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Report on Golden West Financial Corporation, parent company of World Savings.

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Duo's Success Built on Old-School Approach

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One thing that can happen if you survive long enough in business is that the world eventually comes around to your way of thinking.

Herb and Marion Sandler have been watching bemusedly as executives, Wall Street and politicians rediscover the virtues of gobbledygook-free financial reports, of keeping a lid on expenses, of securities analysis based on the crunching of numbers as opposed to the jabbering of CEOs— all principles they've operated by for more than 40 years.

Chief executives and chief financial officers being forced to certify their financial results? "We always thought we were certifying our financial statements," Herb Sandler was saying one day recently.

"Yes, when we signed them," Marion added.

With that banter, the Sandlers were off on a favorite subject—the inability of corporate CEOs to comply with the moral and legal imperatives of running a public company.

In unstylish Oakland stands the headquarters of the decidedly unstylish yet enduring and eminently successful Golden West Financial Corp., parent of one of the last of a breed known as thrift companies, World Savings & Loan. The Sandlers have been the company's husband-and-wife co-chairmen and CEOs since they took it over in 1963.

In the intervening four decades, they have outlasted California booms and busts too numerous to count, a deregulation period that exposed the weaknesses of the S&L business the way a receding tide uncovers ancient wrecks on a harbor bottom, and more investment fashions and fads than one might see on 7th Avenue.

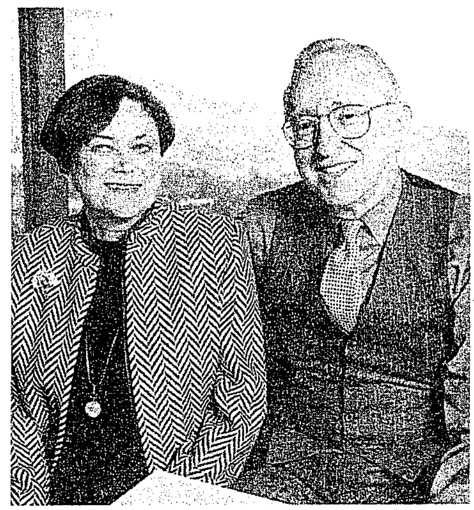
For a sense of how difficult it has been to survive in this environment, consider that of the 20 largest thrifts in 1989, only World Savings remains in business. Right now, Golden West shares are trading near their historic highs, and the company recently reported record quarterly earnings.

The rule behind this success is simple: Take care of the business, and the bottom line and stock price (and stock analysts) will follow.

Not long ago Marion went on the radio show "Marketplace" to explain that Golden West has never ever made financial forecasts for Wall Street, because the only reason to do so is to hype a stock. When a company is wrong, as it sometimes must be, it gets unduly punished. Instead, she said, "We don't talk about what we're going to do; we just do it."

Swearing Off Forecasts

The show aired about the time that Coca-Cola Co., McDonald's Corp., Home Depot Inc. and other big companies announced they were swearing off quarterly forecasts.



Marion and Herbert Sandler

But they already were at a disadvantage. Because they had taken the forecasting drug in good times, they were widely presumed by Wall Street to be giving it up because the results they would have to project from here on out would be lousy.

As Marion might have observed, it's easier to avoid a bad habit from the start than to have to break it later.

One thing people have always found intriguing about Golden West's duumvirate is how complementary they are. Marion, 72, and Herb, 71, don't complete each others' sentences so much as step on each others' lines.

It's not uncommon for Marion to start answering a question with a learned observation on macroeconomics or sound operational principles, only to be interrupted by Herb with a telling anecdote, which places the facts and figures in a historical context.

"There's a funny story about that," he'll say. "Actually, it happened to Marion."

Their relationship gives new meaning to the adage that two heads are better than one.

"It's an unusual but highly desirable situation," Marion says. "You have somebody who can be a sounding board, whose motives you can completely trust, who you can unburden yourself with, who you will always get the best advice from, who knows precisely what you're talking about, who has experienced precisely what you have experienced."

Together they have built a business model that allows Golden West to roll atop the ebbs and swells of the economy. The company's lending is centered on adjustable-rate mortgages (ARMs); even last year, when historically low interest rates lured millions of homeowners to lock in fixed-rate loans, 91% of Golden West's originations were ARMs. Although it will issue a fixed-rate mortgage in a pinch, it sells those off as fast as it can, keeping the ARMs in its portfolio.

Some analysts believe this strategy leaves Golden West so flexible that it should not suffer even if an expected rise in rates this year cuts sharply into mortgage volumes.

Observing recently that the refinancing boom is about to run out, and that higher interest rates will probably narrow net interest spreads (from which banks make their money), Salomon Smith Barney analyst Michael Diana actually raised his 2003 earnings-per-share estimate for Golden West to $6.50 from $6.28.

Part of Golden West's secret is how much of its operation it conducts autonomously.

The company, for instance, relies on its own staff of appraisers rather than accept the judgment of independent outsiders. It does not use credit scores, those mysterious numbers spit out by statistical formulas, but rather its own underwriting judgments.

It even uses its own home-grown financial index as the basis for the interest rate charged on its adjustable-rate mortgages—the Golden West cost of deposits index.

Does this old-school approach work in the modern world? All you need to know for the answer is that Golden West's net loan charge offs have been 0% for five years in a row.

Many of the principles by which the Sandlers operate were forged amid the absurdities of traditional savings and loan regulation—and the subsequent absurdities of deregulation in the early 1980s. Until deregulation, thrifts were expected to make 30-year loans to home buyers but were forbidden by law from taking certain steps, including issuing ARMs, which could help them hedge their interest-rate exposure. When Fed Chairman Paul A. Volcker raised interest rates to fight inflation in the late '70s, tough times befell the industry.

Deregulation was supposed to be the solution. Golden West took advantage of the sudden removal of restraints on S&L portfolios to balance its borrowing and lending, so it would no longer be whipsawed between the high rates it paid depositors and the low-rate mortgages still on its books.

Staying Their Course

But many of its rivals chose a different course, plunging into flashy new businesses they thought could drive growth.

The Sandlers recall learning from a friend in 1979 that the thrift industry's share of commercial real estate loans had soared from near zero to 49% in a couple of years. "The moment he said that, we knew we were in for a debacle," Herb says. "For one thing, the thrifts knew nothing about the field. Plus, their timing could not have been worse."

Around that time, the couple was traveling in Texas and "saw something very unusual," Herb recounts. "You remember see-through office buildings? These were see-through shopping centers. They'd have one tenant—the S&L that made the loan to build them."

Still, the pressure on Golden West to branch out into new lending lines was intense.

"This is the situation where 'everybody is doing it,' " Marion says. "We thought, let the others do it, and if it's successful, we could always join them."

This addresses another of their rules: There is no percentage in being first at anything.

"I have a funny story about that," Herb says. It was the time Gibraltar Savings & Loan, a competitor of World's, decided to open its branches on Saturdays. "They poured a ton of money into it. Newspaper ads, TV ads. I said, 'Marion we have to...' Marion says, 'Relax, they have to re-educate the public.' So on Saturdays we would visit Gibraltar's offices and, guess what? Nobody was there."

Marion: "I'd have people in the parking lots of various branches with clickers, counting the number of people going in. And when it got to be a critical mass, we decided we're going to be open on Saturdays."

"Gibraltar must have spent tens of millions of dollars," Herb says, "for us!"