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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;

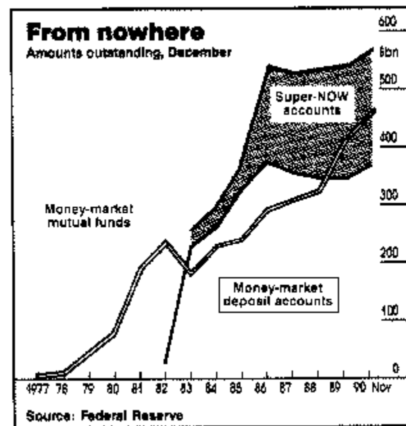
(3) kept its *total* operating costs under two-tenths of 1% of deposits per annum as it avoided costs of maintaining branch offices, deposit insurance, etc.;

(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

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* 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
Chairman of the Board

March 8, 1991