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WESCO FINANCIAL CORP **10-K**

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CARD 1 DISCLOSURE INCORPORATED BETHESDA MD 20816 FOR 12/31/88

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Legend **A** - *always included - included - if occurred or significant* **F** - *frequently included* ■ *special circumstances only*

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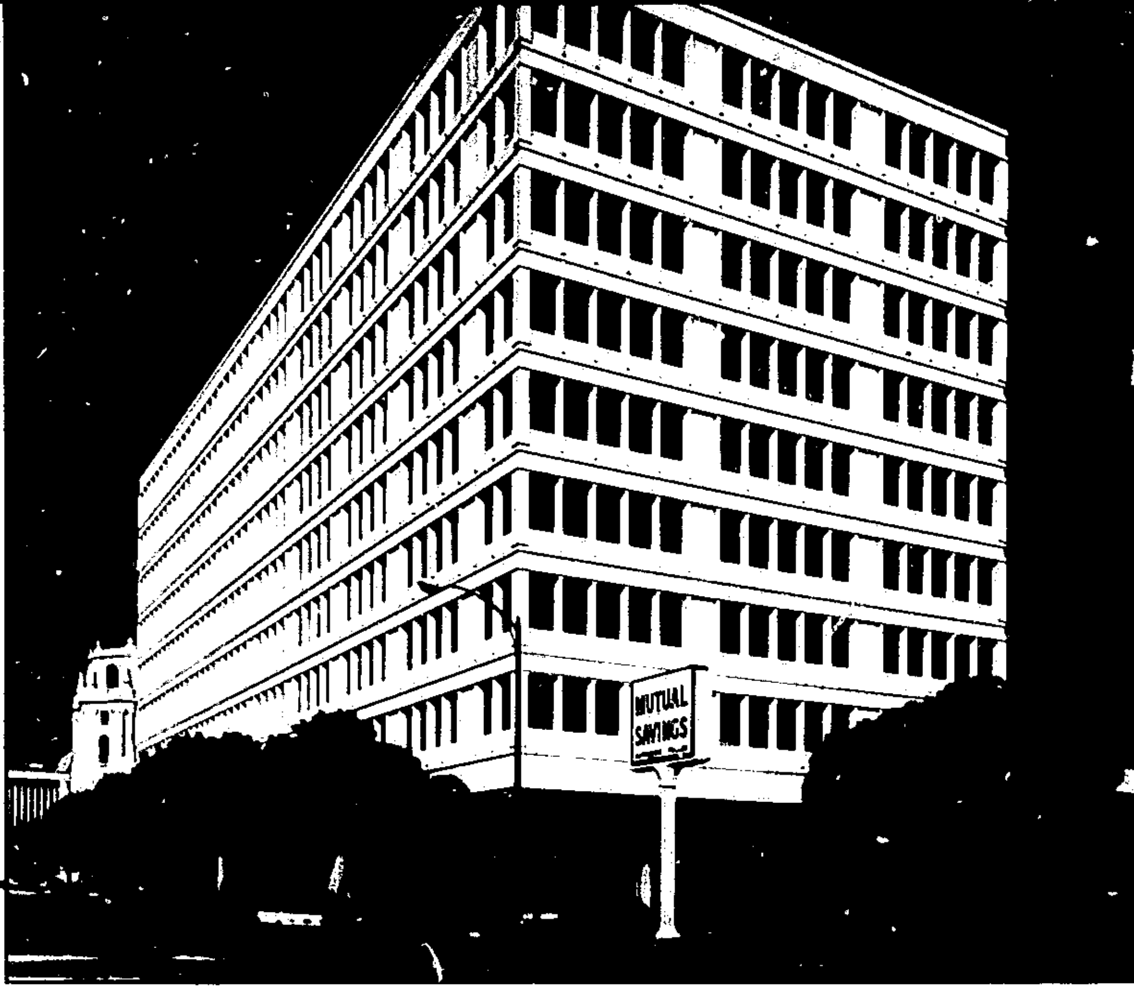
5161 River Road ☐ Bethesda, MD 20816 ☐ 301/951-1300

WESCO FINANCIAL CORPORATION

Annual Report 1988

Form 10-K Annual Report 1988



Headquarters building
of Wesco Financial Corporation
and Mutual Savings and Loan Associati

BOARD OF DIRECTORS

Charles T. Munger
Chairman of the Board, Wesco Financial Corporation and Mutual Savings and Loan Association; President, Wesco Financial Corporation; Chairman of the Board, Blue Chip Stamps (trading stamps; parent of Wesco Financial Corporation); Vice Chairman of the Board, Berkshire Hathaway Inc. (insurance, candy, retailing, manufacturing, newspaper and encyclopedia publishing; parent of Blue Chip Stamps); Chairman of the Board, Daily Journal Corporation (publisher of specialty newspapers in California); Director, Salomon Inc. (a financial services holding company)

William T. Caspers*
Personal investments

Harold R. Dettmann
Vice President, Wesco Financial Corporation; President, Mutual Savings and Loan Association

James N. Gamble*
Investment counseling and trust administration

Elizabeth Caspers Peters
Personal investments

David K. Robinson*
Partner of Hahn & Hahn, attorneys at law

*Audit Committee member

EXECUTIVE OFFICERS OF WESCO FINANCIAL CORPORATION AND MUTUAL SAVINGS AND LOAN ASSOCIATION

Charles T. Munger
Chairman of the Board and President, Wesco; Chairman of the Board, Mutual Savings

Harold R. Dettmann
Vice President, Wesco; President, Mutual Savings

Robert D. Aston
Vice President, Wesco; Executive Vice President, Mutual Savings

Jeffrey L. Jacobson
Vice President and Chief Financial Officer, Wesco and Mutual Savings

Robert E. Sahm
Vice President, Wesco and Mutual Savings

Jeanne Leach
Treasurer, Wesco; Vice President and Controller, Mutual Savings

Margery Patrick
Secretary, Wesco and Mutual Savings

Dolly Russo
Senior Vice President and Branch Manager, Mutual Savings

Legal Counsel

Hahn & Hahn

LISTED ON

American Stock Exchange
Pacific Stock Exchange

TRANSFER AGENTS AND REGISTRARS

Security Pacific National Bank
P.O. Box 3546, Terminal Annex, Los Angeles, California 90051

Security Pacific National Bank
63 Wall Street, 13th Floor, New York, New York 10004

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

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

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

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

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

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

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

Mutual Savings

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(1) wise changes in laws;

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

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

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

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

Precision Steel

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

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

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

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

Wesco-Financial Insurance Company

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

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

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

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

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

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

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

All Other "Normal" Net Operating Income

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

Net Gains On Sales Of Securities

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

Salomon Inc

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

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

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

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

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

New Subsidiary

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

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

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

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

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

Consolidated Balance Sheet and Related Discussion

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Charles T Munger

Charles T. Munger
Chairman of the Board

February 24, 1989

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1988 | Commission file number 1-4720

WESCO FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	95-2109453 (I.R.S. Employer Identification No.)
315 East Colorado Boulevard, Pasadena, California (Address of principal executive offices)	91101-1954 (Zip Code)

Registrant's telephone number, including area code: (818) 449-2345

Securities registered pursuant to section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Capital Stock, $1 par value	American Stock Exchange and Pacific Stock Exchange
10⅛% Notes Due 1991	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months and (2) has been subject to such filing requirements for the past 90 days. YES...X ...NO......

The aggregate market value of voting stock of the registrant held by non-affiliates of the registrant as of March 14, 1989 was: $52,978,543.

The number of shares outstanding of the registrant's Capital Stock as of March 14, 1989 was: 7,119,807.

DOCUMENTS INCORPORATED BY REFERENCE

Title of Document	Parts of Form 10-K
Proxy Statement for 1989 Annual Meeting of Stockholders	Part III, Items 10, 11, 12 and 13

PART I

Item 1. Business

GENERAL

Wesco Financial Corporation ("Wesco") was incorporated in Delaware on March 19, 1959. The principal businesses of Wesco, conducted by wholly owned subsidiaries, are the savings and loan business, through Mutual Savings and Loan Association ("Mutual Savings"), which was incorporated in California in 1925, the property and casualty insurance business, through Wesco-Financial Insurance Company ("Wes-FIC"), which was incorporated in 1985, and the steel service center business, through Precision Steel Warehouse, Inc. ("Precision Steel"), which was begun in 1940 and acquired by Wesco in 1979. Wesco also has investments in real estate and marketable securities and owns a small insurance agency. Beginning in 1989 Wesco's operations will also include electrical equipment manufacturing through New America Electrical Corporation ("New America Electric"— see below).

From 1973 to July 1983, Wesco was controlled by a corporation named Blue Chip Stamps. In July 1983, that company transferred ownership of its 80.1% investment in Wesco to a newly formed, wholly owned company (the present Blue Chip Stamps) and was subsequently merged into Berkshire Hathaway Inc. ("Berkshire"). Thus, Wesco and its subsidiaries are controlled and 80.1%-owned directly by the present Blue Chip Stamps and indirectly by Berkshire.

Wesco's activities fall into three business segments — financial, insurance, and steel service. The financial segment includes (a) the savings and loan business, (b) operation of a business block in Pasadena, California, and (c) investments, principally in marketable preferred and common stocks. The insurance segment comprises the property and casualty insurance business. The steel service segment comprises mainly steel service center operations. The amounts of revenue, operating profit and identifiable assets attributable to each of these three business segments are included in the "Business Segment Data" note to Wesco's consolidated financial statements contained in Item 8, Financial Statements.

On December 22, 1988, Wesco purchased 80% of the outstanding capital stock of New America Electric for $8,200,000. A 69.9% interest in the stock was purchased from the NAF Liquidating Trust for $7,164,750 in cash, and the remaining 10.1% was purchased from the president of the company, Glen H. Mitchel, for a $1,035,250 promissory note due in ten years, with interest at an annual rate of 10% payable monthly. Mr. Mitchel retains a 20% minority interest in the company. The principal seller, the NAF Liquidating Trust, has three trustees, one of whom, Charles T. Munger, is Chairman of the Board of Wesco. The transaction was approved unanimously by Wesco's Board of Directors, with Mr. Munger abstaining from the vote, and with Mr. Warren E. Buffett, Chairman of Berkshire, recommending the transaction to Wesco.

New America Electric was organized in 1982, and in early 1983 it purchased Unicorn Electrical Products. The combined company is engaged in the manufacture and sale, under both the New America and Unicorn names, of various commercial and residential electrical products, including high- and low-voltage switchgear, circuit breakers and boxes, metering equipment, lighting ballasts and starters and electrical equipment for marinas and mobile homes and recreational vehicle parks.

Because the transaction occurred at yearend and New America Electric's size is not material to Wesco, only its balance sheet is included in Wesco's consolidated financial statements as of 1988 yearend. Its results of operations will be included beginning in 1989.

FINANCIAL SEGMENT

The earnings of Mutual Savings have been and are dependent on the spread between the yields earned on its real estate loans and investments, and the costs of savings accounts.

The savings and loan business has been a difficult business since the late 1970s, as institutions with substantial amounts of long-term, low-yielding mortgage loans on their books, funded by short-term borrowings from depositors, have seen their cost of funds increase dramatically. The increase in cost of funds has been due both to prevailing interest rates at levels much higher than were once thought normal, and to fundamental changes that have occurred in the savings and loan industry. As a result of changes in federal regulations affecting savings and loan associations (and other depository institutions such as banks), regulations limiting rate competition for depositors' accounts were largely dismantled by 1985, and completely eliminated in 1986. Other regulations and regulatory attitudes were modified to enable savings and loan associations and banks to compete more directly with each other and with other financial institutions in providing a wide variety of consumer financial services. In the early 1980s, most savings and loans suffered operating losses, and although many have more recently earned profits, principally as a result of the possibly short-term moderation of interest rates, hundreds of others, many insolvent and garnering wide publicity, have driven the Federal Savings and Loan Insurance Corporation ("FSLIC"), the federal agency that insures savings deposits, into insolvency. Changes in the statutory and regulatory framework are being proposed; and President Bush, reiterating the promise that the full faith and credit of the U.S. government backs FSLIC-insured deposits, has recently proposed to Congress a plan to rescue the industry at a cost estimated possibly to exceed $100 billion.

Mutual Savings, which has retained its financial strength and is not expected to burden the insurance fund, prepared for the changes in the savings and loan business by substantially reducing the size and scope of its business and altering the nature of its business activities while pondering an operating plan that would provide a socially constructive service while operating with acceptable profits accompanied by an acceptable level of risk. In 1979 Mutual Savings substantially curtailed its real estate loan originations because of the high cost of savings deposits, the reduction in net savings inflow, and uncertainty as to the future direction of loan interest rates.

In December 1980, Mutual Savings, which had operated at seventeen locations in Southern California and had ranked approximately 39th among California savings and loan associations in assets, sold all of its offices, except for its Pasadena headquarters office and a satellite office in a shopping mall across the street, to another association. Under terms of the sale, Mutual Savings transferred to the buyer approximately $307 million of net branch savings accounts together with an equal book value of its highest-yielding mortgage loans and the physical assets of the branch offices, receiving approximately $8 million, in cash. Mutual Savings realized a gain on the sale of branch premises and equipment, after income taxes and expenses of sale, of approximately $2.9 million.

Mutual Savings, in 1986, re-entered real estate lending, offering a fully adjustable-rate mortgage loan. Loans made under this program beginning December 1, 1987 have borne a 25% interest-rate cap. These loans yield a spread of about 2% above the rate available from one year U.S. Treasury Notes. Approximately $50 million has been lent since the inception of this program.

Federal regulations make it desirable that Mutual Savings maintain at least 60% of its assets in housing-related categories. Mutual Savings, in December 1987, invested approximately $51 million in mortgage obligations collateralized by pools of Government National Mortgage Association- and Federal Home Loan Mortgage Corporation-backed loans. These fixed-rate mortgage securities yield approximately 9% over their expected average lives of 3 years. Management is hopeful that, as Mutual Savings continues its program of direct real estate lending, and as these fixed-rate obligations are repaid, they will be replaced by Mutual Savings' own directly made loans. In any event, at least 60% of Mutual Savings' assets will be in housing-related assets.

In 1988, Mutual Savings invested $65.3 million in another form of housing-related assets, by increasing its position in preferred stock of Federal Home Loan Mortgage Corporation ("Freddie Mac") to 2,400,000 when-issued shares, making total cost $71.7 million. This is 4% of the total shares outstanding, the legal limit for any one holder. Freddie Mac supports housing primarily by purchasing mortgage loans for immediate transmutation into mortgage-backed securities that it guarantees and promptly sells. The 1988 yearend trading value on the New York Stock Exchange of Mutual Savings' Freddie Mac shares, was $121.2 million. Thus, based on 1988 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $49.5 million. At current tax rates the potential after-tax profit was about $29.2 million as of that date.

Mutual Savings is now relatively small, ranking approximately 70th among California's savings and loan associations in assets at the end of 1988. Because it sold its highest-yielding mortgage loans in 1980, and it has begun to lend and invest in mortgage-backed securities only recently, after interest rates had fallen from the higher levels which generally prevailed since 1980, Mutual Savings' entire loan portfolio, including $45 million invested in mortgage-backed loans as of 1988 yearend, bears what may be one of the lowest average interest rates (8.7% per annum at the end of 1988) of all associations in the United States. The fixed-rate old (pre-1980) portion of the portfolio, which bears an average interest rate of 7.4%, and which is carried on Mutual Savings' books at the end of 1988 at about $46.6 million, consists of rapidly repaying, seasoned loans, all collateralized by properties in which the borrowers have large equity positions. The whole portfolio of housing-related assets is believed to present almost no risk of loss to Mutual Savings. Compared with other associations, Mutual Savings is believed to have a higher ratio of shareholders' equity to total interest-bearing liabilities and a much higher proportion of assets in short term, interest-bearing cash equivalents and intermediate-term, tax-exempt bonds and preferred stocks.

Savings and loan associations are required to pay federal insurance premiums to maintain insurance of accounts. From 1962 to 1973 supplemental insurance premiums were required. These built up on the accounts of FSLIC as the industry's "secondary insurance reserve," and were considered assets, "prepaid insurance premiums," on the books of the savings and loan associations. FSLIC has, in recent years, been forced to assist and rescue numerous associations that have either become innocent victims of regional economic collapse or aggressively ventured into high-risk areas on high-risk terms, sometimes involving dishonesty. Following an audit by the Federal General Accounting Office in early 1987, FSLIC was declared insolvent, and as a result, prepayments to the secondary insurance reserve were required to be written off. Mutual Savings, accordingly, wrote off its $3.6 million share of this reserve during 1987, resulting in an after-tax charge of $1.9 million for the year.

The federal government directly supports FSLIC's commitment to protect insured deposits. This federal guarantee was restated when, in August 1987, President Reagan signed into law the Competitive Equality Banking Act of 1987, containing language reaffirming that deposits up to the prescribed coverage limits in federally insured depository institutions are backed by the full faith and credit of the United States. This law also enables FSLIC to raise $10.8 billion over a three-year period through the sale of bonds. However, FSLIC's current financial troubles, widely publicized, cannot be cured with the limited resources now available. President Bush has proposed to Congress a "bailout" program which must somehow cover embedded losses estimated possibly to exceed $100 billion. As part of any federal "bailout" plan, Mutual Savings' deposit-insurance premiums are likely to be sharply increased from their 1988 level of $611,000.

Federal and state regulations provide that a savings and loan association can invest, subject to certain limitations, in any securities deemed prudent by its management. Under this authority Mutual Savings increased its holdings of public utility preferred stocks by approximately $7 million during 1987 and 1988.

Mutual Savings expects the savings and loan business to continue to be a difficult and competitive business. It intends to preserve its options by retaining financial strength and remaining very flexible with respect to expansion (including possible acquisition) or contraction. It may also consider revision of services designed to create more differentiation in the marketplace from standard financial services provided by others.

Effective in January 1983, the regulations of the California Savings and Loan Commissioner were amended to provide that a service corporation wholly owned by a savings and loan association could engage in any activity approved by the Commissioner. Mutual Savings' service subsidiary, Wes-Fin Service Corp. ("Wes-Fin"), accordingly, obtained approval to purchase common and preferred stocks from time to time provided that, at the time of any purchase, the total amount invested would not exceed 7½% of the then total assets of Mutual Savings. In October 1987 Wes-Fin joined with other Wesco and Berkshire subsidiaries, and invested $26 million in cumulative convertible preferred stock of Salomon Inc (see Note 2 to the accompanying consolidated financial statements for additional information).

Wesco, as a savings and loan holding company, and Mutual Savings, as a savings and loan association, are subject to regulation by the Federal Savings and Loan Insurance Corporation ("FSLIC"), the Federal Home Loan Bank Board and the California Department of Savings and Loan. The regulatory framework encompasses reserve requirements, reporting requirements, periodic regulatory examinations, limitations on the types of loans and investments that can be made, and regulations affecting the acquisition or disposition of certain types of businesses.

Issues currently of particular concern to the regulators and the industry are summarized below.

- The need for new assistance to FSLIC, now considered insolvent as a result of its having rescued numerous associations in the past several years, with numerous other rescues on the horizon.
- The maintenance of adequate liquidity in the industry, especially in the current environment of rising interest rates and widely publicized insolvency of FSLIC.
- An increase in the level of net worth required of the industry. The most recent proposal would require, by 1991, roughly 6%, plus or minus, depending upon an asset-by-asset risk profile developed separately for each association. (Mutual Savings' net worth amounted to 16% of liabilities at 1988 yearend.)
- The management of interest rate risk through the matching of interest-sensitive assets with liabilities of similar maturities.

Wesco, while it seeks suitable businesses to acquire and expansion of its existing operations, invests in marketable securities, including common stocks of unaffiliated companies. (See Note 2 to the accompanying consolidated financial statements for a summary of these investments and Schedule I accompanying such statements for further information.) Wesco owns a business block in Pasadena, California, which includes the nine-story office building in which its headquarters and the main offices of Mutual Savings, Wes-Fin and WSC Insurance Agency (a small insurance agency wholly owned by Wesco) are located, and a multistory garage structure. These properties are nearly fully leased under agreements expiring at various dates to 1994.

Approximately 60 full-time employees are engaged in the savings and loan business and other financial segment activities.

INSURANCE SEGMENT

Wesco-Financial Insurance Company ("Wes-FIC") was incorporated in 1985 to engage in the property and casualty insurance and reinsurance business. Wesco contributed, as initial capital, $45 million in cash and cash-equivalents to Wes-FIC in September 1985, $36.2 million in cash in January 1986 and an additional $9 million in March 1987.

Wes-FIC, as its principal insurance transaction to date, reinsured, through a Berkshire Hathaway insurance company subsidiary, National Indemnity Company ("NICO"), as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Insurance Companies. Wes-FIC thus assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period ending August 31, 1989. The arrangement put Wes-FIC in virtually the same position it would have been in if it, instead of Fireman's Fund, had directly written the business reinsured. Differences in results occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1988 exceeded $62 million.

Wes-FIC in 1988 began to write direct business, as distinguished from reinsurance. It is now licensed in Nebraska, Utah and Iowa. It wrote $412,000 in premiums on a surplus lines basis in Alabama. Earned direct premiums were $108,000.

Insurance companies are subject to regulation by the departments of insurance of the various states in which they operate. Regulations relate to, among other things, capital requirements, loss reserve requirements, reporting requirements, periodic regulatory examinations, and limitations on the types of investments that can be made.

In recent years, financial failures in the insurance industry have received considerable attention from news media, regulatory authorities and rating agencies. As one result, industry participants and the public have been made more aware of the benefits derived from dealing with insurers whose financial resources supported, with significant margins of safety against adversity, their promises. In this respect Wes-FIC is competitively well positioned, inasmuch as it possesses above-average financial strength. Expiration of the reinsurance contract with FFC will leave Wes-FIC with much capital (over $125 million as of 1988 yearend) but not a significant amount of current insurance business.

Wes-FIC is operated by personnel employed by Berkshire and NICO; it has no employees of its own.

STEEL SERVICE SEGMENT

Precision Steel, acquired in 1979 for approximately $15 million, operates a well-established steel service center business in two service center locations: one in Franklin Park, Illinois, near Chicago; the other, operated by a wholly owned subsidiary, in Charlotte, North Carolina. The service centers buy low carbon sheet and strip steel, coated metals, spring steels, stainless steel, brass, phosphor bronze, aluminum and other metals, cut these metals to order, and sell them to a wide variety of customers.

The service center business is highly competitive. For example, Precision Steel's annual sales volume of about $63 million compares with the steel service industry's annual volume of over $20 billion. Precision Steel competes not only with other service centers but also with mills which supply metal to the service centers. Competition exists in the areas of price, quality, availability of products and speed of delivery. Because it is willing to sell in relatively small quantities, Precision Steel has been able to compete in geographic areas distant from its service center facilities. Competitive pressure is intensified by imports and by a tendency of domestic manufacturers to substitute less costly components for parts traditionally made of steel.

Precision Brand Products, Inc. ("Precision Brand"), a wholly owned subsidiary of Precision Steel, manufactures shim stock and other tool room specialty items, as well as hose and muffler clamps, and distributes them under its own brand names nationwide, using both salesmen and manufacturers' representatives. This business is highly competitive.

Steel service raw materials are obtained principally from major domestic steel mills, and their availability is considered good. Precision Steel's service centers maintain extensive inventories in order to meet customer demand for prompt deliveries. Typically, an order is filled and the processed metals delivered to the customer within one week. Precision Brand normally maintains inventories adequate to allow for off-the-shelf service to customers.

The steel service businesses are subject to economic cycles. These businesses are not dependent on a few large customers. Steel service backlog orders increased to approximately $5.5 million as of December 31, 1988, from $5.4 million as of December 31, 1987.

Approximately 265 full-time employees are engaged in the steel service business, almost half of whom are members of unions. Management considers labor relations to be good.

Item 2. Properties

Wesco owns a business block in downtown Pasadena, California, which is improved with a nine-story office building that was constructed in 1964 and has approximately 125,000 square feet of net rentable area, as well as three commercial store buildings and a multistory garage with space for 425 automobiles. Approximately 22,000 square feet of the office building are used by Wesco as its headquarters or leased to Mutual Savings for use as its main office, while the balance is leased to outside parties under agreements expiring at various dates to 1994. Mutual Savings leases its 1,700-square-foot satellite office in the Plaza Pasadena shopping center located across the street from its main office; this lease expires in 1990 and may be extended under two five-year options.

Wes-FIC uses the headquarters office of NICO, a subsidiary of Berkshire Hathaway Inc., its ultimate parent, in Omaha, Nebraska, as its place of business.

Mutual Savings holds real estate which has been acquired by foreclosure. The most valuable parcel consists of 22 acres of vacant, largely oceanfront land near Santa Barbara, California, where residential development is presently under way. Such development is subject to various expensive burdens under land-use laws. The property is expected eventually to provide a yield greatly in excess of its book cost. Other properties include several buildings in a small shopping center in Upland, California, which are leased to various small businesses.

Precision Steel and its subsidiaries own three buildings housing their plant and office facilities having usable area approximately as follows: 138,000 square feet in Franklin Park, Illinois; 42,000 square feet in Charlotte, North Carolina; and 59,000 square feet in Downers Grove, Illinois.

Item 3. Legal Proceedings

Wesco and its subsidiaries are not involved in any legal proceedings which are expected to result in material loss.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of Wesco's shareholders subsequent to the annual meeting held in April 1988.

PART II

Item 5. Market for the Registrant's Common Stock and Related Stockholder Matters

Wesco's common stock is traded on the American Stock Exchange and the Pacific Stock Exchange.

The following table sets forth the ranges of stock prices reported in the Wall Street Journal for Wesco's shares trading on the American Stock Exchange by quarter for 1988 and 1987, as well as cash dividends paid by Wesco on each outstanding share.

	1988				1987		
	Sales Price				Sales Price		
Quarter Ended	High	Low	Dividends Paid	Quarter Ended	High	Low	Dividends Paid
March 31	$36	$33⅝	$0.185	March 31	$43¾	$38	$0.175
June 30	35¾	32	0.185	June 30	42¾	36⅞	0.175
September 30....	35⅝	32⅝	0.185	September 30....	43	36	0.175
December 31	42⅞	34¾	0.185	December 31	43⅝	32¼	0.175
			$0.74				$0.70

There were approximately 1,000 shareholders of record of Wesco's common stock as of the close of business on February 28, 1989.

Item 6. Selected Financial Data

Set forth below and on the following pages are selected consolidated financial data for Wesco and its subsidiaries. For additional financial information, attention is directed to Wesco's audited 1988 consolidated financial statements appearing elsewhere in this report. (Dollar amounts are in thousands except for amounts per share.)

	Year Ended December 31,				
	1988	1987	1986	1985	1984
Income items:					
Interest on loans	$ 11,248	$ 6,528	$ 5,982	$ 6,794	$ 7,711
Insurance premiums earned	62,465	73,384	67,515	20,412	—
Steel service revenues	62,694	54,843	52,304	51,124	55,098
Interest and dividends on investments	38,177	35,399	32,227	31,595	24,935
Securities gains	9,952	2,194	8,282	62,895	19,360
Other	1,677	1,628	2,154	5,017	3,097
	186,213	173,976	168,464	177,837	110,201
Cost and expense items:					
Interest on savings accounts	20,579	20,903	22,275	25,191	20,940
Insurance losses and expenses	65,938	77,641	70,234	23,346	—
Cost of steel products sold	50,674	45,333	42,836	40,914	44,830
Selling, general and administrative	11,033	10,715	10,082	10,293	9,848
Interest on notes payable	3,051	3,078	3,114	3,035	3,103
Writeoff of prepaid FSLIC insurance premiums	—	3,618	—	—	—
	151,275	161,288	148,541	102,779	78,721
Income before income taxes	34,938	12,688	19,923	75,058	31,480
Income tax provision (benefit)	4,849	(2,525)	3,399	23,517	7,824
Net income	$ 30,089	$ 15,213	$ 16,524	$ 51,541	$ 23,656
Amounts per share:					
Net income	$4.22	$2.14	$2.32	$7.24	$3.32
Cash dividends	$ .74	$ .70	$ .66	$ .62	$ .58

	December 31,				
	1988	1987	1986	1985	1984
Assets:					
Cash, temporary cash investments, investments with fixed maturities and marketable equity securities	$503,449	$444,294	$466,715	$425,727	$289,540
Loans receivable	137,007	139,468	78,657	83,472	95,172
Total assets	706,264	647,396	611,199	561,957	417,003
Liabilities:					
Savings accounts	$286,909	$286,211	$282,358	$269,047	$227,087
Insurance losses and loss adjustment expenses	95,585	79,578	49,202	16,111	—
Notes payable	31,786	31,017	31,273	31,523	31,882
Total liabilities	467,676	434,576	408,608	371,156	273,364
Shareholders' equity	$238,588	$212,820	$202,591	$190,801	$143,639
Per share	$33.51	$29.89	$28.45	$26.80	$20.17

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

FINANCIAL CONDITION

Financial strength has grown in recent years as Wesco's several business operations have provided a positive cash flow. Wesco and its subsidiaries generally maintain, as a matter of practice, liquidity beyond norms for the industries in which they operate.

Wesco, in December 1988, purchased 80% of the outstanding common stock of a small manufacturer of electrical equipment, investing $8,200,000, including $7,165,000 cash and a note due in December 1998 for the balance. Wesco and certain of its subsidiaries, in October 1987, invested $100,000,000 in 9% cumulative convertible preferred stock of Salomon Inc. These purchases were financed principally through the sale of temporary cash investments (see Note 2 to the accompanying consolidated financial statements for further information). Although these investments utilized the excess liquidity at Wesco's parent company level, Wesco has various other sources of funds available if needed, such as dividends from its subsidiaries or borrowings from banks or others.

Mutual Savings, in 1988, purchased preferred stock of Federal Home Loan Mortgage Corp. ("Freddie Mac"), at cost of $65,307,000, including $20,182,000 paid in January 1989. These transactions were financed mainly through liquidation of temporary cash investments and FHLB bonds. Although these transactions utilized much of its excess liquidity, Mutual Savings retains liquidity above regulatory requirements. As of 1988 yearend, Mutual Savings' total Freddie Mac holdings amounted to $71,729,000, at cost, vs. $121,200,000 at market value (see Item 1, Business).

The key component of a savings and loan association's earnings, the spread between the yield earned on its assets, and the cost of its liabilities, is its net interest income. Its dependable generation not only requires the management of yields, costs and maturities of assets and liabilities, but also a limitation, consistent with the ratio of net worth to total interest-bearing liabilities, on the margin, or "gap," between interest-sensitive liabilities and interest-sensitive assets. Federal Home Loan Bank Board policies require that savings and loan associations monitor this gap and restructure maturities of assets and liabilities towards a reduction of interest rate risk. The table below sets forth the major balance sheet categories and dollar amounts of items for Mutual Savings and its consolidated subsidiary as of 1988 yearend which are rate sensitive, and the resulting net gaps as of the last three yearends (amounts are in thousands of dollars):

Gap Analysis

	Amounts (in Thousands) Subject to Repricing(*)					
Balance Sheet Category	**Within 6 months**	**Within 1 year**	**Within 3 years**	**Within 5 years**	**Within 10 years**	**Total**
Rate-sensitive assets:						
Cash and temporary cash investments ...	$ 54,067	$ 54,067	$ 54,067	$ 54,067	$ 54,067	$ 54,067
State and municipal and FHLB bonds ...	30,000	30,000	32,675	41,975	47,519	47,519
Common and preferred stocks	—	—	—	—	20,800	139,105
Loans receivable** ...	45,000	54,000	93,500	112,000	132,000	136,970
Total	129,067	138,067	180,242	208,042	254,386	377,661
Rate-sensitive liabilities:						
Savings accounts	201,983	244,222	286,230	288,516	288,522	288,522
Net gap at —						
December 31, 1988	$ (72,916)	$(106,155)	$(105,988)	$ (80,474)	$ (34,136)	$ 89,139
December 31, 1987	$(124,798)	$(156,578)	$ (64,241)	$ (35,100)	$ (21,981)	$ 51,697
December 31, 1986	$ 39,479	$ 4,217	$ (32,210)	$ (26,053)	$ 12,668	$ 50,000

* and ** — see following page

* Amounts are *cumulative;* for example, loans that can be repriced in one year include loans which can be repriced in six months.

** Amounts subject to repricing in each period have been estimated inasmuch as they include prepayments as well as normal principal amortization.

The foregoing figures demonstrate the effect that Mutual Savings' recent investment in housing-related securities, including Freddie Mac stock, has had on its gap. Although as presently structured Mutual Savings, and thus Wesco's financial segment, have more short- and intermediate-term exposure to detrimental effects should interest rates sharply increase, such exposure is not expected to result in significant detriment to Wesco in terms of its future net income or net worth. As indicated in Item 1, Business, Mutual Savings re-entered the real estate lending market in 1986, offering adjustable-rate first mortgage loans with low "spread" over cost of funds and a reasonably high cap (currently 25%) on future interest rate changes, on owner-occupied residential property. The volume of these loans approximated $50 million since 1986. Management is hopeful that, as the old fixed-rate loans and the mortgage-backed securities purchased at yearend in 1987 are repaid, and as Mutual Savings continues its program of adjustable-rate lending, the mortgage-backed securities and fixed-rate loans eventually will be replaced by Mutual Savings' adjustable-rate loans, directly made, with aggregate interest rate risk at an endurable level.

Management hopes that the attempts at resolution by the federal government of the FSLIC insolvency (see Item 1, Business) will detrimentally affect Mutual Savings' future operations only to a moderate extent. However, a probable sharp increase in the future cost of federal insurance premiums combined with other changes in regulations, could significantly impact Mutual Savings to an extent not yet possible to quantify. Such an effect, while possibly material to Mutual Savings in terms of net income that might be reported for any single year, is not expected significantly to affect Mutual Savings' net worth, or that of Wesco's consolidated operations.

Mutual Savings is believed to have had one of the lowest loan delinquency rates of any savings and loan association for the past several years. At 1988 yearend, monthly payments were past due over 60 days on only one loan, whose outstanding principal balance was below $8,000 and expected to be fully collected by the end of March 1989. Management attributes Mutual Savings' favorable loan loss experience (no loan losses have been required during the past five years) principally to three factors. First, the seasoned fixed-rate loans are secured by properties in which the borrowers have large equity interests. Second, Mutual Savings' adjustable-rate first mortgage loans are collateralized by conservatively appraised owner-occupied properties. Third, the balance of Mutual Savings' loan portfolio not in the foregoing categories is backed by government guarantees or is otherwise of extremely high quality.

Wesco and its subsidiaries are believed to have adequate capital resources for all anticipated operational needs.

As presently structured, Wesco's financial segment and insurance operations are not suffering significant detrimental effects from inflation. The gap figures contained in the foregoing table indicate, however, that Mutual Savings and the financial segment are exposed to detrimental effects should interest rates rapidly rise in the near future; and interest rates have begun to rise. Very large unanticipated changes in the rate of inflation could adversely impact the insurance business, wherein premium rates are established well in advance of incurrence of the related costs.

The effects of inflation in the steel service businesses are discussed in the section entitled Steel Service Segment below. The inflationary pressures currently affecting the steel service businesses are not considered material to the consolidated operations of Wesco.

RESULTS OF OPERATIONS

The savings and loan industry is currently in considerable turmoil. In response to perceived uncertainties in the savings and loan industry Wesco, in the 1970s, began to diversify its operations; and the savings and loan business has declined, both in size and in relative importance to Wesco's consolidated operations. As funds have become available pending their use in expansion or acquisition, the portfolio of marketable securities has grown, and dividend and interest income and gains on securities transactions have increased in importance to Wesco's consolidated net income. Steel service operations were added in 1979, property and casualty insurance operations were added in September 1985, and electrical manufacturing operations were added at 1988 yearend. (See Item 1, Business, for further discussion of the changes in the savings and loan industry and of Wesco's other operations.)

The following summary indicates the contribution to consolidated net income of each of Wesco's three business segments, and demonstrates the prevalence and effect on consolidated net income of large, unusual items in recent years (amounts are in thousands of dollars, all after income tax effect):

	1988	1987	1986	1985	1984
Financial segment:					
"Normal" net operating income of					
Mutual Savings	$ 4,694	$ 2,895	$ 2,159	$ 3,342	$ 3,476
Other operations*	3,609	1,808	1,459	3,354	4,550
	8,303	4,703	3,618	6,696	8,026
Unusual items:					
Securities gains	454	1,199	4,238	41,523	13,138
Fluctuation in market value of GNMA futures contract	—	—	—	1,671	458
Writeoff of prepaid FSLIC insurance premiums	—	(1,935)	—	—	—
	454	(736)	4,238	43,194	13,596
Net income — financial	8,757	3,967	7,856	49,890	21,622
Insurance segment:					
"Normal" net operating income (loss)	12,094	9,459	6,615	(359)	—
Securities gains	6,071	9	352	—	—
Net income — insurance	18,165	9,468	6,967	(359)	—
Steel service:					
"Normal" net operating income	3,167	2,450	1,701	2,010	2,034
Flood loss	—	(672)	—	—	—
Net income — steel service	3,167	1,778	1,701	2,010	2,034
Net income — consolidated	$30,089	$15,213	$16,524	$51,541	$23,656

* Comprises net commercial real estate rental income, plus interest and dividend income from cash equivalents and marketable securities held outside Mutual Savings and Wes-FIC, less interest and other corporate expenses.

The foregoing summary contains consolidated *after-tax* earnings data. Reference is made to the following: Wesco's consolidated financial statements beginning on page 40, including in particular Note 11, for information as to operating profit *before taxes* for each of Wesco's business segments for the past three years; and the condensed consolidated balance sheet of Mutual Savings as of 1988 and 1987 yearends, on page 56. The following discussion, by business segment, should be read in conjunction with all these data.

Financial Segment

The stability of Mutual Savings' consolidated "normal" net operating income for each of the past five years has resulted significantly, and to a declining degree, from income tax benefits available principally because of the presence of interest income on state and municipal bonds and dividend income on preferred and common stocks, taxed at very favorable corporate rates. Following is a summary of the components of Mutual Savings' consolidated "normal" net operating income (in thousands of dollars):

	1988	1987	1986	1985	1984
Revenues:					
Interest on loans and temporary cash investments and miscellaneous other revenues ...	$18,704	$20,391	$18,554	$20,172	$17,572
Dividends on preferred and common stocks ..	8,058	4,163	4,238	5,455	4,735
Interest on state and municipal bonds	1,983	2,022	2,348	3,220	3,643
	28,745	26,576	25,140	28,847	25,950
Expenses:					
Interest on savings accounts	20,840	20,944	22,396	25,265	22,012
Operating expenses	4,108	4,241	3,902	3,763	3,419
	24,948	25,185	26,298	29,028	25,431
Income (loss) before income tax benefit	3,797	1,391*	(1,158)	(181)	519
Income tax benefit relating thereto	(897)	(1,504)	(3,317)	(3,523)	(2,957)
Normal net operating income	$ 4,694	$ 2,895*	$ 2,159	$ 3,342	$ 3,476

* These figures are before writeoff of premiums prepaid to FSLIC amounting to $3,618 before taxes and $1,935 after taxes. (See Item 1, Business.)

Mutual Savings' interest expense on savings accounts varies from year to year. The decreases in such costs in each of the last three years resulted from declines in interest rates; savings balances increased each year. On an incremental-effects basis, growth in savings accounts has been unprofitable, because Mutual Savings has incurred more in interest and other expenses than it has received from employing proceeds in short-term interest-bearing investments to an extent far above regulatory requirements for liquidity. Only interest on state and municipal bonds and dividends on preferred and common stocks, taxed at favorable rates, have, between 1980 and 1986, enabled Mutual Savings to report a positive rate spread; and, although a positive rate spread was earned by Mutual Savings on its real estate loan portfolio in 1987 and 1988, the investment income components remained important factors for Mutual Savings' reporting of a positive rate spread. Details are set forth in the following table:

	1988	1987	1986
Yield on loans and mortgage-backed securities	8.44%	7.66%	7.47%
Yield on investments*	10.63	9.02	9.76
Combined yield on loans and investments	9.74	8.68	9.19
Cost of savings	(7.14)	(7.25)	(8.24)
Rate spread**	2.60	1.43	0.95

* Interest on short-term investments, interest on state and municipal bonds and dividends on common and preferred stocks, all stated on a so-called tax-equivalent basis, i.e., on a pre-tax basis as if fully subject to income taxes at maximum corporate rates.

** The difference between the combined yield on loans and investments and the cost of savings.

Although the figures presented in the foregoing table indicate that Mutual Savings experienced a favorable increase in the margin of comfort between its yields and costs through 1988, the rate spread will very likely deteriorate in 1989. Mutual Savings in 1988 and early 1989 invested approximately $65 million in Freddie Mac stock, whose indicated 1989 dividend rate will not match the yield previously earned on the funds invested. Additionally, interest rates began to rise in the latter half of 1988 and have continued to rise into early 1989. The future of interest rates, however, remains uncertain.

"Normal" net operating income for financial operations other than Mutual Savings', as summarized in the table on page 32, increased to $3,609,000 in 1988 from $1,808,000 in 1987 and $1,459,000 in 1986, following a decline from $3,354,000 in 1985. This category of net operating income contains interest and dividend income on investments held outside the savings and loan and insurance businesses. The increases in the latter years resulted principally from changes in mix of Wesco's investment portfolio. The decrease in 1986 resulted mainly from Wesco's contribution of funds to Wes-FIC in September 1985 and January 1986; interest and dividend income earned on these funds is classified as income of the insurance segment.

Insurance Segment

Wesco entered into the property and casualty insurance business in September 1985. Substantially all of its insurance business to date has been an arrangement under which it reinsures 2% of the property and casualty insurance business of Firemen's Fund Insurance Companies ("FFC"), although it began to write direct insurance business during 1988. (See Item 1, Business, for further information on Wesco-Financial Insurance Company — "Wes-FIC.")

The "normal" net operating income or loss of Wes-FIC (i.e., income or loss before securities gains) represents the combination of its underwriting results with the interest and dividend income from its investment activities. Following is a summary of such data, in thousands of dollars:

	Year Ended December 31,			Four Months Ended December 31,
	1988	1987	1986	1985
Premiums written	$59,227	$71,032	$70,506	$46,738
Premiums earned	$62,465	$73,384	$67,515	$20,412
Underwriting loss before income taxes	$(3,473)	$(4,257)	$(2,719)	$(2,934)
Interest and dividend income	15,377	11,618	9,685	2,219
Income (loss) before income taxes	11,904	7,361	6,966	(715)
Income tax provision (benefit)	(190)	(2,098)	351	(356)
Normal net operating income (loss)	$12,094	$ 9,459	$ 6,615	$ (359)

Wes-FIC's underwriting results are necessarily based on estimates and actuarial assumptions. Underwriting results in the property and casualty insurance business have historically tended to be cyclical. Results were disastrous to many insurers for several years prior to 1986, as price competition, inflation and new judicial notions tended to extend insurance coverages beyond limits contemplated when policies were issued. Several financial failures had occurred in the industry. The result was a decrease in the industry's insuring capacity (basically a multiple of its capital). This decreased capacity enabled insurers beginning in 1985 to increase prices (premium rates) significantly, as well as to become more selective in their underwriting. FFC attributed the improvement in its property and casualty underwriting results for 1986 mainly to higher premium rates and use of tighter underwriting standards. The 1987 and 1988 pre-tax underwriting figures, however, indicate that the cycle began to turn against underwriters during 1987, resulting principally from increased price competition. FFC management has attributed the recent decline in volume of premiums written to its strategy of maintaining pricing discipline throughout the current soft cycle.

Insurance losses and loss expenses, and the related liabilities reflected on Wesco's consolidated balance sheet, because they are based in large part upon estimates, are subject to estimation error. Revisions of such estimates in future periods could significantly affect the results of operations reported for future periods.

Interest and dividend income has been earned by Wes-FIC from its investment of net insurance premium proceeds, or "float," and on capital contributed to the insurance business by Wesco — $45 million in September 1985, $36.2 million in January 1986 and $9 million in March 1987. Following is a summary, at cost, of the components of Wes-FIC's investment portfolio, as of yearend, in thousands of dollars:

	December 31,			
	1988	1987	1986	1985
Taxable, interest bearing cash equivalents	$ 1,017	$ 21,073	$ 6,675	$60,982
State and municipal bonds	154,455	138,191	141,853	—
Equity securities	65,702	33,020	—	6,543
	$221,174	$192,284	$148,528	$67,525

The income tax provision or benefit of Wes-FIC has fluctuated as a percentage of its pre-tax income or loss in each of the periods presented in the table on page 34 and has been influenced by the reduction in the statutory federal income tax rate, from 46% to 40% and 34%, for 1986, 1987 and 1988, by differences in the method of computing income taxes as a result of the Tax Reform Act of 1986, and by amounts and proportions that the various components of pre-tax income, some of which are taxed at very favorable rates, have borne to its total pre-tax income. Changes in size and mix of Wes-FIC's investment portfolio have resulted in changes in amounts of such favorably-taxed components of investment income. Interest on state and municipal bonds and dividends on equity securities are taxed at favored rates, while interest on short-term cash equivalents is fully taxable at the maximum statutory rate.

Although Wes-FIC's arrangement for the reinsurance of 2% of FFC's property and casualty insurance business expires August 31, 1989, the liability for losses and loss adjustment expenses (over $95 million as of 1988 yearend) which represents float, will continue to be invested, albeit in declining amounts, as claims are paid over many future years. Wes-FIC maintains a strong capital position which provides it the opportunity to accept other insurance contracts.

Steel Service Segment

Sales revenues increased approximately 14% in 1988, following an increase of about 5% in 1987, all in spite of steady competitive pressures in the marketplace. Sales volume, in terms of pounds sold, decreased approximately 2% in 1988, following an increase of about 3.5% in 1987. Precision Steel has held its pricing at levels that management has believed to be endurable. Steel service revenues generally have followed economic cycles.

Cost of products sold, as a percentage of sales, amounted to 80.8%, 82.7% and 81.9% for 1988, 1987 and 1986. The increase in the cost percentage in 1987 resulted from the inclusion of an uninsured flood loss of $1,340,000 in cost of steel products sold. The loss followed an unusually severe rainstorm in the Chicago area, during which nine inches of rain fell in a twenty-four hour period. Were it not for the flood loss, cost of products sold in 1987 would have amounted to 80.2% of steel service revenues. The cost percentage typically fluctuates slightly from year to year as a result of changes in product mix, the effect of competition for sales volume based on selling prices, and the availability of favorable quantity order prices on materials purchased.

"Normal" net income of the steel service business increased approximately 29% in 1988 and 44% in 1987 from the levels reported for each respective prior year. The steel service business operates on a low gross margin. A significant change in its revenues, or any slight change in its cost of products sold as a percentage of revenues, has a large effect on its net income.

* * * * * *

Realized securities gains have been an element of Wesco's net income for each of the past several years. The amounts of these gains, recorded by Wesco when appreciated securities are sold, tend to fluctuate significantly from period to period. The varying effect upon Wesco's pre-tax income is evident on the face of the consolidated statement of income. The amount of realized gain for any period has no predictive value, and variations in amount from period to period have no practical analytical value, given the preexistence of substantial unrealized price appreciation in Wesco's consolidated investment portfolio, from time to time. Realized securities gains amounted to $6,525,000, $1,208,000 and $4,590,000 after income taxes in 1988, 1987 and 1986. The 1988 figure included $4,836,000 after income taxes, realized by Wes-FIC on the sale of its 9% equity interest in Bowery Savings Bank.

Wesco's consolidated revenues include significant amounts of fully tax-exempt interest on state and municipal bonds, substantially exempt dividend income from preferred and common stocks, and gains and losses on sales of stocks which, through 1987, have been subject to favorable income tax rates. Fluctuations in the amounts of and proportion that these investment income components have borne to total consolidated pre-tax income have resulted in tax provisions and benefits expressed as percentages of pre-tax income, as follows: a tax provision of 13.9% in 1988, a tax benefit of 19.9% in 1987, and tax provisions of 17.1%, 31.3% and 24.9% in 1986, 1985 and 1984. (See Note 6 to the accompanying consolidated financial statements for further information on income taxes.)

In December 1987 the Financial Accounting Standards Board issued Statement No. 96 ("FASB 96") which requires a change in accounting for income taxes. This statement must be implemented no later than 1990. Uncertainties exist with respect to the most appropriate means of implementing the changes, and Wesco management has not determined precisely how it will accomplish the newly prescribed methods. Management believes that if changes expected under FASB 96 had been made as of 1988 yearend, the resulting 1988 consolidated earnings and shareholders' equity data of Wesco would not have significantly differed from such information contained in Item 6, Selected Financial Data, and in the consolidated financial statements beginning on page 40.

Consolidated revenues, expenses and earnings set forth in Item 6, Selected Financial Data, and in Wesco's consolidated statement of income, are not necessarily indicative of future revenues, expenses and earnings, in that they are subject to significant variations in amount and timing of securities gains and losses, the possible occurrence of other unusual items and significant changes in the interest rate spread.

Item 8. Financial Statements

Following is an index to financial statements and related schedules appearing in this report:

The data appearing on the financial statement schedules listed below should be read in conjunction with the consolidated financial statements and notes of Wesco Financial Corporation and the independent auditor's report referred to above. Schedules not included with these financial statement schedules have been omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

Item 9. Disagreements on Accounting and Financial Disclosure

Not applicable.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information set forth in the section entitled "Election of Directors" appearing in the definitive combined notice of annual meeting and proxy statement of Wesco Financial Corporation for its 1989 annual meeting of shareholders is incorporated herein by reference.

Item 11. Management Remuneration and Transactions

The information set forth in the section "Compensation of Directors and Executive Officers" in the definitive combined notice of annual meeting and proxy statement of Wesco Financial Corporation for its 1989 annual meeting of shareholders is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information set forth in the section "Voting Securities and Principal Holders Thereof" in the definitive combined notice of annual meeting and proxy statement of Wesco Financial Corporation for its 1989 annual meeting of shareholders is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

The information set forth in the section "Transactions With Management and Others" in the definitive combined notice of annual meeting and proxy statement of Wesco Financial Corporation for its 1989 annual meeting of shareholders is incorporated herein by reference.

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

The following exhibits (listed by numbers corresponding to Table 1 of Item 601 of Regulation S-K) are filed as part of this Annual Report on Form 10-K or are incorporated herein by reference:

3a. Articles of Incorporation and By-Laws of Wesco Financial Corporation (incorporated by reference to Exhibit 3a. of Form 10-K Annual Report of Wesco Financial Corporation for year ended December 31, 1987).

4. Form of Indenture (incorporated by reference to Exhibit 2 to Amendment No. 1 of Form S-7 Registration Statement of Wesco Financial Corporation filed June 20, 1979. File No. 2-64616).

22. Subsidiaries.

The index to financial statements and related schedules set forth in Item 8 of this report is incorporated herein by reference.

No reports on Form 8-K were filed during the quarter ended December 31, 1988.

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WESCO FINANCIAL CORPORATION

By:

Charles T. Munger Chairman of the Board and President (principal executive officer)	March 23, 1989

By:

Jeffrey L. Jacobson Vice President and Chief Financial Officer (principal financial officer)	March 23, 1989

By:

Jeanne G. Leach Treasurer (principal accounting officer)	March 23, 1989

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Charles T. Munger Director	March 23, 1989
H. R. Dettmann Director	March 23, 1989
David K. Robinson Director	March 23, 1989
James N. Gamble Director	March 23, 1989

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholders of
Wesco Financial Corporation

We have audited the accompanying consolidated balance sheets of Wesco Financial Corporation and subsidiaries as of December 31, 1988 and 1987, the related statements of income and retained earnings and cash flows for the three years in the period ended December 31, 1988, and the schedules listed in the index at Item 8. These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Wesco Financial Corporation and subsidiaries as of December 31, 1988 and 1987, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1988, in conformity with generally accepted accounting principles, and the schedules referred to above present fairly, in all material respects, when read in conjunction with the related financial statements, the information therein set forth.

Touche Ross & Co.

Los Angeles, California
February 24, 1989

WESCO FINANCIAL CORPORATION
CONSOLIDATED BALANCE SHEET
(Dollar amounts in thousands)

ASSETS	December 31, 1988	December 31, 1987
Cash and temporary cash investments	$ 42,703	$ 61,398
Investments:		
Preferred stock of Salomon Inc	100,000	100,000
Other obligations with fixed maturities	209,026	246,380
Marketable equity securities:		
Preferred stock of Federal Home Loan Mortgage Corp.	71,729	6,422
Other	79,991	30,094
Investment in Bowery Savings Bank	—	9,020
Loans receivable	137,007	139,468
Accounts receivable from customers, agents and others	15,355	15,162
Property, premises and equipment	8,055	8,024
Other assets	42,398	31,428
	$706,264	$647,396

LIABILITIES AND SHAREHOLDERS' EQUITY	1988	1987
Savings accounts	$286,909	$286,211
Insurance losses and loss adjustment expenses	95,585	79,578
Unearned insurance premiums	23,727	26,964
Income taxes payable	3,252	5,324
Notes payable	31,786	31,017
Other liabilities	26,417	5,482
Total liabilities	467,676	434,576
Shareholders' equity:		
Capital stock, $1 par value — authorized 7,500,000 shares; issued 7,119,807 shares	7,120	7,120
Capital surplus arising from stock dividends	23,319	23,319
Unrealized appreciation of marketable equity securities of insurance business	948	—
Retained earnings — partially restricted	207,201	182,381
Total shareholders' equity	238,588	212,820
	$706,264	$647,396

See accompanying notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

(Dollar amounts in thousands except for amounts per share)

	Year Ended December 31,		
	1988	1987	1986
Income items:			
Interest on loans	$ 11,248	$ 6,528	$ 5,982
Insurance premiums earned	62,465	73,384	67,515
Steel service revenues	62,694	54,843	52,304
Interest and dividend income on investments	38,177	35,399	32,227
Securities gains	9,952	2,194	8,282
Rental income of $2,436, $2,272 and $2,229, less expense of $1,288, $1,167 and $1,138	1,148	1,105	1,091
Other income	529	523	1,063
	186,213	173,976	168,464
Cost and expense items:			
Interest expense on savings accounts	20,579	20,903	22,275
Insurance losses and loss adjustment expenses	44,335	53,970	48,454
Insurance underwriting expenses	21,603	23,671	21,780
Cost of steel products sold	50,674	45,333	42,836
Selling, general and administrative expenses	11,033	10,715	10,082
Interest expense on notes payable	3,051	3,078	3,114
Writeoff of prepaid FSLIC insurance premiums	—	3,618	—
	151,275	161,288	148,541
Income before income taxes	34,938	12,688	19,923
Income tax provision (benefit)	4,849	(2,525)	3,399
Net income	30,089	15,213	16,524
Retained earnings — beginning of year	182,381	172,152	160,327
Cash dividends declared and paid	(5,269)	(4,984)	(4,699)
Retained earnings — end of year	$207,201	$182,381	$172,152
Amounts per share based on 7,119,807 shares:			
Net income	$4.22	$2.14	$2.32
Cash dividends	$ .74	$ .70	$ .66

See accompanying notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollar amounts in thousands)

	Year Ended December 31, 1988	1987	1986
Cash flows from operating activities —			
Net income	$ 30,089	$ 15,213	$ 16,524
Adjustments to reconcile net income to net cash, including temporary cash investments, provided by operating activities:			
Pretax gain on sales of securities	(9,952)	(2,194)	(8,282)
Provision for depreciation and amortization, including amortization of bond premiums of $2,278, $2,629 and $1,509	3,229	3,582	2,504
Net increase in losses and loss adjustment expenses of insurance business	16,007	28,023	36,082
Decrease in income taxes payable	(2,072)	(6,196)	(11,610)
Other, net	(7,769)	3,015	(3,430)
Net cash provided by operating activities	29,532	41,443	31,788
Cash flows from investing activities —			
Proceeds from sales of obligations with fixed maturities and marketable equity securities	145,917	167,276	250,654
Purchases of obligations with fixed maturities and marketable equity securities	(202,813)	(354,483)	(268,602)
Proceeds from sale of investment in Bowery Savings Bank	16,870	—	—
Real estate loans originated	(16,716)	(25,425)	(8,992)
Purchases of mortgage-backed securities	—	(51,224)	—
Principal collections on real estate loans and mortgage-backed securities	19,730	15,600	13,758
Other, net	(7,414)	(993)	(2,250)
Net cash used by investing activities	(44,426)	(249,249)	(15,432)
Cash flows from financing activities —			
Net increase (decrease) in passbook, money-market-rate and interest-bearing checking accounts	(4,928)	3,415	8,267
Increase in certificate accounts of over 3 months' maturities	193,770	207,110	233,494
Payments for maturing certificate accounts of over 3 months' maturities	(188,144)	(206,672)	(228,450)
Payment of cash dividends	(5,269)	(4,984)	(4,699)
Other, net	770	(256)	(250)
Net cash provided (used) by financing activities	(3,801)	(1,387)	8,362
Increase (decrease) in cash, including temporary cash investments	(18,695)	(209,193)	24,718
Cash, including temporary cash investments, at beginning of year	61,398	270,591	245,873
Cash, including temporary cash investments, at end of year	$ 42,703	$ 61,398	$270,591

	1988	1987	1986
Supplementary disclosures of cash paid during year for:			
Interest	$ 23,630	$ 23,981	$ 25,389
Income taxes	6,921	8,721	15,009

See accompanying notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollar amounts in thousands except for amounts per share)

Note 1. Presentation and Consolidation

Wesco Financial Corporation ("Wesco") is 80.1%-owned by Blue Chip Stamps ("Blue Chip"), which in turn is wholly owned by Berkshire Hathaway Inc. ("Berkshire").

The consolidated financial statements of Wesco include the accounts of Wesco and its subsidiaries which, with the exception of New America Electrical Corporation ("New America Electric" — see below), are all either directly or indirectly wholly owned. Wesco and its subsidiaries are engaged in several diverse businesses, notably Mutual Savings and Loan Association ("Mutual Savings"), Wesco-Financial Insurance Company ("Wes-FIC") and Precision Steel Warehouse, Inc. ("Precision Steel"). See Note 11 for financial information classified by Wesco's business segments.

All material intercompany balances and transactions have been eliminated in the preparation of the accompanying consolidated financial statements.

Wesco, at approximately 1988 yearend, purchased 80% of the outstanding common stock of New America Electric, for $8,200, paying $7,165 cash, and issuing a 10-year note for the balance. New America Electric manufactures various commercial and residential electrical products. Its 1988 yearend balance sheet is included in the accompanying consolidated balance sheet of Wesco; its results of operations will be included in Wesco's consolidated figures beginning in 1989.

The accompanying consolidated statement of cash flows has replaced a somewhat similar statement, the consolidated statement of changes in financial position, that, through 1987, had been included in Wesco's annual report as one of the primary financial statements. Data appearing in the new statement for the years 1987 and 1986 have been restated for comparability.

For purposes of the new statement, temporary cash investments considered cash equivalents now include only those whose dates of maturity are three months or less at dates of investment. Previously, temporary cash investments included those whose maturities were up to one year at the balance sheet date. Figures appearing throughout these consolidated financial statements have also been restated.

The changes referred to in the two preceding paragraphs were made in accordance with Statement No. 95 issued by the Financial Accounting Standards Board.

Note 2. Investments

Investments in obligations with fixed dates of maturity — temporary cash investments having maturities of at least three months at dates purchased, bonds and redeemable preferred stocks — are carried on the consolidated balance sheet at cost, adjusted for accretion of discount or amortization of premium. Marketable equity securities are carried at the lower of aggregate cost or market, except for those held in the insurance business, which, when held, are carried at market value, with any resulting unrealized gain or loss added to or deducted from shareholders' equity, net of deemed applicable income taxes, without effect on net income.

Wesco, in October 1987, invested $100,000 in 100,000 newly issued shares of Cumulative Convertible Preferred Stock of Salomon Inc ("Salomon"). This investment was part of a $700,000 transaction in which other subsidiaries of Berkshire participated, and it was subject to an agreement, principal terms of which included the following: (1) the preferred stock pays dividends at the annual rate of 9%; (2) each preferred share will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur, such as a tender offer for Salomon's common stock; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at Wesco's cost plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

Following is a summary of investments at yearend:

	1988			1987		
	Cost	Market	Carrying Value	Cost	Market	Carrying Value
Preferred stock of Salomon Inc	$100,000	$100,000*	$100,000	$100,000	$ 98,000*	$100,000
Other obligations with fixed maturities	$209,026	$216,067	$209,026	$246,380	$253,891	$246,380
Marketable equity securities —						
Preferred stock of Federal Home Loan Mortgage Corp. ("Freddie Mac")	$ 71,729	$121,200	$ 71,729	$ 6,422	$ 7,275	$ 6,422
Other	78,554	84,866	79,991	30,094	35,655	30,094
	$150,283	$206,066	$151,720	$ 36,516	$ 42,930	$ 36,516

* Although market quotations are not available with respect to shares of Salomon preferred stock, management of Wesco estimated that its fair market value had recovered from the estimate of $98,000 reported a year earlier, to an amount somewhat in excess of its cost at December 31, 1988, with any such excess considered immaterial.

The investment in preferred stock of Freddie Mac includes certain shares acquired through commitments entered into in August 1988, and settled in January 1989. The yearend liability of $20,182 is included in other liabilities on the accompanying consolidated balance sheet, and is collateralized by certain obligations with fixed maturities held by the broker.

At December 31, 1988, the consolidated portfolio of marketable equity securities contained aggregate unrealized gains of $56,156 and losses of $373.

In addition to the foregoing investments, the consolidated balance sheet included, at December 31, 1987, an equity investment in approximately 9% of Bowery Savings Bank ("Bowery") at cost of $9,020. The sale of Bowery was completed early in 1988, and the related gain of $4,836, after income taxes, is included in 1988 net income.

Dollar amounts in thousands except for amounts per share

Note 3. Loans Receivable

Following is a summary of loans receivable by type of collateral at yearend:

	1988	1987
Residential property of one to four units	$ 83,163	$ 78,439
Residential property of more than four units	5,735	6,689
Mortgage-backed securities (residential)	45,367	52,080
Commercial property and vacant land	1,800	1,983
Other, principally savings accounts	942	278
	137,007	139,469
Less unearned loan fees	—	(1)
	$137,007	$139,468
Average interest rate	8.70%	8.38%

Interest income on loans is recognized under the accrual method of accounting. Such accrued interest amounted to $1,170 and $539 at 1988 and 1987 yearends.

Note 4. Property, Premises and Equipment

Following is a summary of property, premises and equipment, stated at cost at yearend:

	1968	1987
Land	$ 2,065	$ 2,065
Buildings and leasehold improvements	10,234	10,069
Machinery and equipment	7,689	5,789
Furniture and fixtures	1,083	1,063
	21,071	18,986
Less accumulated depreciation and amortization	13,016	10,962
	$ 8,055	$ 8,024

Land and buildings collateralize certain debt. See Note 7.

Property, premises and equipment are depreciated under the straight-line method over the estimated useful lives of the assets.

Dollar amounts in thousands except for amounts per share

Note 5. Savings Accounts

Following is a summary of accounts by type of account and interest rate at yearend:

Type of Account	Interest Rate(a)	1988	1987
Interest-bearing checking accounts(b)	4.85%	$ 3,425	$ 3,762
Passbook accounts(b)	5.0	15,687	16,183
Money market rate accounts(b)	5.44	68,772	72,867
Certificate accounts:			
32 days-6 months	7.68	41,283	30,370
7 months-1 year	7.55	39,844	30,715
13 months-2 years	7.60	35,853	32,389
25 months-4 years	7.75	24,923	48,655
Over 4 years	8.75	17,560	12,839
IRA/Keogh accounts, 18 months(c)	7.95	33,133	30,914
IRA/Keogh accounts, 4 years	9.72	5,713	4,072
Jumbo certificates of deposit	7.40	501	2,907
Other accounts	7.77	215	538
		$286,909	$286,211

(a) Weighted average interest rate at 1988 yearend.

(b) No stated maturity.

(c) Other IRA/Keogh accounts included in the various certificate accounts amounted to $270 and $1,599 at 1988 and 1987 yearends.

The weighted average interest rates on all accounts at 1987 and 1986 yearends were 7.06% and 7.18%. These rates are based upon stated interest rates without giving consideration to daily compounding of interest or forfeiture of interest due to premature withdrawals.

At yearend in 1988, certificate accounts mature as follows: 1989, $154,725; 1990, $38,396; 1991, $3,612; 1992, $2,286; 1993, $0; thereafter, $6.

Dollar amounts in thousands except for amounts per share

Note 6. Taxes on Income

Certain items of income and expense are recognized in the financial statements in periods that differ from the periods in which these items are recognized on the income tax returns, giving rise to the recognition in the financial statements of deferred and prepaid income taxes. The liability for deferred income taxes is included on the accompanying consolidated balance sheet, net of prepaid income taxes, in income taxes payable. Following is a breakdown of the liability for income taxes reflected on the accompanying consolidated balance sheet:

	1988	1987
Payable currently	$ 309	$ 1,768
Deferred	2,943	3,556
	$ 3,252	$ 5,324

The consolidated statement of income contains income tax charges (benefits) as follows:

	1988	1987	1986
Payable currently—			
Federal	$ 6,515	$ 2,391	$ 807
State	1,121	591	895
	7,636	2,982	1,702
Payable (recoverable) in the future—			
Federal	(2,928)	(5,141)	1,747
State	141	(366)	(50)
	(2,787)	(5,507)	1,697
Total income tax provision (benefit)	$ 4,849	$(2,525)	$ 3,399

Following is a summary of the tax effects of timing differences:

	1988	1987	1986
Deferred insurance premium acquisition costs	$ (167)	$ (204)	$ 357
Discounting of losses and loss adjustment expense reserves of insurance business	(2,221)	(3,041)	—
Reversal of accrual of interest credited by FSLIC to secondary reserve (Note 8)	—	(1,076)	—
Loan fees recognized under different methods	(360)	(342)	(403)
State income taxes deducted on cash basis for tax return purposes vs. accrual basis for financial reporting purposes	(4)	(91)	1,903
Other, net	(35)	(753)	(160)
Income taxes payable (recoverable) in the future	$(2,787)	$(5,507)	$ 1,697

Dollar amounts in thousands except for amounts per share

A reconciliation of the statutory federal income tax rate with the effective income tax rate resulting in the income tax provision (benefit) appearing on the accompanying consolidated statement of income follows:

	1988	1987	1986
Statutory federal income tax rate	34.0%	40.0 %	46.0 %
Increase (decrease) resulting from:			
Tax-exempt interest income	(11.9)	(39.7)	(19.2)
Exclusion from taxable income of a significant portion of dividend income	(10.0)	(14.7)	(8.9)
Fresh-start adjustment relating to discounting losses and loss adjustment expense reserves	(0.7)	(3.9)	—
Rate differentials relating to realized investment gains	—	(0.2)	(1.9)
State income taxes, less federal tax benefit	1.6	1.1	2.2
Other differences, net	0.9	(2.5)	(1.1)
Effective income tax provision (benefit) rate	13.9%	(19.9)%	17.1 %

Wesco and its subsidiaries join with other Berkshire subsidiaries in the filing of consolidated federal income tax returns for the Berkshire group. The consolidated federal tax liability is apportioned among group members pursuant to methods that result in each member of the group paying or receiving an amount that approximates the increased or decreased taxes attributable to each member.

Federal income tax returns through 1983 have been examined by and settled with the Internal Revenue Service.

Wesco intends to implement a change in accounting for income taxes in 1990 as mandated by Statement No. 96 of the Financial Accounting Standards Board ("FASB 96"). Management of Wesco believes that if the changes required by FASB 96 had been made as of 1988 yearend, the resulting 1988 consolidated earnings and shareholders' equity data of Wesco would not have significantly differed from those data presented in the accompanying consolidated financial statements.

Dollar amounts in thousands except for amounts per share

Note 7. Notes Payable

Following is a list of notes payable at yearend:

	1988	1987
Notes due June 1991, currently redeemable at 101% of face value, declining to 100% by June 1989, bearing interest at 10⅛% payable in semiannual installments	$25,000	$25,000
Notes payable, collateralized by land, buildings and assignment of leases, due in monthly installments through February 2007 of $45 including interest at 9¼%	4,751	4,850
Note payable, due December 1998, bearing interest at 10% payable monthly	1,035	—
Industrial revenue bonds, due in quarterly installments through December 1994 of $42 plus interest at 6½%	1,000	1,167
	$31,786	$31,017

Notes payable at yearend in 1988 mature as follows:

Year	
1989	$ 266
1990	285
1991	25,296
1992	309
1993	323
Thereafter	5,307
	$31,786

Agreements relating to the 10⅛% notes and the industrial revenue bonds contain covenants, among others, restricting funded debt, dividends and liens on property, premises and equipment. The obligors are in compliance with all of the covenants.

Note 8. Writeoff of Prepaid FSLIC Insurance Premiums

The 1987 consolidated results of operations of Wesco include a charge of $1,935 ($.27 per share), representing the after-tax effect of a writeoff of prepaid Federal Savings and Loan Insurance Corporation ("FSLIC") insurance premiums. Wesco's subsidiary, Mutual Savings, took this charge in May 1987 following a notice from the Federal Home Loan Bank Board that FSLIC had eliminated the savings and loan industry's secondary reserve in an attempt to strengthen its financial condition in order to cover future losses associated with troubled financial institutions.

Dollar amounts in thousands except for amounts per share

Note 9. *Quarterly Financial Information*

Unaudited quarterly financial information for 1988 and 1987 follows:

	Quarter Ended			
	December 31, 1988	**September 30, 1988**	**June 30, 1988**	**March 31, 1988**
Total revenues	$43,632	$43,715	$45,024	$53,842
Net income	6,626	6,612	5,937	10,914
Per share	.93	.93	.83	1.53
Securities gains net of income taxes, included in net income above	1,246	200	53	5,026
Per share	.17	.03	.01	.70

	Quarter Ended			
	December 31, 1987	**September 30, 1987**	**June 30, 1987**	**March 31, 1987**
Total revenues	$42,729	$44,687	$43,642	$42,918
Net income	5,207	4,559	2,292	3,155
Per share	.74	.64	.32	.44
Securities gains net of income taxes, included in net income above	60	959	189	—
Per share	.01	.14	.02	—

Note 10. Retained Earnings

Retained earnings of Wesco include $47,314 of undistributed retained earnings of Mutual Savings, which were taken as special bad debt deductions for income tax purposes through 1968, after which such deductions were no longer available to Mutual Savings due to its having reached certain limitations. These deductions are not related to amounts of losses actually anticipated and have not been charged against income for financial reporting purposes. If, in the future, any portion of such retained earnings is used for any purpose other than to absorb loan losses, including payment of dividends to Wesco or distribution in liquidation, such withdrawal will necessitate accrual and payment of income taxes.

Because of the special bad debt deductions, and other differences in methods of reporting results of operations for tax return and financial statement purposes, Mutual Savings' ability to pay dividends to Wesco without being subject to tax is limited to approximately future earnings on a tax-return basis. (Dividends of $11,800 and $7,500 were paid by Mutual Savings to Wesco in 1988 and 1986; none were paid in 1987.)

Dollar amounts in thousands except for amounts per share

Note 11. Business Segment Data

Financial information for each of the three most recent years is presented below, broken down as to Wesco's business segments.

The financial segment includes the accounts of Wesco, Mutual Savings and Wes-Fin Service Corporation, as well as temporary cash investments and other investments of Precision Steel, its subsidiaries, together with related interest and dividend income and gain or loss on related sales. The insurance segment includes the accounts of Wes-FIC. The steel service segment includes principally the operating accounts of Precision Steel and its subsidiaries.

	1988	1987	1986
Revenues:			
Financial	$ 36,236	$ 33,909	$ 38,109
Insurance	87,041	85,013	77,853
Steel service	62,936	55,054	52,502
	$186,213	$173,976	$168,464
Operating profit (loss) before taxes:			
Financial	$ 11,849	$ 5,490	$ 12,264
Insurance	21,103	7,365	7,619
Steel service	5,257	3,139	3,372
Corporate expenses	(220)	(228)	(218)
Interest expense on notes payable	(3,051)	(3,078)	(3,114)
	$ 34,938	$ 12,688	$ 19,923

The above revenue and operating profit (loss) data include securities gains before taxes, as follows:

	1988	1987	1986
Financial	$ 753	$ 2,190	$ 7,629
Insurance	9,199	4	653
	$ 9,952	$ 2,194	$ 8,282

Additional business segment data follows:

	1988	1987	1986
Capital expenditures, excluding expenditures in connection with business acquisitions:			
Financial	$ 71	$ 332	$ 379
Steel service	556	591	343
	$ 627	$ 923	$ 722

Depreciation and amortization of tangible assets:

	1988	1987	1986
Financial	$ 362	$ 340	$ 297
Steel service	589	612	670
	$ 951	$ 952	$ 967

Identifiable assets at yearend:

	1988	1987	1986
Financial	$434,307	$412,887	$420,877
Insurance	246,154	215,293	172,020
Steel service, including $7,653 in 1988 relating to New America Electric	25,803	19,216	18,302
	$706,264	$647,396	$611,199

Dollar amounts in thousands except for amounts per share

WESCO FINANCIAL CORPORATION
SCHEDULE I—MARKETABLE SECURITIES — OTHER INVESTMENTS
DECEMBER 31, 1988
(Dollar amounts in thousands)

Name of Issuer and Title of Each Issue	Number of Shares of Stock or Principal Amount of Notes	Cost	Market Value	Balance Sheet Carrying Value
Marketable securities held by the consolidated group were as follows:				
Temporary cash investments —				
Securities of U.S. Government and obligations of the Federal Home Loan Bank and other U.S. Government agencies	$ 12,041	$ 12,041	$ 12,041	$ 12,041
Other	28,074	28,040	28,041	28,040
		$ 40,081	$ 40,082	$ 40,081
Fixed maturities —				
State and municipal bonds	$ 161,345	$173,200	$181,466	$173,200
Cumulative convertible preferred stock of Salomon Inc ("Salomon")	100,000 shares	100,000	100,000*	100,000
Federal Home Loan Bank bonds, 7¾%, due 6-26-89	30,000	30,000	29,700	30,000
Sinking fund preferred stocks of public utilities	96,500 shares	4,524	4,311	4,524
Other	1,310	1,302	1,296	1,302
		$309,026	$316,773	$309,026
Marketable equity securities —				
Preferred stock of Federal Home Loan Mortgage Corporation (when issued)	2,400,000 shares	$ 71,729	$121,200	$ 71,729
Preferred stocks of various public utilities	1,087,004 shares	36,852	41,727	36,852
Common stock of Coca-Cola Company	500,000 shares	21,779	22,313	22,313
Common stocks of various other corporations	219,000 shares	19,923	20,826	20,826
		$150,283	$206,066	$151,720
GNMA and FHLMC mortgage-backed securities —				
Shearson Lehman CMO, Series L-3, 7.0%, 10-25-99, expected maturity 4-25-93	$ 20,966	$ 19,810	$ 19,512	$ 19,810
Various others	26,298	25,557	25,155	25,557
		$ 45,367	$ 44,667	$ 45,367
All of the securities listed above were held by Mutual Savings except as indicated below:				
Held by Wesco (registrant) —				
U.S Government securities	$ 810	$ 808	$ 808	$ 808
Other temporary cash investments	62	62	62	62
Cumulative convertible preferred stock of Salomon	50,000 shares	50,000	50,000*	50,000*
		$ 50,870	$ 50,870	$ 50,870
Held by Precision Steel (wholly owned subsidiary of Wesco) —				
Other temporary cash investments	$ 15,323	$ 15,295	$ 15,297	$ 15,295
State and municipal bonds	1,000	1,226	1,216	1,226
		$ 16,521	$ 16,513	$ 16,521
Held by Wesco-Financial Insurance Company (wholly owned subsidiary of Wesco) —				
Other temporary cash investments	$ 1,017	$ 1,017	$ 1,017	$ 1,017
State and municipal bonds	143,970	154,455	159,915	154,455
Cumulative convertible preferred stock of Salomon	24,000 shares	24,000	24,000*	24,000
Common stocks of various corporations	719,000 shares	41,702	43,139	43,139
		$221,174	$228,071	$222,611
Held by Wes-Fin Service Corporation (wholly owned subsidiary of Mutual Savings) —				
Other temporary cash investments	$ 9,156	$ 9,151	$ 9,150	$ 9,151
Cumulative convertible preferred stock of Salomon	26,000 shares	26,000	26,000*	26,000
		$ 35,151	$ 35,150	$ 35,151
Held by New America Electric (80% owned subsidiary of Wesco) —				
Other temporary cash investments	$ 2,400	$ 2,400	$ 2,400	$ 2,400

* Market Quotations are not available. Charles T. Munger, Chairman of the Board and President of Wesco, and acting on behalf of the board of directors of Wesco, in consultation with Warren E. Buffett, a controlling person of Wesco, has determined the fair market value to be somewhat in excess of cost, with any such excess at December 31, 1988 considered immaterial.

WESCO FINANCIAL CORPORATION
SCHEDULE III — CONDENSED FINANCIAL INFORMATION OF REGISTRANT
BALANCE SHEET
(Dollar amounts in thousands)

	December 31, 1988	December 31, 1987
ASSETS		
Cash and temporary cash investments (including savings accounts at Mutual Savings of $1,576 and $892)	$ 2,566	$ 934
Investment in Salomon Inc	50,000	50,000
Investment in subsidiaries, at equity:		
Mutual Savings	49,660	56,559
Precision Steel	30,107	26,107
Wesco-Financial Insurance Company	125,410	106,297
New America Electric	8,200	—
Other	139	119
	213,516	189,082
Premises and equipment, net	2,953	3,189
Other assets	828	428
	$269,863	$243,633
LIABILITIES AND SHAREHOLDERS' EQUITY		
Notes payable	$ 30,786	$ 29,850
Accounts payable and accrued expenses	171	222
Income taxes payable	318	741
Total liabilities	31,275	30,813
Shareholders' equity (see consolidated balance sheet)	238,588	212,820
	$269,863	$243,633

See notes to consolidated financial statements.

STATEMENT OF INCOME AND RETAINED EARNINGS
(Dollar amounts in thousands)

	Year Ended December 31, 1988	1987	1986
Revenues —			
Dividends on preferred and common stocks	$ 4,500	$ 1,125	$ 179
Interest on temporary cash investments	167	2,237	3,077
Interest on savings accounts at Mutual Savings	260	37	117
Rental of office, store and garage premises, net	1,875	1,820	1,791
Dividends from subsidiaries	11,800	60	7,500
Gain on sales of marketable securities	—	702	3,165
Other	32	36	44
	18,634	6,017	15,873
Expenses —			
Interest	2,980	2,995	3,200
General and administrative	631	591	574
	3,611	3,586	3,774
Income before items shown below	15,023	2,431	12,099
Income tax provision	(222)	(726)	(2,267)
Equity in undistributed earnings of subsidiaries	15,288	13,508	6,692
Net income	30,089	15,213	16,524
Retained earnings — beginning of year	182,381	172,152	160,327
Cash dividends	(5,269)	(4,984)	(4,699)
Retained earnings — end of year	$207,201	$182,381	$172,152

See notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
SCHEDULE III — CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENT OF CASH FLOWS
(Dollar amounts in thousands)

	Year Ended December 31,		
	1988	1987	1986
Cash flows from operating activities —			
Net income	$ 30,089	$ 15,213	$ 16,524
Adjustments to reconcile net income to net cash, including temporary cash investments, provided by operating activities:			
Gain on sales of marketable securities, before taxes	—	(702)	(3,165)
Decrease in income taxes payable	(423)	(1,015)	(9,063)
Other, net	(150)	218	201
Net cash provided by operating activities	29,516	13,714	4,497
Cash flows from investing activities —			
Equity in undistributed earnings of subsidiaries	(15,288)	(13,508)	(6,692)
Purchases of obligations with fixed maturities and marketable equity securities	—	(71,855)	(81,408)
Proceeds from sales of obligations with fixed maturities and marketable equity securities	—	22,557	85,693
Investment in subsidiaries	(8,200)	—	—
Other, net	(64)	(351)	(202)
Net cash used by investing activities	(23,552)	(63,157)	(2,609)
Cash flows from financing activities —			
Payment of cash dividends	(5,269)	(4,984)	(4,699)
Other, net	937	(90)	(83)
Net cash used by financing activities	(4,332)	(5,074)	(4,782)
Increase (decrease) in cash, including temporary cash investments	1,632	(54,517)	(2,894)
Cash, including temporary cash investments, at beginning of year	934	55,451	58,345
Cash, including temporary cash investments, at end of year	$ 2,566	$ 934	$ 55,451

See notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
SUPPLEMENTARY INSURANCE INFORMATION
(Dollar amounts in thousands)

SCHEDULE V

Segment	Deferred Policy Acquisition Costs	Future Claim and Loss Expenses	Unearned Premiums	Earned Premiums	Net Investment Income	Loss and Loss Adjustment Expenses Incurred	Amortized Deferred Policy Acquisition Costs	Other Underwriting Expenses	Written Premiums
Property and casualty insurance —									
1988	$8,030	$95,585	$23,727	$62,465	$15,377	$44,335	$20,833	$ —	$59,227
1987	8,521	79,578	26,964	73,384	11,618	53,970	22,947	—	71,032
1986	9,030	49,202	29,317	67,515	9,685	48,454	20,939	—	70,506

See notes to consolidated financial statements.

MUTUAL SAVINGS AND LOAN ASSOCIATION
(A Wholly Owned Subsidiary of Wesco Financial Corporation)
CONDENSED CONSOLIDATED BALANCE SHEET
(Dollar amounts in thousands)

	December 31, 1988	December 31, 1987
ASSETS		
Cash and temporary cash investments	$ 54,067	$120,645
State and municipal bonds, at cost (market $20,335 and $20,528)	17,519	17,566
Marketable equity securities owned by Mutual Savings, at cost:		
Federal Home Loan Mortgage Corp. preferred stock (market $121,200 and $7,275)	71,729	6,422
Public utility preferred stocks (market $41,726 and $32,759)	36,852	27,257
Other marketable securities, at cost (market $4,311 and $1,292)	4,524	1,506
Investment in preferred stock of Salomon Inc, by service subsidiary	26,000	26,000
Loans receivable, principally real estate, yielding 8.70% and 8.38%	136,970	139,427
Real estate held for sale	5,833	2,441
Investment in stock of Federal Home Loan Bank	1,556	794
Other assets	5,454	5,498
	$360,504	$347,556
LIABILITIES AND SHAREHOLDER'S EQUITY		
Savings accounts	$288,522	$287,126
Accounts payable and accrued expenses	20,515	1,037
Income taxes payable, principally deferred	1,807	2,834
	310,844	290,997
Shareholder's equity:		
Guarantee stock and additional paid-in capital	100	100
Retained earnings — substantially restricted	49,560	56,459
Total shareholder's equity	49,660	56,559
	$360,504	$347,556
Cash dividends declared and paid	$ 11,800	$ —

See notes to consolidated financial statements of Wesco Financial Corporation.

Main entrance to Mutual Savings head office

MUTUAL SAVINGS
AND LOAN ASSOCIATION

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Plaza Pasadena Office: 255 Plaza Pasadena
Pasadena, California 91101-2311

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