competitors or branded products which can be sold through the acquirer's present sales system, are difficult to find.

It is not just the Peter Principle which makes corporate acquisition records so bad, on average, although that Principle does especially intense damage in the acquisition field. (This occurs because, when you promote the General Sales Manager to CEO making unrelated business acquisitions, you naturally cause more trouble than you earlier did when you made a less substantive change by promoting the Sales Manager of some territory to General Sales Manager.) Even a CEO with good acquisition judgment is lucky if, in his remaining career, he finds one large opportunity which tempts rational response.

The scarcity of good acquisition transactions, of course, does not imply that no wonderful businesses are ever for sale. It is just that, in a finite, competitive world, no business is so wonderful that it can't be ruined as an acquisition candidate by increasing the price. When this happens, many corporations buy anyway, for reasons Columbia's great philosopher, Charles Frankel, so well understood. The system is so constructed (irresponsibly, Frankel would say) that the corporate manager gains even though the shareholder loses. (Incidentally, Frankel was mugged to death in a final inadvertent contribution to the study of irresponsible systems, reminding many conservative social critics of Socrates.)

At this point, a last question remains: If successful corporate business acquisition is so hard, how does one explain the widespread recent success of most of the leveraged-buy-out ("LBO") operators who have purchased corporations? A huge part of the answer comes from income-tax effects and other simple effects. When, in a typical LBO, the typical mostly equity corporate capitalization was replaced by 90% debt plus a new 10%-of-capitalization common stock position:

(1) the combined market value of all the new common stock plus all the new debt became much higher than the previous market value of all the old common stock, because the existing stream of pre-tax earnings was no longer shared with corporate income tax

collectors who, in many cases, had previously received more cash each year than shareholders; and

(2) even after the value-enhancing effect of the corporate tax reduction was shared with former shareholders by paying them extra-high prices to leave, a retained residue of value-enhancing tax effect made the new common stock (which now became much like a speculative warrant with good terms) worth considerably more than cost as the ink dried on acquisition papers; and

(3) the new "owners" then resorted to strategies, difficult neither to conceive nor implement, including the following:

   (a) they eliminated many of the easily removable costs (largely personnel costs) and sub-par segments which in some mix (i) bedevil successful corporations (including ours) with sloth and folly and (ii) create their humane grace and, through present sacrifice, good long-term prospects, justifying sacrifice endured; and

   (b) they sold off a few operations at super-high prices, sometimes exercising the easiest microeconomic insight by selling to a direct competitor and sometimes selling to a surprisingly easy-to-find non-competitive corporate buyer, not owned by its managers, willing to pay almost as high a price as a competitor would; and

(4) the new "owners" then profited, in due course, not only from the tax effect and other simple reshuffling activities described above, but also from the wonderful upside effects of extreme financial leverage during a long business boom accompanied by a rising stock market.

Whether the country wants a large number (or even any) of its large corporations to have extremely leveraged capitalizations, except through occasional adversity, presents interesting social questions. Is one social function of corporations to be financially strong so that they act as shock absorbers, protecting dependent employees, suppliers and customers from part of the volatility implicit in capitalism? Was Ben Franklin right when he included the following folk wisdom in *Poor Richard's Almanac:* "It is hard for an empty sack to stand upright." Is a weak corporation, borrowed to the hilt, the social equivalent of a bridge with an inadequate reserve of structural strength? Granting that leveraged buy outs have some favorable effects (as well as unfavorable effects) on long term efficiency, how many thousands of able people do we wish to attract into promotional corporate recapitalization activity which (1) reduces corporate income taxes, (2) often tests the limits of antitrust law, and (3) focuses business attention on short-term cash generation to pay down oppressive levels of debt? Finally, as Columbia Law School's Professor Lou Lowenstein puts it (more or less): "Do we really want entire corporate businesses, as important social institutions, continuously traded like pork belly contracts?"

However the social questions are answered, three aspects of the present situation are clear. First, the corporate tax effect is so large in LBO transactions that easy success in such transactions does not imply that success is easy in ordinary corporate acquisitions. Second, the hordes of leveraged-buy-out operators now with us raise the general level of acquisition prices to the detriment of other would-be acquirers, including Wesco, which are not willing to maximize tax benefits through maximized borrowing. And, third, the LBO operators will not go away so long as present permissive laws last. The operators have a real advantage under such laws, not just a fig leaf aiding promotion. Even though failure and disgrace will reduce their number, and prices paid in leveraged-buy-out transactions will fall, the capitalized value of reducing the corporate income tax will remain. Therefore, plenty of rational incentive will remain for transactions. The LBO genie will encounter reverses, but he is not going back in the bottle unless ordered to do so by new laws.

It should also be noted that the LBO operators' incentives to bid high do not end with real advantages derived from tax law and willingness to reshuffle businesses with much speed and few scruples. Additional incentives for high bids come from typical structures in which general partners of LBO partnerships risk little of their own money (often less than none after fees are taken into account), yet share significantly in gains. Such arrangements are similar to the system of the race track tout. And who has ever seen a tout who didn't want his backer to make a lot of bets?

To Wesco, as a non-LBO operator, the good-corporate-acquisition game was always tough. And that game in each recent year has become more like fishing for muskies at Leech Lake, in Minnesota, where the writer's earliest business partner, Ed Hoskins, had the following conversation with his Indian guide:

"Are any muskies caught in this lake?"

"More muskies are caught in this lake than in any other lake in Minnesota. This lake is famous for muskies."

"How long have you been fishing here?"

"19 years."

"And how many muskies have you caught?"

"None."

When a management has our point of view, infrequency of business acquisition may safely be predicted. Whether this happens, as we like to believe, because the game is hard for almost everyone, or merely because the game is hard for us, the result for Wesco shareholders is the same: less worthwhile activity than we all would like. But there may be one consolation: A series of big, incorrectable acquisition troubles, with no meaningful salvage, is seldom caused by people who think the acquisition game is like fishing for muskies at Leech Lake. One terrible acquisition result is, of course, quite possible. For instance, Wesco would cheerfully invest $75 million tomorrow, with a 60% chance of total loss, provided the pay-off for winning was large enough to cause statistical expectation to provide a handsome return.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 11% in 1987-89, was dependent to a significant extent on securities gains, irregular by nature.

The considerable, and higher than desired, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric. It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent. There must be some wisdom in the folk saying: "It's the strong swimmers who drown". Our approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action.

Moreover, our approach continues to be applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway, Wesco's parent corporation, has a much larger proportion of its intrinsic value in durable high-return businesses.

The foregoing description of attitude, as well as the following historical explanation of the current situation, is repeated in the annual report each year, accompanied by a standard disclaimer designed to deter inappropriate optimism. When Wesco's parent corporation acquired control, Wesco's activities were almost entirely limited to holding (1) some surplus cash, plus (2) a multi-branch savings and loan association which had many very long-term, fixed-rate mortgages, offset by interest-bearing demand deposits. The acquisition of this intrinsically disadvantageous position was unwisely made, alternative opportunities considered, because the acquirer (including the signer of this letter) was overly influenced by a price considered to be moderately below liquidating value. Under such circumstances, acquisitions have a way of producing, on average, for acquirers who are not quick-turn operators, low to moderate long-term results. This happens because any advantage from a starting "bargain" gets swamped by effects from change-resistant mediocrity in the purchased business. Such normal effects have not been completely avoided at Wesco, despite some successful activities, including a large gain in 1985 from an investment in General Foods.

A corporation like Wesco, with no significant proportion of intrinsic value in great businesses, continues to be like a tortoise in a race of hares. And, as we have demonstrated in one more year, this particular tortoise is not very sprightly. Moreover, what sprightliness remains is often deterred by remembrance of past new-activity outcomes which were at least as bad as those of the writer's dog when it limped home from its first foray outside the yard both (1) injured by a car and (2) bloated from overeating garbage. (Some long-time Wesco shareholders may painfully remember one such once-new activity: hillside subdivision in the place with the ironic name, "Friendly Valley.")

On January 25, 1990, Wesco increased its regular quarterly dividend from 19½ cents per share to 20½ cents per share, payable March 13, 1990, to shareholders of record as of the close of business on February 28, 1990.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger
Chairman of the Board

March 5, 1990

Reproduced on this page is a copy of the May 30, 1989 letter of resignation of Mutual Savings and Loan Association from United States League of Savings Institutions.

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MUTUAL SAVINGS AND LOAN ASSOCIATION

315 EAST COLORADO BLVD. • PASADENA, CALIFORNIA 91101-1954

May 30, 1989

United States League of Savings Institutions,
1709 New York Avenue N. W.,
Washington, D. C. 20006

Gentlemen:

This letter is the formal resignation of Mutual Savings and Loan Association from the United States League of Savings Institutions.

Mutual Savings is a subsidiary of Wesco Financial Corporation, listed ASE, and Berkshire Hathaway Inc., listed NYSE, which are no longer willing to be associated with the League.

Mutual Savings does not lightly resign after belonging to the League for many years. But we believe that the League's current lobbying operations are so flawed, indeed disgraceful, that we are not willing to maintain membership.

Our savings and loan industry has now created the largest mess in the history of U. S. financial institutions. While the mess has many causes, which we tried to summarize fairly in our last annual report to stockholders, it was made much worse by (1) constant and successful inhibition over many years, through League lobbying, of proper regulatory response to operations of a minority of insured institutions dominated by crooks and fools, (2) mickey-mouse accounting which made many insured institutions look sounder than they really were, and (3) inadequate levels of real equity capital underlying insured institutions' promises to holders of savings accounts.

It is not unfair to liken the situation now facing Congress to cancer and to liken the League to a significant carcinogenic agent. And, like cancer, our present troubles will recur if Congress lacks the wisdom and courage to excise elements which helped cause the troubles.

Moreover, despite the obvious need for real legislative reform, involving painful readjustment, the League's recent lobbying efforts regularly resist minimal reform. For instance, the League supports (1) extension of accounting conventions allowing "goodwill" (in the financial institutions' context translate "air") to count as capital in relations with regulators and (2) minimization of the amount of real equity capital required as a condition of maintenance of full scale operations relying on federal deposit insurance.

In the face of a national disaster which League lobbying plainly helped cause, the League obdurately persists in prescribing continuation of loose accounting principles, inadequate capital and, in effect, inadequate management at many insured institutions. The League responds to the savings and loan mess as Exxon would have responded to the oil spill from the Valdez if it had insisted thereafter on liberal use of whiskey by tanker captains.

It would be much better if the League followed the wise example, in another era, of the manufacturer which made a public apology to Congress. Because the League has clearly misled its government for a long time, to the taxpayers' great detriment, a public apology is in order, not redoubled efforts to mislead further.

We know that there is a school of thought that trade associations are to be held to no high standard, that they are supposed to act as the League is acting. In this view, each industry creates a trade association not to proffer truth or reason or normal human courtesy following egregious fault, but merely to furnish self-serving nonsense and political contributions to counterbalance, in the legislative milieu, the self-serving nonsense and political contributions of other industries' trade associations. But the evidence is now before us that this type of trade association conduct, when backed as in the League's case by vocal and affluent constituents in every congressional district, has an immense capacity to do harm to the country. Therefore, the League's public duty is to behave in an entirely different way, much as major-league baseball reformed after the "Black Sox" scandal. Moreover, just as client savings institutions are now worse off because of the increased mess caused by League short-sightedness in the past, client institutions will later prove ill-served by present short-sightedness of the League.

Believing this, Mr. Warren E. Buffett and I are not only causing Mutual Savings to resign from the U.S. League of Savings Institutions; we are also, as one small measure of protest, releasing to the media, for such attention as may ensue, copies of this letter of resignation.

Truly yours,

MUTUAL SAVINGS AND LOAN ASSOCIATION

Charles T Munger

Charles T. Munger
Chairman of the Board

# WESCO FINANCIAL CORPORATION

## Annual Report 1990

## Form 10-K Annual Report 1990

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all net gains from sales of marketable securities) for the calendar year 1990 increased to $25,038,000 ($3.52 per share) from $24,414,000 ($3.43 per share) in the previous year.

Consolidated net income (i.e., after net gains from sales of marketable securities) decreased to $25,429,000 ($3.57 per share) from $30,334,000 ($4.26 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1990 | | December 31, 1989 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income of: | | | | |
| Mutual Savings | $ 4,099 | $ .58 | $ 4,191 | $ .59 |
| Wesco-Financial Insurance business | 14,924 | 2.10 | 14,276 | 2.00 |
| Precision Steel's businesses | 1,985 | .28 | 2,769 | .39 |
| All other "normal" net operating income[2] | 4,030 | .56 | 3,178 | .45 |
| | 25,038 | 3.52 | 24,414 | 3.43 |
| Net gains on sales of marketable securities | 391 | .05 | 5,920 | .83 |
| Wesco consolidated net income | $25,429 | $3.57 | $30,334 | $4.26 |

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

### Mutual Savings

Mutual Savings' "normal" net operating income of $4,099,000 in 1990 was almost equal to the $4,191,000 figure the previous year.

As usual, these "normal-income" figures come from an abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1989 and 1990 are set forth at the end of this annual report. They show (1) total savings accounts declining to $286 million from $293 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, and (4) a loan portfolio (mostly real estate mortgages) of about $131 million at the end of 1990, down moderately from $154 million at the end of 1989.

As pointed out in Note 9 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings overstates the amount realizable, after taxes, from sale or liquidation at book value. Wesco would get only about $30.8 million, after paying income taxes, from the liquidation at book value of the $47 million portion of Mutual Savings' shareholders' equity which is considered bad debt reserves for income tax purposes. The $4.1 million Mutual Savings earned in 1990 is an inadequate return (8.7%) on the $47 million amount at which we try to maintain shareholders' equity, but this same

$4.1 million is a respectable return (13.3%) on the $30.8 million which would be the after-tax proceeds of liquidation at book value.

The loan portfolio at the end of 1990, although containing almost no risk of loss from defaults, bore an average interest rate of only 9.20%, probably near the lowest among U.S. savings and loan associations and roughly the same as the 9.23% rate at the end of 1989. Because the loan portfolio is almost entirely made up of instruments of short maturity or bearing interest rates that adjust automatically with the market, there is now much less unrealized depreciation in the loan portfolio than the net unrealized appreciation in Mutual Savings' interest-bearing securities and public utility preferred stocks. That appreciation at December 31, 1990 was about $11 million.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, this "spread" improved again last year. The "spread" improved because interest rates paid on savings declined. Moreover, the disadvantage from inadequate "spread" has been reduced in each recent year by the effect of various forms of tax-advantaged investment, primarily preferred stock and municipal bonds. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock and municipal bonds, with their fixed yield and long life, will decline in value, and not provide enough income to cover Mutual Savings' interest and other costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment has been kept conservative, relative to the amount of its net worth.

New federal legislation enacted in 1989, widely known under the acronym "FIRREA," is now causing Mutual Savings, step by step, to dispose of the preferred stock portion ($54.4 million, at cost, at December 31, 1990) of its tax-advantaged assets. Ownership of preferred stock has heretofore helped preserve earning power because tax-equivalent yield is so high (about 15% at December 31, 1990). Adding to our forced-disposition-of-desirable-assets problem, recent changes in income-tax law now make impracticable the replacement, as they mature, of Mutual Savings' direct holdings of municipal bonds ($16.9 million, at cost, at December 31, 1990). The municipal bonds also have a high tax-equivalent yield (about 17.5% at December 31, 1990). By mid-1994, and possibly much sooner, we expect virtually all benefit from tax-advantaged investment to vanish from Mutual Savings.

Mutual Savings remains a "qualified thrift lender" under the old federal regulatory standard (which ends June 30, 1991) requiring 60% of assets to be in various housing-related categories. It will shortly change its asset mix as necessary to comply with a new standard, imposed by FIRREA, which requires that 70% of assets be maintained in a more restricted list of housing-related assets.

Until U.S. laws governing financial institutions are further revised, Mutual Savings expects to keep its required 70% in housing-related assets within the following five categories:

(1) mortgages issued in the course of sale of individual parcels, as Mutual Savings disposes of foreclosed seaside property in Santa Barbara, California;

(2) directly made, fixed-rate house mortgages with short expected lives;

(3) indirectly made fixed-rate house mortgages with short expected lives, purchased in the open market in the form of mortgage-backed securities;

(4) a modest amount of directly made, long-term house mortgages with variable interest rates that fluctuate with the market up to 25% per annum;

(5) a substantial number of directly made, long-term, fixed-rate house mortgages given only to persons of low-to-moderate income, many in minority groups, who have good credit, reside within seven miles of Mutual Savings' office, and support Mutual Savings' loans with house equities amounting to at least 20% of house value, with the maximum size of mortgage permitted being about $191,000.

We will work hard to expand assets in category (5), covering small, long-term, fixed-rate house mortgages for local people of low-to-moderate income. Indeed this category is expected to cover a majority in number of all new directly made mortgages. We expect to impose no loan fees and to charge slightly below-market interest rates. Therefore, each new loan will cause an immediate economic loss, which will hit our earnings statement even before we sell the loans, as we plan to do. The loans will be resold, not because they are inferior credit instruments, but because we do not wish to endure the asset-versus-liability maturity mismatch imposed by any long-term, fixed-rate mortgage.

FIRREA has increased pressure on both banks and associations to expand lending of the sort covered by category (5). As a result, in our area there can now be no lack of availability in this category of market-rate loans, meeting legislative objectives, for persons with good credit. Instead, all lenders face a shortage of qualified applicants. Given this shortage, as we now compete with bigger, better loan departments of larger institutions, the most efficient way to get our share of qualifying loans is to quote below-market interest rates and loan charges.

We do not resent making these loss-causing loans. We intend, with pleasure, to make more than our share, which we can well afford to do. We regret that we waited so long to compete vigorously for these loans and that we required regulatory prompting before we found a satisfactory solution of such simplicity. We were formerly brain-blocked, because (1) we didn't want to hold any long-term, fixed-rate loans, (2) we didn't want to impose on moderate-income borrowers the risks implicit in the only kind of variable-rate loan we were willing to make, (3) we had never routinely resold loans or deliberately loaned at a loss, and (4) we were preoccupied with avoiding calamitous results which came to many other savings and loan operators. Regulators, of course, have not demanded that we now lend at a loss. That aspect of our program is the result of our initiative alone.

We have had trouble attracting a significant volume of loans, with satisfactory characteristics, in category (4), covering our variable-rate loans which can escalate to bear interest rates of 25%. These loans have been in short supply despite our use of a very low interest rate spread (about 2 percentage points over the one-year U.S. Treasury rate). Moreover, while we have realized no losses on our variable-rate loans, we have encountered several collection delays, partly attributable to an incompetent policy decision of the Chairman. These two factors cause us to expect this category to shrink to minor significance.

Category (3), the short-term, fixed-rate, mortgage-backed security category, is a "last-resort" category for us. But it could eventually amount to a substantial percentage of assets, depending on what is available elsewhere.

As we select mortgage-backed securities, we will probably not be buying any complex instruments. Despite our love of comedy, we are going to avoid the newest form of "Jump Z tranches in REMICS." This refers to a particular contractual fraction — the "Z Form" — of a pool of mortgages, now subdivided by obliging issuers, advised by obliging investment bankers, into two new contractual fractions: (1) the "Sticky Jump Z" and (2) the "Non-Sticky Jump Z." At this rate, subdivision will soon get down to quarks.

We are deterred from buying such securities partly by our hatred of complexity. We also dread the prospect of state and federal examiners, none of whom has a Ph.D. in physics, reviewing, one after the other, our choices for soundness and billing us on a cost-plus basis to reflect value thus added. Some of the wonders of modern finance go on without us as we yearn for a lost age when most reasonable people could, with effort, understand what was going on.

In total, during the next few years, our policies will very likely cause our housing-related assets (exclusive of the one-time effect of development of our foreclosed seaside property) to continue to produce close to the lowest average gross return in the savings and loan industry. Incremental returns may not quite cover incremental interest and operating costs as we invest each new dollar of savings. It is quite conceivable that Mutual Savings will decline in size because it should decline in size.

Even so, we expect that Mutual Savings will muddle through in a manner satisfactory to Wesco shareholders with moderate expectations. Our optimism comes mainly (1) from an expected minor profit boost from disposition of our foreclosed seaside property and (2) from an expected major profit boost caused by ownership of our large holding of Freddie Mac stock. Both of these grounds for optimism are discussed below.

Mutual Savings has a buried value in a piece of foreclosed property: 22 seaside acres in Santa Barbara, acquired in 1966. By the time Mutual Savings started development (into 20 houses and 12 lots) in order to facilitate sale, the value of this property had appreciated by at least $12 million. The built-in appreciation will now be captured through development, assuming no large reverses caused by collapse of housing prices or unanticipated new regulatory troubles.

The first house is nearly finished, and about 15 houses are under construction. We expect to close sale of about half the parcels during the next year. There will be little or no profit added to built-in appreciation by the development process. Seaside land development, under present regulatory and market conditions in California, tends to be a no-profit activity — if you are lucky. It is full of queer happenings and closely resembles a Chevy Chase movie of extreme duration.

In 1988 Mutual Savings made a large and unusual purchase. It increased its holdings of Federal Home Loan Mortgage Corporation (widely known as "Freddie Mac") to 2,400,000 shares, 4% of total shares outstanding. Mutual Savings' average cost is $29.89 per share, compared to a price of $48.75 per share in trading on the New York Stock Exchange at the end of 1990. Thus, based on 1990 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $45.3 million. At current tax rates the potential after-tax profit is about $26.7 million, or $3.75 per Wesco share outstanding.

Freddie Mac, created and long run by a federal agency (the Federal Home Loan Bank Board), is now owned privately, largely by institutional investors. It is now led by a very smart CEO, Leland Brendsel, and governed by an outstanding independent board of directors, including John B. McCoy of Banc One and Henry Kaufman, former chief economist of Salomon Brothers. Freddie Mac supports housing primarily by purchasing housing mortgage loans for immediate transmutation into mortgage-backed securities that it guarantees and promptly sells. In the process Freddie Mac earns fees and "spreads" while avoiding most interest-rate-change risk. This is a much better business than that carried on by most (or indeed most of the top 10% of) savings and loan associations, as demonstrated by Freddie Mac's high percentage returns earned on equity capital in recent years. One ironic cause of the high returns is that this creation of federal regulators pays no deposit-insurance premiums as it replaces much of the former function of the savings and loan industry. Freddie Mac's high returns on equity are caused by a strong competitive position that is likely to last a long time. In its activities it faces only one other competitor of similar size, efficiency and reputation: Federal National Mortgage Association (widely known as "Fannie Mae"), a similar private corporation with governmental overtones.

At Freddie Mac's 1990 dividend rate ($1.60 per annum per share), Mutual Savings' pre-tax yield was only 5.35% on its $29.89 average cost per share. Post-tax, the dividend yield was only 4.4%, but this amounted to about 75% of the current after-tax yield from very high grade mortgages. Moreover, Freddie Mac has a creditable history of avoiding really hurtful loan losses and increasing its earnings and dividend rate, virtues that contribute to increases in the market price of its stock. Following are figures for 1985-1990:

| Year Ended 12/31: | Earnings per Share | Dividends per Share | Year-End Market Price per Share | Freddie Mac's Return Earned on All Average Equity |
|---|---|---|---|---|
| 1985 | $2.98 | $ .53 | $ 9.19 | 30.0% |
| 1986 | 3.72 | 1.13 | 15.17 | 28.5 |
| 1987 | 4.53 | 1.10 | 12.12 | 28.2 |
| 1988 | 5.73 | 1.25 | 50.50 | 27.5 |
| 1989 | 7.28(1) | 1.60 | 67.12 | 25.0 |
| 1990 | 6.90 | 1.60(2) | 48.75 | 20.4 |

(1) restated

(2) raised to annualized rate of $2.00 per share on March 8, 1991

Despite Freddie Mac's strong competitive position, its stock declined in market value by 27% in 1990 (from $67.12 per share to $48.75 per share, in trading on the New York Stock Exchange). One reason for the decline was unanticipated losses from apartment house loans, particularly in New York and Atlanta. As a result, Freddie Mac wisely discontinued the most obviously dangerous part of its apartment house loan buying program. But it remains the guarantor or owner of some old loans (fortunately a small portion of total apartment house loans and a really tiny portion of total loans) that will create misery for years. It was probably ill-advised for Freddie Mac, given its position and financial leverage and the nation's needs, (1) ever to finance anything except owner-occupied, single-family, non-vacation houses, for which substantial down payments had been made by credit-worthy people, and (2) ever to deal with anyone other than mortgage originators and servicers of obvious integrity and competence. Just as it is unwise for an individual to risk losing what he has and needs in an effort to gain what he doesn't have and doesn't need, it seems unwise for Freddie Mac to stretch its leveraged resources beyond purchase from obviously responsible people of carefully selected first mortgages on individual houses. Each lender, including the one writing this letter, seems destined to learn through painful, personal experience two obvious lessons from the past:

(1) The first chance you have to avoid a loss from a foolish loan is by refusing to make it; there is no second chance.

(2) As you occupy some high-profit niche in a competitive order, you must know how much of your present prosperity is caused by talents and momentum assuring success in new activities, and how much merely reflects the good fortune of being in your present niche.

In common experience, including ours, lesson (1) is eventually learned, but lesson (2) resists learning, despite high pain inflicted by multiple reverses.

As nearly as we can foretell, Freddie Mac's troubles with apartment house loans are endurable in scale and will no more significantly impair its long-term prospects than the salad oil swindle of 1963 impaired the long-term prospects of American Express. Moreover, the present managers and directors of Freddie Mac all seem to have absorbed a catechism appropriate for Freddie Mac and to be willing to endure political friction burns as necessary to keep operations sound. We like our large position.

Strangely, Mutual Savings' holdings of Freddie Mac, while lawful to own under FIRREA, (1) so far do not count as "housing-related assets" in the new 70%-of-assets test, and (2) must be written down, in stages, to a value of zero for regulatory accounting purposes. As these provisions start to bind, Mutual Savings will dispose of part of its Freddie Mac stock. One option is the transfer of stock to another Wesco subsidiary in return for cash.

What future in the savings and loan business do we expect? We don't know anything more than that we are satisfied at the moment with our temporizing strategy. We expect further changes, possibly radical, in the bank/savings-and-loan-association field, to which we will adapt as they unfold.

The present situation, with its many insolvent and almost-insolvent institutions, is such a mess that further legislation seems inevitable. We can predict neither the changes, nor whether the changes will make matters better or worse. But we do have some opinions. These opinions are almost totally out of step with current thinking in academia, among government officials, among banking executives and, most of all, among banking lobbyists. Despite this unconventionality, our opinions are now given to Wesco shareholders because they may provide some insight into our institutional nature and likely future action. We also hope, but only slightly, that the opinions, set forth below, will have a wider, civic utility.

First, let us turn to banking, after which we will consider the savings and loan business.

The sum of all deposit-insurance losses in banking will probably be much lower than the $200 billion or so recently caused by savings and loan associations. But there are a lot of very sick banks, and deposit-insurance losses are sure to be large. Moreover, even if there had been no such losses, there would be much to regret in the nature of our modern banks as they have increasingly emphasized lending for consumption (even lending at 20% for vacations in Tahiti) and lending to financial promoters and real estate developers. We have come a long way from an ideal emphasizing the banker's provision, to both big and small businesses, of what Pierre DuPont provided to General Motors. Plainly, we have a two-forked banking problem, with a questionable shift in priorities accompanying rising insolvencies.

Let us attempt to diagnose the causes of our problem. By and large, our problem did not come because banks couldn't branch across state lines, sell insurance, or underwrite corporate securities. Instead, it came because banks "reached" for higher yields on assets as they faced higher interest costs that came from (1) decontrol of interest rates paid by insured institutions plus (2) pressure from new competitors, including money-market funds possessing a large competitive edge.

Exactly how great is the money-market funds' competitive edge? To see, compare the average heavily regulated bank, paying high deposit-insurance premiums, with what has been created in an extreme form of uninsured money-market fund. In the fiscal year ended June 30, 1990 one such $4 billion fund (The Common Fund for Short Term Investments) did all of the following:

(1) kept its assets in liquid short-term obligations of the U.S. government and other credit-worthy entities;

(2) furnished efficient checkwriting privileges and wire transfer service to its depositors;

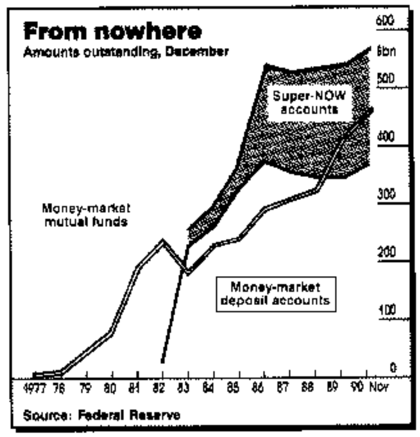
(3) kept its *total* operating costs under two-tenths of 1% of deposits per annum as it avoided costs of maintaining branch offices, deposit insurance, etc.;

(4) furnished no capital of its own as a cushion supporting promises to depositors; and

(5) paid very competitive rates on its interest-bearing accounts, as a result of which it grew 27% in size.

This example demonstrates the raw competitive power of keeping things simple. Indeed, in this example all costs combined have been controlled so as to be roughly equal to what the average local bank pays for federal deposit insurance alone! We are not dealing with some minor competitive advantage. The new competition is a juggernaut.

How important has the new competitor become? Naturally, the new competitor has taken a huge bite out of the market formerly served by banks (and savings and loan associations) burdened by much higher costs. How could it be otherwise? Here is a dramatic graph reprinted from what is surely among the best magazines in the world, England's *The Economist*:




The money-market funds are, in substance, "non-bank" banks, furnishing interest-bearing savings and checking accounts. And, by an odd stroke of good fortune, their light regulation by an overburdened SEC has turned out to be more advantageous than no regulation at all. The rules of the SEC force investment largely confined to reasonably safe and liquid categories. This has spawned simple operations with very low costs.

The simple, low-cost*, cream-the-market approach thus taken (or stumbled into) often works well in business. For instance, look at (1) GEICO, a hugely successful auto insurer almost 50% owned by Wesco's parent corporation or (2) various membership warehouse clubs, in the form invented by Sol Price, which are now clobbering retailing competitors as they get total "markup" under 10%. And this approach, as would be expected, is working like gangbusters for the money-market funds, as you see in the graph from *The Economist.*

What were the effects on banks as these new and successful, low-cost competitors took more and more of the market while, at the same time, each bank's banking competitors could bid as they wished

* Total costs are low, even though they include fees containing a substantial profit element that are paid by the "non-bank" banks to the "non-independent" independent managing companies employed in conformity with mutual fund practice. While Lewis Carroll might have liked the consistency of the nomenclature just used, it is not clear that it befits a banking system. "Pretending" under misleading labels is not a good idea in banks. All "pretending" habits tend to spread.

for funds, using the government's credit? Well, naturally, almost every bank, being inherently saddled with much higher costs, and not wanting to go out of business, tried to get higher contractual interest rates on its loans. And this caused greater emphasis on loans for consumption and loans to financial promoters and real estate developers. Indeed, many of our most decisive bankers, quite logically, stopped trying to make loans to their most credit-worthy customers, accepting the disappearance of any important linkage between our best banks and our best businesses. The banks had been forced into an entirely different market niche (which already had some occupants): high-interest-rate lending.

And what can be expected when virtually all banks become specialists in high-interest-rate lending? It is hard to know for sure, because, throughout the past, high-interest-rate lending was hard to fund since it came from skeptical sources, instead of from government-insured deposits. Really large-scale, high-interest-rate lending is a comparatively recent phenomenon, made possible by governmental support in the form of deposit insurance used by banks with altered natures. But such experience as exists gives a likely answer: many bank insolvencies will come. Just as the simple, low-cost, cream-the-market strategy is a common business winner, the opposite strategy, involving high costs and high prices, is a common loser. High interest rate lending as a field has usually provided (1) some winners and (2) many casualties, often coming in bunches after periods of "follow-the-leader" asset-quality debasement. (Remember the widespread disasters in R.E.I.T. lending.) And the past bad experience should naturally worsen as the high-interest-rate lending field both expands and becomes overcrowded, driven by governmental support.

We are not alone in our diagnosis. Here is an excerpt from a recent *Wall Street Journal* editorial: "When more efficient, uninsured and less regulated financial institutions creamed off profitable lines of business, the [Bank of New England] was left concentrated in commercial real estate. This artificially diverted money into Boston's building boom, which inevitably became a bust."

Granting the presence of perverse incentives, what are the operating mechanics that cause widespread bad loans (where the higher interest rates do not adequately cover increased risk of loss) under our present system? After all, the bad lending, while it has a surface plausibility to bankers under cost pressure, is, by definition, not rational, at least for the lending banks and the wider civilization. How then does bad lending occur so often?

It occurs (partly) because there are predictable irrationalities among people as social animals. It is now pretty clear (in experimental social psychology) that people on the horns of a dilemma, which is where our system has placed our bankers, are extra likely to react unwisely to the example of other peoples' conduct, now widely called "social proof." So, once some banker has apparently (but not really) solved his cost-pressure problem by unwise lending, a considerable amount of imitative "crowd folly," relying on the "social proof," is the natural consequence. Additional massive irrational lending is caused by "reinforcement" of foolish behavior, caused by unwise accounting convention in a manner discussed later in this letter. It is hard to be wise when the messages which drive you are wrong messages provided by a mal-designed system.

In chemistry, if you mix items that explode in combination, you always get in trouble until you learn not to allow the mixture. So also, in the American banking system. To us, a lot of foolish, unproductive lending and many bank insolvencies are the natural consequences, given existing American banking culture, of the combination of the following two elements alone:

(1) virtually unlimited deposit insurance; and

(2) uncontrolled interest rates on insured deposits.

These two elements combine to create a Gresham's law effect, in which "bad lending tends to drive out good." Then, if factor (3) below is added to an already unsound combination, we think deposit-insurance troubles are sure to be further expanded — and not by a small amount:

(3) relatively unregulated, non-insured, low-cost "non-bank" banks.

Moreover, when the government starts suffering big deposit-insurance losses, if it continuously responds (in a natural, unthinking reaction) by raising deposit-insurance prices, we think it creates a "runaway-feedback" mode and makes its problems worse. This happens because the government, by adding even more cost pressure on banks, increases the cause of the troubles it is trying to cure. The price-raising "cure" is the equivalent of trying to extinguish a fire with kerosene.

Many eminent "experts" would not agree with our notions about systemic irresponsibility from combining (1) "free-market" pricing of interest rates with (2) government guarantees of payment. If many eminent "experts" are wrong, how could this happen? Our explanation is that the "experts" are over-charmed with an admirable, powerful, predictive model, coming down from Adam Smith. Those discretionary interest rates on deposits have a "free-market" image, making it easy to conclude, automatically, that the discretionary rates, like other free-market processes, must be good. Indeed, they are appraised as remaining good even when combined with governmental deposit insurance, a radical non-free-market element.

Such illogical thinking displays the standard folly bedeviling the "expert" role in any soft science: one tends to use only models from one's own segment of a discipline, ignoring or underweighing others. Furthermore, the more powerful and useful is any model, the more error it tends to produce through overconfident misuse.

This brings to mind Ben Graham's paradoxical observation that good ideas cause more investment mischief than bad ideas. He had it right. It is so easy for us all to push a really good idea to wretched excess, as in the case of the Florida land bubble or the "nifty fifty" corporate stocks. Then mix in a little "social proof" (from other experts), and brains (including ours) often turn to mush. It would be nice if great old models never tricked us, but, alas, "some dreams are not to be." Even Einstein got tricked in his later years.

We may be right or wrong. But, if we are right, if there are deep, structural faults in the American banking system, it follows that merely giving banks the right to branch across state lines, to sell insurance, or to enter investment banking (or all of the above) is not going to end our troubles.

Instead, a good long-term fix can come only after the government considers more extreme modifications in the system, each of which has powerful, vocal opponents. What are the more extreme modifications to consider? We think the list includes:

(1) greatly reducing deposit insurance;

(2) eliminating money-market funds;

(3) bringing back some form of controls on interest paid on insured deposits;

(4) intensifying regulatory control of bank lending in an attempt to reduce loan losses;

(5) forcing more conservative accounting covering bank lending;

(6) forcing weak banks into other hands before the weak banks become insolvent; and

(7) forcing insolvent banks into competing local banks, or entirely out of business, instead of into strong, out-of-state banks.

Let us next attempt a brief discussion of the merits and/or political prospects of each of these seven governmental options.

**Option (1): greatly reducing deposit insurance:**

To many people, remembering former banking panics, this option, adopted fully, seems like trying to solve the overcrowding problem by bringing back cholera. Accordingly, proponents of this option typically would limit its effects by (1) bringing back bank "runs" only for small banks (big banks, regardless of law, are "too big to fail" in all advanced countries) and (2) bringing back deposit losses only to some rich depositors. Because voters don't like bank "runs" of any size, and small banks don't like discrimination, it seems unlikely that reductions in deposit insurance are going to be made on a scale that solves the structural defect problem. Conceivably, "brokered" deposits could be removed from insurance coverage, in a move driven by legislative remembrance of many abuses involving stockbroker-assisted financing of despicable insured institutions. (Many stockbrokers could easily see that the insured certificates of deposit they were paid to sell were issued by institutions managed by knaves and fools, presiding over piles of junk loans and junk securities. The stockbrokers thus knew, or should have known, that their government was being robbed. To sell certificates under such conditions was a lot like finding currency in a post office bag and deciding it was ethical to keep it.)

**Option (2): eliminating the money-market funds:**

This option is almost never discussed. This seems peculiar. The money-market funds came into being without public policy input when some clever person combined (1) mutual fund status under the S.E.C. with (2) purchase, under subcontract, of services from a bank. What was created was, in essence, a virtually unregulated, uninsured bank furnishing interest-bearing savings and checking accounts. The creation of such entities would probably not have been authorized if new legislation had been necessary. Where else do we have virtually identical regulated and unregulated entities operating on the same scale, side by side? If new legislation had been needed, the following questions might have been raised:

(1) What do money-market funds do for "community" lending, lifeline services to the elderly, etc.?

(2) Are they fair to existing institutions?

(3) Won't the new "non-bank" banks make it harder for the Federal Reserve System to render constructive economic service?

(4) Since the public is already on the hook as guarantor of solvency of existing institutions, is it wise for the guarantor to risk losses from allowing uninsured, cream-the-market, more efficient operators to add to the competition? (This question would not be hard to answer in a private setting. If you were guarantor of all obligations of your brother-in-law's hamburger joint, you would consider it very foolish to allow McDonald's to commence operations by his side when you possessed the ability to prevent it.)

(5) Considering all of the above (and more), are the money-market funds in the long-term interest of the soundness and service of the total banking system?

These questions are still good questions. But possession is strength under law. The money-market genie is now out of the bottle. And, considering his size, it would be hard to put him back. The prospects of rebottling are plainly remote.

**Option (3): bringing back some form of controls on interest paid on insured deposits:**

This option, too, is now seldom discussed. Again, this seems peculiar. It is among the first things you or I would consider if we had to guarantee all obligations of that hamburger joint owned by a brother-in-law. We would no more guarantee an 11% obligation for him, when we could easily borrow at 8%, than we would burn currency in the fireplace. In fact, we would suspect dishonorable "monkey business" if an 11% transaction occurred.

One reason for present lack of legislative interest in interest-rate controls lies in the knowledge that a former version of such controls constricted housing credit when interest rates rose to high levels. No one now seems interested in trying to develop new controls, more flexible in form and practice, that would avoid former defects. Nor is anyone much interested in the success the Japanese (or the United States) had during a long period of control of interest rates paid by banks. The interest-rate-control option, at the moment, seems dead.

**Option (4): intensifying regulatory control of bank lending in an attempt to reduce loan losses:**

This option is already being exercised — erratically — with effects both good and bad. It certainly has successful counterparts in non-banking businesses. For instance, take McDonald's franchised restaurants. If you want to use the McDonald's authenticating name and arches on your restaurant, you have to operate in a very limited, foolproof way. Moreover, the McDonald's approach once worked in banking. When deposit insurance first came in, and long thereafter, most insured banks operated in simple, sound fashion, often through ill-paid employees. But, based on all recent precedents, the government won't now act like McDonald's, or itself in a former era. (If it wished to do that, it might now give deposit insurance to all the simple, sound money-market funds, lending to big business through purchases of commercial paper, and take deposit insurance away from all the banks and savings and loan associations!) Government, instead, will probably take the more limited approach of concurrently: (1) leaving banking over-stressed by competition, (2) leaving banking very complicated, (3) trying to prevent problems by writing massive, hard-to-understand regulations that create more work for lawyers, and then (4) monitoring bank operations through overburdened civil servants. These limited remedies may be better than nothing, but their prospects for causing a real banking fix seem poor. It is almost a general rule of American life that, when incentives are all wrong, controls (even criminal-law controls) can't fix our troubles. We can expect limited good effects from Option 4 and the continuation of important, basic problems.

**Option (5): forcing more conservative accounting covering bank lending:**

Bank accounting is a hot current topic, but conservatism is not the goal. Everyone is wondering how much to delay loan write-offs, when loans go sour, so as not to over-correct weak banks. We are not going to enter the lists on that problem.

The almost-never-discussed problem that interests us is that presented by newly made loans, bearing high interest rates, that under current bank accounting tend to be treated as "born good." The result is that all interest accrued, and sometimes some up-front fees, are treated as fully earned, even though the final outcome of the whole loan transaction is far from clear. To us, this is counterproductive accounting, even though we use it ourselves when pushed by convention.

We think current accounting for many high-interest-rate loans has terrible consequences in the banking system. In essence, it "front ends" into reported income revenues that would have been deferred until much later, after risky bets were more clearly won, if more conservative accounting had been employed. This practice turns many a banker into a human version of one of B. F. Skinner's pigeons, since he is "reinforced" into continuing and expanding bad lending through the pleasure of seeing good figures in the short term. The good figures substitute nicely in the mind for nonexistent underlying institutional good, partly through the process, originally demonstrated by Pavlov, wherein we respond to a mere association because it has usually portended a reality that would make the response correct.

Under prevailing accounting, banks now ordinarily report increases in both earnings and equity capital during any transition they make toward less conservative lending. And then, if more lending of that type is done, and is accompanied by growth in institutional size, good reported figures will continue for an additional period. If an increase in institutional size is deemed necessary, it is, of course, assured by the bank's access to the government's credit through deposit insurance.

We think acculturated corporate nature, in American financial institutions, simply cannot, on average, handle temptations implicit in this sort of accounting. Indeed, the succumbing to the temptations, in a manner not consistent with long-term institutional interest, often occurs through a subconscious process. The subconscious process includes bad effects from both (1) "social proof," and (2) a "reality-denial" mode that creates bias in people stimulated, honored and paid in proportion to institutional size. Under our present system a Columbia Savings, and many less obscene versions of its model, are almost inevitable.

Of course, a large minority, even a majority, of bankers will remain sound, despite the temptations. But this outcome is not sufficient to protect the deposit insurer from unacceptable ultimate losses. In due course, given present conditions, the deposit insurer will suffer from what some wag called the problem of there being so many more banks than bankers.

What should now be considered are mandatory accounting changes, including changes in accounting to shareholders, designed to force "back-ending" into reported income of revenue from various types of gamy lending (and letters of credit), in lieu of allowing "front-ending" to continue. The changes would cause American bank accounting, by fiat, to imitate what some of the best European bankers have long done by choice. Eventually, credibility might be returned to banks' audited financial statements, now often regarded as fairy tales.

Despite the obvious (to us) accounting defects that bedevil our system, we don't think any wise and important accounting changes will be made. Typical bank reaction to such proposals is, at best, that of the man who asked, well before his ultimate sainthood: "God, give me chastity, but not yet." Also, time periods for accomplishing even the simplest, "no-brainer" changes in accounting convention tend to stretch into years.

**Option (6): forcing weak banks into other hands before the weak banks become insolvent:**

This option is also a hot topic. Usual governmental practice at the moment is to force merger only when all shareholders' equity is gone and the deposit insurer has a large loss. This is "bonkers," due process gone mad. It seems entirely logical now to commence the forced merger or closure of many of the nation's 13,000 banks and to do it in many cases before a weak bank is insolvent. Because the need is so obvious, laws and customs may possibly change to cause more of this to happen. And interstate branching may be allowed in order to enlarge the number of potential bank buyers.

While these steps seem helpful, they won't fix the problem of deep structural fault in the system — at least within any acceptable time period. Look at the present carnage in airlines. Even when we are down to fewer than a dozen significant operators, messy airline failures continue. If we wait for an airline-style solution in banking, we will have to endure years, maybe decades, of suffering.

**Option (7): forcing insolvent banks into competing local banks, or entirely out of business, instead of into strong out-of-state banks:**

According to Martin Mayer, writing recently in *The Wall Street Journal*, the FDIC now typically deals with an insolvent bank by choosing between two options:

(1) forcing the insolvent bank into a competing local bank, or entirely out of business, thus dampening local competition; or

(2) first, replacing all the insolvent bank's bad assets with good assets, and, second, selling it to some skillful out-of-state buyer, after which process the new bank can help clobber the remaining also-weak-and-also-insured banks in the area.

Mayer believes it was "insane" for the FDIC to do as it did in many instances, which was to select option (2). According to Mayer, the FDIC thus arranged that "overcapacity was rigorously maintained." Mayer raises an interesting question. Coming back to the analogy earlier used, if you or I were really unlucky and were guarantor for seven local brothers-in-law, each with a troubled hamburger joint, what would we do when the first one went broke? We would surely reject the idea of, first, fixing up the defunct joint so that it was better than the others, and, second, guaranteeing the obligations of a new and more skillful out-of-state operator who wanted to enter the market by taking over the improved facility.

Mayer is right insofar as he implies that there are too many banks and bank branches, just as there were formerly too many filling stations, sometimes three or four at an intersection. The departed filling stations "never will be missed," so perhaps the FDIC should "have a little list," like the bloodthirsty figure in the Mikado.

Beyond that, we are not certain that Mayer's conclusions will always prove right. The basic banking system is right out of *Alice in Wonderland*, so maybe it's like non-Euclidean geometry and only *Alice-in-Wonderland*-type cures really fit in. After all, the scenario which troubles Mayer has a perverse beauty, at least to a government. The bank failures cascade, on and on, refreshed by new governmental acts, so that the FDIC can be saving a large part of the banking system each year for a long time.

And we must admit that, if we were the FDIC and were thus forced to participate heavily in our present banking system, like it or not, we would occasionally do what Mayer finds objectionable, in those rare cases when we saw a chance for greatly improving banking culture in some community. We would, for instance, occasionally sell a sick bank to John McCoy (of Banc One), even when this brought a new bank to a state full of troubled banks, if every in-state bank seemed too weak or foolish to be selected as an alternative buyer. We would figure that (1) some subsequent insolvencies of other local banks were in our long-term interest, (2) we were supporting a sound model, and (3) eventually, as the example spread, our troubles as deposit-insurer of a silly system would be reduced. We would then have a pleasant lull before the silly system caused new troubles to pop up, maybe even under McCoy's successors at Banc One.

While Mayer's subject is interesting, we probably don't have to worry much about worldly consequences. Outside science, it is amazing how little impact there can be from a powerful idea, published in a prominent place (such as the *Journal*). Everyone's experience is that you teach only what a reader almost knows, and that seldom.

If our foregoing comments about systemic irresponsibility and chances for a rational cure are right, or substantially right, it is hard to be optimistic about coming legislative "reform" of banking. Perhaps the best we can hope for is Menckenian reform where old error is replaced, not by truth, but by new error. It is also possible that we will see exactly the same old systemic error repeated, but bearing bells and whistles in the form of new bank powers. This outcome is roughly what is recommended by the banking lobby, which has evidently learned nothing from the history of the savings and loan laws.

Let us next turn to the savings and loan field. Here, faced with a more disastrous mess, the legislators were so outraged that they attempted what they thought was extreme reform: FIRREA. This legislation took a "back-to-basics" approach and has since been interpreted by regulators who seem to believe, understandably, that they must act as though they were tough "bouncers," given the job of bringing order to a drunken brawl (a description that understates what the regulators faced).

This regulatory approach is now squeezing out (1) much folly, and (2) some non-folly needed to keep institutions healthy. Most executives we know at other associations concentrate only on the negative side and are outraged at instances of regulatory elimination of non-folly. They tend to construe present FIRREA enforcement as the equivalent of Mark Twain's prescription for preventing children's stuttering: "Remove the lower jaw."

Our view is different, even though we are much harmed by FIRREA. We think the system needed new rules, interpreted by tough "bouncers," and that the "bouncing" process, done with sufficient vigor, inevitably involves some lumps for the undeserving. There may even be some deaths from "friendly fire." Nonetheless, the process must go on.

What concerns us is the most important question of all. Did our legislators, through FIRREA, even with their "never again" mindset, fix the most important systemic error in the savings and loan industry? We think not.

As the dust has cleared, the best savings and loan associations are clearly worse businesses than the best banks (which themselves have plenty of troubles). This conclusion is supported by both (1) stock market prices and (2) action of governmental liquidators in response to market conditions. Stocks of the best associations now sell at much lower price/book-value ratios than stocks of the best banks. And governmental liquidators are constantly selling association branches to banks while almost never selling bank branches to associations. FIRREA has not made associations, on average, as desirable for owners as banks. The two institutional types remain different and unequal, while quite comparable in essential residual function, now that Fannie Mae and Freddie Mac exist to perform a lion's share of the finance function supporting housing.

The savings and loan system, in a modern era in which the government is always a large net borrower, still tries to use short-term savings accounts to finance long-term housing lending. This is, in essence, a very bad idea, violating the logic of an elementary prescription: "If a thing isn't worth doing at all, it isn't worth doing well."

To be sure, some fix of systemic maturity-mismatch risk is now attempted, through encouragement of variable-rate loans. But the variable-rate loans typically "cap" interest rate escalation at a few percentage points, which must be done for moderate-income borrowers to prevent both (1) unacceptable hardship and (2) sudden falls in non-housing spending. This compromise is like having building codes in California protect only up to 5 points on the Richter earthquake scale. The compromise is almost sure to bring back, probably at a remote date, another horrible collapse of the savings and loan system.

As we say this, we are not critical of the best California associations, such as Home Savings, Great Western Savings and World Savings. These people have logical operations bearing one big systemic risk that cannot be avoided by permanent players. If we had to play forever under current rules, we would try to imitate them. But we would have a big disadvantage: "we don't know how to get there from here," because they have such momentum in systems, particularly in loan origination. Fortunately, no one is sentencing us to play forever in a game with a systemic risk we don't like and in which we are at a big disadvantage. Instead, we have temporized with a different, acceptable "there" in a form combining (1) a big holding of Freddie Mac, with (2) financial flexibility to adapt as we choose to new conditions.

So much for ridicule, pessimistic speculations, and excuses for our defects, always easy to provide. As any responsible calamity-howler should, we will now risk playing the fool in public by attempting to say what we would do with the bank/money-market fund/savings and loan system if we were Congress:

(1) Because we have a help-housing bias, we would keep government-assisted housing finance for low-to-moderate-income people. We would do this by forcing pension funds to maintain a significant portion of their assets in housing-related assets in the form of Freddie Mac and Fannie Mae mortgage-backed securities representing interests in fixed-rate mortgages. This

requirement strikes us as fair, given the tax exemption possessed by the pension funds. And the pension funds are the logical suppliers of housing finance because they by nature have (a) massive assets, and (b) liabilities with maturities matching homeowners' needs for long-term, fixed-rate credit. Our reason for specifying Freddie Mac and Fannie Mae securities as a conduit for housing assistance is our belief that these entities would assure loan quality better and more cheaply than would any government bureaucracy. In quantitative terms, we would leave housing finance more assisted than it is now, particularly for first-time home buyers who have won their spurs.

(2) We would merge the banks, money-market funds and savings and loan associations into one banking system, with insured deposits. The new banking system would be separate from both (a) industry and (b) the part of investment banking likely to disappoint investors. It would have the following characteristics:

(i) There would be one federal regulator that also served as deposit-insurer, in lieu of the truly crazy, inefficient Balkanization of our present regulatory and insurance apparatus. (Eliminating Balkanization would do more than reduce costs, delays, confusion and competition in laxity. There is a system-design advantage in making the deposit-insurance loss payer and the bank-controlling loss preventer one and the same. The system then becomes more "responsible" in the Frankelian sense, requiring that systems be organized, to the extent feasible, so that decision-makers, not others, bear consequences of decisions.)

(ii) There would be no bank-holding companies, but the new banks would have a monopoly in offering check-writing privileges, debit cards and credit cards, except for credit cards offered on behalf of a single vendor. (The new law would permit tax-free spinoffs of existing banks, newly organized banks, and non-banks to help existing corporations come into compliance. Spun-off non-banks could include specialists in high-interest-rate lending to businesses.)

(iii) Flexible, government-regulator-run controls would set a ceiling on interest that could be paid on bank accounts. (If you are going to guarantee the credit of an entire industry, there is a limit to the competition that is desirable. Besides, many banks will behave badly in their important function when they are under the extreme cost pressure, not normal in business, that occurs when one's competitors are all financed without limit by the government, through deposit insurance.)

(iv) All capital satisfying regulatory requirements would have to be in the form of stock, either common or preferred, except for "grandfathered" debt.

(v) Stockbrokers (and others) could buy for customers all the insured certificates of deposit they wished, but they could not, in exchange, receive commissions or other advantages from the banks issuing the certificates. ("Abuse it and lose it," is our motto.)

(vi) The federal regulator would have clear power, exercisable without an excess of "due process" or "second guessing," to close out or force sale or merger of weak banks well before they became insolvent. Banks could ordinarily avoid such calamities, after a first warning, by raising new capital through "rights" issues, or in some other way. (There is nothing novel in such a system. Close-out orders, issued well short of insolvency, have long been standard practice under regulatory practice governing securities and currency traders.)

(vii) Bank accounting for all purposes would count much revenue as profit only after all significant risk had been removed from the transactions generating the revenues. Bank dividends, of course, could be paid only from the more conservatively reported profits. Income tax would be deferred on the deferred revenues required by this new conservatism in accounting. (It is a terrible mistake, a novice's mistake, to try to control important behavior with an all-stick-and-no-carrot approach. Therefore, the carrot-providing tax deferment would be wise.)

(viii) There would be no 2,000-page mass of government regulations. But there would be some rule for business and real estate loans such as: loan as you wish, but no new loans count as bank assets unless supported by substantial equity, a stipulation that would create a large margin of safety.

(ix) Deposit-insurance rates would promptly be lowered from present levels, but under a new system so tough that risk of loss to the deposit insurer would be reduced, even after taking into account the effects from lower rates.

(x) The whole system would be designed to have the best businesses, small and large, again become intimate with the best banks. The banks would again concentrate on being (1) relatively low-interest-rate lenders to high-quality businesses, and (2) lenders to consumers who are not "fiscaholics". High-interest-rate lending, to people with weak credit, would be forced into non-banking systems retaining no common-management or common-premises links with banking.

There is, no doubt, much wrong with our recommendations. But there is also much wrong with our present system, which has helped cause a questionable shift in banking priorities and a big mess, with every prospect for more of the same. In contrast, there is little in history to suggest that our recommendations would be as bad. And even if the new system had serious faults, it would probably be a better way station on the path to a banking system befitting a great country.

In recent years the government has tried to maintain a useful, relatively trouble-free banking system by making the banking business bear increased competitive burdens, and, when the system has responded by working worse, the government has increased both the burdens and the permitted scope of banks' activities. After such revisions the system has again worked worse. Surely it is time to reverse our approach. We should act like the artillery officer who, when he has put one shell over the target, next tries to put a shell clearly short, expecting to get the desired result in due course.

Some people might worry that banking would get too profitable under the system we recommend. To this worry there are three answers:

(1) The prospect of better profits, with less risk, would tend to (a) reduce governmental losses as many billions of dollars worth of foreclosed thrift and bank assets are sold off by the FDIC, and (b) enable the government, through tough capital standards, to cause eager private augmentation of banking capital by shareholders, precisely what is needed.

(2) Based on past experience, the nation's bankers (including us) may, on average, be up to the challenge of not earning excessive profits, even in an easier system.

(3) If excessive profits came, they could easily be reduced in due course by a new governmental tax, charge or burden.

We now quitclaim legislative reform to those who make it their business. We also assure Wesco shareholders that this reform-minded section of our letter to shareholders is an unlikely-to-be-repeated aberration. It was caused, in part, by a combination of (1) overwhelming disgust with the present scene, and (2) long association by the writer with an eccentric fellow who may not share all the notions herein expressed but who encourages this kind of writing.

This eccentric, who heads Berkshire Hathaway, Wesco's parent corporation, believes for some reason that accumulated wealth should *never* be spent on oneself or one's family, but instead should merely serve, before it is given to charity, as an example of a certain approach to life and as a didactic platform. These uses, plus use in building the platform higher, are considered the only honorable ones not only during life but also after death. Shareholders who continue in such peculiar company are hereby warned by our example in writing this section: some of the eccentricities of this fellow are contagious, at least if association is long continued.

**Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $1,985,000 to normal net operating income in 1990, down 28% compared with $2,769,000 in 1989, when earnings were increased by $337,000 through termination of a pension plan. The decrease in 1990 profit occurred as pounds of product sold declined by 3%. Revenues were down slightly more, by 4%, to $57,018,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1990 continued, during one more year, to provide an extraordinary return on resources employed.

The good financial results have an underlying reason, although not one strong enough to cause the results achieved in the absence of superb management. Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses.

It is not common that steel warehouses have results like Precision Steel's. What we see, year after year, under David Hillstrom's leadership is boring, repetitive excellence as he remembers a basic catechism emphasizing service of the highest quality. We hope to remain associated with him for a long time.

**Wesco-Financial Insurance Company ("Wes-FIC")**

Wes-FIC's "normal" net income for 1990 was $14,924,000, versus $14,276,000 for 1989. The "normal" income figures excluded securities gains, net of income taxes, of $391,000 in 1990 versus $5,910,000 in 1989. These items are reported as "Net Gains on Sales of Securities," below.

At the end of 1990, Wes-FIC retained $68 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with the Fireman's Fund Group. This arrangement was terminated August 31, 1989, but it will take years before all claims are settled. Meanwhile Wes-FIC is helped by proceeds from investing "float."

Wes-FIC has another reinsurance arrangement, patterned after the one with Fireman's Fund, with Cypress Insurance Company, a wholly owned subsidiary of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's share of premiums earned under this arrangement was about $1.8 million in 1990. It is too early to forecast how this will work out, but the arrangement is very small and was not nearly so promising at outset as the Fireman's Fund deal, which began at a time when premium rates were being raised by dramatic, double-digit percentages. In contrast, premium rates on virtually all insurance have now been driven down by competition to levels that, at best, will produce small profits, even after including benefit from investing "float."

Wes-FIC is also writing a small amount of direct insurance business, as distinguished from reinsurance. It is licensed in Nebraska, Utah, and Iowa and can write "surplus lines" insurance in Alabama. Total direct premiums earned in 1990 were only $133,000.

Wes-FIC continues to have a "longage" of capital and a shortage of good insurance business. But every year that passes sees Wes-FIC's credit, and that of the Berkshire Hathaway Insurance Group, enhanced relative to the average competing insurer or reinsurer. We expect expansion of earned premiums in due course, made possible by (1) balance sheet strength, (2) a disciplined rejection of under-priced business, combined with quick, non-bureaucratic acceptance of fairly priced risks, and (3) more worry among insurance buyers about claims-paying capacity of competing insurers.

**All Other "Normal" Net Operating Income**

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to $4,030,000 in 1990 from $3,178,000 in 1989. Sources were (1) rents ($2,647,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) earnings of New America Electrical Corporation.

**Net Gains On Sales Of Securities**

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $391,000 in 1990 from $5,920,000 in 1989. As noted above, all $391,000 of these gains were realized in the Wes-FIC insurance subsidiary in 1990, versus $5,910,000 realized in 1989.

**Convertible Preferred Stockholdings**

At the end of 1990, Wesco and its subsidiaries owned $175 million, at cost, in convertible preferred stocks, all requiring redemption at par value within 10 years or so, and all purchased at par value:

| Security | Preferred Dividend Rate | Par Value of Holding | Conversion Price at Which Par Value May Be Exchanged for Common Stock | Market Price of Common Stock on 12/31/90 |
|---|---|---|---|---|
| Salomon Inc | 9.00% | $100 Million | $38.00 | $24.37 |
| The Gillette Company | 8.75% | 40 Million | 50.00 | 62.75 |
| USAir Group, Inc. | 9.25% | 12 Million | 60.00 | 15.75 |
| Champion International Corporation | 9.25% | 23 Million | 38.00 | 25.62 |

These preferred stocks were purchased at the same time Berkshire Hathaway purchased additional amounts of the same stocks at the same price per share.

Last year we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. In aggregate these holdings are probably worth a little more than we paid for them (with the Gillette holding now worth more and the USAir holding worth less than was paid for it). Effective April 1, 1991 conversion of the Gillette preferred will be forced, causing us to hold Gillette common stock which pays a much lower annual dividend.

**New America Electrical Corporation ("New America Electric")**

The financial results from Wesco's $8.2 million payment, made at the end of 1988, for 80% of the stock of New America Electric are included in our residual category: "All Other "Normal" Net Operating Income." New America Electric caused this category to benefit by only $158,000 in 1990 after adjustments under consolidated accounting convention.

Ignoring adjustments under consolidated accounting convention, Wesco's 80% share of New America Electric's earnings was $234,000 in 1990 versus $134,000 in 1989.

Balance sheet liquidity improved. Wesco's 80% share of New America Electric's cash at the end of 1990 was $2.8 million, versus $2 million at the end of 1989.

If you deduct from Wesco's cost ($8.2 million) Wesco's share of cash ($2.8 million), this leaves Wesco at risk for $5.4 million, on which it is earning an inadequate, but improving return.

The people at New America Electric have responded superbly to a difficult environment. It is a pleasure to watch Glen Mitchel, Thomas Vogele, Thomas Johnson and Jeff Mowry meet challenge. They have recently purchased, under terms showing promise, some of the assets, the trade name and the sales organization of another manufacturer of high-quality electrical equipment. And they continue to "shake down" the large new plant into which they recently moved.

Effective at the beginning of 1991, Thomas Vogele, a capable and enthusiastic manager, was promoted to President of New America Electric, assuming responsibility for operations. Glen Mitchel remains heavily involved as CEO. They, and the other executives, face large tasks: (1) incorporating complex, newly acquired product lines into the existing manufacturing base; and (2) generating increased sales of all products, new and old.

Even with the hard tasks ahead, we would not be surprised to see better financial results in 1991 and 1992, despite a recession that is bound to be extra hard on most manufacturers of electrical equipment, dependent as they are on new construction.

**Consolidated Balance Sheet and Related Discussion**

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1990 by about $46 million, down significantly from about $98 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $61.3 million. As earlier emphasized, about $56.2 million of this unrealized appreciation lies within the savings and loan subsidiary and includes $45.3 million of appreciation in stock of Freddie Mac.

The foregoing paragraph deals only with unrealized appreciation of securities above "carrying value." Wesco also has some unrealized appreciation in securities that is already in "carrying value." This has happened because Wesco's insurance subsidiary at December 31, 1990 had about $40.9 million in appreciation in common stocks (mostly stock of The Coca-Cola Company). Under a peculiar accounting convention applicable only to insurance companies, this appreciation, minus the income taxes that would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Wesco's Pasadena real estate comprises a full block containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings, which it would probably be wiser to destroy than improve. This real estate has a market value substantially in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,524,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value ($3,163,000) in Wesco's balance sheet at December 31, 1990, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but not in 1991 and 1992. The next two years are not likely to be good years for most owners of commercial real estate.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities. It values its AA+ credit rating.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity requires patience, at least for people like us.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, we seek to better understand the few decisions we make.*

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 12% in 1988-90, was dependent to a significant extent on securities gains, irregular by nature.

When Berkshire Hathaway bought into Wesco in 1973, the present stock (adjusted for a later three-for-one split) traded at about $6. At yearend 1990, the stock traded at $47⅞ and it has paid modest dividends, increased every year, during Berkshire Hathaway's stewardship.

The financial results for Wesco shareholders have not been bad. But they are not outstanding, considering the power of compound interest and the generally favorable business climate. And now,

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* It is interesting to compare Wesco's approach (deliberate non-diversification of investments in an attempt to be more skillful per transaction) with an approach promoted for years by Michael Milken to help sell junk bonds. The Milken approach, supported by theories of many finance professors, argued that (1) market prices were efficient in a world where investors get paid extra for enduring volatility (wide swings in outcomes); (2) therefore, the prices at which new issues of junk bonds came to market were fair in a probabilistic sense (meaning that the high promised interest rates covered increased statistical expectancy of loss) and also provided some premium return to cover volatility exposure; and (3) therefore, if a savings and loan association (or other institution) arranged diversification, say, by buying, without much examination, a large part of each new Milken issue of junk bonds, the association would work itself into the sure to-get-better-than-average-results position of a gambling house proprietor with a "house" edge. This type of theorizing has now wreaked havoc at institutions, governed by true-believers, which backed their conclusions by buying Milken's "bonds." Contrary to the theorizing, widely diversified purchases of such "bonds" have in most cases produced dismal results. We can all understand why Milken behaved as he did and believed what he had to believe in order to maintain an endurable self-image. But how can we explain why anyone else believed that Milken was paid 5% commissions to put "bond" buyers in the position of the house in Las Vegas? We suggest this cause: many of the foolish buyers, and their advisers, were trained by finance professors who pushed beloved models (efficient market theory and modern portfolio theory) way too far, while they ignored other models that would have warned of danger. This is a common type of "expert" error, as we have earlier indicated.

after all these years, Wesco continues to have (1) a *very* strong balance sheet, and (2) a shortage of direct ownership of businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, the parent company, Berkshire Hathaway, is better positioned. This outcome was explained in Wesco's annual report last year, to which we refer Wesco shareholders, new and old.

On January 24, 1991, Wesco increased its regular quarterly dividend from 20½ cents per share to 21½ cents per share, payable March 12, 1991, to shareholders of record as of the close of business on February 28, 1991.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T Munger

Charles T. Munger
Chairman of the Board

March 8, 1991

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P.E. 12/31/91

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# WESCO FINANCIAL CORPORATION

*Annual Report 1991*

*Form 10-K Annual Report 1991*

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all net gains from sales of marketable securities and foreclosed property) for the calendar year 1991 decreased to $22,872,000 ($3.21 per share) from $25,038,000 ($3.52 per share) in the previous year.

Consolidated net income (i.e., after net gains from sales of marketable securities and foreclosed property) increased to $29,522,000 ($4.15 per share) from $25,429,000 ($3.57 per share) in the previous year.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1991 | | December 31, 1990 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income of: | | | | |
| Mutual Savings | $ 3,644 | $ .51 | $ 4,099 | $ .58 |
| Wesco-Financial Insurance business | 13,986 | 1.96 | 14,924 | 2.10 |
| Precision Steel's businesses | 1,414 | .20 | 1,985 | .28 |
| All other "normal" net operating income[2] | 3,828 | .54 | 4,030 | .56 |
| | 22,872 | 3.21 | 25,038 | 3.52 |
| Net gain on sales of marketable securities | 5,825 | .82 | 391 | .05 |
| Net gain on sales of foreclosed property | 825 | .12 | — | — |
| Wesco consolidated net income | $29,522 | $4.15 | $25,429 | $3.57 |

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

## Mutual Savings

Mutual Savings' "normal" net operating income of $3,644,000 in 1991 represented a decrease of 11% from the $4,099,000 figure the previous year.

As usual, these "normal-income" figures come from an abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1990 and 1991 are set forth at the end of this annual report. They show (1) total savings accounts increasing to $289 million from the $286 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, including over $129 million invested in high quality, rapidly maturing mortgage-backed securities, and (4) a loan portfolio (mostly real estate mortgages) of about $101 million at the end of 1991, down moderately from $107 million at the end of 1990.

As pointed out in Note 9 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings overstates the amount realizable, after taxes, from sale or liquidation at book value. Wesco would get only about $31.3 million, after paying income taxes, from the liquidation at book value of the $48 million portion of Mutual Savings' shareholders' equity which is considered bad debt reserves for income tax purposes. The $3.6 million Mutual Savings earned (ignoring capital gains) in 1991 is an inadequate return (7.6%) on the $48 million amount at which we try to maintain shareholders' equity. It is an even more inadequate return on the somewhat higher amount of capital actually employed within Mutual Savings last year.

The loan portfolio at the end of 1991 bore an average interest rate of only 8.53%, probably the lowest rate on any collection of sound loans in the savings and loan industry. Nonetheless, we believe that the loan portfolio is worth approximately the book value at which it is carried. This appraisal seems right despite some unwise loans we made a couple of years ago, which caused us to reduce carrying value of home loans (and one foreclosed home, so far) by $200,000 in 1991.

Mutual Savings continues cheerfully to make a large number of fixed-rate loans to persons with low-to-moderate income, frequently in minority groups. We loan at below-market interest rates, intending to suffer considerable disadvantage as a matter of community service. But last year we couldn't suffer much disadvantage, despite our best efforts, because interest rates continually declined, making our inventory of loans in process rise in value. Next year we will do better at obtaining the disadvantage we seek, causing a worse outcome for shareholders. We will sell off most of these fixed-rate loans above a "pipe-line" inventory, because we don't like the interest-rate risks implicit in a loan-and-hold policy.

Generally (meaning without effect from unusual sources), Mutual Savings' future earning power during the short-term future has been impaired, exactly as we predicted, by recent revisions in savings and loan laws generally known under the acronym: "FIRREA".

Prodded by FIRREA, all Mutual Savings' preferred stocks in public utility companies have been sold at a considerable profit, and its $26 million holding of Salomon Inc convertible preferred stock (with a tax-equivalent yield of 12.6%) has been transferred at cost to another Wesco subsidiary. Soon, all extra-high-yielding assets will be gone. Meanwhile, regulatory costs have increased, and deposit-insurance costs will increase after exhaustion of a temporary exemption now in place. Short-term, this will probably lower our return on capital employed. But, long term, we will probably get back all the extra-high-tax-equivalent yield we once had, and more. This will happen if Federal Home Loan Mortgage Corporation ("Freddie Mac") continues to increase the dividend on our large holding of its stock as it last did a few days before this letter was written.

Moreover, despite FIRREA, Mutual Savings has reasonable prospects for doing much better than "all right" for a considerable number of years, because of potential assistance from two unusual sources.

A first (and small) source of potential assistance is the probability that we will make an overall profit, despite occasional quarterly losses, from disposition of foreclosed Santa Barbara real estate. This profit is now expected to be somewhat lower than the $12 million in unrealized land appreciation which we believe existed before we started development. The factors which have caused continuous reductions in our profit expectation are (1) the delays and indignities, even larger and more costly than expected, imposed by local laws, and (2) slow sales of houses and lots as California receives, for a change, more than its pro-rata share of a nationwide recession.

A second (and large) source of potential assistance is the probability that we will eventually realize gains from sales of portions of Mutual Savings' holding of 2,400,000 shares of Freddie Mac, traded on the New York Stock Exchange. At year-end 1991, Mutual Savings' carrying value of this holding was $71.7 million, and the unrealized pre-tax appreciation was $258.3 million. If Mutual Savings' Freddie Mac holdings had been liquidated at market value on December 31, 1991, the after-tax profit would have been about $152.1 million, or $21.37 per Wesco share outstanding.

As we have stated in previous annual reports, Freddie Mac has a much better basic business than Mutual Savings. That is why we did the logical thing and redeployed capital to reflect realities. Freddie Mac and its rough equivalent, "Fannie Mae," now perform most of the former function of the savings and loan industry in support of essential housing.

We continue to expect future changes in banking and savings and loan laws, combined with continuing troubles in many insured institutions, including some large ones. In such a climate, we continually explore expansion-by-acquisition options for Mutual Savings. We are not restricted to planning for a reasonable sort of future on the assumption that no large expansion will prove feasible.

**Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $1,414,000 to normal net operating income in 1991, down 29% compared with $1,985,000 in 1990. The decrease in

1991 profit occurred as pounds of product sold increased 12%. Revenues were up only 1% to $57,484,000, reflecting the pounding which competition gave to prices.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1991 handled a strong recessionary downdraft with skill. Profits were lower because of tough conditions, not poor management.

### Wesco-Financial Insurance Company ("Wes-FIC")

Wes-FIC's "normal" net income for 1991 was $13,986,000, versus $14,924,000 for 1990. The "normal" income figures excluded securities gains, net of income taxes, of $391,000 in 1990 versus none in 1991. These items are reported as "Net Gains on Sales of Securities," below.

At the end of 1991 Wes-FIC retained $54 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with the Fireman's Fund Group. This arrangement was terminated August 31, 1989, but it will take years before all claims are settled. Meanwhile Wes-FIC is helped by proceeds from investing "float."

The rest of Wes-FIC's insurance business is disappointingly small, but we continue to explore various options.

### All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,828,000 in 1991 from $4,030,000 in 1990. Sources were (1) rents ($2,801,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) results from New America Electrical Corporation.

### Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $5,825,000 in 1991 from $391,000 in 1990. All the gains last year were realized by Mutual Savings, in sales forced by FIRREA.

### Convertible Preferred Stockholdings

At the end of 1991, Wesco and its subsidiaries owned $135 million, at cost, in convertible preferred stocks, all requiring redemption at par value within 10 years or so from date of acquisition, all at par value:

| Security | Preferred Dividend Rate | Par Value of Holding | Conversion Price at which Par Value may be Exchanged for Common Stock | Market Price of Common Stock on 12/31/91 |
|---|---|---|---|---|
| Salomon Inc | 9.00% | $100 Million | $38.00 | $30.62 |
| USAir Group, Inc. | 9.25% | 12 Million | 52.35 | 12.12 |
| Champion International Corporation | 9.25% | 23 Million | 38.00 | 24.00 |

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In a previous year we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. In aggregate our remaining holdings are probably worth a little less than we paid for them. (We estimate that (1) the $12 million USAir holding is now worth about 35% less than was paid for it, (2) the $100 million Salomon holding is worth about 2% more than we paid for it, and (3) the $23 million Champion holding is worth about cost.) More than offsetting an overall shrinkag in value of retained holdings which is quite minor ($2.2 million), we last year converted a $40 million holding of Gillette convertible preferred stock into Gillette common stock worth $89.8 million at year end. See comments below under the title "Consolidated Balance Sheet and Related Discussion."

**New America Electrical Corporation ("New America Electric")**

The financial results from Wesco's $8.2 million payment, made at the end of 1988, for 80% of the stock of New America Electric are included in our residual category: "All Other "Normal" Net Operating Income." New America Electric caused this category to lose $40,000 in 1991 after adjustments under consolidated accounting convention.

Ignoring adjustments under consolidated accounting convention, Wesco's 80% share of New America Electric's earnings was $36,000 in 1991 versus $234,000 in 1990.

Balance sheet liquidity declined slightly. Wesco's 80% share of New America Electric's cash at the end of 1991 was $2.5 million, versus $2.8 million at the end of 1990, -- but New America purchased a new line of business last year, which more than accounts for the small reduction in cash.

If you deduct from Wesco's cost ($8.2 million) Wesco's share of cash ($2.5 million), that leaves Wesco at risk for $5.7 million, on which it is earning an inadequate return.

The people at New America Electric continue to respond superbly to a difficult environment, the worst since the 1930s, in commercial construction. It remains a pleasure to watch Glen Mitchel, Thomas Vogele, John Medel and Jeff Mowry meet challenge.

**Consolidated Balance Sheet and Related Discussion**

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1991 by about $259 million, up significantly from about $55 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $263 million. As earlier emphasized, about $258 million of this unrealized appreciation lies within the savings and loan subsidiary in the form of appreciation in stock of Freddie Mac.

The foregoing paragraph deals only with unrealized appreciation of securities above "carrying value." Wesco also has some unrealized appreciation in securities that is already in "carrying value." This has happened because Wesco's insurance subsidiary at December 31, 1991 had about $153 million in appreciation in common stocks (mostly stocks of The Coca-Cola Company and The Gillette Company). Under a peculiar accounting convention applicable only to insurance companies, this appreciation, minus the income taxes that would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Wesco's Pasadena real estate comprises a full block containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings, which it would probably be wiser to destroy than improve. Despite a sharp, nationwide reduction in value for office buildings, this real estate retains some market value in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,394,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value ($3,365,000) in Wesco's balance sheet at December 31, 1991, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 99% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. Even with these rational-but-not-very-common practices, a prime location and superior parking facilities, we no longer anticipate increases in cash flow during the next five years. We will catch some share of bad effects from glut conditions in the office building segment of the commercial real estate market, no matter how rationally we manage our building.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities. It values its AA+ credit rating.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity requires patience, at least for people like us whose valuable insights are few.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, we seek to better understand the few decisions we make.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 11% in 1989-91, was dependent to a significant extent on securities gains, irregular by nature.

On January 23, 1992, Wesco increased its regular quarterly dividend from 21½ cents per share to 22½ cents per share, payable March 12, 1992, to shareholders of record as of the close of business on February 28, 1992.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger
Charles T. Munger
Chairman of the Board

March 9, 1992

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WESCO PASADENA

# WESCO FINANCIAL CORPORATION

*Annual Report 1992*

*Form 10-K Annual Report 1992*

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" net operating income (i.e., before all net gains or losses from sales of marketable securities and foreclosed property and unusual charges associated with a proposed give-up of Mutual Savings' status as a regulated savings and loan association) for the calendar year 1992 decreased to $22,500,000 ($3.16 per share) from $22,872,000 ($3.21 per share) in the previous year.

Consolidated net income (i.e., after net gains or losses from sales of marketable securities and foreclosed property and unusual income tax charges associated with the proposed give-up of Mutual Savings' status as a regulated savings and loan association) decreased to $5,001,000 ($.70 per share) from $29,522,000 ($4.15 per share) in the previous year.

Wesco has three major subsidiaries: Mutual Savings, currently engaged in the savings and loan business in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1992 | | December 31, 1991 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income of: | | | | |
| Mutual Savings | $ 3,746 | $ .52 | $ 3,644 | $ .51 |
| Wesco-Financial Insurance business | 13,146 | 1.85 | 13,986 | 1.96 |
| Precision Steel's businesses | 2,075 | .29 | 1,414 | .20 |
| All other "normal" net operating income[2] | 3,533 | .50 | 3,828 | .54 |
| | 22,500 | 3.16 | 22,872 | 3.21 |
| Net gain on sales of marketable securities | 147 | .02 | 5,825 | .82 |
| Net gain (loss) on sales of foreclosed property | (146) | (.02) | 825 | .12 |
| Charges associated with the proposed give-up of Mutual Savings' status as a regulated savings and loan association[3] | (17,500) | (2.46) | — | — |
| Wesco consolidated net income | $ 5,001 | $ .70 | $29,522 | $4.15 |

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

(3) Consists of income tax provision on about $47 million of Mutual Savings' net worth considered bad debt reserve for income tax (not financial statement) purposes, required to be recorded at 1992 yearend as a result of the decision to give up Mutual Savings' status as a regulated savings and loan association and thereby trigger recapture, for income tax purposes, of the bad debt reserve.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

**Mutual Savings**

We have decided that Mutual Savings will shortly give up its status as a regulated savings and loan association. To achieve this objective, Mutual Savings is negotiating to sell to another financial institution, subject to regulatory approval, the leaseholds and related tangible personal property necessary to operate Mutual Savings' deposit-gathering offices. We expect that the buyer will assume all deposits and receive cash and other assets amounting, at Mutual Savings' book value, to slightly less than Mutual Savings' book value for the deposits assumed. After provision for costs, including some employee-severance payments, Wesco will probably report in 1993 a modest after-tax gain from the sale, measured from a point after the unusual income tax charge from bad debt reserve recapture in 1992.

At roughly the same time, Mutual Savings will transfer its real estate (including but not limited to its Santa Barbara seaside property) to a newly formed Wesco subsidiary which will thereafter manage the real estate and make such dispositions as seem appropriate.

After these transactions, Mutual Savings will retain a majority (at market value) of its former assets (consisting mostly of stock of Federal Home Loan Mortgage Corporation ["Freddie Mac"] and indirect loans in the form of securitized mortgages). Mutual Savings will then be merged into another long-existing Wesco subsidiary, Wesco-Financial Insurance Company, which will thereafter continue the portion of Mutual Savings' business that in recent years has employed the majority of its assets. However, the continuation of this business, including investment in mortgages, will be regulated by the Nebraska Department of Insurance, replacing the many different state and federal officials who now govern institutions like Mutual Savings.

We anticipate that future operating costs of the merged business will be very much lower than Mutual Savings' present costs as a heavily regulated institution. At the same time, asset deployment options will be greatly increased.

The 1992 earnings figures of Wesco include an unusual charge of $17.5 million caused by our decision to leave the regulatory scheme governing savings and loan associations. The figure consists of income tax provision on the $47 million of Mutual Savings' shareholders' equity that has never heretofore been taxed because it has been considered a bad debt reserve for income tax purposes.

Under conservative and reasonable accounting principles, when we first firmly planned to discontinue qualifying for that special bad-debt-reserve tax treatment which is given only to regulated savings and loan associations, we were required to accrue income tax provision as we have.

The financial impact on Wesco shareholders of the large new income tax provision at yearend 1992 is likely to be minimally negative over the short term and positive over the long term. After all, there are practical advantages in moving hundreds of millions of dollars of assets (at market value) from a high-cost, low-flexibility environment to a low-cost, high-flexibility environment.

Separate balance sheets of Mutual Savings at yearend 1991 and 1992 are set forth at the end of this annual report. They show (1) total savings accounts decreasing to $251 million from $289 million the year before and (2) a very high ratio of shareholders' equity to savings account liabilities (near the highest for any mature U.S. savings and loan association) even after the unusual 1992 yearend income tax charge of $17.5 million.

We reserved $200,000 for loan losses in 1991 and $650,000 more in 1992. These provisions constitute the only loan losses recorded in over a decade. They were caused by some bonehead errors we made in 1988-89, combined with the effects of the worst Southern California real estate recession in many years. On loans made after 1989, experience has reverted to wonderful.

Our prediction of future profit from disposition of foreclosed Santa Barbara seaside property goes down every year. Last year was no exception, but we still expect a small eventual profit, amounting approximately to compound interest on capital employed over the long development period.

At yearend 1992, Mutual Savings' carrying value of its holding of Freddie Mac common stock, traded on the New York Stock Exchange, was $71.7 million. The unrealized pre-tax appreciation was $276.6 million. If Mutual Savings' Freddie Mac holdings had been liquidated at market value on December 31, 1992, the after-tax profit would have been about $162.4 million, or $22.82 per Wesco share outstanding.

As we have stated in previous annual reports, Freddie Mac has a much better basic business than Mutual Savings. That is why we did the logical thing and redeployed capital to reflect realities. Freddie Mac and its rough equivalent, "Fannie Mae," now perform most of the former function of the savings and loan industry in support of essential housing.

**Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,075,000 to normal net operating income in 1992, up 47% compared with $1,414,000 in 1991. The increased 1992 profit was achieved in spite of a 2% decrease in pounds of product sold, and was attributable largely to some favorable quantity-order prices on steel purchased and a change in mix of product. Revenues were up only 1% to $58,048,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1992 continued, during one more year, to provide an extraordinary return on resources employed.

**Wesco-Financial Insurance Company ("Wes-FIC")**

Wes-FIC's net income for 1992 was $13,146,000, versus $13,986,000 for 1991.

At the end of 1992 Wes-FIC retained $45 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with the Fireman's Fund Group. This arrangement was terminated August 31, 1989, but it will take years before all claims are settled. Meanwhile Wes-FIC is helped by proceeds from investing "float."

Wes-FIC entered into another reinsurance arrangement in 1992 with National Indemnity Company ("NICO"), a wholly owned subsidiary of Berkshire Hathaway, Wesco's ultimate parent, whereby NICO retroceded to it 50% of certain personal lines reinsurance it had assumed. This arrangement was responsible for almost the entire $19.6 million of Wes-FIC's earned premiums for 1992.

After Wes-FIC's capital and claims-paying capacity have been greatly augmented by the merger into Wes-FIC of Mutual Savings, Wes-FIC plans, through subcontracts with the Berkshire Hathaway Insurance Group, to enter the business of super-catastrophe ("super-cat") reinsurance. In such event, we believe: (1) Wes-FIC will thereafter report earnings with very wide fluctuations as it sometimes gets hit by big losses caused by super-catastrophes such as 1992's Hurricane Andrew and sometimes realizes large underwriting profits in years in which no super-catastrophes occur, and (2) Wes-FIC will thereafter have somewhat improved prospects for long-term prosperity.

**All Other "Normal" Net Operating Income**

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,533,000 in 1992 from $3,828,000 in 1991. Sources were (1) rents ($2,816,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) results from New America Electrical Corporation.

**Net Gains on Sales of Securities**

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $147,000 in 1992 from $5,825,000 in 1991. All the gains were realized by Mutual Savings. Those realized in 1991 resulted from sales forced by Federal regulation.

## Convertible Preferred Stockholdings

At the end of 1992, Wesco and its subsidiaries owned $135 million, at cost, in convertible preferred stocks, all requiring redemption at par value within ten years or so from date of acquisition:

| Security | Preferred Dividend Rate | Par Value of Holding | Conversion Price at Which Par Value May Be Exchanged for Common Stock | Market Price of Common Stock on 12/31/92 |
|---|---|---|---|---|
| Salomon Inc | 9.00% | $100 Million | $38.00 | $38.12 |
| USAir Group, Inc. | 9.25% | 12 Million | 44.28 | 12.75 |
| Champion International Corporation | 9.25% | 23 Million | 38.00 | 28.75 |

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In a previous year we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. In aggregate our holdings are probably worth a little more than we paid for them. We estimate that (1) the $100 million Salomon holding is worth about 8% more than we paid for it, (2) the $12 million USAir holding is now worth about 25% less than was paid for it, and (3) the $23 million Champion holding is worth about 3% more than we paid for it. These figures when combined create $5.7 million in net appreciation at the 1992 yearend, attributable principally to the effect that the general decline in interest rates has had on values of fixed-rate investments.

## New America Electrical Corporation ("New America Electric")

The financial results from Wesco's $8.2 million payment, made at the end of 1988, for 80% of the stock of New America Electric are included in our residual category: "All Other 'Normal' Net Operating Income." New America Electric caused this category to lose $195,000 in 1992, up from a loss of $40,000 in 1991, after adjustments under consolidated accounting convention.

Ignoring adjustments under consolidated accounting convention, Wesco's 80% share of New America Electric's loss was $119,000 in 1992 versus income of $36,000 in 1991.

Balance sheet liquidity remained steady. Wesco's 80% share of New America Electric's cash at the end of 1992 remained unchanged from the $2.5 million reported at the end of 1991.

If you deduct from Wesco's cost ($8.2 million) Wesco's share of cash ($2.5 million), this leaves Wesco at risk for $5.7 million, on which it is earning an inadequate return.

The people at New America Electric continue to respond superbly to a difficult environment, the worst since the 1930s in commercial construction. It remains a pleasure to be associated with Glen Mitchel, John Medel and Jeff Mowry.

**Consolidated Balance Sheet and Related Discussion**

As indicated in the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1992 by about $278 million, up moderately from about $259 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $280 million. As earlier emphasized, $276.6 million of this unrealized appreciation lies within the savings and loan subsidiary in the form of appreciation in stock of Freddie Mac. None of the foregoing figures includes the net unrealized appreciation, per our appraisal, of $5.7 million in our holdings of convertible preferred stocks.

The foregoing paragraph deals only with unrealized appreciation of securities above "carrying value." Wesco also has some unrealized appreciation in securities that is already in "carrying value." This has happened because Wesco's insurance subsidiary at December 31, 1992 had about $163 million in appreciation in common stocks (mostly stocks of The Coca-Cola Company and The Gillette Company). Under a peculiar accounting convention applicable only to insurance companies, this appreciation, minus the income taxes that would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

Under this same peculiar accounting convention applicable only to insurance companies, Wesco's audited consolidated net worth is about to go up sharply. This will happen because unrealized appreciation in Freddie Mac stock, after provision for income tax as if sold, will count as net worth after Mutual Savings has been merged out of the savings and loan system and into the Wes-FIC insurance business. Sophisticated Wesco shareholders will not take this accounting quirk very seriously.

Wesco's Pasadena real estate comprises a full block containing (1) about 125,000 first-class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings, which it would probably be wiser to destroy than improve. Despite a sharp, nationwide reduction in value for office buildings, this real estate retains some market value in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,251,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value ($3,446,000) in Wesco's balance sheet at December 31, 1992, and (2) substantial current net cash flow (about $750 thousand per year) to Wesco after debt service on the mortgage. The modern office building is 97% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. Even with these rational-but-not-very-common practices, a prime location and superior parking facilities, we no longer anticipate increases in cash flow during the next five years. Instead, we expect continuing modest decreases. We are catching some share of bad effects from glut conditions in the office building segment of the commercial real estate market.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities. It values its AA+ credit rating. Indeed, it hopes to get the best credit rating possible, only one notch up, after giving up status as a savings and loan holding company.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity has been slow because our valuable insights are few.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, we seek to better understand the few decisions we make.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 7% in 1990-92 (9% before the unusual income tax charge of $17.5 million relating to the proposed give-up of Mutual Savings' status as a regulated savings and loan association), was dependent to a significant extent on securities gains, irregular by nature.

Wesco's record looks much better when changes in unrealized appreciation of marketable securities (held principally in its savings and loan and insurance subsidiaries) are taken into account. For instance, compare status at yearends 1989 and 1992:

| | Book Value of Common Equity, Before Any Unrealized Appreciation in Marketable Securities | Unrealized Appreciation, Before Any Provision for Income Tax, in Marketable Securities |
|---|---|---|
| 1989 | $262 million | $127 million |
| 1992 | $304 million | $441 million |

Wesco, as it manages its affairs, makes no effort to remove fluctuations, even extreme fluctuations, from reported earnings. All it cares about are long-term results.

On January 28, 1993, Wesco increased its regular quarterly dividend from 22½ cents per share to 23½ cents per share, payable March 10, 1993, to shareholders of record as of the close of business on February 11, 1993.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger
Chairman of the Board

March 25, 1993

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# WESCO FINANCIAL CORPORATION



*Annual Report 1993*

*Form 10-K Annual Report 1993*

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

**To Our Shareholders:**

Consolidated "normal" net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1993 decreased to $20,382,000 ($2.87 per share) from $22,500,000 ($3.16 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) increased to $19,718,000 ($2.77 per share) from $5,001,000 ($.70 per share) in the previous year.

Wesco in 1993 had three major subsidiaries: Mutual Savings, engaged until late in the year in the savings and loan business in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)(1):

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1993 | | December 31, 1992 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income of: | | | | |
| Mutual Savings | $ 2,458 | $ .35 | $ 3,746 | $ .52 |
| Wesco-Financial Insurance business | 12,434 | 1.75 | 13,146 | 1.85 |
| Precision Steel's businesses | 2,189 | .31 | 2,075 | .29 |
| All other "normal" net operating income(2) | 3,301 | .46 | 3,533 | .50 |
| | 20,382 | 2.87 | 22,500 | 3.16 |
| Net gain on sales of marketable securities | 1,156 | .16 | 147 | .02 |
| Net loss on sales of foreclosed property | — | — | (146) | (.02) |
| Unusual income tax charges | (1,109)(3) | (.16) | (17,500)(4) | (2.46) |
| Gain on disposition of Mutual Savings' deposits and some loans | 906 | .13 | — | — |
| Loss on disposition of approximately 80% interest in New America Electrical Corporation | (1,617) | (.23) | — | — |
| Wesco consolidated net income | $19,718 | $2.77 | $ 5,001 | $ .70 |

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Wesco and Mutual Savings headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco through June 30, 1993.

(3) Consists principally of effect of tax rate change on deferred tax on unrealized appreciation of marketable equity securities.

(4) Consists of income tax provision on about $47 million of Mutual Savings' net worth considered bad debt reserve for income tax (not financial statement) purposes, required to be recorded at 1992 yearend as a result of the decision to give up Mutual Savings' status as a regulated savings and loan association and thereby trigger recapture, for income tax purposes, of the bad debt reserve.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

**Mutual Savings and its Successors**

On October 8, 1993, Mutual Savings closed the sale covered by its contract, previously made and announced, with CenFed Bank ("CENFED"), a highly regarded, insured institution also headquartered in Pasadena. In part, this buyer had been chosen to take over Mutual Savings' offices because it was considered likely to serve depositors safely and well.

In the closing of the transaction, Mutual Savings transferred to CENFED that part of Mutual Savings' liabilities (principally insured deposit liabilities) which was causing Mutual Savings to pay substantial deposit-insurance premiums in exchange for remaining a highly regulated savings and loan association. Also transferred to CENFED were some mortgage loans and a large amount of cash offset by deposits assumed.

At roughly the same time, Mutual Savings transferred certain troubled assets to a newly organized Wesco subsidiary that will conduct a slow liquidation of those assets. The transferred assets were:

(1) the unsold residue (with a book value of $23.1 million) of Mutual Savings' now-slow-selling residential real estate project, created in an attempt to maximize proceeds from foreclosed mostly-seaside land in the Montecito district of Santa Barbara, California, plus

(2) other foreclosed real estate with an aggregate book value of $8.2 million, plus

(3) seven troubled first mortgage loans on houses, with an aggregate book value of $1.9 million.

Then, a little later, Mutual Savings, now removed by the CENFED transaction from savings and loan regulation, merged into Wesco's long-existing Omaha-domiciled insurance subsidiary, Wesco-Financial Insurance Company ("Wes-FIC"), thus causing continuation of Mutual Savings' business and continued business holding of its main assets by Wes-FIC. Assets thus transferred incident to the merger with Wes-FIC consisted mostly of $45.8 million (at book value) in high quality mortgage-backed securities plus 7.2 million shares of Federal Home Loan Mortgage Corporation ("Freddie Mac") with a cost of $71.7 million and a market value of $359.1 million (based on the 1993 yearend NYSE quotation of $49.87 per Freddie Mac share).

Accordingly, 1993 was the last year in which Wesco will report any earnings from the savings and loan business. In 1994 and thereafter roughly all former savings and loan business earning power will augment reported results of Wesco's Wes-FIC subsidiary, now greatly enlarged in net worth.

As the table showing sources of income indicates, Mutual Savings got creditably through its last year, contributing $2.5 million to normal net operating income, down 34% from $3.7 million in 1992. A $2.0 million pre-tax writedown in the fourth quarter of the residue of Mutual Savings' Montecito residential real estate project caused almost all of the 1993 reduction in income.

In addition, an after-tax gain of $906,000 ($.13 per Wesco share) was realized in the transaction between Mutual Savings and CENFED. As part of this transaction Wesco loaned CENFED's parent corporation $4 million for three years at a market rate of interest and made some guarantees of loan quality. Also, CENFED leased from Wesco for 15 years at a market rental rate the groundfloor space formerly occupied by Mutual Savings in Wesco's retained building, formerly named the "Mutual Savings Building" and now renamed the "CenFed Bank Building" pursuant to terms of the lease. And, later, the building was transferred by Wesco to its new California real estate subsidiary.

The building, with its new name, is shown in the photograph at the front of this annual report. (We were proud of the economical old photograph, used successively over so many years that all the automobile models therein had eventually disappeared from the earth, but we finally shot a new photograph after the savings and loan charter, as well as the automobile models, had vanished from the scene.)

Because all failures and faults deserve extra attention in annual reports, we hereby state for the second time that it is not only Wes-FIC which has succeeded to former assets of Mutual Savings. As indicated above, Wesco now has a new real estate subsidiary that, mostly, it does not want. The subsidiary, named MS Property Company, will hereafter both (1) hold and operate Wesco's office and parking property in Pasadena, California and (2), as we said above, liquidate the $33.2 million (at yearend 1993 book value) of assets neither transferred to CENFED nor left in Mutual Savings when it was merged into Wes-FIC. The liquidation part of the game will occur in a poor climate for liquidations. The California real estate crash has been no small crash, and it has taken a large toll on values. Our best guess is that Wesco will eventually (and slowly) realize, from all real estate assets of MS Property Company combined, (1) more than present book value but (2) less than present book value plus a market rate of interest, after corporate taxes.

Generally, real estate holding, and even real estate development, when conducted in publicly held corporate form, subject to corporate income taxes, has a very poor record for serving shareholders well. This occurs because the real estate game, in which most market values are set in transactions involving people who are not paying corporate income taxes and many of whom pay virtually no taxes at all, is not ordinarily lucrative enough to create a decent return for persons in the same game, disadvantaged by a level of corporate taxes. We have no antidote for the share of this general investment disadvantage now being borne by Wesco shareholders.

Shareholders who wonder why tag-end real estate assets from the past should now bedevil a small percentage of Wesco's future will not find the experience reassuring as they appraise management. In retrospect, it appears (1) that some troubles — from poor loan quality — came because the writer was not paying enough attention and (2) that a more devoted approach didn't work very well either as troubles — from the slow-selling residential real estate project in Montecito — came because the writer gave too much effort and attention, even going so far as to create in the project a personal house now worth considerably less than he paid for it in cash, much of which went to Mutual Savings under firm-price conditions it would very much like to see again.

However, the writer does not wish to go too far in wearing a hair shirt. All things weighed, Mutual Savings' record was not so bad, and its Montecito project will some years hence be recognized as a minor, one-of-a-kind, extremely creditable place, reflecting well on its creators. Moreover, it seems to the writer that any patient person who now buys a needed residence therein is virtually sure to come out quite well. **Accordingly, every Wesco shareholder who is a prospective user of a Montecito residence is hereby invited to consider buying into our project.**

A last word on Mutual Savings is now appropriate in requiem. Many Wesco shareholders have an income tax basis of only a few pennies (or less) per Wesco share and are related to respected founders. All the value they now own in their Wesco shares has eventually come from a tiny savings and loan association carried through a tough 1930s economic climate by these founders, long ago. Under such circumstances, heightened by a prideful remembrance of much service to California housing, some tinge of regret is inevitable for these shareholders and, indeed, even for shareholders like Berkshire Hathaway that came in much later. But we make no apology for changing course. In our view, Freddie Mac, which has low costs and pays no deposit insurance premiums, is a much better business than Wesco had in its heavily regulated savings and loan operation, and Wesco did the logical thing as it deployed Mutual Savings' assets and momentum to the better Freddie Mac business.

**Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,189,000 to normal net operating income in 1993, compared with $2,075,000 in 1992. Sales increased from $58,048,000 to $60,127,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1993 continued to provide a fine return on resources employed.

**Wesco-Financial Insurance Company ("Wes-FIC")**

Wes-FIC's normal net income for 1993 was $12,434,000, down slightly from $13,146,000 for 1992.

At the end of 1993 Wes-FIC retained about $39.3 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing "float."

As reported last year, Wes-FIC in 1992 entered into another reinsurance arrangement with National Indemnity Company ("NICO"), a wholly owned subsidiary of Berkshire Hathaway, Wesco's ultimate parent, whereby NICO retroceded to Wes-FIC 50% of certain personal lines reinsurance it had assumed. This arrangement was responsible for almost the entire $12.2 million of Wes-FIC's earned premiums for 1993. However, it terminated during 1993 because the original source of the reinsurance stopped making cessions to NICO.

In last year's annual report we informed shareholders that Wes-FIC planned, through reinsurance to be retroceded by Berkshire Hathaway, to enter the business of super-catastrophe ("super-cat") reinsurance in late 1993 or 1994. This would occur after Wes-FIC's net worth and claims-paying capacity had been greatly augmented by the proposed merger (which has now happened) of Wesco's former savings and loan subsidiary into Wes-FIC.

The super-cat reinsurance business then seemed a very logical business for Wes-FIC. After all, Wes-FIC would have a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to become a "stand alone" reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a "stand alone" reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

Unfortunately, after issuance of Wesco's 1992 Annual Report, other reinsurers, as 1993 progressed, hurried more and more into the super-cat field. As a consequence, volumes of super-cat reinsurance business available to NICO at prices that seemed rational were greatly reduced.

Under such circumstances of shortage at NICO of acceptable super-cat business, we later told shareholders (in the third quarter report) that NICO would probably have no surplus super-cat reinsurance business to cede to Wes-FIC.

In connection with the retrocessions of super-cat reinsurance from NICO to Wes-FIC the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of NICO and only 80% of Wesco and Wes-FIC, is not, for some philanthropic reason, ordinarily going to retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions will occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions will ordinarily happen only (1) when Berkshire Hathaway, for some reason (usually a policy of overall risk limitation) desires lower amounts of business than are available on the terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and (3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called "the punctilio of an honor the most sensitive," but it cannot be expected to make large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and the 1993 reductions in opportunities in the super-cat reinsurance market, it appeared until very recently that we were right in the 1993 third quarter report in projecting poor prospects over the near term for Wes-FIC's acquisition of retroceded super-cat reinsurance. But what are the predictions of man! In February 1994, Wes-FIC was offered by NICO participations in four *very* unusual super-cat reinsurance contracts. Considering its other exposures to the same risks, NICO was willing to retrocede to Wes-FIC 20% of what was then available to NICO under each contract in return for a ceding commission amounting to 3% of Wes-FIC's premiums to be received. The remaining 80% of the risk was to be retained by NICO. A little later, a fifth retrocession was offered: 10% of a one-year NICO property loss contract with a maximum loss amount of $50 million. The annual premium is 5% of the maximum possible loss.

Wes-FIC promptly accepted all of these five unusual super-cat reinsurance participations offered by NICO.

In the first four contracts, in aggregate, Wes-FIC thus became exposed, during a single year, to either winning about $4 million pre-tax or losing about $20 million pre-tax. In addition, there is some slight possibility of a huge "long tail" loss for Wes-FIC and NICO many years after the four contracts end, because a minority part of the insurance is liability insurance written on an "occurrence" basis. This is not the first time such "long tail" risks have been accepted by Wes-FIC. There are also, it should be remembered, possibilities for unpleasant surprises involving similar possible large "long tail" losses, many years hence, from Wes-FIC's long-terminated reinsurance arrangement with Fireman's Fund Group. Wes-FIC, now as then, is willing to run such "long tail" risks, carefully weighed against prospects for gain, provided it is much better capitalized than other insurance companies more influenced by animal spirits and institutional momentums.

In the fifth super-cat retrocession to Wes-FIC from NICO, which covers only property loss, there is no possibility of a surprising "long tail" loss. However, for the year covered, Wes-FIC has a very small chance of losing $5 million pre-tax, while it can gain only $250,000, less 3%, leaving Wes-FIC's net proceeds $242,500, pre-tax.

Needless to say, NICO does not believe that the average yearly loss to be expected from writing over many years a great series of super-cat reinsurance contracts like the five new ones it has retroceded in part to Wes-FIC would be as high as the one-year premiums to be received. But such super-cat reinsurance, like other super-cat reinsurance, is not for the faint of heart. A huge variation in annual results, with some *very* unpleasant years, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with wholly owned Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal "intermediary's" profit, hard to get because they must find a "layoff" seller both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any significant risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect *acceptable* long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements recently made with NICO, receives a special business-acquisition advantage from using Berkshire Hathaway's better credit rating and general reputation. Under all the circumstances, a 3% ceding commission seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, an important word about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by Berkshire Hathaway insurance subsidiaries. But, happily, the Berkshire Hathaway insurance group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be "eating their own cooking." Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a 3%-of-premiums ceding commission. Finally, two conditions must be satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably, more or less as we have done here.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have already proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions, if buyers of super-cat coverage are rational.

We have also examined other possible insurance-writing opportunities, and even insurance company acquisitions, not involving Berkshire Hathaway.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

### All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $3,301,000 in 1993 from $3,533,000 in 1992. Sources were (1) rents ($2,848,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office property (predominantly leased to outsiders and with CENFED as the new ground floor tenant), (2) interest and dividends from cash equivalents and marketable securities held outside the savings and loan and insurance subsidiaries, and (3) results from New America Electrical Corporation until its disposition.

### Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $1,156,000 in 1993 from $147,000 in 1992.

### Convertible Preferred Stockholdings

At the end of 1993, Wesco and its subsidiaries owned $135 million, at cost, in convertible preferred stocks, all requiring redemption at par value within ten years or so from date of acquisition:

| Security | Preferred Dividend Rate | Par Value of Holding | Conversion Price at Which Par Value May Be Exchanged for Common Stock | Market Price Common Stock on 12/31/93 |
|---|---|---|---|---|
| Salomon Inc | 9.00% | $100 Million | $38.00 | $47.63 |
| USAir Group, Inc. | 9.25% | 12 Million | 38.74 | 12.88 |
| Champion International Corporation | 9.25% | 23 Million | 38.00 | 33.38 |

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In previous years we described these convertible preferred stock investments as "sound but not exciting," noting that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our ideas have not changed. But in aggregate our holdings at yearend 1993 were worth more than we paid for them. We estimate that (1) the $100 million Salomon holding was worth about 25% more than we paid for it, (2) the $12 million USAir holding was worth about 25% less than we paid for it, and (3) the $23 million Champion holding was worth about 5% more than we paid for it. These figures when combined created $23.1 million in net appreciation, before taxes, at the 1993 yearend.

**New America Electrical Corporation ("New America Electric")**

It was not just Wesco's savings and loan privileges that left our corporate fold in 1993. New America Electric, of which Wesco has owned about 80% since 1988, sold its business last year to a long-established and high-quality midwestern firm engaged in similar businesses. During 1993, Wesco's share of net loss was $192,000 for the six-month period preceding sale of the business, and Wesco realized an additional after-tax loss of $1.6 million ($.23 per Wesco share) on final disposition of its interest.

The sale decision was made entirely by Glen Mitchel, New America Electric's CEO and 20% owner, who did not wish to wait for an eventual upturn in commercial construction after years of enduring a worst-since-the-1930s business climate to which he had adjusted through several painful downsizings. The bad timing of Wesco in entering the electrical equipment field when it did was entirely the result of misjudgment by the writer, caused by a strong, near-lifelong preference for predicting relative consequences from business and human quality while not attempting to predict business cycles.

Considering the very hostile business climate we later encountered, New America Electric's business was always run extremely well by Glen Mitchel, and his dedication and skill prevented us from losing much more than we did. The writer caused Wesco's loss, not Glen Mitchel.

**Consolidated Balance Sheet And Related Discussion**

As indicated in the accompanying financial statements, Wesco increased its net worth, as accountants compute it under their conventions, from $411.7 million at yearend 1992 to $626.1 million at yearend 1993.

This increase in reported net worth happened only in very small measure ($13.0 million) because of retention of 1993 income after deduction of dividends paid. Virtually the entire balance of the 1993 net worth increase occurred through accounting quirk and without real economic import, because (1) before 1993 only unrealized appreciation in equity securities of the Wes-FIC insurance subsidiary, after provision for income taxes to become due if the securities were sold, was included in Wesco's reported consolidated net worth, leaving all other securities valued at cost, whereas (2) in 1993, due to changed notions in accounting, all of

Wesco's consolidated unrealized appreciation in equity securities was given the same accounting treatment formerly in place at the Wes-FIC insurance subsidiary.

Even after the new accounting notions were applied, the result at yearend 1993 still leaves out of Wesco's consolidated net worth of $626.1 million a residue of unrealized appreciation — in Wesco's consolidated holdings of non-equity securities. This residue of unrealized appreciation exists almost entirely in Wesco's convertible preferred stocks, and, after tax provision, amounted to about $15.2 million more.

If this additional $15.2 million were added to the $626.1 million of Wesco's consolidated net worth reported at yearend 1993, the resulting figure of $641.3 million, or about $90 per Wesco share, would give an approximation of Wesco's after-tax liquidation value at yearend 1993.

The foregoing liquidation value figure is based on the assumption that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative, making our computation of approximate after-tax liquidation value slightly too low. But our computation is unlikely to be too low by more than a couple of dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential lies almost entirely in Wesco's equity in its office and parking property in Pasadena, plus the residue of Wesco's residential real estate project in Montecito) is now far below its former high, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free "loan" from the government equal to its deferred income taxes on unrealized gains, subtracted in determining its net worth. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about $24 per Wesco share at yearend 1993.

However, some day, perhaps soon, major parts of the interest-free "loan" must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $24 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $24 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about $8 per Wesco share at yearend 1993.

After the value of the advantage inhering in the interest-free "loan" is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free "loan" per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral "loan" present was $8 per Wesco share at yearend 1993, and after-tax liquidating value was then about $92 per share (figures that seem plenty high to the writer), Wesco's intrinsic value per share would become only about $100 per share at yearend 1993.

And, finally, this reasonable-to-this-writer, $100-per-share-figure for intrinsic per share value of Wesco stock should be compared with the $129.50 per share price at which Wesco stock was selling on December 31, 1993. This comparison indicates that Wesco stock was then selling about 30% above intrinsic value.

There are, to be sure, at least some circumstances where presence of some superior management in place at some corporation as large as Wesco would rationally justify an investor's payment of so large a premium over intrinsic value. It may even be remotely conceivable that the market's present implicit optimistic appraisal of Wesco's managerial quality will be justified by outcomes to follow. But it may also be that new buyers of Wesco stock are making a mistake similar to the one that would be made if the past performance of a very old NFL quarterback, including some performance that occurred long ago, was projected as likely to indicate long-term performance to come.

It has never been the writer's view that the unvarying duty of management is to whoop up the stock price. Instead, the duty is to "tell-it-like-it-is." Now, for some reason, perhaps the relative novelty of our approach, our "tell-it-like-it-is" attitude seems to be a contributing factor in pushing Wesco's stock price up — perhaps even higher than it would be if we followed the more normal whoop-it-up policy.

As part of a "tell-it-like-it-is" policy we now report that some recent Wesco stock-buying enthusiasm plainly has irrational roots. Indeed, some people have gone so far as to suggest that Wesco stock is a better buy than stock of Berkshire Hathaway because Wesco is smaller or because Wesco's stock price per share is lower. Such reasoning processes constitute arrant nonsense in method. Also nonsensical is the notion that business and human quality in place at Wesco is anywhere near as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco plainly provides much less intrinsic value than a similar dollar of book value at Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco vs Berkshire Hathaway stock at present stock-market quotations. Instead, we simply communicate, out of a feeling of duty, the writer's opinion that more caution is probably needed in some quarters as prospects for new buyers of Wesco stock are evaluated.

On January 26, 1994 Wesco increased its regular dividend from 23½ cents per share to 24½ cents per share, payable March 9, 1994, to shareholders of record as of the close of business on February 9, 1994.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T Munger

Charles T. Munger
Chairman of the Board

March 23, 1994

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# WESCO FINANCIAL CORPORATION

Annual Report 1994

Form 10-K Annual Report 1994

# WESCO FINANCIAL CORPORATION
# LETTER TO SHAREHOLDERS

**To Our Shareholders:**

Consolidated "normal" net operating income (i.e., before irregularly occurring items shown in the table below) for the calendar year 1994 increased to $24,659,000 ($3.46 per share) from $20,382,000 ($2.87 per share) in the previous year.

Consolidated net income (i.e., after irregularly occurring items shown in the table below) decreased to $18,972,000 ($2.66 per share) from $19,718,000 ($2.77 per share) in the previous year.

Wesco in 1994 had two major subsidiaries: Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business and in indirect real estate lending following its statutory merger with Mutual Savings on January 1, 1994, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

| | Year Ended | | | |
|---|---|---|---|---|
| | December 31, 1994 | | December 31, 1993 | |
| | Amount | Per Wesco Share | Amount | Per Wesco Share |
| "Normal" net operating income of: | | | | |
| Wes-FIC business | $21,582 | $3.03 | $12,434 | $1.75 |
| Precision Steel businesses | 2,900 | .40 | 2,189 | .31 |
| Mutual Savings | — | — | 2,458 | .35 |
| All other "normal" net operating income[2] | 177 | .03 | 3,301 | .46 |
| | 24,659 | 3.46 | 20,382 | 2.87 |
| Gain on sales of marketable securities | 163 | .02 | 1,156 | .16 |
| Decline in value of USAir preferred stock | (5,850)[3] | (.82) | — | — |
| Unusual income tax charges | — | — | (1,109)[4] | (.16) |
| Gain on disposition of Mutual Savings' deposits and some loans | — | — | 906 | .13 |
| Loss on disposition of 80% interest in New America Electrical Corporation | — | — | (1,617) | (.23) |
| Wesco consolidated net income | $18,972 | $2.66 | $19,718 | $2.77 |

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses and, in 1994, costs and expenses associated with delinquent loans and foreclosed real estate previously charged against Mutual Savings. Income was from ownership of the Wesco headquarters office building, primarily leased to outside tenants, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco through June 30, 1993.

(3) Represents writedown of investment in preferred stock of USAir Group, Inc., explained in section "Convertible Preferred Stockholdings" below.

(4) Consists principally of effect of tax rate change on deferred tax on unrealized appreciation of investments.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

**Mutual Savings and its Successors**

On October 8, 1993, Mutual Savings closed the sale covered by its contract, previously made and announced, with CenFed Bank ("CENFED"), a highly regarded, insured institution also headquartered in Pasadena. In part, this buyer had been chosen to take over Mutual Savings' offices because it was considered likely to serve depositors safely and well.

In the closing of the transaction, Mutual Savings transferred to CENFED that part of Mutual Savings' liabilities (principally insured deposit liabilities) which was causing Mutual Savings to pay substantial deposit-insurance premiums in exchange for remaining a highly regulated savings and loan association. Also transferred to CENFED were some mortgage loans and a large amount of cash offset by deposits assumed.

At roughly the same time, Mutual Savings transferred certain troubled assets to MS Property Company ("MS Property"), a newly organized Wesco real estate subsidiary that is slowly liquidating those assets. The 1994 yearend balances on MS Property's books of those transferred assets were:

(1) the unsold residue (with a book value of $18.8 million) of Mutual Savings' now-slow-selling residential real estate project, created in an attempt to maximize proceeds from foreclosed mostly-seaside land in the Montecito district of Santa Barbara, California, plus

(2) other foreclosed real estate and troubled first mortgage loans on houses, with a combined book value of $8.3 million.

On January 1, 1994, after its transfer of troubled assets to MS Property, Mutual Savings merged into Wesco's long-existing Omaha-domiciled insurance subsidiary, Wes-FIC, thus causing continuation of Mutual Savings' business and continued business holding of its main assets by Wes-FIC. Assets thus transferred incident to the merger with Wes-FIC consisted mostly of 7.2 million shares of Federal Home Loan Mortgage Corporation ("Freddie Mac") with a cost of $71.7 million and a 1994 yearend market value of $363.6 million (based on the 1994 yearend NYSE quotation of $50.50 per Freddie Mac share), plus approximately $30 million of high quality mortgage-backed securities.

Accordingly, 1993 was the last year in which Wesco reported any earnings from the savings and loan business. Beginning in 1994 roughly all former savings and loan business earning power augments reported results of Wesco's Wes-FIC subsidiary, now greatly enlarged in net worth.

An after-tax gain of $906,000 ($.13 per Wesco share) was realized in the transaction between Mutual Savings and CENFED. As part of this transaction Wesco loaned CENFED's parent corporation $4 million for three years at a market rate of interest and made some guarantees of loan quality. Also, CENFED leased from Wesco for 15 years at a market rental rate the ground floor space formerly occupied by Mutual Savings in Wesco's retained headquarters building, formerly named the "Mutual Savings Building" and now renamed the "CenFed Bank Building" pursuant to terms of the lease. And, later, the building was transferred by Wesco to MS Property.

The building, with its new name, is shown in the photograph at the front of this annual report.

Because all failures and faults deserve extra attention in annual reports, we hereby repeat what we emphasized last year: It is not only Wes-FIC that has succeeded to former assets of Mutual Savings. As indicated above, Wesco still retains a recently formed real estate subsidiary that, mostly, it does not want. The subsidiary, MS Property, both (1) holds and operates Wesco's office and parking property in Pasadena, California and (2) continues liquidation of the $27.1 million (at yearend 1994 book value) of assets heretofore described that were neither transferred to CENFED nor left in Mutual Savings when it was merged into Wes-FIC. The liquidation part of the game is occurring in a poor climate for liquidations. The California real estate crash has been no small crash, and it has taken a large toll on values. MS Property took a $3.0 million pre-tax writedown of the residue of Mutual Savings' Montecito residential real estate project during 1994, following a $2.0 million pre-tax writedown taken by Mutual Savings in 1993. Our best guess is that Wesco will eventually (and slowly) realize, from all real estate assets of MS Property combined, (1) more than present book value (after the two writedowns) but (2) less than such present book value plus interest imputed at a market rate, after corporate taxes.

Generally, real estate holding, and even real estate development, when conducted in publicly held corporate form, subject to corporate income taxes, has a very poor record for serving shareholders well. This occurs because the real estate game, in which most market values are set in transactions involving people who are not paying corporate income taxes and many of whom pay virtually no taxes at all, is not ordinarily lucrative enough to create a decent return for persons in the same game, disadvantaged by a level of corporate taxes. We continue to have no antidote for the share of this general investment disadvantage now being borne by Wesco shareholders. But, fortunately, it affects only a very small percentage of Wesco's consolidated assets.

**Precision Steel**

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, contributed $2,900,000 to normal net operating income in 1994, compared with $2,189,000 in 1993.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1994 continued to provide an excellent return on resources employed.

**Wesco-Financial Insurance Company ("Wes-FIC")**

Wes-FIC's normal net income for 1994 was $21,582,000, up significantly from $12,434,000 for 1993. The earnings on the assets contributed in the merger with Mutual Savings at the beginning of 1994 were responsible for the greater part of this increase.

At the end of 1994 Wes-FIC retained about $35 million in invested assets, offset by claims reserves, from its former reinsurance arrangement with Fireman's Fund Group. This arrangement was terminated August 31, 1989. However, it will take a long time before all claims are settled, and, meanwhile, Wes-FIC is being helped over many years by proceeds from investing "float."

In last year's annual report we informed shareholders that Wes-FIC had entered into the business of super-catastrophe ("super-cat") reinsurance through retrocessions from National Indemnity Company ("NICO"), a wholly owned insurance company subsidiary of Berkshire Hathaway, Wesco's ultimate parent. Wes-FIC's entry into the super-cat reinsurance business followed the large augmentation of its claims-paying capacity caused by its merger with Mutual Savings. In 1994, in recognition of Wes-FIC's sound financial condition, Standard and Poor's Corporation assigned to Wes-FIC the highest possible claims-paying-ability rating: AAA.

The super-cat reinsurance business continues to be a very logical business for Wes-FIC. After all, Wes-FIC has a large net worth in relation to annual premiums being earned. And this is exactly the condition rationally required for any insurance company planning to be a "stand alone" reinsurer covering super-catastrophe risks it can't safely pass on to others sure to remain solvent if a large super-catastrophe comes. Such a "stand alone" reinsurer must be a kind of Fort Knox, prepared occasionally, without calling on any other reinsurers for help, to pay out in a single year many times more than premiums coming in, as it covers losses from some super catastrophe worse than Hurricane Andrew. In short, it needs a balance sheet a lot like Wes-FIC's.

In connection with the retrocessions of super-cat reinsurance from NICO to Wes-FIC the nature of the situation as it has evolved is such that Berkshire Hathaway, owning 100% of NICO and only 80% of Wesco and Wes-FIC, is not, for some philanthropic reason, ordinarily going to retrocede to Wes-FIC any reinsurance business that Berkshire Hathaway considers desirable and that is available only in amounts below what Berkshire Hathaway wants for itself on the terms offered. Instead, retrocessions will occur only occasionally, under limited conditions and with some compensation to Berkshire Hathaway. Such retrocessions will ordinarily happen only (1) when Berkshire Hathaway, for some reason (usually a policy of overall risk limitation) desires lower amounts of business than are available on the terms offered and (2) Wes-FIC has adequate capacity to bear the risk assumed and

(3) Wes-FIC pays a fair ceding commission designed to cover part of the cost of getting and managing insurance business.

Generally, Berkshire Hathaway, in dealing with partly owned subsidiaries, tries to lean over a little backward in an attempt to observe what Justice Cardozo called "the punctilio of an honor the most sensitive," but it cannot be expected to make large and plain giveaways of Berkshire Hathaway assets or business to a partially owned subsidiary like Wes-FIC.

Given Berkshire Hathaway's unwillingness to make plain giveaways to Wes-FIC and reductions in opportunities in the super-cat reinsurance market in recent years, prospects are often poor for Wes-FIC's acquisition of retroceded super-cat reinsurance. Nonetheless, in February 1994, Wes-FIC was offered by NICO participations in four very unusual super-cat reinsurance contracts. Considering its other exposures to the same risks, NICO was willing to retrocede to Wes-FIC 20% of what was then available to NICO under each contract in return for a ceding commission amounting to 3% of Wes-FIC's premiums to be received. The remaining 80% of the risk was to be retained by NICO. A little later, a fifth retrocession was offered: 10% of a one-year NICO property loss contract with a maximum loss amount of $50 million. The annual premium is 5% of the maximum possible loss. Then, in June, a sixth contract became available.

Wes-FIC promptly accepted all of these six unusual super-cat reinsurance participations offered by NICO.

In the first four contracts, in aggregate, Wes-FIC thus became exposed, during a single year, to either winning about $4 million pre-tax or losing about $20 million pre-tax. In addition, there is some slight possibility of a huge "long tail" loss for Wes-FIC and NICO many years after the four contracts end, because a minority part of the insurance is liability insurance written on an "occurrence" basis. This is not the first time such "long tail" risks have been accepted by Wes-FIC. There are also, it should be remembered, possibilities for unpleasant surprises involving similar possible large "long tail" losses, many years hence, from Wes-FIC's long-terminated reinsurance arrangement with Fireman's Fund Group. Wes-FIC, now as then, is willing to run such "long tail" risks, carefully weighed against prospects for gain, provided it is much better capitalized than other insurance companies more influenced by animal spirits and institutional momentums.

In the fifth super-cat retrocession to Wes-FIC from NICO, which covers only property loss, there is no possibility of a surprising "long tail" loss. However, for the year covered, Wes-FIC has a very small chance of losing $5 million pre-tax, while it can gain only $250,000, less 3%, leaving Wes-FIC's net proceeds $242,500, pre-tax.

In the sixth retrocession from NICO, Wes-FIC is participating to the extent of 5% in a $400 million contract with 20th Century Industries, a California insurer currently attempting to recover from devastating effects of the Northridge, California earthquake. The amount of reinsurance under the contract (covering what is mostly earthquake risk) is declining monthly over the term, expiring early in 1995, as 20th

Century withdraws from the homeowners and earthquake insurance markets in California. Wes-FIC could earn a premium of approximately $1 million in 1995 under the contract.

Needless to say, NICO does not believe that the average yearly loss to be expected from writing over many years a great series of super-cat reinsurance contracts like those it has retroceded in part to Wes-FIC would be as high as the one-year premiums to be received. But such super-cat reinsurance, like other super-cat reinsurance, is not for the faint of heart. A huge variation in annual results, with some very unpleasant years, is inevitable.

But it is precisely what must, in the nature of things, be associated with these bad possibilities, with their huge and embarrassing adverse consequences in occasional years, that makes Wes-FIC like its way of being in the super-cat business. Buyers (particularly wise buyers) of super-cat reinsurance often want to deal with wholly owned Berkshire Hathaway subsidiaries (possessing as they do the highest possible credit ratings and a reliable corporate personality) instead of other reinsurers less cautious, straightforward and well endowed. And many competing sellers of super-cat reinsurance are looking for a liberal "intermediary's" profit, hard to get because they must find a "layoff" reinsurer both (1) so smart that it is sure to stay strong enough to pay possible losses yet (2) so casual about costs that it is not much bothered by a liberal profit earned by some intermediary entity not willing to retain any significant risk. Thus the forces in place can rationally be expected to cause acceptable long-term results for well-financed, disciplined decision makers, despite horrible losses in some years and other years of restricted opportunity to write business. And, again, we wish to repeat that we expect only acceptable long-term results. We see no possibility for bonanza.

It should also be noted that Wes-FIC, in the arrangements recently made with NICO, receives a special business-acquisition advantage from using Berkshire Hathaway's general reputation. Under all the circumstances, a 3% ceding commission seems more than fair to Wes-FIC. Certainly and obviously, Berkshire Hathaway would not offer terms so good to any other entity outside the Berkshire Hathaway affiliated group.

Finally, we repeat an important disclosure about Wes-FIC's super-cat-reinsurance-acquisition mechanics. It is impractical to have people in California make complex accept-or-reject decisions for Wes-FIC when retrocessions of reinsurance are offered by Berkshire Hathaway insurance subsidiaries. But, happily, the Berkshire Hathaway insurance group executives making original business-acquisition decisions are greatly admired and trusted by the writer and will be "eating their own cooking." Under such circumstances, Wesco's and Wes-FIC's boards of directors, on the writer's recommendation, have simply approved automatic retrocessions of reinsurance to Wes-FIC as offered by one or more wholly owned Berkshire Hathaway subsidiaries. Each retrocession is to be accepted forthwith in writing in Nebraska by agents of Wes-FIC who are at the same time salaried employees of wholly owned subsidiaries of Berkshire Hathaway. Moreover, each retrocession will be made at a

3%-of-premiums ceding commission. Finally, two conditions must be satisfied: (1) Wes-FIC must get 20% or less of the risk (before taking into account effects from the ceding commission) and (2) wholly owned Berkshire Hathaway subsidiaries must retain at least 80% of the identical risk (again, without taking into account effects from the ceding commission).

We will not ordinarily describe individual super-cat reinsurance contracts in full detail to Wesco shareholders. That would be contrary to our competitive interest. Instead, we will try to summarize reasonably, more or less as we have done here.

Will more reinsurance be later available to Wes-FIC through Berkshire Hathaway subsidiaries on the basis and using the automatic procedure we have above described? Well, we have often proved poor prognosticators. We can only say that we hope so and that more reinsurance should come, albeit irregularly and with long intermissions, if buyers of super-cat coverage are rational.

We continue to examine other possible insurance-writing opportunities, and also insurance company acquisitions, not involving Berkshire Hathaway.

Wes-FIC is now a very strong insurance company, with very low costs, and, one way or another, in the future as in the past, we expect to continue to find and seize at least a few sensible insurance opportunities.

On super-cat reinsurance accepted by Wes-FIC to date (March 9, 1995) there has been no loss whatsoever that we know of. However, no underwriting profit flowed through Wesco's books in 1994 because none of its super-cat contracts expired in 1994, and our accounting policy requires contract expiration before super-cat underwriting profit is recognized. Needless to say, we would not have similar reticence to report losses before contract expirations. Our super-cat accounting policy is not irrationally super-conservative, although it may amount to "best-practice" accounting.

**All Other "Normal" Net Operating Income**

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $177,000 in 1994 from $3,301,000 in 1993. Sources were (1) rents ($3,050,000 gross) from Wesco's Pasadena office property (leased almost entirely to outsiders and with CENFED as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiary, mostly offset in 1994 by certain costs and expenses that had not previously been charged against this category — namely, the costs and expenses of liquidating the delinquent loans and foreclosed real estate, including additions to loss reserves, that in prior years had been charged against Mutual Savings. The 1994 figure also includes an intercompany charge for interest expense ($826,000 after taxes) on borrowings from Wes-FIC made late in 1993 principally to facilitate the transfer of loans and foreclosed properties to MS Property. This intercompany *interest expense* does not affect Wesco's consolidated net income inasmuch as the same amount is included as *interest income* in Wes-FIC's normal net operating income.

## Net Securities Gains and Losses

Wesco's earnings in 1994 contain securities gains of $163,000, after income taxes, and also reflect the after-tax effect of a writedown of an investment in preferred stock of USAir Group, Inc. by $5,850,000, described in the section Convertible Preferred Stockholdings below. Earnings for 1993 include securities gains of $1,156,000, after income taxes.

## Convertible Preferred Stockholdings

At the end of 1994, Wesco and its subsidiaries owned $135 million, at original cost, in convertible preferred stocks, all requiring redemption at par value within ten years or so from date of acquisition.

The investments are carried on Wesco's consolidated balance sheet at fair market value and, with the exception of the investment in preferred stock of USAir Group, Inc. ("USAir"), any differences between historical cost and market value are included in shareholders' equity, net of income tax effect, without affecting reported net income, according to accounting convention. The investment in USAir, however, was written down to fair market value effective at 1994 yearend, and the resulting $5.9 million after-tax loss on the writedown, is shown as a separate charge on Wesco's accompanying 1994 statement of income. Following is a summary of these investments:

| Security | Preferred Dividend Rate | Par Value of Holding | Conversion Price at Which Par Value May Be Exchanged for Common Stock | Market Price of Common Stock on 12/31/94 | 12/31/94 Yearend Carrying Value of Holding |
|---|---|---|---|---|---|
| Salomon Inc ................ | 9.00% | $100 Million | $38.00 | $37.50 | $ 105 Million |
| USAir Group, Inc. .......... | 9.25% | 12 Million | 38.74 | 4.25 | 3 Million |
| Champion International Corporation .............. | 9.25% | 23 Million | 38.00 | 36.50 | 24.2 Million |

These preferred stocks were purchased at the same time Wesco's parent corporation, Berkshire Hathaway, purchased additional amounts of the same stocks at the same price per share.

In previous years we noted that "few, if any, investors have ever prospered mightily from investing in convertible preferred stocks of leading corporations." Our three holdings at yearend 1994 appear to bear this out. We estimate that (1) our $100 million Salomon holding was worth about 5% more than we paid for it, and (2) our $23 million Champion holding was worth about 5% more than we paid for it. These figures when combined created $6.2 million in pre-tax *appreciation*, versus the $9 million pre-tax *loss* just recorded on our investment in USAir. Readers should bear in mind, however, that Wesco's experience to date has been good in an investment in convertible preferred stock of The Gillette Company, made in 1989 at cost of $40 million, and converted into Gillette common stock in 1991. This investment is carried at a $119.8 million yearend market value in Wesco's consolidated 1994 balance sheet, $79.8 million higher than the investment cost. However, even with the good Gillette experience factored in, our overall investment returns from convertible preferred stockholdings have been unexciting, just as we have predicted.

## New America Electrical Corporation ("New America Electric")

It was not just Wesco's savings and loan privileges that left our corporate fold in 1993. New America Electric, of which Wesco has owned about 80% since 1988, sold its business in 1993 to a long-established and high-quality Midwestern firm engaged in similar businesses. During 1993, Wesco's share of net loss was $192,000 for the six-month period preceding sale of the business, and Wesco realized an additional after-tax loss of $1.6 million ($.23 per Wesco share) on final disposition of its interest.

The sale decision was made entirely by Glen Mitchel, New America Electric's CEO and 20% owner, who did not wish to wait for an eventual upturn in commercial construction after years of enduring a worst-since-the-1930s business climate to which he had adjusted through several painful downsizings. The bad timing of Wesco in entering the electrical equipment field when it did was entirely the result of misjudgment by the writer, caused by a strong, near-lifelong preference for predicting relative consequences from business and human quality while not attempting to predict business cycles.

Considering the very hostile business climate we later encountered, New America Electric's business was always run extremely well by Glen Mitchel, and his dedication and skill prevented us from losing much more than we did. The writer caused Wesco's loss, not Glen Mitchel.

The foregoing comments were repeated verbatim from Wesco's 1993 report. The writer, as a minority selling shareholder of New America Electric, realized his pro rata share of profit made by all selling shareholders when Wesco bought 80% of New America Electric in 1988 in a transaction approved by Warren Buffett, Berkshire Hathaway's chairman, and non-Munger directors of Wesco, none of whom owned any shares in New America Electric. Under these circumstances, it is only fitting that the writer's nose be again publicly rubbed in the ensuing bad result for Wesco.

## Consolidated Balance Sheet And Related Discussion

As indicated in the accompanying financial statements, Wesco increased its net worth, as accountants compute it under their conventions, to $678.1 million at yearend 1994, or about $95 per Wesco share, from $626.1 million at yearend 1993.

The $52 million increase in reported net worth in 1994 was the result of three factors: (1) $36.5 million resulting from continued net appreciation of investments after provision for future taxes on capital gains; (2) $12.0 million from retention of 1994 net income after deduction of dividends paid; (3) $3.5 million resulting from our decision at the beginning of 1994 to conform our accounting for investments in securities with fixed maturities to our accounting for marketable equity securities, with the result that we now carry them on the consolidated balance sheet at market value.

The foregoing $95-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value. Probably, this assumption is too conservative. But our computation of liquidation value is unlikely to be too low by more than a couple of dollars per Wesco share, because (1) the liquidation value of Wesco's consolidated real estate holdings (where interesting potential now lies almost entirely in Wesco's equity in its office property in Pasadena) is now far below its former high, and (2) unrealized appreciation in other assets (primarily Precision Steel) cannot be large enough, in relation to Wesco's overall size, to change very much the overall computation of after-tax liquidating value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated assets, it has, in effect, an interest-free "loan" from the government equal to its deferred income taxes on unrealized gains, subtracted in determining its net worth. This interest-free "loan" from the government is at this moment working for Wesco shareholders and amounted to about $27 per Wesco share at yearend 1994.

However, some day, perhaps soon, major parts of the interest-free "loan" must be paid as assets are sold. Therefore, Wesco's shareholders have no perpetual advantage creating value for them of $27 per Wesco share. Instead, the present value of Wesco's shareholders' advantage must logically be much lower than $27 per Wesco share. In the writer's judgment, the value of Wesco's advantage from its temporary, interest-free "loan" was probably about $9 per Wesco share at yearend 1994.

After the value of the advantage inhering in the interest-free "loan" is estimated, a reasonable approximation can be made of Wesco's intrinsic value per share. This approximation is made by simply adding (1) the value of the advantage from the interest-free "loan" per Wesco share and (2) liquidating value per Wesco share. Others may think differently, but the foregoing approach seems reasonable to the writer as a way of estimating intrinsic value per Wesco share.

Thus, if the value of the advantage from the interest-free tax-deferral "loan" present was $9 per Wesco share at yearend 1994, and after-tax liquidating value was then about $95 per share (figures that seem plenty high to the writer), Wesco's intrinsic value per share would become only about $104 per share at yearend 1994, up 4% from intrinsic value as guessed in a similar calculation at the end of 1993.

And, finally, this reasonable-to-this-writer, $104-per-share figure for intrinsic per share value of Wesco stock should be compared with the $115.12 per share price at which Wesco stock was selling on December 31, 1994. This comparison indicates that Wesco stock was then selling about 11% above intrinsic value.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. In this connection, it should be noted that the writer caused or helped cause not only Wesco's New America Electric loss but also (1) what will now plainly turn out to be a bad financial result, opportunity cost considered, from development of foreclosed mostly-seaside land in the Montecito district of Santa Barbara and (2) some recent losses from boom-time mortgage loans on residences. Wesco, under the writer's leadership, has managed to be clobbered in three different ways by the California real estate crash, albeit in categories employing a very small portion of Wesco's assets.

Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

On January 18, 1995 Wesco increased its regular dividend from 24½ cents per share to 25½ cents per share, payable March 8, 1995, to shareholders of record as of the close of business on February 8, 1995.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T Munger

Charles T. Munger
Chairman of the Board

March 9, 1995