

## CHOU ASSOCIATES FUND

April 7, 2006

Dear Unitholders of Chou Associates Fund,

In 2005, Chou Associates Fund returned 13.7% while the S&P 500 Total Return Index returned 1.5% in Canadian dollars. In \$US, Chou Associates Fund returned 17.1% while the S&P 500 Total Return Index returned 4.9%.

The table below shows our 1 year, 3 year, 5 year, 10 year and 15 year annual compound rates of return.

December 31, 2005	Past Year	Past 3 Years	Past 5 Years	Past 10 Years	Past 15 Years
Chou Associates(\$Cdn)	13.7%	8.7%	15.2%	15.5%	16.0%
S&P500 (\$Cdn)	1.5%	3.3%	-4.5%	7.3%	11.5%
Chou Associates(\$US) <sup>1</sup>	17.1%	20.1%	21.1%	17.2%	15.9%
S&P500 (\$US)	4.9%	14.2%	0.5%	9.0%	11.5%

- The indicated returns are the historical annual compounded total returns assuming reinvestment of distributions and do not take into account sales, redemption, distribution or income taxes payable by the investor. Mutual funds are not guaranteed. Their values fluctuate and past performance may not be repeated.

### Factors influencing the 2005 results

Major positive contributors to the Fund's performance were Boskalis Westminster, King Pharmaceuticals, Criimi Mae, Cardinal Health and Utah Medical. Conversely, we suffered declines in OCA Inc., XO Communications, GB Holdings and Allegiance Telecom debt.

Our average month-end cash balance of 32% of net assets has had a restraining effect on returns. We chose to maintain cash because we were not able to find investments meeting our Margin of Safety criteria.

### General comments on the market

We continue to have problems finding compelling bargains in the market. Although in the past we voiced deep reservations about the overvaluations in the market, the Fund has done reasonably well over the past 5, 10 and 15 years as we were able to find a few bargains each year. Nonetheless, we remain quite concerned about the overvaluations and the potential negative impact on the Fund.

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<sup>1</sup>The alternative method of purchasing Chou Associates Fund in \$US has been offered since September 2005. Performance for years prior to September 2005 are based on the \$US equivalent conversion of the results of the Chou Associates Fund(\$Cdn). The investments in the Chou Associates Fund (\$Cdn) is the same as the investments in Chou Associates Fund(\$US) except for the currency applied.

Lately, we have been looking at stocks in the Pulp & Paper Industry. It is a highly cyclical industry and its operations have been negatively impacted by the strong Canadian dollar. Our experience has shown that unless stocks like these are bought dirt cheap, you risk being beaten to a pulp and the stocks will not be worth the paper they are written on.

### **No single factor is paramount when assessing a company**

When hunting for a bargain, there are many factors that merit consideration. Some are macroeconomic, such as the magnitude and trend of trade deficits, interest rates and currencies. Some are company specific, such as fundamental valuations and significant insiders' ownership, to name a few. While each factor is important, placing undue emphasis on any single one can skew one's judgment and lead to significant errors in decision making.

By being aware of our individual biases and how we give different weights to various factors, we can significantly reduce, though not eliminate, the misjudgment that can occur when evaluating a stock.

A case in point pertains to a stock we held in 2005. The company had high cash holdings and its management had significant stock ownership. Accordingly, we felt that management would act rationally and strive to maximize shareholder value. We gave undue weight to this factor and not enough to compelling evidence suggesting that, historically, management had not managed the business for the benefit of shareholders. In fact, they suffered from a syndrome that is popularly known as the bladder problem, 'The more cash one holds, the greater the pressure to piss it away.'

### **Admit mistakes early, make corrections, then move on**

We are fortunate that the Fund has had a satisfactory long-term track record despite some hiccups over the years. In instances, such as the one just mentioned, we are getting better, and faster, at realizing that an error has been made, especially considering that once a decision is made to purchase a stock it can take 3-5 times more evidence to admit that one has not made the best decision. The proper thing to do is to admit the mistake early on and avoid any temptation to justify or rationalize the decision along the way. After that, make the necessary correction and move on. When faced with overwhelming evidence, ignore the tempting retort, "Please, don't confuse me with the facts!"

Over the years I have learned to hold off purchasing a stock until I have assessed the company thoroughly. Only then is it wise to go to the decision making stage. My advice is to stay in the assessment stage as long as possible.

Lastly, it is ironic that decision making pitfalls in the stock market often involve stocks that appear to have the best long term prospects and which give you the feeling that you should buy them for your old age. As it turns out, those feelings can get confirmed fairly quickly. A year later I would feel very, very old.

**Small capitalization (“cap”) stocks are too small to make an impact on the Fund**

The assets in the Fund have now increased to over \$400 million. As such, it does not make sense to hold small cap stocks as they, because of their small weighting, do not affect the portfolio materially even if one of them doubles. Therefore, we have started the process of disposing of them although they may be somewhat undervalued. We have found that selling them into the market is not as easy as it sounds. One needs to wait patiently for a buyer and often times the price needs to be discounted by 15%-20% before a buyer will even bite. And this is in a benign environment!

Generally, we do not sell securities between the Chou Funds. But occasionally we sell a small cap stock to either Chou Asia Fund, Chou Europe Fund or Chou Bond Fund if it makes sense to do so for both parties at the prevailing market price.

**Management Expense Ratio (MER) is as low as it is going to be**

The Chou Associates Fund pays a 1.5% management fee plus other expenses such as custodial, recordkeeping, legal, audit, regulatory fees and filing fees, to name a few. As the assets of the Fund have grown, the MER has trended down from 2.11% in 1998 to 1.75% in 2005.

The average MER for a fund in the U.S. equity category is approximately 2.73%.

We believe the MER for the Fund is as low as it can be. As all funds face greater regulatory scrutiny and increased requirements found in National Instrument (“NI”) 81-106 and possibly NI 81-107 in the future, the cost of running the Fund will increase and result in a higher MER. We hope to keep it below 2% which is still well below the industry average of approximately 2.73%, but if the Sarbanes-Oxley Act in the U.S. is any indication (complying with the Act will cost businesses listed on U.S. stock exchanges an estimated \$28 billion in 2007), the costs will escalate as we move forward. At some point, the regulators will have to assess whether the costs borne by the unitholders, as well as the management time and human resources required by fund companies to meet the compliance requirements, are worth the debatable intended benefits.

What may also be affected are the style and manner in which letters to the unitholders are written. We believe that our investors would like to hear from their portfolio manager in a straightforward and forthright manner on how he or she is looking at the investment landscape rather than have the letter drastically rewritten by public relations or legal counsel.

**Chou Bond Fund**

Chou Bond Fund was opened to investors on September 16, 2005. The minimum initial investment is \$10,000, as with the other Chou Funds. The Fund has done quite well from inception to date (2006 year-to-date return of 11.9%) but investors should keep that performance in perspective. Be aware of the risks involved including that of the Manager who does not have a long history of investing heavily in that area. Caveat emptor!! Having said that, we feel optimistic that if we apply the same value principles we have

used in the past in investing in equities, we have the potential to do reasonably well in the future.

As with the launch of the Chou Asia Fund and Chou Europe Fund, we will not charge the full management fee of 1.15% to the end of 2006. We will charge a fee only to cover the trailer fees paid to dealers and financial planners (0.15%).

**Other matters**

Quebec: The Chou Funds are now open to Quebec residents.

Fee Based (“F”) Class shares: Due to consistent requests from financial planners and dealers, we have introduced a new class of shares called F class shares. In this class the dealers will not receive any trailer fees but they can charge any fee with the consent of their client.

Foreign Currency Hedging: Chou Associates Fund has hedged \$US 60 million of its U.S. assets.

\$US Dollar Valuation: Any investor who requests to purchase the Chou Funds in \$US will now be able to do so.

Redemption fee: We have a redemption fee of 2% if unitholders redeem their units in less than 2 years. None of this fee goes to the Fund Manager. It is put back into the Fund for the benefit of the remaining unitholders. We hope this fee is enough to dissuade short-term investors from jumping in and out of the Fund to chase possible short-term performance.

As of April 7, 2006, the NAV of the Fund was \$84.89 and the cash position was 33.4% of assets. The Fund is up 8.5% from the beginning of the year.

Except for the performance numbers of the Chou Associates Fund the remainder of the above letter contains estimates and opinions of the Fund Manager and is not intended to be a forecast of future events, a guarantee of future returns or investment advice. Any recommendations contained or implied herein may not be suitable for all investors.

Yours truly,



Francis Chou

Fund Manager

Dear Unitholders of the Chou Funds:

The results of the Chou Funds are as follows:

As of June 30, 2005	NAV	% Cash Holding	6Month	1 YR	3YRS	5YRS	10YRS
Chou Associates Fund	\$75.37	34%	7.6%	12.4%	11.1%	15.2%	16.4%
S&P 500 Total Return	-	-	-0.8%	6.3%	8.1%	-2.4%	9.9%
S&P 500 Total Return (\$Cdn)	-	-	1.3%	-2.4%	0.8%	-6.0%	8.7%
Chou RRSP Fund	\$30.22	28%	6.7%	13.8%	12.7%	18.5%	18.7%
S&P/TSX Total Return	-	-	8.1%	18.0%	13.6%	1.1%	10.0%
Chou Asia Fund	\$12.32	54%	1.8%	5.8%	-	-	-
MSCI AC Asia Pacific	-	-	0.9%	1.3%	-	-	-
Chou Europe Fund	\$12.94	55%	9.3%	16.4%	-	-	-
MSCI AC Europe	-	-	2.4%	8.1%	-	-	-

- The indicated returns are the historical annual compounded total returns assuming reinvestment of distributions and do not take into account sales, redemption, distribution or income taxes payable by the investor. Mutual funds are not guaranteed. Their values fluctuate and past performance may not be repeated.

### **National Instrument 81-106 and proposed National Instrument 81-107**

National Instrument 81-106 is a new regulation that will impose important new continuous disclosure requirements for mutual funds. The new rule will impose specific requirements on the form and content of financial statements. In addition, it requires the fund manager to write a management report on the performance of the fund (somewhat similar to Management's Discussion and Analysis ("MD&A") for public companies) and the fund must disclose how it voted its proxy on each of its portfolio holdings.

Although some of the reporting requirements may appear onerous and unnecessary, it is important that financial statements be as transparent as possible. If we are going to err, it is preferable to err on the side of providing a greater amount of information that is accurate and useful.

We know from experience that management of public companies understand that investors use different metrics for different industries to measure a company's net worth. These metrics are a standard of measurement specific to the industry being measured. Problems occur in that management, aware of the metric being used to measure their own company, may be tempted to use this knowledge to stretch the GAAP rules in order to make their financials look better. Many investors have learned, much to their chagrin, that it is important to examine closely the metric being used to measure the company's net worth and then check every item that goes into that calculation.

When management adopts soft accounting to downplay the impact of poor financials, they are ignoring reality, are in denial, and are doing a great disservice to themselves, employees and shareholders. In the end, what management may fail to realize is that any illusory gains achieved by playing with numbers to make financials look good may lead to a much greater loss - their

credibility and reputation. Instead, management should adopt the most conservative accounting treatment and tackle their problems head on. As the saying goes, the moment you face up to the problem, you are well on the way to resolving 90% of it.

In essence, if a gun were to be pointed at our heads and we have to accept disclosure requirements that make the financials more transparent, we would quote Clint Eastwood and say, "Make my day."

### **Proposed National Instrument 81-107**

NI 81-107 has been renamed "Independent Review Committee for Investment Funds" (the "Instrument"). Under the Instrument, every investment fund that is a reporting issuer must establish an independent review committee (the "IRC") comprised of at least 3 individuals to oversee all conflict of interest matters faced by the fund manager in the operation of the fund. The IRC would be required to have a chair who is responsible for managing the committee, and who acts as a liaison between the manager and the fund.

There are aspects of the Instrument that we agree and disagree with:

The parts we agree with include:

- 1) Those dealing with conflict of interest that may arise between a manager's own interest and that of his or her duty to manage the fund in the best interest of the fund. These are conflicts relating to the operation of the fund by the manager, and are not specifically regulated under the securities legislation - such as the fund's decision to charge operational or incentive fees to the fund; or to allocate securities among funds in a fund group; or to use affiliates in fund operations including as service providers or in securities lending.
- 2) Other conflicts include those that result from proposed transactions by the manager with related entities of the manager, fund or portfolio manager and which are currently prohibited or restricted by the conflict of interest and self-dealing provisions - for example, transactions of securities of related parties.

The parts we disagree with include:

- 1) Orientation and continuing education: The manager must provide each IRC member with an orientation program and support any continuing education (**at the expense of the fund**). In addition, the members of the IRC can reasonably supplement any such training **at the expense of the fund**.
- 2) Self-assessment: The IRC must conduct a full review of its effectiveness as a committee and the contribution of individual members, at least annually, again **at the expense of the fund**.
- 3) IRC masquerading as a whistleblower: The IRC would be given explicit authority to report certain conflict of interest matters or securities law breaches directly to the securities regulators. This may lead to a highly adversarial relationship with the manager.
- 4) Some mandatory reporting to unitholders and the manager. **Again at the expense of the fund**.

- 5) The Office of the Chief Economist at the Ontario Securities Commission speculates that smaller funds may have to pay as much as **\$250,000 per annum** to run an IRC. We believe that this number is a conservative estimate and that it will escalate in the future.

If this Instrument is passed as it is proposed, it will impose higher costs and an enormous burden on all mutual funds, including Chou Funds. It will raise the MER substantially, with debatable benefit, to the unitholders. It is unfortunate and unfair that this broad sweeping net will take with it funds that are being run honestly and ethically. In life, we see it happen repeatedly where a small minority of wrongdoers are responsible for a string of scandals - understandably raising a huge public uproar - and Regulators react by imposing an onerous burden on any and all fund managers without regard to cost (in many cases, unnecessary), the people required to make it happen, and the management time needed to meet the new requirements.

We hope that the trend does not progress to the point whereby the portfolio manager cannot express his or her views in a forthright manner. Already there are reports that if one admits to making a mistake one can be sued under the Instrument for not exercising the degree of care, diligence and skill that a reasonable person would exercise in similar circumstances. In the 2004 Annual Report, for example, on the advice of counsel, it was necessary to add a small disclaimer, ‘...the letter contains estimates and opinions of the Fund Manager and is not intended to be a forecast of future events, a guarantee of future returns or investment advice. Any recommendations contained herein may not be suitable for all investors.’

We believe that our investors would like to hear from their portfolio manager in a straightforward and forthright manner on how he or she is looking at the investment landscape rather than have the letter drastically rewritten by public relations or legal counsel.

### **Derivatives**

We need to give unitholders 60 days prior written notice before engaging in derivative transactions. At this time, the Chou Funds are not allowed to enter into derivative transactions other than currency hedging and writing covered calls.

Derivative instruments are financial instruments created by market participants so that they can trade and/or manage more easily the asset upon which these instruments are based. Derivatives are not asset classes unto themselves. Their values are derived solely from an underlying interest, which may be a commodity such as wheat or a financial product such as a bond or stock, a foreign currency, or an economic/stock index.

Derivative instruments are most useful in hedging against market declines and in many ways are similar to currency hedging. Hedging is the attempt to eliminate or reduce the risk of holding the stock portfolio. We have expressed concern over the years with the high market levels and the paucity of bargains in the marketplace. As a result, we have maintained a high cash balance. By hedging the portfolio, wholly or partially against market declines, the Chou Funds could be more fully invested than before. This is one of the attractions of using derivatives.

The Chou Funds are also interested in Credit Default Swap (“CDS”). We may be interested in other derivative products as time goes by. Within the Credit Derivative category, CDS is the most straightforward form of derivative. One party sells credit protection and the other party buys credit protection. Put another way, one party is selling insurance and the counterparty is buying insurance against the default of the third party’s debt. The Chou Funds would be interested in ‘buying’ insurance.

Potential Maximum Loss: The most we would stand to lose is the premium that we have to pay for getting the insurance against the default of the third party's debt. For example, let's assume we enter into a credit default swap for two years with a counterparty against the default of the debt of the company called 'ABC'. The notional amount is \$100 million and we agree to pay them 50 basis points (half of one percent) or \$500,000 per year for two years. At most, what we could lose is the premium i.e., \$500,000 per year or \$1 million in total for 2 years.

Potential Gains:

- 1) If ABC defaults and its debt is now trading at 40 cents on the dollar, the cash payoff would be \$60 million. This is the windfall gain that one can occasionally expect, however it is a 'best case' scenario and not a given.
- 2) ABC does not need to default on the debt. If the market senses that the economy and/or the ABC company is about to face some economic headwind, it may reprice the premium from 50 basis points to 300 basis points or more. We can then unwind/offset the contract at any time for a price greater than 50 basis points. If we unwind the contract at 300 basis points, we would receive \$3 million. In essence, this is what CDS is about.

We would not engage in any derivative transaction whereby the losses could be multiples of the funds we have committed to the transaction. For instance, the counterparty, in the example given above, can lose multiples of the 50 basis points premium that they are receiving. They are obviously confident of the economic prospects of ABC for the next two years and the premium they receive will be enhancing their return. We, obviously, think that the premium is too low and is priced for a Goldilock's type economy and does not justify the risk the counterparty is taking.

Some 3 to 4 years ago, the premiums were priced closer to 300 basis points versus the 20 to 50 basis points currently for companies with similar financial characteristics. We think CDS are among the better buys today.

### **Chou Bond Fund**

We are planning to open Chou Bond Fund on September 16, 2005, subject to the approval of the various securities commissions in Canada. It will be under the category of 'Foreign Bond Fund'. We expect the Prospectus to be ready by that time. The minimum initial investment is \$10,000, as with the other Chou Funds. Please be aware of the risks involved including that of the Manager who has not invested heavily in that area. However, we feel confident that if we apply the same value principles we used in the past in investing in equities, we will do reasonably well in the future. Caveat emptor!!

As we have done when we launched the Chou Asia Fund and Chou Europe Fund, we will not charge the full management fee of 1.15% from now to the end of 2006. We will charge a fee only to cover the trailer fees paid to dealers and financial planners (0.15%).

### **Market Outlook**

We continue to have problems finding genuine bargains in the market. We are diligently hunting for them and most times we are finding 'value trap' stocks that we would not touch with a barge pole. Most of these stocks can be grouped under the "If it looks like garbage, smells like garbage, don't eat it" category. We continue to voice our deep reservations about the overvaluations of the market and the potential negative impact on the Chou Funds.



**Other Matters**

Quebec: We are opening the Chou Funds to Quebec residents. We hope to receive approval some time in September 2005, around the time we expect the Prospectus to get renewed.

Fee Based (“F”) Class shares: Due to consistent requests from financial planners and dealers, the Chou Funds will have a new class of shares called F class shares. In this class the dealers will not receive any trailer fees but they can charge any fee with the consent of their client.

Foreign Currency Hedging: Chou Associates Fund and Chou RRSP Fund have hedged \$US 60 million and \$US 20 million respectively.

Chou RRSP Fund: We previously indicated that the Chou RRSP Fund was closing to new investors as at March 21, 2005. The decision to close was based on the 30% foreign content restriction and the limited value investments available in Canada. Since the federal government eliminated the RRSP foreign content restrictions, the Chou RRSP Fund will continue to accept new unitholders for the foreseeable future. Chou RRSP Fund will look for bargains in Canada first before looking in other countries.

\$US Dollar Valuation: We intend to also have the Chou Funds valued in \$US. We hope to receive approval some time in September 2005. Any unitholder who requests to purchase the Chou Funds in \$US will then be able to do so.

Redemption fee: We have a redemption fee of 2% if unitholders redeem their units in less than 2 years. None of this fee goes to the Fund Manager. It is put back into the Fund for the benefit of the remaining unitholders. We hope this fee is enough to dissuade short-term investors from jumping in and out of the Fund to chase short-term performance.

Except for the performance numbers of the Chou Funds, the remainder of the above letter contains estimates and opinions of the Fund Manager and is not intended to be a forecast of future events, a guarantee of future returns or investment advice. Any recommendations contained herein may not be suitable for all investors.

Yours truly,



Francis Chou  
Fund Manager

# CHOU ASSOCIATES FUND

April 14, 2005

Dear Unitholders of Chou Associates Fund,

After the distribution of \$1.47, the net asset value (“NAVPU” or “NAV”) of Chou Associates Fund at December 31, 2004 was \$70.03 compared to \$65.58 at December 31, 2003, an increase of 9.0%. The table below shows our 1 year, 3 year, 5 year, 10 year and 15 year annual compound rates of return:

<b>December 31, 2004</b>	<b>1 year</b>	<b>3 year</b>	<b>5 year</b>	<b>10 year</b>	<b>15 year</b>
Chou Associates Fund	9.0%	13.6%	14.1%	17.1%	14.1%
S&P/TSX Total Return	14.5%	8.3%	3.6%	10.1%	7.6%
S&P 500 Total Return (\$U.S.)	10.8%	3.5%	-2.4%	12.0%	10.9%
S&P 500 Total Return (\$Cdn)	2.7%	-5.7%	-5.9%	10.3%	11.2%

- The indicated returns are the historical annual compounded total returns assuming reinvestment of distributions and do not take into account sales, redemption, distribution fees or income taxes payable by the investor. Those returns are not guaranteed. Mutual fund net asset values fluctuate and past performance may not be repeated.

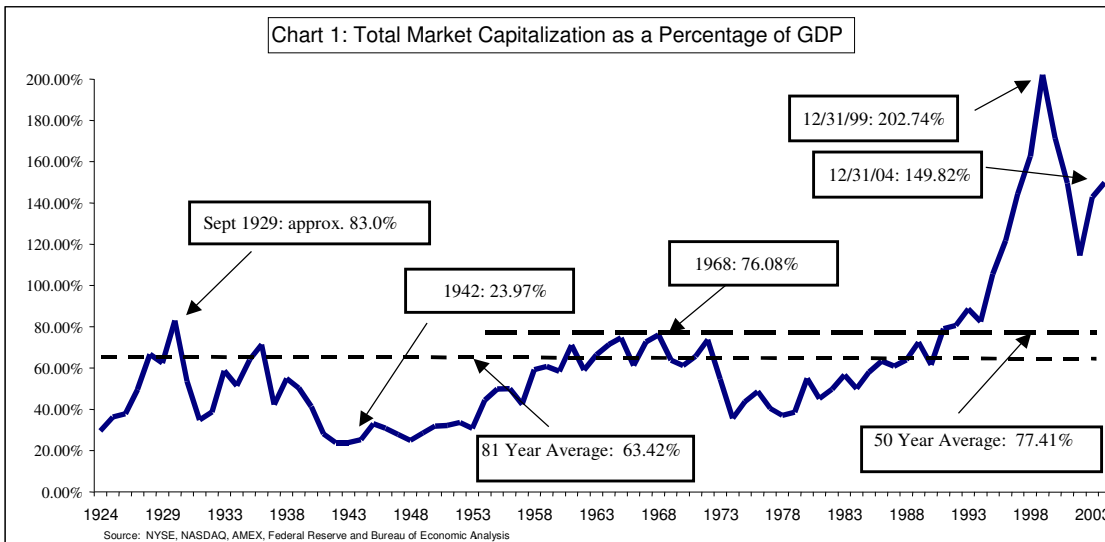
## **Factors influencing the 2004 results**

Cash Position: Our average month-end cash position of 24.8% of net assets has had a restraining effect on returns. We chose to maintain cash because we were not able to find investments meeting our Margin of Safety criteria.

Foreign Exchange: The strength of the Canadian dollar had a negative impact on the 2004 results. If we had calculated the NAVPU in U.S. dollars, the Fund would have been up 17.7%; this valuation method highlights the return for 2004 in the most favourable manner and should, therefore, be taken with a grain of salt. The fairest method of valuation is to calculate all valuations in the same currency. We believe that fluctuation in foreign exchange rates should not have a material impact on long-term results.

## **General comments on the market**

For years we have been saying that the market is overvalued based on P/E ratio, dividend yield and premium to book value. Another important yardstick for determining overvaluation of the market is the ratio of total market capitalization to Gross Domestic Product (GDP). Total market capitalization is determined by adding the market value of each company that trades on the NYSE, AMEX and NASDAQ stock exchanges. GDP is the total value of all goods and services produced in the United States for a specified period. The following chart shows the history of the total market capitalization to GDP ratio for the period from March 1925 to December 2004. Note how the current ratio compares with those of previous years.

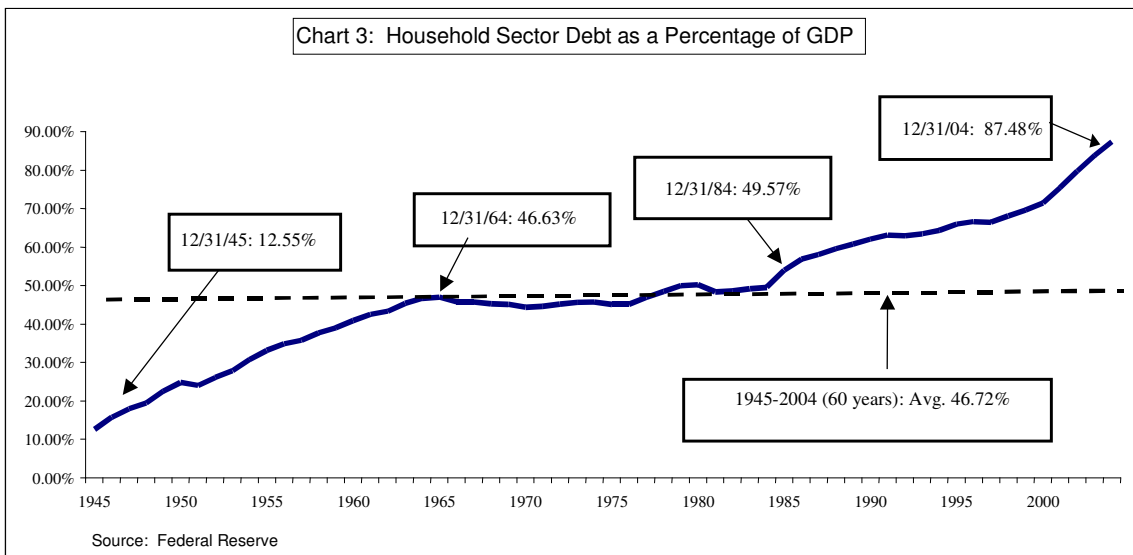
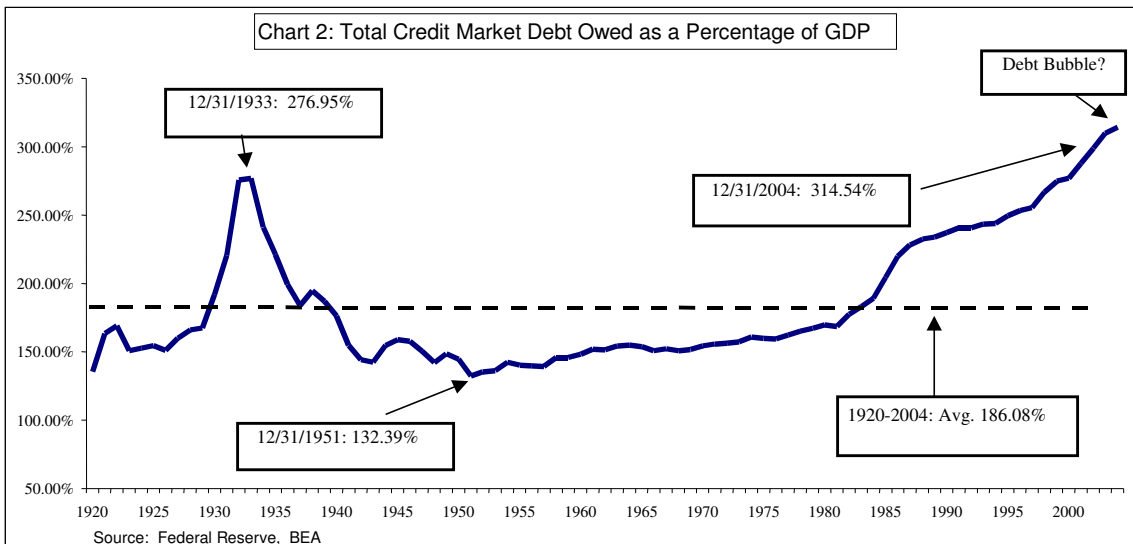


The chart shows that:

- 1) The last 81 year average is 63.4%.
- 2) The last 50 year average is 77.4%.
- 3) During the height of the bull market in 1929 before the great crash, the ratio was approximately 83%.
- 4) In 1968, another bull market, the ratio was 76.1%.
- 5) The highest ratio was in March 2000 at 202.7%.
- 6) The lowest ratio occurred in March 1942 at 24%.
- 7) At present the ratio is over 149.8%, a dangerous level to say the least, when compared to the historical average.

The two charts on the following page, Total Credit Market Debt as a percentage of GDP (“Total Debt”), and Household Sector Debt as a percentage of GDP (“Consumer Debt”), plainly show that Total Debt and Consumer Debt have increased significantly in recent years and that U.S. consumers are highly leveraged. As the charts indicate, the average Consumer Debt for the last 60 years was 46.7%; it is now 87.5% and rising. Consumer spending accounts for more than 70% of economic activity (the 60 year average is 60%) and this indicates that the current economic expansion has been fuelled significantly by debt. Also take into account that consumer spending has been financed by the enormous trade deficit with other nations, and that consumer debt has fuelled the housing boom as well as other financial assets, and we are left to speculate on a number of questions and potential repercussions:

- 1) How much more debt can the economy accommodate? At 314.5%, it is already much higher than the historical average (186%). See Chart 2.
- 2) What happens if and when interest rates go up, making consumers vulnerable?
- 3) Are we in a debt bubble?
- 4) If consumers stop borrowing and the ratios go back to the mean, how severely would the economy suffer?
- 5) Would the Federal Reserve Board use inflationary policies (historically, an easy way out for indebted countries) to get out of trouble?



We look at these issues in conjunction with other factors such as corporate and federal debts, fiscal and monetary policies, trade deficits and so on. While the issues are important, we do not put much emphasis on them unless they are outliers – that is, they have reached a threshold limit whereby the ratios, if not corrected or contained, should start to have an adverse effect on the economy. And while we can always exercise caution in these instances, we can never assume full control. As one government official<sup>1</sup> aptly stated when reflecting on handling the unexpected – “Condoms are not totally safe. My friend was wearing one and he got hit by a bus.”

When investing, the issues mentioned do not mean much if plenty of bargains can be found. What makes us wary about the stock market is that we are not able to find investments meeting our Margin of Safety criteria. I cannot remember a time when bargains in general were so scarce.

<sup>1</sup> Robert Rubin, former Secretary of the Treasury

As usual we believe that it is **not** a good policy to borrow money to invest in stocks or mutual funds. When there are imbalances in the economy and several key ratios show them to be outliers, I strongly urge our unitholders to be debt free. Whether you are short and the market continues to rise or you are long and the market continues to fall, it is important to remember that the market may well stay irrational longer than a debtor can stay solvent<sup>2</sup>.

#### Concept of batting average in investment

In investing there are two kinds of mistakes: Omissions and Commissions. Omissions occur when the stocks you know and understand come down to your bargain price range and yet, for some reason, you defer purchasing them. Commissions are the more common type of mistakes whereby the stocks go down after you purchase them, entailing a permanent loss of capital.

Looking back on our 20 years plus of investing, we feel that our omissions have been far more painful than our commissions. Experience has shown us that it is better to purchase certain stocks that meet our Margin of Safety criteria, and risk making a mistake rather than not buy them. There is an opportunity cost involved when you miss buying a bargain that was in your circle of competence. Similar to baseball, if a batter gets a fat pitch right down the middle of the strike zone, he should take a swing. If he strikes out, so be it. He should not be flailing away, chasing balls out of the strike zone. However, if he strikes out, it should be in spite of his good hitting technique.

In investing there is an opportunity cost involved when you don't swing at a fat pitch. So when opportunity knocks, you should take advantage. From the 1980s to the mid 1990s, if an investor were to pass on a good deal, there were usually another five waiting in the wings. We were really spoiled. Over the last 8 years or so, if you missed out on a good deal, you had to wait for a while before finding the next one.

John Templeton's investment batting average was about .600, that is, 6 out of 10 stock selections did well. When he retired in 1992, he had one of the best mutual fund records spanning over 40 years. In baseball, a batting average of .300 is considered excellent. You don't need to be perfect to be considered a great hitter.

#### Expectations of future returns

In today's climate, almost all sectors are overvalued. As mentioned earlier, I cannot remember a time when bargains in general were so scarce. You can still make money in the market but you are doing so without having a large margin of safety. We would caution all investors that from these overvalued levels the chances of a large permanent loss of capital are extremely high. We feel that it would also be irresponsible to extrapolate the Fund's 3, 5, 10 or 15 year returns into the future. Those returns will be virtually impossible to duplicate.

In baseball, a high batting average depends crucially on waiting for the right pitches. Similarly, in investing, for us to do well, we have to wait for stocks that meet our Margin of Safety criteria. We said it before, we will not chase stocks to keep up with the market averages. If given a choice, we would prefer to lose half of our unitholders rather than half of our unitholders' money.

#### Companies subject to the whims of buyers including retail, restaurants etc

In general, we have done well with retail companies such as BMTC Group. But with retailing and restaurant companies it is difficult to get a handle on how the future will pan out, regardless of how

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<sup>2</sup> John Maynard Keynes

well they may have done in the past. Retailing concepts that work well can be easily duplicated by competitors. Also, if consumer tastes change, the retailing companies are faced with serious financial and operational issues. Liabilities such as operating and capitalized leases suddenly become real short-term debt, much needed cash is used up in severance and closure costs, and a host of other problems crop up. In short, these consequences can quickly put a financially sound retailer into a serious short-term liquidity crisis.

This reminds us of a story of two young business women, named Gloria and Gisella who are owners of their own retailing companies. Gloria was asked what she would do if she were to win a million dollar lottery. Gloria said, "Well, I will pay down the mortgage on my house, take a tour of the world with my sweetheart, buy a villa in the Swiss Alps and live happily ever after." When Gisella was asked the same question, she replied: "Well, (scratching her head), I will keep on retailing until my million dollars are all gone."

In Chou RRSP Fund we took a loss in a retailing company called Denninghouse Inc. When its "A Buck or Two" store concept did not work, we were left with goods worth pennies. Fortunately, for Chou RRSP Fund, it was a small holding.

Our portfolio will have more international (Asia) content in the future

The world is opening up. Over the years we have looked at many companies outside of North America and can say that the best companies in Asia can easily compete with the best in North America. However, last year we warned of some of the problems inherent in China, and we believe that those problems are also applicable to other Asian and less developed countries. The warning is worth repeating:

- 1) Many of the laws in Asia and less developed countries, including investor protection laws that we are accustomed to, are non-existent or not enforced. Consider what happened to Yukos, a Russian oil and gas company in which Chou Europe Fund has a small holding. The criminal charges laid, and the taxes alleged to be owing (more than the revenues generated), raise serious questions about the motives of the government. Truth can be stranger than fiction.
- 2) There are no concrete rules established under Chinese GAAP or under other Asian GAAP; much is subject to interpretation and therefore open to extensive abuse. We know of two accounting firms (both belong to the Big Four) that were looking at the same company in China, yet each came up with substantially different numbers. There are enough examples of subterfuge in the books that makes you feel uncomfortable. When you examine the numbers, you are left wondering whether you are looking at the books prepared for a) tax authorities, b) management, or c) shareholders (patsies?). For example, the profit margins often seem too good to be true. Some Chinese companies net an obscene 40% plus, versus just 5% in North America for a similar type of business. This is also true in other Asian countries. Their selling, general and administrative costs (SG&A) are sometimes unbelievably low.
- 3) Although we might have worried more earlier, we now feel cautiously comfortable that there is no turning back to Communism in spite of the rhetoric we still hear from the Politburo. When we asked one government official about the chances of China reverting back to the old ways, he intoned, "When we talk, we talk left, left, left but we are going right, right, right."

The upside is that these countries have huge labor cost advantages and most of the executives are educated in Western countries. These young executives have gone back to their native countries and have been responsible for changing the political climate for people in business. The changes, if

maintained for a few decades, have the potential to make these nations economic powerhouses in the future. Recent changes of one Asian country include the following:

- 1) Corporate taxes have been reduced to 35%.
- 2) There is no capital gains tax.
- 3) There is no tax on dividends.
- 4) Free enterprise zones are being established where businesses will not be subjected to the huge number of approvals otherwise required and the ruinous delays involved in getting them. At one time it took 32 agencies to get an approval.
- 5) Other tariffs and roadblocks are being dismantled.

A number of companies in Asia produce free cash flow and some managements are well attuned to the concept of generating cash and deploying it wisely. As one manager<sup>3</sup> said: “Sales are vanity, Earnings are sanity, but Cash is reality.”

The key is to buy companies that are soundly financed and well managed. Companies that are mediocre or not soundly financed would be more inclined to hide problems knowing that the investor protection laws we take for granted in North America are virtually non-existent in their own country. We are looking seriously in Asia and less developed countries and hope to buy some companies with honest management and honest numbers, at a cheap price.

#### Investment awards

Please forgive me for this shameful display of self-promotion but I was honoured to receive the ‘The Fund Manager of the Decade’ award at the Investment Awards ceremony held December 3, 2004 in Toronto. Morningstar Canada, which hosted the event, introduced this award in 2004 to honour the Canadian mutual fund manager who had produced the best performance over the past 10 years. Essentially, Morningstar sought to answer the question, “If we had to choose only one manager with whom to invest our money - who would it be?” Only a manager with a 10 year record managing a Canadian mutual fund or segregated fund recognized by the Canadian Investment Funds Standards Committee was considered. Based on those criteria, Chou RRSP Fund was ranked first and Chou Associates Fund was ranked third.

#### **Other matters**

We launched both the Chou Asia Fund and Chou Europe Fund on August 26, 2003. In 2004, we have not charged the full management fee of 1.5%. We have charged a fee only to cover the trailer fees paid to dealers and financial planners (0.5%).

The Chou Associates Fund pays a 1.5% management fee plus other expenses such as custodial, recordkeeping, legal, audit and filing fees. As the assets of the Fund have grown, the management expense ratio (MER) has trended down from 2.11% in 1998 to 1.77% in 2004.

We have a redemption fee of 2% if unitholders redeem their units in less than 2 years. None of this fee goes to the Fund Manager. It is put back into the Fund for the benefit of the remaining unitholders. We hope this fee is enough to dissuade short-term investors from jumping in and out of the Fund to chase short-term performance.

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<sup>3</sup> A Godrej from Godrej Group

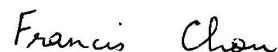
The minimum initial amount to invest in the Fund is \$10,000 and the minimum subsequent investment is \$1,000.

We previously indicated that the Chou RRSP Fund was closing to new investors after March 18, 2005. The decision to close was based on the 30% foreign content restriction and the limited value investments available in Canada. Since it is now expected that the federal government will eliminate the RRSP foreign content restrictions, the Chou RRSP Fund will continue to accept new unitholders for the foreseeable future.

As of April 8, 2005, the NAV of the Fund was \$72.19 and the cash position was 37% of assets. The Fund is up 3.1% from the beginning of the year.

Except for the audited NAVs and performance numbers of the Fund, the remainder of the above letter contains estimates and opinions of the Fund Manager and is not intended to be a forecast of future events, a guarantee of future returns or investment advice. Any recommendations contained herein may not be suitable for all investors.

Yours truly,

A handwritten signature in cursive script that reads "Francis Chou".

Francis Chou

Fund Manager



## CHOU ASSOCIATES FUND

April 22, 2004

Dear Unitholders of Chou Associates Fund,

After the distribution of \$1.40, the net asset value (“NAVPU” or “NAV”) of Chou Associates Fund at December 31, 2003 was \$65.58 compared to \$64.67 at December 31, 2002, an increase of 3.6%. The table below shows our 1 year, 3 year, 5 year, 10 year and 15 year annual compound rates of return.

December 31, 2003	1 year	3 year	5 year	10 year	15 year
Chou Associates Fund	3.6%	17.8%	9.9%	15.8%	14.8%
S&P/TSX Total Return	26.0%	-1.0%	6.5%	8.5%	8.4%
S&P 500 Total Return	28.2%	-4.1%	-0.6%	11.0%	12.2%
S&P 500 Total Return(\$Cdn)	5.6%	-8.7%	-3.9%	10.7%	12.7%

- The indicated returns are the historical annual compounded total returns assuming reinvestment of distributions and do not take into account sales, redemption, distribution or income taxes payable by the investor. Mutual funds are not guaranteed. Their values fluctuate and past performance may not be repeated.

### **Factors influencing the 2003 results**

Cash Position: Our average month end cash position of 52% has had a restraining effect on returns. We chose to maintain cash because, as is explained later, we were not able to find investments meeting our Margin of Safety criteria and we were not as flexible as we might have been on the prices we were willing to pay on some bargains.

Foreign exchange: The strength of the Canadian dollar had a negative impact on the 2003 results. If we had calculated the NAVPU in \$US, the Fund would be up 25.7%; this valuation method highlights the return for 2003 in the most favourable manner and therefore one should take it with a grain of salt. The fairest method is to use one currency in a consistent manner and live with the consequences of not hedging the currency for that given year. We believe that the fluctuation in foreign exchange rates should not have a material impact on long-term results.

Concentration: We normally like to concentrate our holdings. When we first buy, we tend to put as much as 3%-5% of the Fund’s assets into a stock but in 2003 we failed to do that as we were not as flexible as we might have been on the prices we were willing to pay. When we examine our past mistakes, we find that we have lost a lot more by missing or buying an insignificant amount of a stock, because we would not pay a dime more for an obvious bargain, than by buying a stock that has gone down substantially from our purchase price.

Distressed Securities: One distressed security that did not work out was the subordinate debt of Fleming. In retrospect, we clearly overestimated management’s ability to restructure its debt obligations. That move cost the Fund roughly 3.5%. Our forays into distressed securities over the last two years have been reasonably successful even if we include the Fleming mistake. We do not see the area of distressed securities as attractively priced now.

### **Investing in non-financial companies with significant deferred revenue**

We have looked at a number of companies in construction related industries, funeral services and trading stamps. Those businesses all involve fixed contracts where cash is paid upfront for services or goods to be delivered later. The obligation to make this delivery is labeled ‘Deferred Obligation’ or

DO. When valuing these kinds of companies, we should consider the following factors seriously in addition to the normal valuation methods we use as investors for valuing companies:

- 1) Regardless of the value we put on the company, that value should be reduced by the amount of the deferred revenue shown on the balance sheet. For example, when a company receives \$100 million in cash on a fixed contract type of business to render services which will cost it \$95 million (assuming a typical net margin of 5%), the company will eventually have to spend \$95 million to discharge its obligation. Often, for a financially strapped company, management uses the \$100 million in cash to pay down debt – and, in doing so, paints a picture that the company’s financial position has improved significantly. Worse still, the company may acquire similar companies which may appear as good deals but are fraught with huge future obligations that the seller could easily choose to understate.
- 2) In many cases, the deferred revenue amount is not even close to the amount required to discharge its obligation. The actual amount of the DO, which management uses internally to monitor the work still to be done, is frequently much higher than the deferred revenue shown on the balance sheet even when the company states that its revenue recognition policy is based on the percentage of completion method.
- 3) Based on the above, some companies in the construction and other DO-type industries may look to be doing well as long as the growth in revenue continues. But when revenue slows down, or just flattens out, there is a disproportionate hit to earnings. And to add insult to injury, the company runs out of cash in a very short time. This is when the chickens come home to roost and a dire financial picture emerges.
- 4) One can make a case that companies receiving cash upfront have better economics but, in reality, when the company’s financial position is poor, there is stronger temptation for management to knowingly bid for contracts whether they are profitable, or not, as long as they get the cash upfront.

However, for every 10 DO-type companies that stumble, there will be one that truly exploits the favourable economics and comes out ahead. It requires exceptional management with outstanding capital allocation skills. In addition, and equally important, management in these instances must be willing to look at the cost of DO for what it truly is and therefore not minimize the costs and/or underplay the seriousness of any deficiencies. One company that comes to mind is Blue Chip Stamps (“Blue”), a company I remember fondly because it was one of my first picks as a neophyte investor in the 1979/1980 period.

When Warren Buffett and Charlie Munger took over control of Blue in 1969, the only business it had was trading stamps. The company would sell trading stamps to the supermarkets in return for a fee. The shoppers would get a certain number of stamps for each dollar spent in a store. The concept is somewhat similar to what Canadian Tire does in Canada with its Canadian Tire money. Years ago, shoppers would accumulate these stamps in a book until they had enough stamps to redeem them for small consumer items like toasters, bowls, toys, lawn chairs, etc. However, the redemption of stamps would sometimes take several years and, in some cases, the redemption would not take place at all. Meanwhile, the company would have had the use of the money which in investment parlance is commonly referred to as the ‘float’.

To gain perspective on how this money can be used, consider that in 1969, Blue’s revenue was \$108 million, float was \$79 million and book value was just over \$28 million. To cut a long story short, this is what Buffett/Munger did with the float:

- 1) They bought See's Candies (See's) for \$25 million in 1972. In 1999, it had operating profit before taxes of \$74 million. On page 61 of the 1999 Berkshire Hathaway annual report, it mentions that, in 1997, See's earned about \$59 million on \$5 million of net operating assets (these assets are approximately equal to shareholders' equity when the company has no debt). This is indicative of how profitable See's has been over the years. It hardly requires any capital to generate that type of earnings. It is a shame that due to the huge size of Berkshire, See's results since the year 2000 have been consolidated with other subsidiaries and, as such, its extraordinary profitability can no longer be analyzed.
- 2) They bought Buffalo Evening News (Buffalo) for \$32.5 million in 1977. The prior year its operating profit before taxes was about \$1.7 million. In 1999, it generated \$55 million of operating profit before taxes on \$30 million of total assets. I suspect that net operating assets deployed amounts to no more than \$10 million. Again, it is regrettable that from the year 2000, its results have been consolidated with other subsidiaries.
- 3) Blue accounted for the purchase of 80% of Wesco Financial for \$49 million in 1977. As of today, the market capitalization is \$2.9 billion. That 80% would now be worth \$2.3 billion.
- 4) They purchased marketable securities which today are likely worth about \$2 billion. In Blue's 1982 annual report, cash and marketable securities were worth \$178 million. This \$2 billion may sound far fetched but the compound annual rate of return is only 11.6%.
- 5) They likely reinvested all the cash generated by See's, Buffalo and other subsidiaries since 1982; if so, today this would amount to close to \$2 billion.
- 6) Based on their extraordinary profitability, See's and Buffalo would be worth well over \$1 billion.

Most probably, if Blue had not merged with Berkshire Hathaway in 1982 (another regrettable transaction in the sense a great instructive business story was not fully played out), its intrinsic value would now top \$7 billion (give or take a billion) compared to its book value of \$28 million in 1969. This occurred in spite of the trading stamp annual revenue dropping to a mere \$100 thousand.

If there is a secret to the Buffett/Munger success story, it is their willingness to be brutally honest and realistic in their analyses and assessments. They are highly introspective, always checking and rechecking their assumptions and premises against reality. Executives who sugarcoat business realities and embellish results, downplay issues and disguise potential problems to investors may well fool even themselves. They start believing in their own world of make-believe. Buffett/Munger's formidable powers of analysis would be worth nothing if they looked at problems with rose colored glasses.

Our historical returns and what we can learn from them

As we have stated in our past letters, the cardinal principle underlying the investments in the Fund is to pay far less than what the company is worth, measured by sustainable earning power and/or hard assets that are not depreciating in value. In other words, we want an adequate 'Margin of Safety' and this concept, while unappreciated and ignored by most, is what distinguishes investment from speculation.

The Fund's annual returns over 15 years (and since inception) have demonstrated that this concept is so profound and powerful that in spite of making a number of investment decisions that I wished later I had made differently, being blindsided by unpredictable events and getting snookered by unscrupulous management, the Fund still managed to achieve a very satisfactory long term return.

Looking ahead then, it continues to be our opinion that as long as we don't breach our cardinal principle, the Fund should do reasonably well long term.

## **Expectation of future returns**

Based on most common valuation methods such as dividend yield, P/E ratio and premium to book value, the market is not cheap. Four years ago there were sectors that were undervalued that we could exploit. In today's climate, almost all sectors are overvalued. This is an ominous sign. One can still make money in the market but one is doing so without having a large margin of safety. We would caution all investors that from these levels the chances of large permanent loss of capital are extremely high. We feel that it would also be irresponsible to extrapolate the Fund's 3, 5 or 10 year return into the future. Those returns will be virtually impossible to duplicate over the next 10 years.

We are diligently looking for undervalued stocks and will buy them only when they meet our price criteria. However, we will not chase stocks to keep up with the market averages. If given a choice, we would prefer to lose half of our unitholders rather than half of our unitholders' money.

## **China**

We received more calls from investors asking whether we are investing in China than we received about any other country. On the plus side, it is a country that is growing rapidly, its economy is opening up to the western world and it was recently admitted to the World Trade Organization. However, when investing, our first duty is to check where and how we can get tripped up. Some of the negatives are:

- 4) China is an emerging country. Many of the laws, including investor protection laws that we are accustomed to, are non-existent or not enforced.
- 5) There are no concrete rules established in Chinese GAAP; much is subject to interpretation and therefore open to extensive abuse. We know of two accounting firms (both belong to the Big Four) that were looking at the same company and they came up with substantially different numbers. There are enough examples of subterfuge in the books that makes one uncomfortable. When you examine the numbers, you are left wondering whether you are looking at the books prepared for a) tax authorities b) management or c) shareholders (patsies?). For example, the profit margins often seem too good to be true. Some Chinese companies gross an obscene 40% plus, versus just 5% in North America for a similar type of business.
- 6) Although we might have worried more earlier, we now feel somewhat comfortable that there is no turning back to Communism in spite of the rhetoric we still hear from the Politburo. When we asked one Government official about the chances of China reverting back to the old ways, he intoned, "When we talk, we talk left, left, left but we are going right, right, right".

We are looking in China and hopefully can buy some companies with honest management and honest numbers at a cheap price.

## **Derivatives**

Derivatives related issues deserve several pages to do them justice. In brief, we are alarmed by the exponential rise in the use of derivatives. We have chosen to reduce our exposure to financial institutions that rely heavily on derivatives to manage and/or earn profits. We sold the last batch of Freddie Mac (initially bought at about \$3) for \$52 and Citigroup for \$47. These stocks are still undervalued and may continue to do well in the future but they were sold because we did not have the confidence to properly assess the financial liabilities of these companies. Some 25 years ago, there were fewer entries in the financial statements but at least you were clear on what those liabilities meant. In today's world it is precisely the opposite. In annual reports, there are reams of pages of footnotes which are supposed to enlighten you but which, instead, create more serious doubt about the true nature of liabilities. The deeper one delves into the issue, the greater the concerns become. The

three major concerns that we have with companies that rely on derivatives are: 1) They are difficult or impossible to value because the assumptions underlying the valuations are suspect; 2) Even in a mild financial crisis, they will be difficult or impossible to get out of. In practice, this means that they have to be marked down significantly from the market price when you want to sell them; and 3) You have to trust and hope that the counter party with which you have entered into a derivative contract will honour its obligations.

**Other matters**

We launched both the Chou Asia Fund and Chou Europe Fund on August 26, 2003. We have not charged the full management fee of 1.5%. We have charged a fee only to cover the trailer fees paid to dealers and financial planners (0.5%). We are extending this policy for the year 2004.

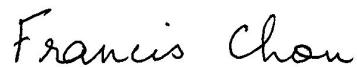
The Fund pays a 1.5% management fee plus other expenses such as custodial, recordkeeping, legal, audit and filing fees. The MER for 2003 was 1.86%.

We have a redemption fee of 2% if unitholders redeem their units in less than 2 years. None of this fee goes to the Fund Manager. It is put back into the Fund for the benefit of the remaining unitholders. We hope this fee is enough to dissuade short-term investors from jumping in and out of the Fund to chase short-term performance.

The minimum amount to invest in the Fund is \$10,000 and subsequent investment is \$1,000.

As of April 16, 2004, the NAV of the Fund was \$69.42 and the cash equivalents were 24% of assets. The Fund is up 5.9% from the beginning of the year.

Yours truly,



Francis Chou

Fund Manager

## CHOU ASSOCIATES FUND

**May 6, 2003**

Dear Unitholders of Chou Associates Fund,

After the dividend distribution of \$3.01, the net asset value (NAV) of Chou Associates Fund at December 31, 2002 was \$64.67, up 30% for the year. The table below shows our 1 year, 3 year, 5 year, 10 year and 15 year annual compound rate of return.

	1 Year	3 Year	5 Year	10 Year	15 Year
Chou Associates Fund	30.0%	19.6%	13.8%	17.1%	15.5%
S&P 500 Total Return	-22.1%	-14.5%	-6.0%	9.3%	11.4%
S&P/TSX Total Return	-12.4%	-6.3%	1.3%	9.1%	7.7%

\* The indicated returns are the historical annual compounded total returns assuming reinvestment of distributions and do not take into account sales, redemption, distribution or income taxes payable by the investor. Mutual funds are not guaranteed. Their values fluctuate and past performance may not be repeated.

By all accounts we had an excellent year. Our returns were largely attributable to 1) BMTC Group, Akita Drilling and Tri-White, and 2) capitalizing on a few 'distress' opportunities that came our way.

### **NET-NET WORKING CAPITAL STOCKS**

Over the years we have done quite well with stocks that were trading below net-net working capital. Stocks that meet this criterion today are often troubled companies that need to restructure their operations. When assessing these stocks it is necessary to take the following into consideration:

1) The cost of restructuring has mushroomed and if factors such as closing cost, severances, termination of leases and underfunded pension liabilities are not properly factored in, one risks coming to the wrong financial conclusion.

2) Management and investors often differ on their perspective of what action needs to be taken, and when. It is important, therefore, to understand what motivates management and specifically what steers their decision making as well as the timing of those decisions - two factors which can ultimately affect the recovery or fall of a company. As investors we see the steps that need to be taken immediately to salvage whatever value is left. There is a sense of urgency: time is of the essence in preserving liquid assets, capping cash drain, closing unprofitable branches, and selling assets including the sale of the whole company. However, some management may not see it that way: the steps that they must take may be painful to their own self-interest and careers unless they have a meaningful portion of their net worth tied up in the company. When faced with making unpleasant decisions management may choose to dawdle, hoping against hope that their industry will turn around and bail them out. Only when faced with the inevitable does such management experience a true awakening. Unfortunately, by then, most of the cash and/or working capital has been depleted. Cases in point: Cable & Wireless and Touch America; in the end the values we saw at the time of investment proved to be a mirage.

Years ago we might have anticipated, with bated breath, that 'there must be a pony somewhere in that basket of net-net working capital stocks', but current experience has taught us that unless we factor in

the cost of restructuring, and the mindset of management, we may find a pony, yes - but it will be a dead one!

## **DISTRESSED SECURITIES**

Although our past successes in 'distressed securities' could be described as anything from average to awful, it has not deterred us from continuing to look in this area. Our broad based definition of distressed securities encompasses companies that 1) emerged from Chapter 11 (Criimi Mae common and preferred shares) 2) are in Chapter 11 (Worldcom senior notes), and 3) have debt securities trading at prices that indicate that they are candidates for Chapter 11 (Elan debentures, RCN senior notes, Time Warner Telecom senior notes, Level 3 senior notes, and Tyco common shares).

The down side to distressed securities is that even if we perform all the due diligence we want we could still end up financially distressed. The reason being that there are too many imponderables to consider - factors which cannot be measured, evaluated or foreseen - and these unknowns leave us vulnerable. Distressed securities involve companies that have one or more serious deficiencies including weak economics, stretched balance sheets, liquidity problems, incompetent management, accounting frauds, potentially mutant cockroaches - you name it. One or more of these negatives may be serious enough to drive some companies into severe financial crises that could potentially bankrupt them. Therefore, one must proceed with eyes wide open and accept that there is a good chance that at some point, most likely sooner than later, one of the companies will tank.

The up side is that because of the uncertainties and the stigma associated with distressed securities, the stocks and bonds of these companies are often selling at deep discounts to their potential 'recovery' values. Remember, we are always searching for bargains and starting in the latter half of 2001 we found many opportunities in this category - a greater number than in other 'more comfortable' sectors. Some of the major purchases for the Fund were:

- 1) Criimi Mae (common shares) at about \$3.75, year-end price \$10.19
- 2) Criimi Mae (preferred class B shares) at about \$14, year-end price \$21
- 3) RCN (10.125% senior notes) at about \$28, year-end price \$22
- 4) Time Warner Telecom (9.75% senior notes) at about \$34, year-end price \$55.75
- 5) Worldcom (6.5% & 8% senior notes) at about \$15, year-end price \$23
- 6) Elan (0% debentures, 2018) at about \$27.50, sold at \$48
- 7) Tyco (common shares) at about \$8.25, sold at about \$12.60
- 8) Level 3 (9.125% senior notes) at about \$43, tendered to the company at \$45 (bought/tendered in 2001)

As the listing shows, we did quite well in 2002 in distressed securities. There is a caveat, however: The gains were notable due mainly to our strategy of concentration. At the time of investing, we put 9.4% of the Fund assets in Criimi Mae (common and preferred shares combined), 9.2% in Worldcom senior notes, 8.9% in Elan debentures, 3.4% in Time Warner Telecom senior notes, and 3% in Tyco common shares. If we had not concentrated, the gains would have been positive but far less positive than the gains actually achieved in 2002.

With regard to 'concentrating', we acted based on a maxim that is still not widely appreciated: What good does it benefit an investor if he does not take advantage of his good ideas in a meaningful way? Good ideas are rare and may only pop up every few years.

We believe the windows of opportunity for distress situations will decline significantly in the future.

## **ACCOUNTING ISSUES**

When analyzing companies we are always aware that their adherence to Generally Accepted Accounting Principles (GAAP) does not necessarily ensure an accurate portrayal of a company's financial position. It is no secret that there is enough leeway for management, within the GAAP rules, to showcase the financials in the best possible light. Of particular concern to us are the areas where management can, and do, play with numbers.

As investors we tend to use different metrics for different industries when calculating a company's worth. These metrics are a standard of measurement specific to the industry being considered. Using these metrics we are able to develop 'rule of thumb' or 'back of the envelope' calculations - that is, a rough estimate of the company's net worth if the accounting is transparent (plus or minus a few adjustments).

Problems occur in that management, aware of the metric that is being used to evaluate their own company, may be tempted to use this knowledge to stretch the GAAP rules in order to make their financials look better. As an investor be sure to identify and examine closely the metric used to measure the company's net worth and then check every item that goes into that calculation.

Here are examples of what some companies have done:

'Percentage growth in annual revenues' was an important metric in the 1997-2001 period for builders of telecom network companies. We found that one builder was swapping revenues that in our opinion have no economic value - close to a billion dollars - with other network builders.

'Earnings before interest, taxes, depreciation and amortization' (EBITDA) is an important metric for cable and telecom companies. We found that some normal operating expenses that should have been expensed were being capitalized. In some cases operational expenses, such as employee costs, were being capitalized for the first 2 years from the day the licenses were granted.

'Growth in net income' is an important metric for evaluating companies. In 2002 some multinational companies lost billions of dollars in their pension funds, but boosted their pre-tax returns in the hundreds of millions by using an unrealistic 9% or more as their expected pension fund investment rate of return! If more appropriate rates of return were used by some companies we would discover that many a pension fund is significantly underfunded. Choosing to use unrealistic rates will have serious repercussions down the road for some companies.

'Free cash flow' is an important metric for some service industries. Keep an eye out for items that do not belong in the calculation including non-recurring items such as sale/leaseback, deferred revenue, and sale of receivables.

Today's financial statements are so closely scrutinized by investors that it is downright comical that some management still believe that the adoption of soft accounting will go unnoticed. Knowledgeable investors will simply make the adjustments needed to reflect what is reality. In the end, what management fail to recognize is that any gains achieved by playing with numbers to make financials look good, will ultimately lead to a much greater loss - their reputation. Soft accounting also affects



management's relationship with investors and sets a wrong example to their employees. It erodes credibility and forces the question - can management be trusted?

Philosophers long ago suggested that 'All is lost save honour' is the honourable way to conduct human affairs, but nonetheless some management still continue to believe in their metric, or should I say mantra, of 'All is lost save EBITDA' regardless of how soft that EBITDA may be.

### **MARGIN OF SAFETY - OUR CREDO**

As we have stated in our past letters, the cardinal principle underlying the investments in the Fund is to pay far less than what the company is worth, measured by sustainable earning power and/or hard assets that are not depreciating in value. In other words, we want an adequate "Margin of Safety" and this concept, while unappreciated and ignored by many, is what distinguishes investment from speculation.

### **RELATIONSHIP WITH FAIRFAX FINANCIAL HOLDINGS (FAIRFAX)**

I run the Chou Funds. I am also a Vice President of Fairfax. In late 2002, Fairfax invested \$50 million in Chou Associates Fund and will invest a further \$50 million in the Fund in the first half of 2003. In order to avoid conflicts of interest, perceived or real, we have agreed to the following arrangement:

- 1) If at any time Fairfax and the Chou Funds desire to purchase or sell the same security within the same price range, any such purchase or sale will be made proportionately to the amount of such security which each of them desires to purchase or sell.
- 2) Fairfax will not exercise any voting rights attaching to units of Chou Associates Fund or otherwise in any manner attempt to influence the affairs of the Chou Funds.
- 3) The Chou Funds will not invest in Fairfax and will not knowingly sell securities to Fairfax nor purchase securities from it.

Fairfax and I will review the arrangement regularly to ensure that we have successfully avoided any conflicts of interest.

In situations similar to mine, most executives would generally continue to receive compensation consistent with their positions as an executive. However, I have chosen to forego all remuneration and benefits whatsoever - including salary, bonus, incentive compensation, employee benefits and other perks associated with my position as an executive of Fairfax (if for convenience I remain a member of any medical or other group benefit plan with Fairfax, I will pay the full cost of participation).

### **EXPECTATION OF FUTURE RETURNS**

Although we had an excellent year in 2002, we are more pleased with our 10 and 15 year results. The market, in general, is still not cheap and we are less than enthusiastic about its future prospects. With that understanding it would be irresponsible of me to extrapolate the Fund's returns of 2002, or the 3 year return, to the future. To be on the safe side, the returns for 2002 should be considered an aberration. Realistically, we would consider it excellent performance if we achieve single digit annual returns for the next few years. Most investors are painfully aware that the market has lost over 40% of its value from its high of 3 years ago. Any positive return is a great return under these circumstances.

A word of caution: Markets are inherently volatile in the short term and therefore can affect the Fund adversely, short term; while the Fund has never suffered large annual losses, they are certainly possible. Having said that, securities that the Fund holds are cheap relative to what they are worth and performance numbers should therefore work out reasonably well in the long run. That has been our experience. Nonetheless, the amount of money that investors choose to invest in the Fund should only be to the degree that they can afford to lose 40% or more of their investment. This may sound drastic, but sleeping well is also an important consideration.

## **COMPENSATION**

The Fund pays a 1.5% management fee plus other expenses such as custodial, record keeping, legal, audit and filing fees. The MER for 2002 was 1.87%. The drop in MER was due primarily to the increase in assets. In general, I would like to see the MER kept below 2%.

Although the management fee is a fixed fee I have always approached it as if it had to be earned. I believe that management fees, in general, should correlate to positive long-term results.

## **GROWTH IN ASSETS**

Some investors have expressed concern regarding the influx of cash to the Fund and whether this factor will have a negative impact on its performance. These points are worth noting:

- 1) We are considering closing the Fund to new investors once its assets reach a certain value. The number being discussed is \$1 billion, a figure that far exceeds our current net assets. This amount is subject to further review.
- 2) The billion dollar figure must be put in perspective; in today's global economy a billion dollars in assets is considered a relatively small amount for a fund that is open to invest almost anywhere in the world.
- 3) The major portion of our returns in the past 15 years has been generated by investing in mid to big capitalization stocks such as Freddie Mac, Citigroup and Progressive, to name a few.
- 4) Finally, and it is worth repeating, our success to date is due to our adherence to the concept of 'Margin of Safety'. As the Fund's assets grow, we will continue to make decisions based on this concept and the same investment criteria that we have used in the past.

## **OTHER MATTERS**

I am pleased to announce that Jingyun Huang joined Chou Associates Management Inc. in December 2002 as a full time administrator. She is responsible for all non-investment related matters.

We are planning to open two new funds, Chou Europe Fund and Chou Asia Fund, in the summer of 2003, subject to the approval of the various securities commissions in Canada. We expect a prospectus for these funds will be available at that time.

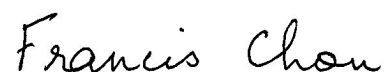
We have a redemption fee of 2% if unitholders redeem their units in less than 2 years. Instead of the fee going to the Fund Manager, it will be put back into the Fund to benefit remaining long-term

unitholders. We hope that this fee is enough to dissuade short-term investors from jumping in and out of the Fund to chase short-term performance.

Effective May 14, 2003, the minimum amount required to invest in Chou Associates Fund will be \$10,000.

As at May 2, 2003, the NAV of the Fund was \$60.44 and the cash equivalents were 51.6% of assets. The Fund is down 6.5% from the beginning of the year. Some of the decline can be attributed to the strong Canadian dollar.

Yours truly,

A handwritten signature in cursive script that reads "Francis Chou".

Francis Chou  
Fund Manager

Chou Associates Fund

2002 Semi-Annual Report

August 28, 2002

Dear Unitholders:

I am pleased to report that the net asset value (NAV) of Chou Associates Fund at June 30, 2002 was \$60.06 compared to \$52.07 at December 31, 2001, an increase of 15.3%. As at August 23, 2002 the NAV was \$59.72.

**Stock Options: We consider stock options to be both an expense and a dilution.**

Before we invest in a company we calculate the potential impact of the following factors on the operating statement: 1) The outcome if stock options were to be properly expensed and 2) The proportion of earnings we anticipate will be diluted in 10 years (the average life span of stock options granted). We consider this analysis essential in understanding the economic reality of our investments - and conduct it regardless of the 'academic' or 'technical' merits of the arguments advanced by those who oppose expensing stock options, and/or are reluctant to show the dilutive effects of the options when the strike price is 'out of the money'.

If an investor ignores the impact of stock options on operating statements, he or she will develop a misleading picture of a company's financial prospects and potential dilution. Here are some points to consider:

1) We need to be aware of the overall increase in the percentage of stock options granted as a percentage of outstanding shares. In most companies, particularly the private ones, almost all executive compensation is paid in cash. Until a few years ago, public companies also paid most executive compensation in cash. Stock options were not a problem back then as they represented a very small part of a company's outstanding shares. But starting in the 1980s the percentage of options granted, as a percentage of shares outstanding, has been increasing and has more recently mushroomed. It is not uncommon to see stock options represent between 20% and 30% of outstanding shares. That is quite high considering that some 40 years ago, anything greater than 5% would have elicited an outcry of grand larceny;

2) When researching companies we have found it impossible to compare apples to apples between companies in the same industry unless stock options are expensed. Here is a real life example that occurred in the service industry (not high tech): It clearly shows that when options are not expensed we are presented with a misleading picture of how well a company is actually performing. Example: Company A had stock options of 30% outstanding, versus Company B that had a negligible number of options. The wages and benefits costs of Company A were 61% -- almost 10% less than the 67% for Company B. However, upon examination, when options for Company A were properly accounted for, it was determined that the wages and benefits costs would have been 66%. Proper expensing of options has a direct bearing on operating margins, pretax margins, pretax return on capital, and more. These are ratios that are commonly used to measure the economics of the business, as well as determine how well the company is being managed. While at first glance, Company A looked to be an excellent company, once stock options were properly accounted for, its status dropped to mediocre;

3) Stock options cannot be considered 'freebies', as they form part of a total compensation package, which is an expense. Executive compensation is highly competitive, and as such, a company in the

same industry cannot afford to significantly underpay its executives, relative to its competitors, simply because executives are highly marketable and can choose to leave. When cash compensation is not enough, it can be augmented in a variety of ways, in particular, with stock options that form part of the total compensation package. This action, however, has tangible financial repercussions. For example: When a company that does not have stock options, proceeds to acquire a company where stock options were part of the compensation package, that company must make up the difference in cash compensation. When it does that, it raises its operating costs. In light of this example, beware of companies that have a high proportion of stock options -- these companies are understating their operating expenses and, therefore, are overstating their earnings; and

4) With regard to the subject of dilution: One of the arguments posed states that since the strike price is 'way out of the money', there is no dilution. Consider this example, however: Take a stock price at \$10 and assume that it is also the intrinsic value of the company. The strike price of the stock option is at \$15, which is 50% above the stock price. (In most cases, the strike price gets granted below the intrinsic value due to the dubious practice of option repricing when the stock drops reflecting the drop in its intrinsic value. This is tantamount to enriching and rewarding executives for destroying shareholder wealth). A huge part in valuing companies is the weight we assign to the potential growth of the company. If the company grows at a rate of 15% a year in 10 years, the current \$10 intrinsic value will be approximately \$40 in 10 years. Surely those stock options will be exercised... We have to conjecture, as we stare at the current financial statements under present GAAP rules, what proportion of the 100% earnings we see currently will be 70% in 10 years. Or will it be 50% or less, as some companies keep issuing 2%-4% of stock options every year? (As if 30% is not generous enough!).

As the examples show, stock options are both an expense and a dilution. For us, this is not an academic exercise but one of real economic significance when we are assessing and valuing companies.

Furthermore, we have rejected many companies as possible investments due to the generous granting of stock options, and the rationales used by CEOs to explain their positions on the subject. In days past, wise men would say that if one is confused by the arguments, follow the money, and if someone is gaining monetarily it would mean that that money is being taken away from someone else in some form or other. If that is the case, why not be upfront about the matter and account for those monies properly?

An even larger issue looms: and that is, the credibility of management. When the CEO downplays the impact of stock options as an expense and dilution, we are led to question other aspects of the financial statements. Can I trust the numbers? Does management use GAAP accounting rules (there is a lot of leeway) to reflect economic reality on its financial statements, or is it otherwise? In light of this scenario, it is not surprising that companies such as Tyco and Elan have seen their stock prices plummet relative to their intrinsic value due to lack of trust in the numbers presented by management.

Yours truly,

Francis Chou

(Fund Manager)

## Chou Associates Fund

2001 Annual Report

April 29, 2002

Dear Unitholders of the Fund:

After the dividend distribution of \$4.23, the net asset value of Chou Associates Fund at December 31, 2001 was \$52.07. It has been a difficult market, and yet I am happy to report that in the year 2001 the Fund gained 21.4%. The 3 year and 5 year annual compound return was 6.0% and 15.5% respectively.

One of the stocks that had a favourable impact on last year's results was BMTC Group, a furniture retailer in Quebec. The company accounted for approximately 35% of the return for the year.

Over time I have sifted through thousands of bargains which have come in different shapes and flavours such as discount to net-net working capital, discount to book value and low P/E ratio. When all is said and done, those which continue to give me the greatest satisfaction are the ones which display the following characteristics:

- 1) Above-average to excellent companies as measured by high ROE in excess of 15% sustained over 10 years or more.
- 2) Companies run by skillful managers as measured by good controls maintained on receivables, inventory and fixed assets.
- 3) Prudent deployment of capital as measured by a company's capital expenditures, judicious acquisitions, and timely buybacks of its depressed shares.
- 4) A stock price which is far lower than what a knowledgeable and rational buyer would pay.

BMTC Group met the above criteria in spades. And when companies such as this one are found, the only rational thing to do is buy as much of the stock as the legal limit allows. In these instances it's not always necessary to be extra careful about the buy price as long as this price falls within a single digit P/E ratio. Even on the sell side, there isn't a pressing need to time the sale as the stock price nears its intrinsic value - the reason being that the company's intrinsic value is growing in excess of 15%.

Another characteristic of well-managed companies with good economics is the deferment of capital gains tax in instances where the stock is held for several years. I consider this to be a very important aspect, yet it is one which has yet to be given its due consideration by the investment community. It can add several points to the after-tax return on an annual basis. With all these attributes in mind, an ideal portfolio would be one where we can purchase 10 securities with similar investment characteristics in 3 or 4 different industries. But as it happens in investment we cannot be too choosy - we can only take advantage of whatever types of bargains are present.

The problem that occurs when buying discount to book value, or discount to net-net working capital is that most of these companies earn low (or negative) returns on equity (ROE). In order to do well with this approach it is important to buy when the company's stock price is thoroughly depressed, and then sell when a fortuitous price presents itself during the next few years; otherwise, the long term investment returns would mirror the ROE of the company: historically these figures have averaged out to less than 3 to 4% over 10 years. During those years, and not infrequently, the company may lose money. Its main attraction as an investment, however, is the stock price itself which is selling at a severe discount to liquidation value. As an investment merit, this aspect should not be pooh-pooed. If done in a disciplined way, both on the buy and sell sides, this type of investment provides a fairly attractive return with the added benefit of low

volatility. Notwithstanding, one should still recognize these companies for what they are - that is, pieces of CRAP (Cannot Realize A Profit) - and capitalize on them accordingly.

With regard to the current valuation of the market, I maintain the same view that I have held for 5 years - and that is, that the markets are unattractively priced. Even so, the Fund achieved a rate of return of 15.5% compounded annually over 5 years (\$1 invested on January 1, 1997 was worth approximately \$2.05 on December 31, 2001); however, we should be circumspect about the result and not extrapolate it to the future. I doubt that the overall returns from equities in general over the next 5 to 10 years will be compelling; on the contrary, I believe that the returns may be far more modest than those hoped for by investors. Not only are the P/E ratios and price-to-book values still high (and dividend yields low) relative to historic valuations - the number of companies that are underpriced is at an all time low. In light of this scenario, and with its obvious lack of bargains, we are faced with the question: Should we be 100% in cash? That would make perfect sense, I suppose, if we could accurately predict a business contraction equivalent to the Great Depression. But as we are well aware, and know from experience, it is tough enough to predict the timing of a recession, let alone the degree of severity! My take on this is as follows: What we have done in the past, and what continues to work for us, is to purchase equities only to the extent that bargains are available - and with what was available to us in the last ten years we were able to achieve a rate of return of 16.2% compounded annually (\$1 invested on January 1, 1992 was worth approximately \$4.49 on December 31, 2001). Now, however, as the bargains are dwindling we should lower our expectations to single digit returns.

In running a portfolio there are always short-term issues to consider as they form part of the bigger picture: these include tax loss selling, interest rate trends, the future economic environment, high valuations and the threat of war, to name a few. The emphasis given to these factors, however, should be put in perspective. Sometimes the weight attributed to them at a subconscious level can be disproportionately high, and if we fail to recognize this influence we run the risk of being derailed from doing what we should be doing, first and foremost, and that is to always diligently hunt for bargains.

By giving undue emphasis to these forces we can easily warp a good concept and turn a sensible long-term investment approach into speculation. For example: I feel fairly optimistic that the Fund - as it continues to be based on the sound investment framework of 'margin of safety' - will give reasonable returns over the next 10 years; in the same breath I would add that I haven't a clue as to how it will perform next week or next year. Predicting short-term performance comes down to the flip of the coin which is as good (or as bad) as gambling. If the outcome of an investment is predicated on time-related factors, unless it is in the area of arbitrage and special situation, the investment will inadvertently turn into speculation. And the shorter the time frame, the more speculative the investment becomes regardless of how sound its underlying investment principles are.

As at April 26, 2002 the Fund's cash level was 23.2% and its MER for the year 2001 was 2.016%.

Yours truly,

Francis Chou  
(Fund Manager)

## Chou Associates Fund

### 2000 Annual Report

April 27, 2001

Dear Unitholders of the Fund:

After the dividend distribution of \$3.58, the net asset value of Chou Associates Fund at December 31, 2000 was \$46.36, up 8.4% for the year. The 3 year and 5 year annual compound return of the Fund was 6.4% and 15.7% respectively.

Relative to the market index, the results were satisfactory, however they would have been better had it not been for two factors:

- 1) Our investment in Reliance Group Holdings, a property and casualty insurer in financial difficulty.
- 2) Selling some of our stocks at below their cost price. The decision to do so was motivated by tax loss selling in order to counterbalance the very substantial realized gains generated for the year. Some consider this a 'bona fide, bone headed' move. To date, the Fund has been fairly successful in identifying and buying good companies at bargain prices. And when prices go down further, logic dictates that we should do more purchasing. Instead, we sold. This short term thinking – minimizing realized gains by taking losses – ran contrary to my better investment judgment. Over the years, I have observed that even the best tenets, if one is not careful, can be shunted aside easily for trivial reasons. It cost us roughly 5% in potential returns for the year 2000.

#### **Impact of Capital Gains on Investment Decisions**

Whenever returns are discussed in the industry, it is implied that they are pre-tax. Our Fund efforts to date have been directed towards achieving the best 'after-tax' rate of return as we have been conscious of the high capital gains tax rate of approximately 40%. When presented with a choice of undervalued securities, we prefer to select companies whose intrinsic value grows at a double digit rate as this allows us to defer selling the stock as long as possible. The high unrealized gains in our portfolio, relative to costs, reflect our investment approach.

A case in point is Freddie Mac. Our initial purchase price in 1990 was \$3 per share. The current price is \$63 – our return to date is 21 times the purchase price, or roughly a 35% pre-tax rate of return compounded annually. If we were to sell at the end of each year, and then repurchase the stock immediately the next day, thus incurring capital gains in the process, the after-tax rate of return would only be 21%. By holding on as we have, if we were to sell Freddie Mac today at the current price, and with the same 40% capital gains tax rate, our after-tax return would be considerably more – 29% compounded annually. While Freddie Mac may be an unusual example due to the extremely high rate of return the Fund achieved on this stock, the same calculations apply to stocks in general.

Here is an example based on a 20% pre-tax rate of return: The after-tax return for a stock that is bought and sold every year is 12%. If it is held and then sold after 10 years, the after-tax return is 15%. A \$100,000 investment compounded annually for ten years at 12% grows to \$300,000, whereas the same \$100,000 compounded annually for ten years at 15% grows to \$400,000.



The capital gains tax rate has now dropped to approximately 25% -- considerably lower than the tax rate on dividends or interest income. If faced with a choice of undervalued securities, we lean more towards companies reinvesting their earnings at a reasonable rate rather than those that are paying out dividends.

### **Technology Stocks**

In the 1999 Annual Report I warned, in no uncertain terms, about the dangers of investing in high tech stocks, stating: "I am alarmed by the cavalier way in which people invest in technology stocks; the thought process they are using is a subversion of the investment process...Paying 500 times for hot air is not an investment; it's pure speculation... Let's not play a fool's game by thinking that a stock can be bought at 100 times revenues... and someone... will buy it at 200 times revenues the following week."

In the wake of the collapse of high tech stocks -- where many have dropped as much as 95% from their high -- we are now taking a serious look at several of these that offer good long term prospects, and whose shares are trading below net cash. Let me add that one should exercise caution rummaging through this rubble, as many of the companies are still burning cash.

The severe drop in high tech stocks was exacerbated by speculators borrowing on margin. In my opinion, rather than borrow on margin, such investors might consider 'buying into' the concept of margin of safety, a cornerstone of sound investing.

The markets are still high and a case can be made for us to be out of equities totally. I have reservation about that approach. Years ago I would give undue consideration to market levels, and react at times by keeping anywhere from 25% to 30% in cash, even though there were bargains to be had. Once a certain mindset is formed, we tend to reaffirm our thinking by only looking for information that confirms our bias. We choose statistics on a selective basis, ignore other information that may be relevant, and only listen to people that echo our thinking -- and in the process we may be missing opportunities. The key is to make the economic environment a component of our decision making process. The most fundamental task at hand is still to search for above average companies with good economics, run by intelligent management, that are selling at an undervalued price.

At year end, cash comprises 24% of our portfolio, due largely to the fact that true bargains have been few and far between. In the past 5 years the Fund has compounded at 15.7%, more than doubling the money. However, I would caution that in light of high market valuation which has persisted for several years now, I am suggesting that we lower our expectations to single digit returns.

In 2000, the Fund's management expense ratio was 2.00% versus 1.85% in 1999. I chose to take a lower management fee in 1999 than allowed.

Yours truly,

Francis Chou

(Manager of the Fund)

## Chou Associates Fund

### 1999 Annual Report

April 10, 2000

Dear Unitholders of the Fund:

After the dividend distribution of \$0.98, the net asset value of Chou Associates Fund at December 31, 1999 was \$46.08, down 9.6% for the year. The 3 year and 5 year annual compound return of the Fund was 16.0% and 20.2% respectively.

Factors affecting the 1999 results included 1) Misreading the political dynamics of a takeover of Surrey Metro Savings by Canada Trust and 2) The craze in technology stocks, a phenomenon which has had a negative impact on undervalued stocks, causing them to drop in price as investors pulled out their money and poured it into technology stocks.

#### Technology stocks

The Fund is not invested in technology stocks. Their current inflated prices make them unattractive and unsuitable to the investment philosophy of the Fund, which is:

- 1) To buy above-average to excellent companies run by skilful managers, at a price far lower than what a knowledgeable and rational acquirer would pay for cash; and
- 2) To buy at deep discount to liquid book value for companies with average prospects.

Before we purchase any stock for the Fund, we examine several criteria to determine the intrinsic value of the company we are considering. The stock price serves a useful function and its importance grows, in terms of a buy or a sell decision, as it deviates from the intrinsic value of the company. When the discount is deep enough and provides an adequate margin of safety (a cornerstone of sound investing), we can then make a decision whether to buy the stock.

I'm alarmed by the cavalier way in which people invest in technology stocks; the thought process they are using is a subversion of the investment process. The rise of a stock price for a period of time is by no means an indicator of value, nor is it an assurance that we are looking at a 'can't miss' investment. By all means take advantage of stock prices but do not get seduced by them! Paying 500 times for hot air is not an investment; it's pure speculation.

From an analytical perspective I find it hard to envision a reasonable return materializing when an investor is paying more than 100 times revenues for a business -- regardless of how attractive the future of that business might appear. An example, for instance, is Microsoft which is trading at more than 25 times revenues and 100 times earnings:

As many a sober analyst has pointed out, for Microsoft to deliver low double digit return for investors it has to increase its earnings by more than 40% annually for the next 10 years. This means it will have to earn more than \$200 billion in 10 years from the current \$8 billion. To put this information in better

perspective consider that Coca Cola currently earns \$4 billion, General Electric \$11 billion and General Motors \$6 billion.

Furthermore, keep in mind that already Microsoft does earn a monopoly type after-tax net margin of 38% plus compared to the average industrial company of 5%. Therefore, not surprisingly, I would have to say that buying technology stocks that are trading over 100 times revenues should not be described as an investment, as we know it, but rather, more charitably, as a 'Venture Capital type' investment.

Lastly, let's not play a fool's game by thinking that a stock can be bought at 100 times revenues and then proceed to hope, against hope, that someone who is carried away by emotion, and is unaware of the risk involved, will buy it at 200 times revenues the following week. When the urge hits to make such a leap, take a cold shower until the inclination passes.

Having laid this cautionary foundation, this does not mean that we will never invest in technology stocks. I'm confident that in the future they can be picked up at prices that are sensible and rational to an informed investor who is fully aware of the risks involved.

Now the good news....there are a number of fine companies in sectors such as property and casualty insurance, banks, home builders, unit trusts and retailers, and the like, that are selling at attractive prices. We are taking a look at these as prices are as low as I have seen them for quite some time. Many are down by as much as 70% from highs of 25 times earnings, and are trading at 50% of revenues (versus 100 times revenues!); they have decent balance sheets and above average long term prospects.

In 1999, the Fund's management expense ratio was 1.73% versus 1.97% in 1998. I chose to take a lower management fee than allowed.

Yours truly,

Francis Chou

(Manager of the Fund)

## Chou Associates Fund

### 1998 Annual Report

April 15, 1999

Dear Unitholders of the Fund:

After the dividend distribution of \$ 4.31, the net asset value per unit of Chou Associates Fund at December 31, 1998 was \$52.07. The Fund was up 23.2% for the year.

The Fund had a good year in an otherwise difficult environment for value investors. While the media heralded the Dow Jones Industrials surpassing 10,000, the rise has made it virtually impossible to buy companies at a price that makes economic sense. We are now paying well in excess of \$33 to purchase a dollar of after-tax earnings: that's a return of less than 3% - a percentage which I consider to be totally inadequate.

Most investors are aware that the market is trading at historically high levels and yet I am amused by how some investors have responded. Price to earnings ratio for an average investor are the highest they've ever been while dividend yields are at their lowest - in the past that combination has caused many investors to lose a shirt or two. And yet, instead of being concerned, dissuaded or cautioned by this situation, there remains a sizable contingent who continue to be mesmerized by healthy past returns and fully expect the future to be more of the same.

Think back to a few years ago. Investors wouldn't even think of investing in a company without first, and seriously, considering the answers to these kinds of questions:

- 1) *How favorable are the economics of the business and where does the company rank in terms of market share?*
- 2) *How sustainable are its earnings stream?*
- 3) *How skilful have management been in deploying capital?*
- 4) *What is the appropriate discount rate to take?*
- 5) *Is the capital structure too leveraged?*
- 6) *What would an acquirer pay for in cash?*
- 7) *And most important of all, what is the appropriate price to pay for such a company that would give an investor more than adequate margin of safety? Margin of safety is simply paying far less for a company than what it is worth, measured by sustainable earning power and/or hard assets that are not depreciating in value. This concept, while unappreciated and ignored by many at the moment, is what distinguishes investment from speculation.*

In today's market, that kind of thought process is considered unnecessary and regarded by some as posing a hindrance to being a successful investor. If anything, I think the process would quickly sober that investor up!

Further, the prices currently being paid for internet stocks represent the extreme form of overvaluation in this ebullient market. It is not 200 times earnings but over 200 times revenues!!! I believe, that at these prices, those betting on internet stocks to deliver high returns are asking for trouble.

I have no interest in buying internet stocks or for that matter any other stocks that I consider to be overvalued for the Fund. Giving in to speculative fever would expose the Fund to major and permanent loss of capital. In addition, it would be a dereliction of duty and a betrayal of the investment principles which have made the Fund achieve respectable rates of return over the long term. When stocks are bought without regard for valuation, I am reminded of a quote: "Those whom the gods wish to destroy, they first blind them with greed."

The 5-year, 3-year and 1-year rate of returns compounded annually for the Fund are 22.0%, 28.5% and 23.2% respectively. In the current environment, it is nearly impossible to achieve returns even approaching these numbers. We must, however, be prepared to accept low returns in the future, possibly in single digits, even if the market goes up substantially.

As for what's new, we are finding pockets of bargains in commodities, commodities-related industries, and companies that have business interests in Eastern Europe and Asia. A proviso, however: because the economics of these types of businesses are not as clear cut, they have to be compellingly cheap before we buy them. We have invested in such companies in the past and have done well with them.

Lastly, on February 8, 1999, Royal Trust took over the record keeping and custodian services of the Fund from CIBC Mellon. The reason we made the switch was that the fees at Royal Trust are 50% cheaper than CIBC Mellon.

For the year 1998, the MER of the Fund was 1.97% without GST and 2.11% with GST.

Yours truly,

Francis Chou

(Manager of the Fund)

## Chou Associates Fund

### 1997 Annual Report

March 20, 1998

Dear Unitholders of the Fund:

After the dividend distribution of \$10.22, the net asset value per unit of Chou Associates Fund at December 31, 1997 was \$45.76. The Fund was up 40.3% for the year.

The return achieved for 1997 was the best ever by the Fund since it went public in 1986. However, the gain must be put in perspective: it was generated against the backdrop of a roaring bull market, and I readily admit that it is easy to look good when you have such a strong tailwind.

It is no secret that I have been nervous about the stock market for the last few years, yet despite the fact that the portfolio was structured defensively to reflect my sentiments, the Fund has done reasonably well since 1994. For the 3 years ending December 31, 1997, the annual compound return was 31.1%. Having said that, I would add that at today's level, if I had my druthers, I would be totally in cash.

Without question, the investment climate has changed:

If viewed from a perspective of just 13 years ago (1985), or for that matter the midpoint of any decade dating back to 1935, we would have been flabbergasted at the prices paid for an 'average' company. Currently, with the Dow Jones Industrials over 8,900, and its P/E ratio over 25 (versus the historical average of 14), we are looking at an earnings yield on inflated profits that is less than 4%! Now consider that in 1985 anyone paying such prices would have been regarded, and laughably so, as a GAAP (*Growth At Any Price*) investor. And had a value investor – such as yours truly – paid such a price, he would have needed a brain surgeon to search for the large 'GAAP' in his own cranium!

The only way to justify paying current prices is if

- a) interest rates stay at current levels, or go down, **AND**
- b) companies sustain current levels of profitability and ROE of 20% *plus*, **AND**
- c) the fallout from the Asian economic crisis is kept to a minimum, **AND**
- d) managements deploy capital wisely, earning 20% plus on investment, **AND**
- e) Producer Price Index stays low, signaling that inflation is in check.

In short, an investor can do well only if **all** the pieces, without exception, fall into place.

Even then, I have my doubts. For example, how can the average company maintain an ROE of 20% *plus* when historically its ROE has hovered between 12% and 13% for over 50 years? Mathematically, it just doesn't make sense. And to take it one step further, let us consider the company whose earnings are currently growing at 20%. At that rate, its earnings will double in 4 years and grow six times in 10 years. With GNP growing between 2% and 4% annually, and revenues growing at a rate no greater than 6%, the writing's on the wall: it's inevitable that with time 'earnings will equal revenues', thus creating a business oxymoron.

Far more disconcerting is the optimism shown by ordinary investors and the methodology used to evaluate companies. I can recall a time about 15 years ago when the multiple being paid for a dollar of

earnings was the accepted benchmark for identifying undervalued companies. Back then I could find busloads of good companies selling at single digit P/Es. However, as the market took off and stocks started to 'appear expensive' on the basis of P/E ratios, the term EBIT (Earnings Before Interest and Taxes) kicked in and replaced Earnings as the new buzzword.

Currently EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is in vogue. Granted, under certain conditions and in specific industries, EBITDA can be useful as a first step for valuation, but what I find disturbing is that the term is being bandied about nonchalantly as a 'normal' basis for valuation. It is not uncommon to hear investors say that 'this stock is cheap because it is selling for only 10 times EBITDA'. I can't help but wonder - at the rate we are going, how long is it before EBE (Earnings Before Everything) becomes the norm for evaluating cheapness?

At the moment, your manager has no concrete idea of where to proceed from here. But one thing is certain: I am not willing to overpay. I am willing to forego profit that is rooted in pure market timing and market speculation.

Over the years, the Fund has made its return primarily from three areas. In order of importance, they are:

- 1) Buying above-average to excellent companies run by skillful managers, at a price far lower than what a knowledgeable and rational acquirer would pay. The acquirer's motivation should be governed by a desire to make a decent return on the cost of acquisition primarily through long-term ownership; it should not be driven by motives such as the need to build a bigger empire at the expense of returns.
- 2) Buying at deep discount to liquid book value. This type of investment does not require a lot of judgement and it is purely a mathematical exercise. As boring as this strategy may appear, it delivers good return with very low risk, and I will continue with it as long as we can find these kinds of investments. Safety in numbers is the key. I peer through my infrared binoculars and find the cheapest cigar butts, take one last puff from each and spit the spoils out of the portfolio. Sorry folks, no hard feelings, it's only investment!
- 3) Special situations. An example is PS Group, which is in semi-liquidation. Our cost was \$9.75 per share. Over the years the company was paying out \$1.50 per share in distributions annually but last year we received \$4.00 per share!!

Regardless of the methodology used, the cardinal principle underlying the investments in the Fund is to pay far less than what the company is worth, measured by sustainable earning power and/or hard assets that are not depreciating in value. In other words, we want an adequate "**MARGIN OF SAFETY**" and this concept, while unappreciated and ignored by many at the moment, is what distinguishes investment from speculation.

What troubles me, however, is that as the market keeps rising, it is injecting a speculative element that will eventually lead to a permanent loss of capital, a risk that we cannot afford. Instead of getting carried away, perhaps a more appropriate response would be to 'Lie down until the feeling passes'.

Shifting to another topic, the Fund will report Management Expense Ratio (MER) in two ways: one that includes Goods & Services Tax (GST) as part of MER and another that excludes it. GST is a real cost to the Fund, it is not recoverable and, therefore, should be included when calculating MER, as I

have done in the past. However, mutual fund accounting allows GST to be excluded when calculating MER. I believe all the mutual funds follow this convention and, seeing it doesn't make sense to be a lone wolf, I am throwing in the towel. It will now make it easier for investors to compare apples to apples and check how Chou Associates Fund stacks up against other mutual funds on the basis of MER.

For the year 1997, the MER of the Fund was 1.86% without GST and 1.99% with GST.

Yours truly,

Francis Chou

(Manager of the Fund)