It's a bird, it's a plane...

...no, it's mild-mannered Francis Chou, who has quietly become the superman of Canadian mutual funds

BY DUNCAN HOOD

PHOTOGRAPHS BY MACKENZIE STROH

HE HAS ONLY A GRADE 12 EDUCATION AND used to labor as a Bell Canada repairman. He has never worked for a big bank or a mutual fund company. He largely shuns the Courvoisier-chugging Bay Street set. But if you're searching for the best mutual fund manager in Canada, you'll find it difficult to avoid quiet, shy Francis Chou.

Quite simply, Chou's numbers are eye-popping. His flagship, the Chou Associates Fund, has achieved compounded returns of about 16% a year for 24 years, leaving his competitors in the dust. In acknowledgment of his outstanding record, he was named the Morningstar Fund Manager of the Decade at the Canadian Investment Awards in 2004. "The reason he got the award," says Scott Mackenzie, president and CEO of mutual fund research firm Morningstar Canada, "is because he's head and shoulders above anyone else in terms of risk-adjusted performance. That means he not only achieved superior performance, he did it in a way that his results were substantially less volatile than other funds like his."

How did this immigrant from Allahabad, India, who came to Canada back in 1976, beat the best and brightest that Bay Street has to offer? It's not an easy question to answer, because Chou is a very private man. He has granted few interviews over the last 20 years and when he does talk, he avoids discussing his personal life. Chou seems to be mystified as to why anyone would care what his parents did (his father was a professor and his mother a university lecturer), how old he was when his dad died (very young), or how many brothers and sisters he has (one older brother, three younger sisters, all now living in Canada). He sees himself as a regular sort of guy who showed up in Canada at age 20 with $200 in his pocket, landed a job at Bell Canada, and proceeded to become fascinated by the writings of Benjamin Graham, the Wall Street financier widely regarded as father of value investing.

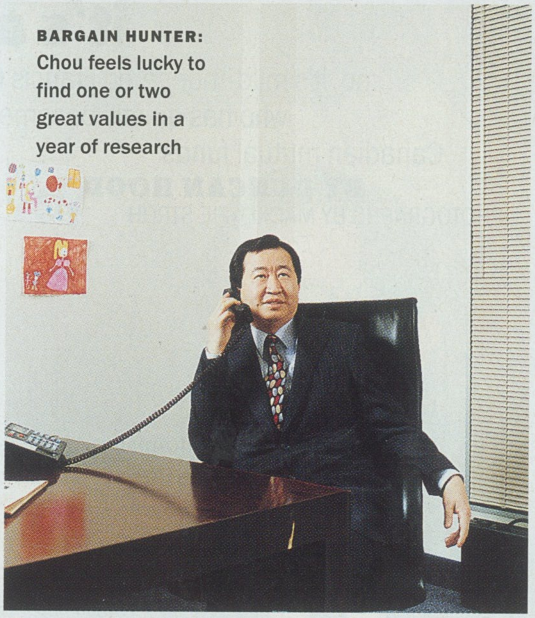
Reading Graham taught Chou that most people buy stocks the wrong way. They get carried away by emotion and buy shares that are rocketing upward. But that strategy is doomed to failure. Think about the mentality of a smart shopper: she doesn't load up on eggs because their price is shooting upward. Instead she looks for bargains. "All you have to do is transfer that mental approach to stocks," Chou says. "But when people buy stocks, instead of looking for bargains, they tend to listen to stories and chase stocks that are going up."

To put his reading into practice, Chou helped launch an investment club at Bell Canada in 1981. He and six co-workers began with a total of $51,000. Five of those original investors are still in the fund to this day, and four of them are now millionaires. In fact, if you had invested just $50,000 with Chou when he turned the investing club into the Associates Fund back in 1982, you would be worth $1.6 million yourself.

His mantra from day one was to always invest with what Graham called a margin of safety. Chou won't buy a stock unless he can get it at a 40% or 50% discount to what he estimates its true value to be. When he began investing in the '80s, he was delighted to find that the market was swimming with such bargains—but he now finds that the obvious deals have disappeared. "As recently as 1999 there were some sectors that you could buy for cheap," Chou says, "but right now, almost all sectors are fairly ➤

valued. The mispricings disappear when there's a lot of money chasing deals."

If that sounds discouraging, keep in mind that Chou is a natural pessimist, and his investors have become used to his annual forecasts of doom and gloom. In his 2004 annual report, for instance, Chou wrote: "In today's climate, almost all sectors are overvalued... We would caution all investors that from these overvalued levels the chances of a large permanent loss of capital are extremely high." He added that the double-digit returns of the past would be "virtually impossible to duplicate." So what kind of return did his Associates fund reap in 2005? A rock-solid 13.7%.



BARGAIN HUNTER: Chou feels lucky to find one or two great values in a year of research

Despite his dire warnings, Chou has been remarkably consistent through good markets and bad. In 24 years of investing, his Associates fund has had only three losing years, and because his strategy doesn't rely on rising markets, his performance has almost no correlation with other funds. For instance, his worst year in recent history (–9.6% in 1999) took place during the tech boom, when most Canadian investors were flying high. After the crash, in 2001 and 2002, he posted successive annual returns of 21.4% and 30%.

Chou applies Graham's value strategy using three tactics. First, he keeps his eyes peeled for what he calls "special situations"—companies facing short-term problems that result in temporary mispricings under unusual circumstances. Second, he likes to buy shares in what he jokingly refers to as CRAP (Cannot Realize A Profit) companies. Chou says the market is prone to overreacting when stocks are heading for the toilet, so failing companies are often irrationally valued for less than they would be worth if they liquidated their assets. He buys baskets of such companies, knowing that he may lose money on three out of 10, but more than make up for those losses with profits on the other seven.

Chou has the ideal personality for a successful value investor. Unlike many Bay Street high-fliers, he is patient, humble and prefers a low profile. "The high IQ, connections, charisma and all that stuff is overrated."

His final tactic is more akin to the way that Warren Buffett invests and it's increasingly Chou's favorite. It entails spending countless hours searching for well-run companies with growth potential that, for some reason, are trading for much less than they're worth. Because the market is so efficient, such companies are extremely rare and often only found among those with short-term problems, but they offer excellent long-term prospects if they're blessed with strong management. Chou is lucky to find one or two during a whole year of searching. But once he's found one, Chou doesn't hesitate to bet 5% or more of his portfolio on that single stock. "When you know you're buying a good company, it's like getting a straight flush," he says. "They're hard to find, so when you've got one, you have to capitalize on it."

Taken together, Chou's three approaches have delivered a very strange portfolio, packed with unfamiliar names and companies most investors wouldn't touch with a barge pole. Just over six months ago, for instance, the troubled retailer Sears Holdings made up a whopping 16% of the equities portion of Chou's Associates Fund. MCI, which is basically the smoldering remains of an imploded WorldCom, was his No. 2 holding, along with Boskalis Westminster, an international dredging contractor that clears mud out of waterways.

What does Chou see in these dogs? As always, a margin of safety. He invested in Sears Holdings, for instance, because most analysts thought Wal-Mart was going to crush the department store chain, so the stock was selling for peanuts. "But I calculated that the real estate holdings alone for Sears were worth more than $40 or $50 (U.S.) a share, and I was able to buy it for just $25 a share," Chou recalls. "Later, the analysts said the real estate was worth more like $75 to $100 a share." A year and a half after Chou bought its stock, Sears was trading for over $120.

Some money managers would crow over a success like Sears, but Chou just shrugs. "If you needed a high IQ to be successful in investing, I'd still be working as a technician at Bell Canada. The high IQ, connections, charisma and all that stuff is overrated."

But there has to be more to it than that. No other fund manager in Canada, and few in the U.S., have matched Chou's long-term performance. George Athanassakos, professor of finance and the Ben Graham Chair in Value Investing at the Richard Ivey School of Business in London, Ont., thinks that Chou might be right: perhaps he's not outperforming because of superior intelligence, better connections or charisma. Maybe it's because Chou's natural disposition just happens to be a perfect match to the investing style he's chosen. "Like other value investors, Francis strikes you as being very humble, very low profile, very quiet. He doesn't beat his chest and say 'I'm the best.' But that's the strength of the value investors: they master their emotions. They're patient. They don't want the world to pay attention to them. They want to invest privately and under the radar." Maybe so. But if Chou keeps posting such stunning results, soon the whole world will be watching. M

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