

CHOU ASSOCIATES FUND

SEMI-ANNUAL REPORT

JUNE 30, 2002

Chou Associates Fund

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

Statement of Income and Expense For the Six months Ended June 30, 2002

(Unaudited) (Stated in \$ Canadian)	
<u>Income:</u>	
Dividends	\$ 166,239
Interest	<u>139,645</u>
	\$ 305,884
<u>Expense:</u>	
Management fees	157,959
Custodian fees	10,736
Audit & Legal	996
Filing fees	<u>13,774</u>
	\$183,465
Net Investment Income	\$ 122,419
Realized gains	<u>535,902</u>
Total Income	\$658,321
Net Investment Income per Unit	\$ 0.32
Total Income per Unit	\$ 1.74

Chou Associates Fund

Statement of Net Assets
As at June 30, 2002

(Unaudited)	
<u>ASSETS</u>	
Cash and Treasury Bills	\$ 3,819,894
Accounts receivable	219,027
Investment at market value (avg. cost \$11,780,884)	<u>18,767,592</u>
Total Assets	\$22,806,513
Less:	
Accounts payable	51,310
Total Net Assets	\$ 22,755,203
Net Asset Value per Unit	\$ 60.0621
NAVPU, December 31, 2001	\$ 52.0721
Percentage Change from December 31, 2001	+15.3%
Units Outstanding, June 30, 2002	378,861

Chou Associates Fund

Statement of Investments Held As at June 30, 2002

<u>Equity Securities</u>		
Shares-Common*	Number of Shares	Market Value
Akita Drilling, Class A	60,000	\$ 1,020,000
BMTC Group, Class A	259,800	3,637,200
Berkshire Hathaway, Class A	5	506,906
Cable & Wireless	40,000	471,695
Caldwell Partners, Class A	410,000	647,800
Cavalier Homes	68,400	394,476
Citigroup	7,500	441,076
Criimi Mae	243,484	2,730,834
Criimi Mae, Pfd, Class B	24,600	598,106
Freddie Mac	10,000	928,821
Global-Tech Appliances	42,000	312,339
Hollinger Inc. Retractable	60,200	602,000
Homefed Corp.	125,000	172,636
IDT, Class B	20,000	488,693
Int'l Forest Products	200,000	930,000
Rothmans Canada	48,600	1,455,570
Tri-White	600,000	1,740,000
Wesco Financial	1,000	457,733
Westshore Terminals, Income Trust	16,700	101,035
Total Equity Securities		<u>\$17,636,920</u>
<u>Corporate Debt Securities</u>		
Worldcom, 7.55%, 2004	1,000,000	\$ 242,829
RCN, 10.125%, 2010	2,250,000	887,843
Total Corporate Debt Securities		\$ 1,130,672
Investments at market value		\$ 18,767,592
*Common Shares unless otherwise indicated		