

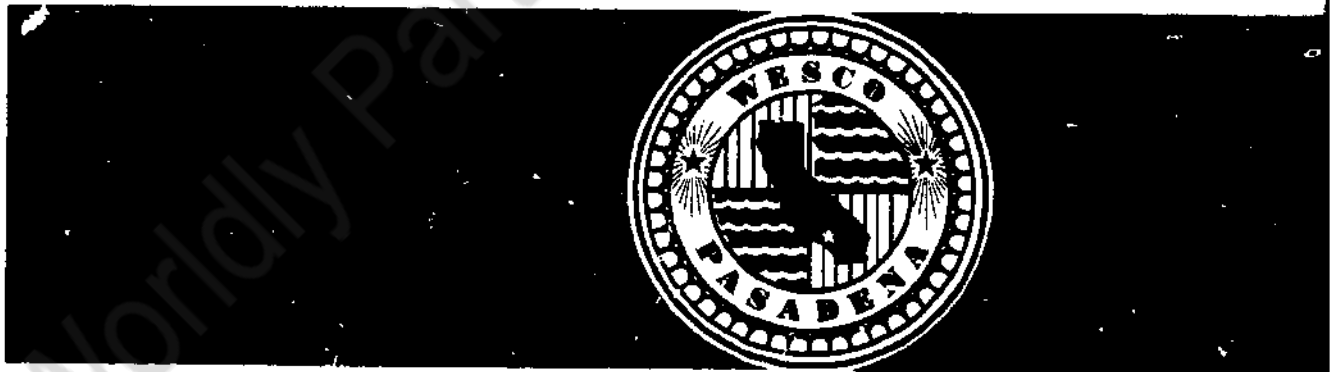
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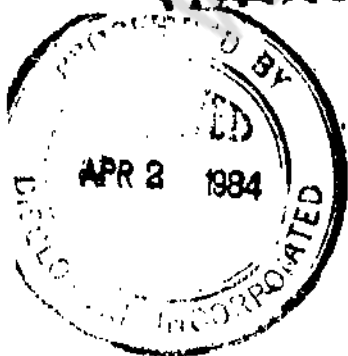
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WESCO FINANCIAL CORPORATION



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):

Year Ended	Ordinary Net Operating Income of		All Other Ordinary Net Operating Income <sup>(1)</sup>	Net Gains on Sales of Securities, Mortgages and Important Fixed Assets <sup>(2)</sup>	Wesco Consolidated Net Income
	Mutual Savings	Precision Steel Businesses			
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 155,000 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 ... 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