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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 compensa-

tion 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.

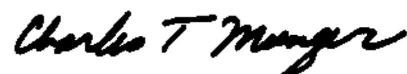
Moreover, our approach continues to be applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway Inc., Wesco's parent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

February 24, 1989