

**Chou Associates Fund  
Chou RRSP Fund**

**ANNUAL  
REPORT**

**2002**

## Chou Associates Fund

Illustration of an Assumed Investment of \$10,000

| Period Ended | Value of Initial \$10,000 Investment | Value of Cumulative Reinvested Capital Distribution | Value of Cumulative Reinvested Dividends | Total Value of Shares |
|--------------|--------------------------------------|---|--|-----------------------|
| Dec.31,1987  | \$10,000                             | \$0   | \$0                                      | \$10,000              |
| Dec.31,1988  | 10,547                               | 567   | 313                                      | 11,427                |
| Dec.31,1989  | 11,731                               | 959   | 874                                      | 13,563                |
| Dec.31,1990  | 9,692                                | 792   | 1,631                                    | 12,114                |
| Dec.31,1991  | 11,031                               | 1,629   | 2,271                                    | 14,931                |
| Dec.31,1992  | 12,994                               | 2,081   | 2,844                                    | 17,918                |
| Dec.31,1993  | 14,411                               | 3,254   | 3,154                                    | 20,819                |
| Dec.31,1994  | 13,892                               | 3,137   | 3,253                                    | 20,282                |
| Dec.31,1995  | 16,504                               | 5,832   | 4,235                                    | 26,571                |
| Dec.31,1996  | 19,841                               | 7,011   | 5,747                                    | 32,599                |
| Dec.31,1997  | 22,755                               | 13,074  | 9,911                                    | 45,739                |
| Dec.31,1998  | 25,894                               | 17,693  | 12,771                                   | 56,358                |
| Dec.31,1999  | 22,914                               | 16,483  | 11,536                                   | 50,933                |
| Dec.31,2000  | 23,054                               | 16,877  | 15,266                                   | 55,197                |
| Dec.31,2001  | 25,894                               | 21,964  | 19,175                                   | 67,033                |
| Dec.31,2002  | 32,159                               | 30,498  | 24,474                                   | <b>87,131</b>         |

Note: The indicated returns are the historical annual compounded total return 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.

## 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.

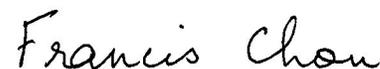
We are planning to open two new funds, Chou Europe Fund and Chou Asia Fund, in the summer of 2003, subject to the approval of the various securities commissions in Canada. We expect a prospectus for these funds will be available at that time.

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,



Francis Chou  
Fund Manager



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## AUDITORS' REPORT

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To the Trustee and the Unitholders of  
Chou Associates Fund

We have audited the statement of net assets of Chou Associates Fund (“the Fund”) as at December 31, 2002 and 2001, the statements of income and changes in net assets for the years then ended and the statement of investments at December 31, 2002. These financial statements are the responsibility of the Fund’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2002 and 2001, its results of operations and changes in its net assets for the years then ended and its investment portfolio as at December 31, 2002, in accordance with Canadian generally accepted accounting principles.

A handwritten signature in black ink that reads "BurnsHubley LLP".

Chartered Accountants

Markham, Ontario  
February 20, 2003

# CHOU ASSOCIATES FUND

## STATEMENT OF NET ASSETS

AS AT DECEMBER 31, 2002

|   | 2002              | 2001              |
|---|-------------------|-------------------|
| <b>ASSETS</b>   |                   |                   |
| Cash and treasury bills   | \$ 51,659,631     | \$ 3,311,682      |
| Accounts receivable   | 520,700           | 33,396            |
| Investments at market value (average cost<br>2002 - \$20,555,845; 2001 - \$7,131,121) | <u>29,584,002</u> | <u>12,131,523</u> |
|   | <u>81,764,333</u> | <u>15,476,601</u> |
| <b>LIABILITIES</b>  |                   |                   |
| Accounts payable and accrued charges  | 171,135           | 43,444            |
| Dividends payable   | 44,132            | -                 |
| Covered call options at market value<br>(average cost 2002 - \$ Nil; 2001 - \$ Nil)   | <u>-</u>          | <u>30,267</u>     |
|   | <u>215,267</u>    | <u>73,711</u>     |
| <b>NET ASSETS AT MARKET VALUE</b>   | \$ 81,549,066     | \$ 15,402,890     |
| <b>NET ASSETS ATTRIBUTABLE TO UNITHOLDERS</b>   |                   |                   |
| Capital   | \$ 72,520,908     | \$ 10,432,756     |
| Unrealized appreciation in the<br>value of investments                                | 9,028,158         | 5,000,401         |
| Unrealized loss in covered call options   | <u>-</u>          | <u>(30,267)</u>   |
|   | \$ 81,549,066     | \$ 15,402,890     |
| <b>NUMBER OF UNITS OUTSTANDING</b> (Note 2)   | 1,260,979         | 295,800           |
| <b>NET ASSET VALUE PER UNIT</b>   | \$ 64.67          | \$ 52.07          |

APPROVED ON BEHALF OF THE BOARD OF DIRECTORS  
OF THE MANAGEMENT COMPANY

*Francis Chou*  
*Tracy Chou*

# CHOU ASSOCIATES FUND

## STATEMENT OF INCOME

FOR THE YEAR ENDED DECEMBER 31, 2002

|  | 2002             | 2001           |
|--|------------------|----------------|
| <b>INCOME</b>  |                  |                |
| Dividends  | \$ 586,032       | \$ 625,278     |
| Interest   | 546,639          | 124,439        |
|  | <u>1,132,671</u> | <u>749,717</u> |
| <b>EXPENSES</b>  |                  |                |
| Management fees (Note 3)   | 437,218          | 218,280        |
| Custodian fees   | 34,987           | 24,213         |
| Filing fees  | 20,024           | 8,726          |
| Audit  | 8,157            | 8,098          |
| Legal  | 8,000            | 15,332         |
| Foreign withholding taxes  | 5,214            | 8,975          |
|  | <u>513,600</u>   | <u>283,624</u> |
| <b>NET INVESTMENT INCOME</b>   | 619,071          | 466,093        |
| <b>REALIZED GAIN FROM INVESTMENTS SOLD</b>   | <u>3,015,688</u> | <u>691,136</u> |
| <b>NET INCOME FROM OPERATIONS</b>  | \$3,634,759      | \$ 1,157,229   |
| <b>NET INVESTMENT INCOME PER UNIT</b> (based upon the<br>number of units outstanding at the year end prior to reinvested<br>distributions of income) | \$ 0.51          | \$ 1.70        |
| <b>REALIZED GAIN PER UNIT</b>  | \$ 2.50          | \$ 2.53        |
| <b>NET INCOME PER UNIT</b>   | \$ 3.01          | \$ 4.23        |

**CHOU ASSOCIATES FUND**  
**STATEMENT OF CHANGES IN NET ASSETS**  
**FOR THE YEAR ENDED DECEMBER 31, 2002**

|  | <b>2002</b>          | <b>2001</b>          |
|--|----------------------|----------------------|
| <b>NET ASSETS</b> , beginning of the year                      | \$ <u>15,402,890</u> | \$ <u>12,679,869</u> |
| <b>INCREASED BY</b>  |                      |                      |
| Net investment income  | 619,071              | 466,093              |
| Net realized capital gains on investments sold                 | 3,015,688            | 691,136              |
| Unrealized appreciation (depreciation) in value of investments | 4,027,757            | (70,322)             |
| Decrease in covered call options                               | 30,267               | 1,614,200            |
| Reinvested distributions                                       | 3,590,627            | 1,157,228            |
| Proceeds from sale of units                                    | <u>58,823,191</u>    | <u>746,138</u>       |
|  | <u>70,106,601</u>    | <u>4,604,473</u>     |
|  | <u>85,509,491</u>    | <u>17,284,342</u>    |
| <b>DECREASED BY</b>  |                      |                      |
| Payments on redemption of units                                | 325,666              | 724,224              |
| Distribution of income to unitholders                          | <u>3,634,759</u>     | <u>1,157,228</u>     |
|  | <u>3,960,425</u>     | <u>1,881,452</u>     |
| <b>NET ASSETS</b> , end of the year                            | \$ 81,549,066        | \$ 15,402,890        |

**CHOU ASSOCIATES FUND**  
**STATEMENT OF INVESTMENTS**  
**AS AT DECEMBER 31, 2002**

|   | Number of<br>Shares | Average<br>Cost     | Market<br>Value     |
|---|---------------------|---------------------|---------------------|
| <b>SHARES*</b>                              |                     |                     |                     |
| Akita Drilling Ltd., Class A                | 60,000              | \$378,967           | \$1,257,000         |
| BMTC Group Inc., Class A                    | 189,800             | 842,255             | 2,723,630           |
| Berkshire Hathaway Inc., Class A            | 45                  | 4,910,620           | 5,152,266           |
| Cable & Wireless Publications Ltd., ADR     | 75,600              | 639,423             | 277,224             |
| Caldwell Partners Int'l Inc., Class A       | 410,000             | 639,600             | 594,500             |
| Cavalier Homes Inc.                         | 68,400              | 189,537             | 208,839             |
| Citigroup Inc.                              | 7,500               | 146,809             | 415,368             |
| Criimi Mae Inc., REIT                       | 243,484             | 1,421,608           | 3,904,787           |
| Criimi Mae, Class B Preferred               | 24,600              | 497,775             | 813,031             |
| Freddie Mac                                 | 5,000               | 43,771              | 464,668             |
| Global Tech Appliances Inc.                 | 30,000              | 230,418             | 223,796             |
| Hollinger Inc., Retractable Common          | 61,002              | 786,062             | 333,681             |
| IDT Corp., Class B                          | 20,000              | 386,309             | 488,196             |
| Int'l Forest Products Ltd., Class A         | 200,000             | 703,469             | 1,170,000           |
| Orthodontic Centres of America Inc.         | 39,000              | 603,646             | 669,641             |
| Rothmans Canada Inc.                        | 48,600              | 520,084             | 1,405,998           |
| Touch America Holdings Inc.                 | 100,000             | 326,976             | 61,379              |
| Tri-White Corporation                       | 600,000             | 1,204,000           | 1,710,000           |
| Westshore Terminals, Income Trust           | 16,700              | 48,465              | 81,496              |
| World Acceptance Corp.                      | 190,000             | 2,191,066           | 2,275,574           |
|   |                     | <u>16,710,860</u>   | <u>24,231,074</u>   |
| <b>BONDS</b>                                |                     |                     |                     |
| RCN Corp. Senior Notes, 10.125%, 2010       | 2,250,000           | 1,012,420           | 779,037             |
| Time Warner Tele. Senior Notes, 9.75%, 2008 | 1,500,000           | 804,723             | 1,316,100           |
| Worldcom Inc. Senior Notes, 6.5%, 2004      | 5,000,000           | 1,076,390           | 1,809,884           |
| Worldcom Inc. Senior Notes, 8.0%, 2006      | 4,000,000           | 951,452             | 1,447,907           |
|   |                     | <u>3,844,985</u>    | <u>5,352,928</u>    |
| <b>TOTAL</b>                                |                     | <u>\$20,555,845</u> | <u>\$29,584,002</u> |

\* Common Shares Unless Indicated Otherwise.

**CHOU ASSOCIATES FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2002**

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**1. SIGNIFICANT ACCOUNTING POLICIES**

The accounting policies of the Fund conform with Canadian generally accepted accounting principles appropriate to the mutual fund industry. The significant policies are summarized below:

- (a) Investments in securities are recorded at market values based on the year end closing sale price or, if the security did not trade, the closing bid price. The calculation of a gain or loss on a partial disposition of an investment position in a certain security is determined using the average cost of the securities purchased within the investment position.
- (b) Foreign currency amounts have been expressed in Canadian dollars on the financial statements as follows:
  - (i) investments held at the year end are converted at the Bank of Canada rate of exchange on that date; and
  - (ii) purchases and sales of investments as well as income and expenses throughout the year are recorded at the Bank of Canada exchange rate prevailing on the respective dates of such transactions.
- (c) The Fund qualifies as a unit trust under the provisions of the Income Tax Act (Canada) and accordingly is subject to tax on income, including net realized capital gains, for the calendar year which is not paid or payable to unit holders as at the end of the calendar year. It is the policy of the Fund to pay out all net income and net realized capital gains so that the Fund will not be subject to income taxes other than foreign withholding taxes, if applicable. The accounting policies of the Fund conform with Canadian generally accepted accounting principles appropriate to the mutual fund industry. The significant policies are summarized below:

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**2. UNITS OF THE FUND**

The units of the Fund are voting, without any par value and an unlimited number may be issued. All units must be fully paid and fractional units may be issued.

|  | <u>2002</u>      | <u>2001</u>     |
|--|------------------|-----------------|
| Units outstanding, beginning of the year     | 295,800          | 273,496         |
| Add: Units issued during the year            | 915,390          | 15,131          |
| Deduct: Units redeemed during the year       | <u>(5,732)</u>   | <u>(15,051)</u> |
| Units outstanding before income distribution | 1,205,458        | 273,576         |
| Add: Units issued on reinvested income       | <u>55,521</u>    | <u>22,224</u>   |
| Units outstanding, end of the year           | <u>1,260,979</u> | <u>295,800</u>  |

**CHOU ASSOCIATES FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2002**

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**3. MANAGEMENT FEES**

Chou Associates Management Inc. (“the Manager”) manages the Fund under a management agreement dated September 1, 1986. The Manager is entitled to a fee calculated on a percentage of the market value of net assets not to exceed 0.125% per month.

For the current year, the Manager has charged the Fund a fee of \$408,615 (2001 - \$204,000) which represents 1.50% (2001 - 1.49%) of the average net assets during the year.

The following summarizes the expenses, relating to the management of the Fund, including any GST paid but not reclaimable.

|                                       | <u>2002</u>   | <u>2001</u>   |
|---------------------------------------|---------------|---------------|
| Investment counselling fees           | \$ 437,218    | \$ 218,280    |
| Other expenses                        | <u>71,168</u> | <u>56,369</u> |
| Total                                 | \$ 508,386    | \$ 274,649    |
| Management expense ratio              | 1.87%         | 2.02%         |
| Management expense ratio (net of GST) | 1.74%         | 1.88%         |

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**4. BROKERS’ COMMISSIONS**

Total commissions paid to brokers in connection with portfolio transactions for the year ended December 31, 2002 were \$83,440 (2001 - \$44,076).

**CHOU ASSOCIATES FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2002**

**5. PERFORMANCE OF FUND**

| <b>December 31</b>                                  | <b>2002</b> | <b>2001</b> | <b>2000</b> | <b>1999</b> | <b>1998</b> |
|---|-------------|-------------|-------------|-------------|-------------|
| Net Asset Value per unit,<br>Beginning of year      | \$52.07     | \$46.36     | \$46.08     | \$52.07     | \$45.76     |
| Income from investment operations:                  |             |             |             |             |             |
| Net investment income                               | 0.51        | 1.70        | 3.31        | 0.22        | 1.49        |
| Net realized and unrealized gains<br>on investments | 15.10       | 8.24        | 0.55        | -5.23       | 9.13        |
| Total income from investment                        | 15.61       | 9.94        | 3.86        | -5.01       | 10.62       |
| Less distributions:                                 |             |             |             |             |             |
| Dividends from net investment income                | 0.51        | 1.70        | 3.31        | 0.22        | 1.49        |
| Distribution from net realized gains                | 2.50        | 2.53        | 0.27        | 0.76        | 2.82        |
| Total distributions                                 | 3.01        | 4.23        | 3.58        | 0.98        | 4.31        |
| Net Asset Value per unit,<br>End of year            | \$64.67     | \$52.07     | \$46.36     | \$46.08     | \$52.07     |
| Total return  | 29.99%      | 21.44%      | 8.37%       | -9.63%      | 23.22%      |
| Net Assets, end of year (in thousands)              | \$81,549    | \$15,403    | \$12,680    | \$12,216    | \$13,046    |
| Management Expense Ratio (MER)                      | 1.87%       | 2.02%       | 2.00%       | 1.85%       | 2.11%       |
| Portfolio turnover rate                             | 43.10%      | 38.90%      | 23.80%      | 11.00%      | 25.90%      |

## CHOU RRSP FUND

May 6, 2003

Dear Unitholders of Chou RRSP Fund,

After the dividend distribution of \$2.53, the net asset value (NAV) of Chou RRSP Fund at December 31, 2002 was \$23.08, up 31.85% 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 RRSP Fund       | 31.9%  | 21.6%  | 14.7%  | 16.2%   | 12.7%   |
| 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, Tri-White and Akita Drilling, 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. A case in point is 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 and RCN senior notes).

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 (senior notes 10.125%, 2010) at about \$28.50, year-end price \$22
- 4) Worldcom (senior notes 7.55%, 2004) at about \$15, year-end price \$23
- 5) Elan (0% debentures, 2018) at about \$27, sold at \$48

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 about 9.4% of the Fund assets in Criimi Mae (common and preferred shares combined) and about 8.6% in Elan debentures. 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 (sister fund of Chou RRSP Fund) and will invest a further \$50 million in Chou Associates 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 1.83%. 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 \$200 million, a figure that far exceeds our current net

assets. This amount is subject to further review.

2) The \$200 million figure must be put in perspective; in the Canadian market today, a company with \$500 million in market capitalization (cap) is considered small cap.

3) 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.

As at May 2, 2003, the NAV was \$23.63 and the cash equivalents were 56.8% of assets. The Fund is up 2.4% from the beginning of the year.

Yours truly,



Francis Chou  
Fund Manager

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## AUDITORS' REPORT

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To the Trustee and the Unitholders of  
Chou RRSP Fund

We have audited the statement of net assets of Chou RRSP Fund (“the Fund”) as at December 31, 2002 and 2001, the statements of income and changes in net assets for the years then ended and the statement of investments as at December 31, 2002. These financial statements are the responsibility of the Fund’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2002 and 2001, its results of operations and changes in net assets for the years then ended and its investment portfolio as at December 31, 2002, in accordance with Canadian generally accepted accounting principles.



Chartered Accountants

Markham, Ontario  
February 20, 2003

# CHOU RRSP FUND

## STATEMENT OF NET ASSETS

AS AT DECEMBER 31, 2002

|  | 2002              | 2001             |
|--|-------------------|------------------|
| <b>ASSETS</b>  |                   |                  |
| Cash and treasury bills  | \$ 6,713,546      | \$ 622,693       |
| Accounts receivable  | 685,527           | 27,192           |
| Investments at market value (average cost<br>2002 - \$6,590,642; 2001 - \$4,154,021) | <u>8,508,274</u>  | <u>5,085,951</u> |
|  | <u>15,907,347</u> | <u>5,735,836</u> |
| <b>LIABILITIES</b>   |                   |                  |
| Accounts payable and accrued charges   | 46,852            | 20,612           |
| Dividend payable   | <u>1,009</u>      | <u>-</u>         |
|  | <u>47,861</u>     | <u>20,612</u>    |
| <b>NET ASSETS AT MARKET VALUE</b>  | \$ 15,859,486     | \$ 5,715,224     |
| <b>NET ASSETS ATTRIBUTABLE TO UNITHOLDERS</b>  |                   |                  |
| Capital  | \$ 13,941,854     | \$ 4,783,294     |
| Unrealized appreciation in the value of investments                                  | <u>1,917,632</u>  | <u>931,930</u>   |
|  | \$ 15,859,486     | \$ 5,715,224     |
| <b>NUMBER OF UNITS OUTSTANDING</b> (Note 2)  | 687,280           | 294,264          |
| <b>NET ASSET VALUE PER UNIT</b>  | \$ 23.08          | \$ 19.42         |

APPROVED ON BEHALF OF THE BOARD OF DIRECTORS  
OF THE MANAGEMENT COMPANY

*Francis Chou*  
*Tracy Chou*

# CHOU RRSP FUND

## STATEMENT OF INCOME

FOR THE YEAR ENDED DECEMBER 31, 2002

|  | 2002             | 2001           |
|--|------------------|----------------|
| <b>INCOME</b>  |                  |                |
| Interest   | \$ 241,116       | \$ 84,158      |
| Dividends  | 217,543          | 84,016         |
|  | <u>458,659</u>   | <u>168,174</u> |
| <b>EXPENSES</b>  |                  |                |
| Management fees (Note 3)   | 152,042          | 83,460         |
| Custodian fees   | 11,253           | 11,986         |
| Filing fees  | 5,740            | 2,517          |
| Legal  | 2,000            | 2,266          |
| Audit  | 1,999            | 4,825          |
| Foreign withholding tax  | 11               | 76             |
|  | <u>173,045</u>   | <u>105,130</u> |
| <b>NET INVESTMENT INCOME</b>   | 285,614          | 63,044         |
| <b>REALIZED GAIN FROM INVESTMENTS SOLD</b>   | <u>1,283,035</u> | <u>132,526</u> |
| <b>NET INCOME FROM OPERATIONS</b>  | \$ 1,568,649     | \$ 195,570     |
| <b>NET INVESTMENT INCOME PER UNIT</b> (based upon the<br>number of units outstanding at the year end prior to invested<br>distributions of income) | \$ 0.46          | \$ 0.22        |
| <b>REALIZED GAIN PER UNIT</b>  | \$ 2.07          | \$ 0.47        |
| <b>NET INCOME PER UNIT</b>   | \$ 2.53          | \$ 0.69        |

## CHOU RRSP FUND

### STATEMENT OF CHANGES IN NET ASSETS

FOR THE YEAR ENDED DECEMBER 31, 2002

|   | <b>2002</b>       | <b>2001</b>      |
|---|-------------------|------------------|
| <b>NET ASSETS</b> , beginning of the year       | \$ 5,715,224      | \$ 4,807,903     |
| <b>INCREASED BY</b>                             |                   |                  |
| Net investment income                           | 285,614           | 63,044           |
| Net realized capital gains on investments sold  | 1,283,035         | 132,526          |
| Unrealized appreciation in value of investments | 985,702           | 406,778          |
| Decrease in covered call options                | -                 | 214,467          |
| Reinvested distributions                        | 1,567,640         | 195,570          |
| Proceeds from sale of units                     | <u>8,674,046</u>  | <u>400,528</u>   |
|   | <u>12,796,037</u> | <u>1,412,913</u> |
|   | <u>18,511,261</u> | <u>6,220,816</u> |
| <b>DECREASED BY</b>                             |                   |                  |
| Payments on redemption of units                 | 1,084,135         | 310,022          |
| Distribution of income to unitholders           | <u>1,567,640</u>  | <u>195,570</u>   |
|   | <u>2,651,775</u>  | <u>505,592</u>   |
| <b>NET ASSETS</b> , end of the year             | \$ 15,859,486     | \$ 5,715,224     |

**CHOU RRSP FUND**  
**STATEMENT OF INVESTMENTS**  
**AS AT DECEMBER 31, 2002**

|   | Number of<br>Shares | Average<br>Cost           | Market<br>Value           |
|---|---------------------|---------------------------|---------------------------|
| <b>SHARES*</b>                          |                     |                           |                           |
| Accord Financial Corp.                  | 8,600               | \$42,749                  | \$42,226                  |
| Akita Drilling Ltd., Class A            | 20,000              | 137,003                   | 419,000                   |
| BMTC Group Inc., Class A                | 85,200              | 419,799                   | 1,222,620                 |
| Caldwell Partners Int'l Inc., Class A   | 162,900             | 437,235                   | 236,205                   |
| Criimi Mae Inc., REIT                   | 24,495              | 149,591                   | 392,830                   |
| Criimi Mae Inc., Class B Preferred      | 18,600              | 410,171                   | 614,731                   |
| Criimi Mae Inc., Class F Preferred      | 7,200               | 81,988                    | 104,249                   |
| Discovery Capital Corp.                 | 396,500             | 71,218                    | 47,580                    |
| Glacier Ventures Int'l Corp.            | 215,228             | 173,043                   | 290,558                   |
| Hollinger Inc., Retractable Common      | 20,672              | 267,679                   | 113,076                   |
| Int'l Forest Products Ltd., Class A     | 204,800             | 838,727                   | 1,198,080                 |
| Leons Furniture Ltd.                    | 4,000               | 79,725                    | 122,000                   |
| Liquidation World Inc.                  | 30,200              | 161,191                   | 161,570                   |
| MFP Financial Services Ltd.             | 8,900               | 54,102                    | 64,525                    |
| Moveitonline Inc.                       | 394,100             | 141,876                   | 118,230                   |
| MRRM Inc.                               | 6,650               | 334,162                   | 412,300                   |
| Net2phone Inc.                          | 22,700              | 176,342                   | 144,688                   |
| Rainmaker Income Fund                   | 264,700             | 870,863                   | 587,634                   |
| Rothmans Canada Inc.                    | 13,200              | 299,748                   | 381,876                   |
| Tri-White Corporation                   | 255,000             | 504,600                   | 726,750                   |
| Westshore Terminals, Income Trust       | 85,700              | 245,467                   | 418,216                   |
| Zonagen Inc.                            | 100,000             | 236,083                   | 154,234                   |
|   |                     | <u>6,133,362</u>          | <u>7,973,178</u>          |
| <b>BONDS</b>                            |                     |                           |                           |
| RCN Corp Senior Notes, 10.125%, 2010    | 500,000             | 227,644                   | 173,119                   |
| Worldcom Inc. Senior Notes, 7.55%, 2004 | 1,000,000           | 229,635                   | 361,977                   |
|   |                     | <u>457,279</u>            | <u>535,096</u>            |
| <b>TOTAL</b>                            |                     | <u><u>\$6,590,641</u></u> | <u><u>\$8,508,274</u></u> |

\* Common Shares Unless Indicated Otherwise.

# CHOU RRSP FUND

## NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 2002

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### 1. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the Fund conform with Canadian generally accepted accounting principles appropriate to the mutual fund industry. The significant policies are summarized below:

- (a) Investments in securities are recorded at market values based on the year-end closing sale price or, if the security did not trade, the closing bid price. The calculation of a gain or loss on a partial disposition of an investment position in a certain security is determined using the average cost of the securities purchased within the investment position.
- (b) Foreign currency amounts have been expressed in Canadian dollars on the financial statements as follows:
  - (i) investments held at the year end are converted at the Bank of Canada rate of exchange on that date; and
  - (ii) purchases and sales of investments as well as income and expenses throughout the year are recorded at the Bank of Canada exchange rate prevailing on the respective dates of such transactions.
- (c) The Fund qualifies as a unit trust under the provisions of the Income Tax Act (Canada) and accordingly is subject to tax on income, including net realized capital gains, for the calendar year which is not paid or payable to unit holders as at the end of the calendar year. It is the policy of the Fund to pay out all net income and net realized capital gains so that the Fund will not be subject to income taxes other than foreign withholding taxes, if applicable.

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### 2. UNITS OF THE FUND

The units of the Fund are voting, without par value and an unlimited number may be issued. All units must be fully paid for and fractional units may be issued.

|  | <u>2002</u>     | <u>2001</u>     |
|--|-----------------|-----------------|
| Units outstanding, beginning of the year     | 294,264         | 279,772         |
| Add: Units issued during the year            | 373,309         | 21,197          |
| Deduct: Units redeemed during the year       | <u>(48,228)</u> | <u>(16,774)</u> |
| Units outstanding before income distribution | 619,345         | 284,195         |
| Add: Units issued on reinvested income       | <u>67,935</u>   | <u>10,069</u>   |
| Units outstanding, end of the year           | <u>687,280</u>  | <u>294,264</u>  |

## CHOU RRSP FUND

### NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 2002

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#### 3. MANAGEMENT FEES

Chou Associates Management Inc. ("the Manager") manages the Fund under a management agreement dated September 1, 1986. The Manager is entitled to a fee calculated on a percentage of the market value of net assets not to exceed 0.125% per month.

For the current year, the Manager has charged the Fund a fee of \$142,095 (2001 - \$78,000) which represents 1.50% (2001 - 1.49%) of the average net assets during the year.

The following summarizes the expenses relating to the management of the Fund, including any GST paid but not reclaimable.

|                                       | <u>2002</u>   | <u>2001</u>   |
|---------------------------------------|---------------|---------------|
| Management fees                       | \$ 152,042    | \$ 83,460     |
| Other expenses                        | <u>20,992</u> | <u>21,594</u> |
| Total                                 | \$ 173,034    | \$ 105,054    |
| Management expense ratio              | 1.83%         | 2.01%         |
| Management expense ratio (net of GST) | 1.71%         | 1.87%         |

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#### 4. BROKERS' COMMISSIONS

Total commissions paid to brokers in connection with portfolio transactions for the year ended December 31, 2002 were \$36,863 (2001 - \$10,859).

**CHOU RRSP FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2002**

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**5. PERFORMANCE OF FUND**

| <b>December 31</b>                                  | <b>2002</b> | <b>2001</b> | <b>2000</b> | <b>1999</b> | <b>1998</b> |
|---|-------------|-------------|-------------|-------------|-------------|
| Net Asset Value per unit,<br>Beginning of year      | \$19.42     | \$17.18     | \$15.69     | \$17.68     | \$20.25     |
| Income from investment operations:                  |             |             |             |             |             |
| Net investment income                               | 0.46        | 0.22        | 0.87        | 0.33        | 0.92        |
| Net realized and unrealized gains<br>on investments | 5.73        | 2.71        | 1.72        | -1.52       | 2.83        |
| Total income from investment                        | 6.19        | 2.93        | 2.59        | -1.19       | 3.75        |
| Less distributions:                                 |             |             |             |             |             |
| Dividends from net investment income                | 0.46        | 0.22        | 0.87        | 0.33        | 0.92        |
| Distribution from net realized gains                | 2.07        | 0.47        | 0.23        | 0.47        | 5.40        |
| Total distributions                                 | 2.53        | 0.69        | 1.10        | 0.80        | 6.32        |
| Net Asset Value per unit,<br>End of year            | \$23.08     | \$19.42     | \$17.18     | \$15.69     | \$17.68     |
| Total return  | 31.85%      | 17.04%      | 16.52%      | -6.71%      | 18.54%      |
| Net Assets, end of year (in thousands)              | \$15,859    | \$5,715     | \$4,808     | \$4,045     | \$2,546     |
| Management Expense Ratio (MER)                      | 1.83%       | 2.01%       | 2.12%       | 1.74%       | 2.26%       |
| Portfolio turnover rate                             | 33.20%      | 25.80%      | 25.60%      | 5.10%       | 92.80%      |

## Chou RRSP Fund

Illustration of an Assumed Investment of \$10,000

| Period Ended | Value of Initial \$10,000 Investment | Value of Cumulative Reinvested Capital Distribution | Value of Cumulative Reinvested Dividends | Total Value of Shares |
|--------------|--------------------------------------|---|--|-----------------------|
| Dec.31,1987  | \$10,000                             | \$0   | \$0                                      | \$10,000              |
| Dec.31,1988  | 10,731                               | 326   | 296                                      | 11,352                |
| Dec.31,1989  | 11,552                               | 1,009   | 704                                      | 13,265                |
| Dec.31,1990  | 9,290                                | 1,054   | 1,416                                    | 11,761                |
| Dec.31,1991  | 9,361                                | 1,062   | 1,857                                    | 12,280                |
| Dec.31,1992  | 10,089                               | 1,145   | 2,170                                    | 13,404                |
| Dec.31,1993  | 11,639                               | 1,321   | 2,504                                    | 15,464                |
| Dec.31,1994  | 10,151                               | 1,152   | 2,528                                    | 13,831                |
| Dec.31,1995  | 11,787                               | 1,338   | 3,338                                    | 16,463                |
| Dec.31,1996  | 14,363                               | 1,630   | 4,100                                    | 20,093                |
| Dec.31,1997  | 19,993                               | 3,396   | 6,878                                    | 30,267                |
| Dec.31,1998  | 17,456                               | 11,031  | 7,387                                    | 35,874                |
| Dec.31,1999  | 15,498                               | 10,746  | 7,237                                    | 33,480                |
| Dec.31,2000  | 16,964                               | 12,261  | 9,775                                    | 39,001                |
| Dec.31,2001  | 19,173                               | 14,915  | 11,551                                   | 45,640                |
| Dec.31,2002  | 22,780                               | 22,589  | 14,808                                   | <b>60,177</b>         |

Note: 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.

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