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Companies, People, Ideas Stick to Your Knitting

Seth Lubove, 03.01.04

After 41 years and many failed competitors along the way, HERB AND MARION SANDLER still run what is not just the U.S.' best-managed thrift, but perhaps its best financial company. More surprising, they're happily married after working side by side the entire time.

Drop in on the Oakland, California headquarters of Golden West Financial and you'll get a taste of a homespun, unassuming company under family control. Shortly into an interview at the thrift holding company, Marion Sandler, co-chief executive, pulls out a knitting needle and ball of yarn and picks up where she left off on a sweater for hubby, Herbert, the other co-chief executive. Marion, 73, admits to frequently knitting during meetings--"except when I'm running it," she helpfully notes. Herb, 72, jumps up, opens his closet and proudly shows off another cable-knit sweater Marion made for him.

It's just the way it was 41 years ago, when the Sandlers, with a little financial help from Marion's brother Bernard Osher, paid \$3.8 million to acquire a two-branch savings & loan in Oakland. Except that the thrift has grown a little bigger. Now Golden West has \$80 billion in assets, making it the second-largest pure thrift after Washington Mutual. The Sandlers' stake is worth \$1.8 billion. Osher's got another \$695 million worth of the stock.

How do the Sandlers do it? It's what they don't do that makes this company a standout among financial institutions. Golden West gathers deposits and lends the money out as mortgages on modestly priced, single-family homes. No junk bonds, no loans for shopping centers, golf courses or million-dollar mansions. The Sandlers installed ATMs only in the 1990s, and they still aren't sure the expense is worth it. They give away free toasters for new accounts.

"We're boring," Herb says, proudly. But not on Wall Street, where Golden West's numbers have drawn some attention. The Sandlers have produced compound annual earnings-per-share growth of 20% over the last 35 years, a record that appears to be unmatched by any other financial firm, with the possible exception of Warren Buffett's Berkshire Hathaway. Golden West was the top performer among banks in the Forbes Best Managed Companies ranking, with a five-year annualized return of 26.6%, better than every other bank by almost half. Citigroup Smith Barney analyst Michael Diana, whose firm doesn't do any investment banking with Golden West, gushes that Golden West isn't

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just the best thrift, or even the best financial services company, but is "among the best companies of all industries."

"It's as if they came into the business and turned everything people hate about their industry on its head," says Christopher Davis, whose Davis Selected Advisers is the largest shareholder of Golden West after the Sandlers, with 14.6 million shares. "People say it's a commodity business. They deal with that by being low cost. It's rate sensitive. They deal with that by predominantly offering adjustable rate mortgages. It's just dramatic."

Yet the couple still run the place as the U.S.' largest mom- and-pop shop. In addition to keeping Herb warm with sweaters, Marion oversees much of the advertising (no TV, mainly print), handpicks the architects for the company's 475 branches and offices and authors much of each annual report. Herb or Marion personally call every employee on significant anniversaries with the company, while Herb keeps a close eye on costs and fires off frequent missives to politicians and regulators warning of one industry catastrophe or another.

"Their business is seven days, seven nights a week," says Marion's brother Osher, who also controlled auction house Butterfield & Butterfield before selling out to Ebay. "They watch the store. That's their life."

Although Herb insists they'll stick around as long as the couple is making "a useful contribution," they're not getting any younger. In anticipation of the day when they finally depart the executive suite, the Sandlers have installed behind them two executives with a combined half a century at the company. But the Sandlers are a unique tandem team who will be hard to replace.

Of more immediate concern, the company has profited like much of its competition from a low-rate, strong housing economy, especially in California, where Golden West has 62% of its loans. But if rates rise, as they surely will in a healing economy, home lenders such as Golden West will feel the pinch as home buyers take out fewer mortgages, or pull back on the maniacal refinancing that has characterized the past few years. On the deposit side of the balance sheet, Golden's chintzy but predictable savings accounts, money market funds and certificates of deposit have thrived as a safe harbor for investors scared off by the past few years of turmoil on Wall Street. But with the markets finally showing some pop, CD rates that barely match inflation are significantly less attractive.

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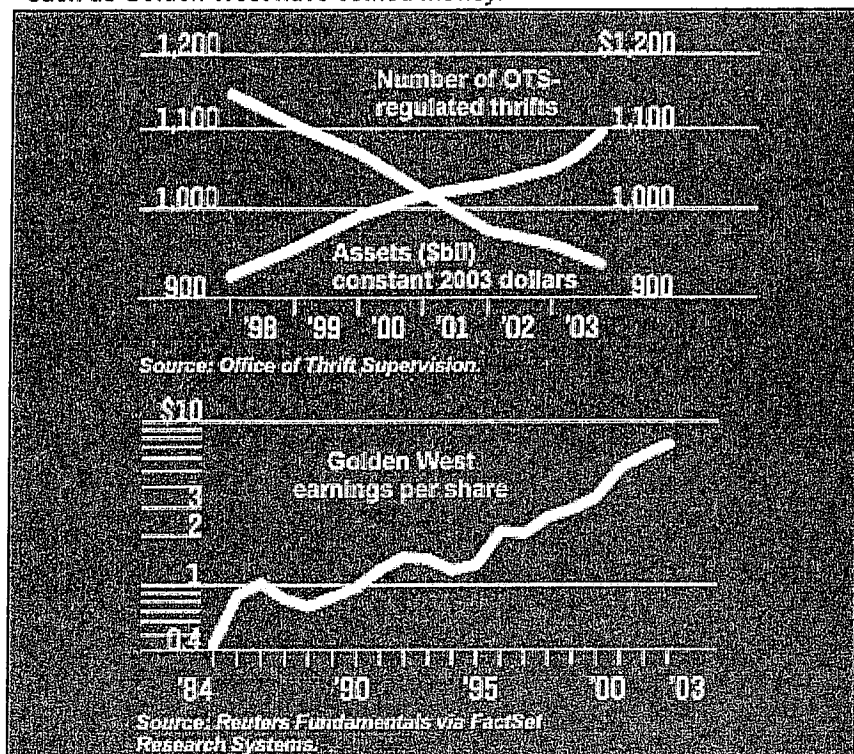
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With fewer thrifts around, but more assets in the bank, well-run outfits such as Golden West have coined money.



The Sandlers are the first to acknowledge the challenge of topping themselves. "We've got a money machine, but what are the new competitive threats?" says Herb, apologizing for a nagging cold that, not surprisingly, struck him and Marion at the same time. "We developed a business with extraordinarily high returns and virtually no risk. How do we make it better?"

As it is, the company is already among the lowest-cost operators in the business, with expenses that run at less than 1% of assets, compared with a thrift industry average 2.3 times that. The savings are both large and symbolic, such as the lack of a receptionist at the company's penthouse headquarters overlooking Oakland's scenic Lake Merritt. (Visitors announce their arrival by a phone in the lobby.)

Rather than being cheapskates, the Sandlers spend money to make money. "The issue of costs isn't counting paper clips, it's how you spend money," says Herb. "You should spend to enhance productivity and efficiency and to improve customer service."

The company's expenses of \$721 million for 2003, for instance, beat the record-high outlay of \$601 million in 2002. But the money was well spent, since it's gone toward a new loan-origination system, Web sites and an upgraded communications network for the branches. Despite Marion's indulgence of hiring name architects (including Walt Disney Concert Hall designer Frank Gehry), the branches are otherwise models of efficiency with a single-minded focus on vacuuming up deposits. Over the past decade the company has increased deposits at a 10.5% compound rate without the benefit of an acquisition, almost twice the rate of all banks and thrifts.

"My ideal customer opens a \$50,000 account, and I don't see them for six months," says Marion.

At the branch in Alhambra, for instance, a mostly Asian suburb of Los Angeles, Marion hired a feng shui consultant to ensure that the branch was in harmony with its surroundings. But aside from the New Age

fiakiness, the emphasis is on selling various savings accounts and CDs, with rates displayed prominently on a menu board in the front window. To stay competitive with the half-dozen or so competing banks, branch manager Jason Jung takes regular surveys of his competitors.

"It's like a chess game," says Jung. "We've got a lot of people who are rate-shoppers."

Meanwhile, on the other side of the balance sheet, the Sandlers have seemingly been able to defy logic with record closings of adjustable-rate mortgages at a time when consumers have been frantically locking in the low rates on 30-year fixed mortgages. For 2003 the company lent out \$36 billion in new mortgages, a 35% increase from the year before. Of that amount, 94% were ARMs. Instead of flipping the loans to Fannie Mae and Freddie Mac, the Sandlers retain all but the fixed-rate loans for their own portfolio, providing a margin of around 3% on the loans, instead of the 0.25% servicing fee left over on loans that are sold off. But despite the fact that the Sandlers don't use or trust the ubiquitous credit-scoring algorithms that have become the lingua franca among lenders, Golden West's bum loan rate is just 0.5% of assets, compared with 0.7% for the thrift industry.

"Obviously we're doing something right," says Herb of his disdain for credit scoring, which he contends is too dependent on borrowing histories accumulated during a relatively benign economy with strong housing prices.

The danger of holding so much paper in your own portfolio is that the short rates Golden West pays its depositors and on its borrowings could fall out of alignment with the long rates it charges on mortgages. This was the dilemma that forced the original deregulation of the thrift industry in the 1980s, and ultimately the S&L fiasco that ended up costing taxpayers and innocent thrifts \$160 billion. (So far, grouches Herb, the crisis caused Golden West's deposit insurance bill to balloon by \$450 million.) Golden West mitigates the risk by keeping fixed-rate loans to a minimum.

Many ARM lenders reset their rates annually, often according to indexes related to U.S. Treasury rates and the London Inter Bank Offered Rate or the 11th District Cost of Funds Index. But in their tradition of breaking ranks with the rest of the industry, the Sandlers decided to take fate into their own hands a few years ago after they saw the institutions that make up the 11th District diversifying away from deposit-gathering and changing the makeup of the index. So they invented their own Cost of Savings Index, set according to the rates Golden West pays on its deposits. Golden West resets its ARMs on a monthly, lagging basis, which allows it to expand margins when rates are falling, as they have been in the past few years.

"The point is to have loan rates match up to the costs of funds on the other side," says Russell Kettell, president and chief financial officer and one of the two executives set to succeed the Sandlers.

After talking with the Sandlers, though, you come away with the impression that, for all their financial accomplishments, they're more interested in using the business as a means to the higher end of political and philanthropic pursuits. Die-hard liberal Democrats, the Sandlers support various do-gooder causes and activist outfits, as well as medical research for the asthma that afflicts Marion. The couple provided seed money alongside hedge fund scold George Soros to start up Clinton apparatchik John Podesta's Center for American Progress, a liberal version of the Heritage Foundation, and is the primary sugar daddy behind UC, Berkeley's Human Rights Center.

"If our dreams come true, we'll give every last dollar away," smiles Herb. Everything but the sweaters.