WESCO FINANCIAL CORPORATION

Annual Report 2008

Form 10-K Annual Report 2008

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated net "operating" income (i.e., before realized investment gains shown in the table below) for the calendar year 2008 decreased to $77,562,000 ($10.89 per share) from $93,405,000 ($13.12 per share) in the previous year.

Consolidated net income decreased to $82,116,000 ($11.53 per share) from $109,161,000 ($15.33 per share) in 2007. These figures included realized after-tax investment gains of $4,554,000 ($.64 per share) for 2008 and $15,756,000 ($2.21 per share) for 2007.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company ("Wes-FIC"), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company ("Kansas Bankers"), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation ("CORT"), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. ("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 thousands except for per-share amounts)[(1)]:

	Year Ended			
	December 31, 2008		December 31, 2007	
	Amount	Per Wesco Share[(2)]	Amount	Per Wesco Share[(2)]
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting gain (loss)	$ (2,942)	$ (.42)	$ 7,040	$ .99
Investment income	64,274	9.03	65,207	9.16
CORT furniture rental business	15,744	2.21	20,316	2.85
Precision Steel businesses	842	.12	915	.13
All other "normal" net operating earnings (loss)[(3)]	(356)	(.05)	(73)	(.01)
	77,562	10.89	93,405	13.12
Realized investment gains	4,554	.64	15,756	2.21
Wesco consolidated net income	$82,116	$11.53	$109,161	$15.33

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has no dilutive capital stock equivalents.

(3) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders. The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting (premiums earned, less insurance losses, loss adjustment expenses and underwriting expenses) with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	Year Ended December 31, 2008	2007
Premiums written	$316,472	$ 54,839
Premiums earned	$237,964	$ 54,411
Underwriting gain (loss)	$ (4,527)	$ 10,831
Dividend and interest income	84,920	89,716
Income before income taxes	80,393	100,547
Income taxes	19,061	28,300
Total operating income — insurance businesses	$ 61,332	$ 72,247

Following is a breakdown of premiums written (in 000s):

	2008	2007
Wes-FIC reinsurance —		
Swiss Re contract	$265,248	$ —
Aviation pools	33,374	35,346
Kansas Bankers primary insurance	17,850	19,493
Premiums written	$316,472	$ 54,839

Following is a breakdown of premiums earned (in 000s):

	2008	2007
Wes-FIC reinsurance —		
Swiss Re contract	$183,166	$ —
Aviation pools	34,418	34,998
Kansas Bankers primary insurance	20,380	19,413
Premiums earned	$237,964	$ 54,411

Following is a breakdown of after-tax results (in 000s):

	2008	2007
Underwriting gain (loss) —		
Wes-FIC reinsurance	$ (1,405)	$ 1,403
Kansas Bankers primary insurance	(1,537)	5,637
Underwriting gain (loss)	(2,942)	7,040
Net investment income	64,274	65,207
Total operating income — insurance businesses	$ 61,332	$ 72,247

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes after-tax investment gains of $4.6 million realized in 2008 and $15.8 million, in 2007. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business. For several years, through yearend 2007, Wes-FIC's principal reinsurance activity consisted of only the participation in several pools managed by an insurance subsidiary of Berkshire Hathaway, Wesco's 80%-owning parent. The arrangement became effective in 2001 and has covered hull, liability and workers' compensation exposures relating to the aviation industry, as follows: for 2006, to the extent of 12½% of the hull and liability pools and 5% of the workers' compensation pool; and, since 2007, 16.67% of the hull and liability pools and 5% of the workers' compensation pool. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss.

At the beginning of 2008, Wes-FIC entered into a retrocession agreement with National Indemnity Company ("NICO"), another Berkshire Hathaway insurance subsidiary, for the assumption of 10% of NICO's 20% quota-share reinsurance of Swiss Reinsurance Company and its principal property-casualty affiliates ("Swiss Re"). Under this agreement, which was enthusiastically approved by Wesco's Board of Directors, Wes-FIC has assumed 2% of essentially all Swiss Re property-casualty risks incepting over the five-year period which began on January 1, 2008, on the same terms as NICO's agreement with Swiss Re. Wes-FIC's share of written and earned premiums under the contract for 2008 were $265.2 million and $183.2 million, representing a very significant increase in Wes-FIC's reinsurance activities to date. It is important to keep in mind that premiums assumed under the contract in each of the next four years could vary significantly depending on market conditions and opportunities.

It is the nature of even the finest property-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 property-casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than in the non-reinsurance portion. Wesco shareholders should remain aware of the inherent imperfections of Wes-FIC's accounting, based as it is on forecasts of outcomes in many future years.

Wes-FIC's underwriting results have typically fluctuated from year to year, but have been satisfactory. When stated as a percentage, the sum of insurance losses, loss adjustment expenses and underwriting expenses, divided by premiums, gives the combined ratio. The combined ratios of Wes-FIC have been much better than average for insurers. Wes-FIC's combined ratios were 101.0% for 2008, 93.9% for 2007 and 94.0% for 2006. We try to create some underwriting gain as results are averaged out over many years. We expect this to become increasingly difficult.

Float is the term for money we hold temporarily, and, as long as our insurance underwriting results are break-even or better, it costs us nothing. We expect that the new business venture with NICO will significantly increase Wes-FIC's float, from its yearend 2008 balance of $164 million, thus providing additional opportunities for investment.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately $80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small- and medium-sized community banks, is spread throughout 39 mainly Midwestern states. Kansas Bankers offers policies for crime insurance, check kiting fraud indemnification, Internet banking catastrophe theft insurance, Internet banking privacy liability insurance, directors and officers liability, bank employment practices, and bank insurance agents professional errors and omissions indemnity.

Because of recent events in the banking industry, including a number of bank failures, we are less confident in the long-term profitability of Kansas Bankers' long-established line of deposit guarantee bonds than previously. These bonds insure specific customer bank deposits above Federal insurance limits. After sustaining a loss of $4.7 million, after taxes, from a bank failure in the latter half of 2008, Kansas Bankers discontinued writing deposit guarantee bonds, and in September 2008 it began to exit this line of insurance as rapidly as feasible. The aggregate face amount of outstanding deposit guarantee bonds has been reduced, from $9.7 billion, insuring 1,671 institutions at September 30, 2008, to $3.4 billion, insuring 796 institutions at February 15, 2009, the first date that non-renewals and non-voluntary cancellations became effective. It is believed that few of the institutions Kansas Bankers insures are facing significant risk of failure. Because of aggregate limits as well as the purchase of reinsurance, the after-tax risk to Wesco from the failure of any single bank insured by Kansas Bankers is limited to a maximum of $7.6 million. Thus, we believe that Wesco's shareholders' equity is not significantly at risk as Kansas Bankers rapidly exits this line of insurance.

This decrease in exposure to loss, of course, will cause a sharp decline in Kansas Bankers' insurance volume, inasmuch as premiums from guarantee bonds not only approximated half of Kansas Bankers' written premiums for 2008, but also represented the entirety of the business it has recently conducted in 16 of the 39 states in which it is licensed to write insurance.

When Wesco purchased Kansas Bankers, it had been ceding almost half of its premium volume to reinsurers. In 2008 it reinsured only about 14%. And, because it has also restructured the layers of losses reinsured, it is now better protected from the downside risk of large losses. Effective in 2006, insurance subsidiaries of Berkshire Hathaway became KBS's sole reinsurers. Previously, an unaffiliated reinsurer was also involved. The increased volume of business retained comes, of course, with increased irregularity in the income stream. Kansas Bankers' combined ratios were 111.6% for 2008, 55.1% for 2007 and 73.8% for 2006. We continue to expect volatile but favorable long-term results from Kansas Bankers.

CORT Business Services Corporation ("CORT")

In February 2000, Wesco purchased CORT Business Services Corporation ("CORT") for $386 million in cash.

CORT is a very long-established company that is the country's leader in rentals of high-quality furniture that lessees have no intention of buying. In the trade, people call CORT's activity "rent-to-rent" to distinguish it from "lease-to-purchase" businesses that are, in essence, installment sellers of furniture.

However, just as Enterprise, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled $410 million for calendar 2008, versus $396 million for calendar 2007. Of these amounts, furniture rental revenues were $340 million and $327 million, furniture sales revenues were $62 million each year, and rental relocation revenues were $8 million and $7 million. CORT operated at after-tax profits of $15.7 million for 2008 and $20.3 million for 2007.

Since its acquisition, CORT has made several "tuck-in" acquisitions, most recently, the residential furniture rental division of Aaron Rents, Inc., and earlier in 2008, the establishment of international operations through the purchase of Roomservice Group, a small regional provider of rental furniture and relocation services in the United Kingdom, now doing business as CORT Business Services UK Ltd. CORT has also started up a nation-wide apartment locator service, originally intended mainly to supplement CORT's furniture rental business by providing apartment locator and ancillary services to relocating individuals. Paul Arnold, long CORT's star CEO, and his management team, have devoted much effort over the past two years, expanding and redirecting CORT's rental relocation services toward the needs of businesses and government agencies who require a skilled and able partner to provide comprehensive and seamless relocation services for the temporary relocation of employees worldwide.

CORT's operating results are subject to economic cycles. When we purchased CORT, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector. Shortly thereafter, with the burst of the dot-com bubble, followed by the events of September 11 and a protracted slowdown in new business formation, CORT's operations were hammered, reflecting generally bad results in the "rent-to-rent" segment of the furniture rental business. There followed a far-too-short period of improving business conditions which have more recently given way to increasingly difficult recessionary conditions, perhaps the beginning of the worst economic recession in decades.

Under Wesco's ownership, CORT has continuously undertaken to improve its competitive position. With several websites, principally, www.cort.com and www.apartmentsearch.com, professionals in more than 80 domestic metropolitan markets, affiliates servicing more than 50 countries, almost twenty thousand apartment communities referring their tenants to CORT, many ancillary services, and its entrée to the business community as a Berkshire Hathaway company, CORT is better positioned than previously to benefit from an economic turnaround, certain to occur in due course. Near term, we expect more of the difficult business conditions of the recent past.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

Precision Steel Warehouse, Inc. ("Precision Steel")

The businesses of Wesco's Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, operated at after-tax profits of $0.8 million in 2008 and $0.9 million in 2007. These figures reflect after-tax LIFO inventory accounting adjustments decreasing after-tax income by $0.7 million for 2008 and $1.0 million for 2007. Precision Steel's operating results for 2008 also reflect the benefit of $0.2 million, after taxes, from the reversal of a portion of a provision for estimated expenses recorded in prior years in connection with the environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the LIFO accounting adjustments or the benefit from the reversal of those environmental-related expenses, Precision Steel would have reported after-tax operating income of $1.3 million for 2008 and $1.9 million for 2007.

Precision Steel is continuing to suffer not only the ongoing effects of a long-term reduction in demand caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States and a trend towards smaller-sized orders, but also, the difficult effects from deepening recessionary conditions. In 2008, Precision Steel's service center volume was 37 million pounds, down from 39 million pounds in 2007 and 69 million pounds sold as recently as 1999. Volume for the fourth quarter of 2008 was only 6.2 million pounds, down 34% from the corresponding 2007 figure. Apart from the recessionary-caused weakness, the general and ongoing decline in Precision Steel's physical volume is a serious reverse, not likely to disappear in some "bounce back" effect once the economy recovers. Nor do we expect that ongoing price increases like the approximately 111% rise that has occurred since 1999, holding dollar volume roughly level despite a precipitous drop in physical volume, will continue.

We do not consider Precision Steel's recent after-tax operating earnings of approximately $1 million annually to be a satisfactory investment outcome, particularly when compared with its after-tax operating earnings which averaged $2.3 million for the years 1998 through 2000. And, because of the intensifying recession, more difficulty for Precision Steel will surely lie ahead.

Terry Piper, who became Precision Steel's President and Chief Executive Officer in 1999, has done an outstanding job in leading Precision Steel through very difficult years. But he has no magic wand with which to compensate for competitive losses among his best customers or from the deepening recession. He is undertaking the difficult task of paring costs to an endurable level.

Tag Ends from Savings and Loan Days

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. Adjacent to that building is a parcel of land on which our construction of a multi-story luxury condominium building is almost complete. We are also seeking city approval of our plans to build another multi-story luxury condominium building, at a later date, on a vacant parcel of land in the next block. For more information, if you want a very-high-end condominium, simply phone Bob Sahm (626-585-6700). MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within "other operating earnings."

Other Operating Earnings (Loss)

Other operating earnings (loss), net of interest paid and general corporate expenses, amounted to ($0.4 million) in 2008, versus ($0.1) million in 2007. The components of the $0.4 million of other operating loss in 2008 were (1) rents ($4.0 million gross in 2008) principally from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus expenses involving tag-end real estate.

Consolidated Balance Sheet and Related Discussion

Strategically, we strive to invest in businesses that possess excellent economics, with able and honest management, at sensible prices. We prefer to invest a meaningful amount in each investee, resulting in concentration, exposing the portfolio to more significant market price fluctuations than might be the case were Wesco's investments more diversified. Concentration has worked out very well in the past as evidenced by significant realized investment gains. Details as to Wesco's investments can be found in Note 2 to the accompanying consolidated financial statements. Most equity investments are expected to be held for long periods of time; thus, we are not ordinarily troubled by short-term price volatility with respect to our investments provided that the underlying business, economic and management characteristics of the investees remain favorable. We strive to maintain much liquidity to provide a margin of safety against short-term equity price volatility.

Since the latter part of 2007, Wesco has invested $1.1 billion, at cost, in marketable equity securities, bringing the aggregate cost of Wesco's equity investments to $1.63 billion at yearend 2008, including an aggregate of $650 million, at cost, invested in the common stocks of Wells Fargo & Company and US Bancorp. The timing of our recent investments could not have been much worse. During 2008, several crises affecting the financial system and capital markets of the U.S. resulted in very large price declines in the general stock market, and in the banking sector, in particular, due significantly to the ongoing liquidity crisis as well as the deterioration of asset quality and earnings reported by the banking industry.

Wesco carries its investments at fair value, with unrealized appreciation or depreciation, after income tax effect, included as a component of shareholders' equity, and related deferred taxes included in income taxes payable, on its consolidated balance sheet. As indicated in the accompanying consolidated financial statements, Wesco's net worth, as accountants compute it under their conventions, decreased to $2.38 billion ($334 per Wesco share) at yearend 2008 from $2.53 billion ($356 per Wesco share) one year earlier. The principal cause of the decrease was the after-tax decline in fair value of Wesco's investments in marketable equity securities. As a result of further declines in fair values of these investments subsequent to yearend 2008, Wesco's shareholders' equity has further declined, by $303 million ($43 per share), through February 24, 2009.

The worldwide economy is currently suffering the effects of a deepening recession, perhaps the worst economic disaster since the Great Depression. We will not attempt to prognosticate the effects that Wesco will suffer or when the economy will recover, but we are certain that in due course, Wesco will prosper. In the mean time, Wesco's operations will bear their share of economic woes. We will continue to practice Ben Franklin's advice, that "a penny saved is a penny earned," as we trim expenses, albeit in higher denominations, to better endure the weakening economic conditions that surely lie ahead.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value's intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

The Board of Directors recently increased Wesco's regular dividend from 38½ cents per share to 39½ cents per share, payable March 5, 2009, to shareholders of record as of the close of business on February 5, 2009.

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.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco's subsidiaries and parent, Berkshire Hathaway, from Wesco's website: www.wescofinancial.com.

Charles T. Munger
Chairman of the Board
and President

February 25, 2009