

## CHOU RRSP FUND

March 13, 2009

Dear Unitholders of Chou RRSP Fund,

After the distribution of \$2.58, the net asset value (“NAVPU” or “NAV”) of a Series A unit of Chou RRSP Fund at December 31, 2008 was \$13.71 compared to \$28.28 at December 31, 2007, a decrease of 42.4%; during the same period, the S&P/TSX Total Return Index decreased 33.0% in Canadian dollars. In \$US, a Series A unit of Chou RRSP Fund decreased 53.2% while the S&P/TSX Total Return Index decreased 45.4%.

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

December 31, 2008 (Series A)	1 Year	3 Years	5 Years	10 Years	15 Years
Chou RRSP (\$CAN)	-42.4%	-16.9%	-5.5%	3.5%	8.2%
S&P/TSX (\$CAN)	-33.0%	-4.8%	4.2%	5.3%	7.1%
Chou RRSP (\$US) <sup>1</sup>	-53.2%	-18.1%	-4.4%	5.9%	8.8%
S&P/TSX (\$US)	-45.4%	-6.0%	5.6%	7.8%	7.6%

Rates of return are historical total returns including changes in unit prices and assume the reinvestment of all distributions. These annual compounded returns do not take into account any sales charges, redemption fees, other optional expenses or income taxes that you have to pay and which could reduce these returns. The returns are not guaranteed. The Fund’s past performance does not necessarily indicate future performance. The table is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of the mutual funds or returns on the mutual funds. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing.

### Factors Influencing the 2008 Results

**CANADIAN DOLLAR:** The weakness of the Canadian dollar against the U.S. dollar had a positive impact on the results of the Fund. However, we did not receive the full benefit from the weakening of the Canadian dollar. The reason was that we had entered into a currency contract for 26% of the portfolio against the rise of the Canadian dollar versus the U.S. dollar. The currency contract cost the Fund approximately \$9.8 million. Had we not contracted against the Canadian dollar, the performance of the Fund, though still negative, would have been better. The returns would have been approximately -38% instead of the -42.4%. The -38% is not an absolutely correct number because it does not incorporate the purchases and redemptions of the Fund over the contract period. Even though the number may not be exact, it does give a more accurate assessment of how the portfolio of the Fund performed for the year 2008.

**INVESTING TOO EARLY:** One of the hazards of being a value investor is that every now and then you are bound to buy stocks too early. Over the last few years, we have communicated through our letters, our deep concern about the easy credit, irresponsible lending, housing bubble and the

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<sup>1</sup>The alternative method of purchasing Chou RRSP 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 RRSP Fund (\$CAN). The investments in the Chou RRSP Fund (\$CAN) are the same as the investments in Chou RRSP Fund (\$US) except for the currency applied.

potential dangers of derivatives like CDOs (collateralized debt obligations) impacting financial companies. As pessimistic as we were over the years, we did not anticipate how severely these factors would paralyze and cripple the financial system when the bubble did burst. There was no place to hide.

And so, based on the information we had in 2007, we purchased some stocks at prices that, in hindsight, were too high. The ensuing economic crisis, credit freeze and deleveraging severely impacted the intrinsic values of some of the stocks we purchased. As you may be aware, the intrinsic value is based on the sustainability of earning power and when it is negatively impacted by any severe economic crisis, the intrinsic value is impacted also. As a consequence, we suffered a permanent loss of capital investing in those companies.

While the stock prices of other companies we bought too early declined with the economic crisis, their fundamentals were not impaired. We expect these companies to do quite well in the future. We classify such losses as a temporary quotational loss of capital and not a permanent loss of capital. A unitholder facetiously said that we suffered from a severe case of premature accumulation.

As you can see, we cannot forecast the market. Speaking from hindsight, perhaps, we could have done a better job of safeguarding capital but most likely, if we were given the same information as we had in 2007, we would have made substantially the same investment decision as we did then.

Major positive contributors to the Fund's performance were King Pharmaceuticals and Symetra. Conversely, we suffered significant price declines in CanWest Global, Torstar, Danier Leather, TVA Group, Rainmaker Entertainment, International Forest Products, and debt securities of Abitibi and Hollinger.

### **Repricing of Risk**

At the time of writing two years ago, preservation of capital was given little consideration. However, in 2008 there was a huge repricing of risk. For example, the greater the probability of permanent loss of capital, the greater the spread should be between a particular debt instrument and risk-free treasuries. Currently the spreads between the higher risk securities and U.S. treasuries are at near historic highs. Other indicators are showing that investors are running scared, and banks and financial institutions are hoarding capital instead of lending. The following are some examples:

- 1) Two years ago, the spread between U.S. corporate high yield debt and U.S. treasuries was 311 basis points; a year ago it was 800 basis points. Currently, it is over 1,600 basis points, down from its peak of over 1,900 basis points in December 2008. (Source: JP Morgan).
- 2) Two years ago, the spread between U.S. investment grade bonds and U.S. treasuries was approximately 85 basis points; a year ago it was approximately 274 basis points. It is now over 550 basis points, which is slightly down from its peak of 592 basis points in December 2008. (Source: JP Morgan).
- 3) In December 2008, an auction of 4 week treasury bills ended with a 0% yield (currently they are yielding 8 basis points or 0.08%). The yield on 10 year treasury is 2.94% (up from 2% in December 2008) but down from 4.75% two years ago. In September 1981, it was 15.3%.

- 4) Today, investment bankers and anyone working for the financial/investment industry are considered the new pariahs of society. They are the butt of jokes. My favorite one is, 'What is the difference between an investment banker and a pigeon'? 'At least a pigeon can still put a deposit on a house'.

The examples show that the pricing of risk has changed 180 degrees from a couple of years ago. One can argue that corporate bonds, both investment grade and non-investment grade, are mispriced more than equities. In addition, if corporate bonds are cheap, the treasuries are in bubble territory. In our opinion, this is the worst time to hold cash and short-term treasuries unless you believe we are headed into a 1930's style depression. If you believe that you should redeem all of your Fund units.

### **General Comments on the Market**

**ZOMBIE COMPANIES:** The Fed and the U.S. government have a tough job in tackling the financial crisis and, whatever actions they take, they are scrutinized, criticized and/or second guessed. There is no one perfect approach. Every approach has its pros and cons. However, where zombie companies are concerned, we would prefer to give companies that are insolvent and failing the opportunity to reorganize and restructure their capital structure in an organized way. When they do emerge from reorganization, they will come out leaner and stronger. What we are seeing now is that the U.S. government has pledged \$9.7 trillion (and still counting) to counter the financial crisis. Billions of dollars have been given to prop up failing financial institutions and still they are asking for more financial assistance. The requests from the very large financial institutions are not based on business and investment merit but more on the line that if they don't receive more bailout money, they would have to file for bankruptcy and that would precipitate a chain reaction that will totally paralyze not only the U.S. financial system but also the entire Western banking system. The sooner we recapitalize the zombie companies in some form or the other (including nationalization for a short-term period) the quicker we can unfreeze the credit market and get the economy moving again.

**MARK-TO-MARKET ACCOUNTING:** We have been hearing of late that the current financial mess is caused in part by mark-to-market accounting. Nothing could be further from the truth. The financial mess was caused by misguided policies and actions on the part of some companies and would have occurred regardless of whether this accounting rule was in place or not. As investors, we prefer transparency and clarity and unless these rules exist, companies will not disclose what the assets are currently worth in the market. Obviously, when there are extenuating circumstances like the period we are in now, good and toxic assets may be priced at unduly low prices. In such a case, we would favour a provision that gives companies some grace period before they have to take action to shore up their balance sheets either through asset sales or by raising capital. In the end, transparency should prevail over opaqueness and undisclosed market values in the financial statements.

**INFLATION:** Almost all governments whose economies have been adversely affected by the financial crisis have been providing all kinds of liquidity including printing money to minimize the impact of the credit freeze on their economies. Historically, that is how nations have tackled their debt burden and this episode is no different. In the short term it may work, as the liquidity will counter some of the deleveraging and credit freeze in today's crisis. But longer term such actions can bring huge unintended consequences including the return of high inflation and the likely debasement of the U.S. currency. We don't know the timing of it but all that excess liquidity will have to go somewhere when normal times return.

**MORE REGULATION:** Yes, we will have a more regulated environment going forward. You can bet your last dollar on it. There is a need for regulatory reforms to ensure that, in the future, the near collapse of the world financial system does not happen again. And more regulation of financial institutions will most certainly lower their future growth and profitability.

We need to also get away from the notion of 'too big to fail'. Failing financial companies have used this excuse to hold us ransom in giving them financial assistance.

**PENSION ASSETS:** Most corporate pension plans have a majority of their assets invested in equities. With the markets down at least 40% across the world, we can safely assume that pension assets are down significantly. Eventually, companies have to make up the shortfall of their underfunded pension assets and therefore, their cash flow and earnings will take a significant hit in the future.

**RECOVERY OF THE STOCK MARKET AND ECONOMY:** The economy may get worse before it gets better. However, I have strong faith in the strength and resilience of a free market system. In the 20th century, the standard of living went up seven times in spite of the Great Depression, two World Wars, the oil embargo in the 1970s, interest rates of 15% or more to combat inflation and so on. The current financial crisis is severe, probably not as bad as the Great Depression, but worst of all the recessions in the 20th century. One unitholder said, 'This market feels worse than a divorce. You lose 50% of your assets and you still have your spouse'.

The good news is, if one wants to look at the current situation in a contrarian manner, most of the bad news is already reflected in the stock prices. We don't know whether the stock market has hit bottom yet but we suspect that when we look back at the current environment 10 years from now, we will classify this as one of the best periods for buying stock and debt securities.

**BANKING SECTOR:** Banks that have not been affected by the financial crisis will do quite well in the future. With the governments driving the treasuries to yield nearly 0%, the spread between what the banks are paying for deposits and borrowings in the market (like FDIC insured), and what they can lend at is enormous. For the first time in many years, banks are being paid handsomely for the risks they are taking. See the section under 'Repricing of Risk'.

**CREDIT DEFAULT SWAPS (CDS):** In general, the CDSs are way overpriced. What a dramatic difference from two years ago. To give you some sense of perspective, in October 2002, the 5 year CDS of General Electric Company was quoted at an annual price of 110 basis points. Two years ago, it was quoted at an annual price of 8 basis points and lately it is priced at over 900 points.

Some pricing in the CDS market is absurd. Barrons (March 9, 2009) reported that, 'A Merrill Lynch analyst Friday noted it was more costly to protect oneself from the possibility of a default by Berkshire Hathaway (ticker: BRKA) than one by Vietnam. And General Electric (GE) CDS prices outstripped those of Russia -- a country that a dozen years ago actually did default on its foreign debt'.

### **Other Matters**

**FOREIGN CURRENCY CONTRACT:** None existed as at December 31, 2008.

WAIVER AND REBATE OF MANAGEMENT FEE: Almost all management fees, net of trailer fees paid, were rebated for 2008 and all prior years for Chou Europe Fund since its inception in September, 2003.

The Manager waived approximately 77% of the management fees for 2008, net of trailer fees paid, for Chou Bond Fund.

The decision to waive or rebate the management fees, in whole or in part, is reviewed annually and determined at the discretion of the Manager without notice to unitholders.

U.S. DOLLAR VALUATION: Any investor who wishes to purchase the Chou Funds in \$US is now able to do so.

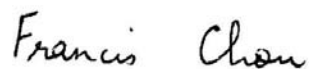
REDEMPTION FEE: We have a redemption fee of 2% if unitholders redeem their units in less than two years. None of this fee goes to the Fund Manager. It is put back into the Fund for the benefit of the remaining unitholders.

INDEPENDENT REVIEW COMMITTEE: The Manager has established an IRC as required by NI 81-107. The members of the IRC are Sandford Borins, Bruce Kerr and Joe Tortolano. The 2008 IRC Annual Report is available on our website [www.choufunds.com](http://www.choufunds.com).

As of March 13, 2009, the NAV of a Series A unit of the Fund was \$12.46 and the cash position was 1% of net assets. The Fund is down 9.1% from the beginning of the year. In \$US, it is down 13%.

Except for the performance numbers of the Chou RRSP Fund, this 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,

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

Francis Chou  
Fund Manager

## CHOU RRSP FUND

March 12, 2008

Dear Unitholders of Chou RRSP Fund,

After the distribution of \$2.42, the net asset value (“NAVPU” or “NAV”) of a Series A unit of Chou RRSP Fund at December 31, 2007 was \$28.28 compared to \$33.83 at December 31, 2006, a decrease of 9.3%, while the S&P TSX Total Return Index returned 9.8%. In \$US, the Fund returned 6.9% for Series A units while the S&P/TSX Total Return Index returned 29.1%.

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

December 31, 2007 (Series A unit)	Past Year	Past 3 Years	Past 5 Years	Past 10 Years	Past 15 Years
Chou RRSP Fund(\$Cdn)	-9.3%	4.8%	7.8%	11.2%	13.3%
S&P TSX (\$Cdn)	9.8%	16.9%	18.3%	9.5%	12.1%
Chou RRSP Fund(\$US) <sup>2</sup>	6.9%	11.8%	18.3%	15.3%	15.2%
S&P TSX (\$US)	29.1%	24.7%	29.8%	13.5%	13.9%

Rates of return are historical total returns including changes in unit prices and assume the reinvestment of all distributions. These annual compounded returns do not take into account any sales charges, redemption fees, other optional expenses or income taxes that you have to pay and which could reduce these returns. The returns are not guaranteed. The Fund's past performance does not necessarily indicate future performance.

### Factors influencing the 2007 results

**Canadian Dollar:** The strength of the Canadian dollar against the U.S. dollar, the pound sterling, and the Euro had the biggest negative impact on the results of the Fund. The dramatic difference in performance results between the net asset value per unit (NAVPU) priced in Canadian dollars, versus U.S. dollars, is attributable to the fact that on December 31, 2006, one U.S. dollar was worth approximately \$1.17 Canadian, whereas one year later, on December 31, 2007, one U.S. dollar was worth approximately \$0.99 Cdn. Even if the price of an American security remained the same in 2007, it would have nonetheless shown a depreciation of roughly 15.1% at year end when priced in Canadian dollars. Similarly, a security denominated in the pound sterling and the Euro would have depreciated by roughly 13.5% and 6.1% respectively.

For the year 2007, the average monthly assets held by the Fund in non-Canadian securities was 46.4%. As such, the strength of the Canadian dollar had a significant impact on the Fund's results.

**Round Trips:** For the year 2007 we took more than our fair share of “round trips.” Some of the undervalued stocks we bought did appreciate to close to fair value, but unfortunately we hung on for

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<sup>2</sup>The alternative method of purchasing Chou Associates Fund in \$US has been offered since September 2005. Performance for years prior to September 2005 is based on the \$US equivalent conversion of the results of the Chou Associates Fund(\$Cdn). The investments in the Chou Associates Fund (\$Cdn) are the same as the investments in Chou Associates Fund(\$US) except for the currency applied.

too long. In hindsight, it would have been better to sell them rather than wait for the last 5% to 10% of appreciation which would have brought them right up to fair value.

Major positive contributors to the Fund's performance were Danier Leather, Berkshire Hathaway and BMTC Group. We suffered declines in King Pharmaceuticals, Biovail Corporation, Liquidation World, CanWest Global Communications and Hollinger debts.

### **Hedging Currency for the long term**

We are long term investors and, in general, our bias has been to concentrate on stock selections and not worry about currency fluctuations. With years like 2007, the question arises as to whether there have been major disparities in annualized returns over the long term between a hedged portfolio and an unhedged portfolio; in other words, does one offer more advantageous performance results during currency fluctuations? Two studies, one covering the period from 1975 through 1988 and the other from 1988 through 2003, confirm that with respect to the long term there have been no material differences in returns.

The study for the period from 1975 to 1988 was conducted by Lee Thomas, and presented in a paper titled "The Performance of Currency – Hedged Foreign Equities". I first read about his findings in an article written by Tweedy Browne, a famous value investment firm in the United States. Excerpts from the Tweedy Browne article appear below.

"A study by Lee Thomas, 'The Performance of Currency – Hedged Foreign Equities', examined the performance of equities in Germany, France, Canada, the United Kingdom, Japan and Switzerland from 1975 through 1988, comparing unhedged results to hedged results for a U.S. dollar investor. These six stock markets accounted for about 88% of the world market capitalization, excluding the United States. The study used FT-Actuaries Indices returns, included dividends and assumed that the beginning of each month the investor hedged by selling forward (for U.S. dollars) for one-month delivery the foreign currency value of his equity shares. Over the 1975 through June 1988 study period, the compounded annual returns on hedged and unhedged foreign equities were **16.4%** and **16.5%** respectively."

The study for the period from 1988 to 2003 was done by Meir Statman, and Glenn Klimek, Professor of Finance at Santa Clara University. They wrote, "We examined hedged and unhedged portfolios during 1988 - 2003 and find that their realized returns and risk were virtually identical. Portfolio managers who care about the risk and expected returns of policy portfolios could have chosen to hedge or not to hedge by the toss of the coin. The mean monthly returns of unhedged global portfolios were higher than those of hedged ones in eight of the 16 years from 1988 through 2003 and lower in the other eight.... The **8.53%** mean annualized return of the unhedged global portfolio was slightly lower than the **8.60%** mean annualized return of the hedged portfolio during the overall 1988-2003 period."

While the effect on long term results may be statistically insignificant, on a year-to-year basis, currency swings can truly distort results. These swings can be heart stopping, particularly for our unitholders, and especially when the currency goes against them. This was evident with the Fund in 2007. But in this situation the reactions were mixed. We received a number of calls regarding the results. Investors from Niagara Falls on the U.S. side of the border were quite pleased with the 2007

performance (+6.9%), whereas investors just half a mile away, in Niagara Falls, Canada, expressed concerns about the Fund's performance (-9.3%).

We don't know what the true value of the Canadian dollar is vis-à-vis the U.S. dollar but we would hazard a guess that it is somewhere between 80 cents and \$1.20. Therefore, we believe that the Canadian dollar is trading in the range of fair value. However, on a short term basis, it is subject to many variables such as the current price of energy, monetary and fiscal policies of both countries, carry trades by currency speculators (they can swing it either way by 30%) and so on.

When deciding to hedge vs. not hedge, it is only in hindsight that there can ever be certainty that the right decision was made. It is virtually impossible to sustain any reliable degree of success in predicting which way to go. When measured on a year to year basis we have been wrong in the past and it is likely that we will be wrong again in the future. But there is little need for concern. The ramifications of such hedging decisions should only affect short term performance results for the Fund. We are long term investors and therefore, over the long term, whether we 'got it right' or not should be immaterial.

Our bias at this time is 'not' to hedge because we believe that the Canadian dollar is trading in the range of fair value. In the long run, it will be influenced significantly by energy prices. Based on the latest trade figures, Canada's trade with the world is at a deficit net of energy. With the dollar at parity with the U.S. dollar all the numbers from exports, tourism, manufacturing and retail sales look appalling when compared to last year. The only time where we may be inclined to hedge the currency is during a period of extreme undervaluation. So for now, be prepared for a bit of a bumpy ride, and some extra volatility, but take into account the results of the aforementioned studies which indicate that (at least in the past) it all evens out in the long run. And remember, hedging currencies comes with a cost ...about 1% a year.

One final thing to consider: As the Fund's perspective is long term, the fluctuations in performance should also be put into perspective. An 85 year old woman approached me recently and asked, "How would you define long term to me? Based on your definition, I will be dead anyway." I was flummoxed, obviously, and sheepishly replied, with great optimism, that perhaps she might live to be 115 and set the record for the longest living person on earth.

We do offer an alternative to investors who believe strongly that the Canadian dollar is going to strengthen considerably against the U.S. dollar. We offer units of the Fund in U.S. dollars, and investors can switch the units denominated in Canadian dollars to U.S. dollars without any penalty, charges or incurring a capital gain or loss in so doing.

### **General comments on the market**

Despite a decline of about 10% from its high, the market is not cheap, however it is not expensive either. For years we have been lamenting the fact that we cannot find any decent bargains, but lately three sectors have been hit hard and we can find plenty of companies in those sectors that are selling significantly below what they are worth. The three sectors are: retail, media and pharmaceuticals.

### **Repricing of risk**

At the time of writing last year, preservation of capital was given almost zero consideration. However, this year there has been a huge repricing of risk. The following are some examples:

- 1) The spread between U.S. corporate high yield debt and 5 year U.S. treasuries was 270 basis points a year ago. Currently, it is 778. At its widest, in November 2002, it was 1,094 basis points (source: Citigroup).
- 2) The spread between U.S. corporate high yield debt and U.S. investment grade bonds was 187 basis points a year ago. Currently, it is 549. At its widest, in November 2002, it was 845 basis points (source: Citigroup).

Last year, we wrote that some of the greatest excesses of easy credit were committed by subprime lenders. Credit standards were so lax and liberal that homeowners didn't even need to produce verification of income to be able to borrow up to 100% or more of the appraised value of their houses.

The chickens are coming home to roost for companies that were in any way associated with housing and housing related issues, and those companies include banks, mortgage lenders, monoline bond insurers, hedge funds, you name it. So far, they have announced \$255 billion (source: Deutsche Bank) in losses. While the numbers may look awful, the reality is far worse. The problem started with subprime borrowers and it is spreading to Alternate A borrowers (between subprime and prime) and ultimately, although to a lesser degree, it will affect prime borrowers. The reason for the spreading is that credit standards were equally lax with Alternate A borrowers and prime borrowers. On top of that we have yet to factor in the impact of liquidity squeeze from financial deleveraging, and that of loans in leveraged buyouts, commercial real estate, automobiles, margin loans, structured products, and the like. Institutions were so driven by incentives to securitize assets into asset backed securities and CDOs (Collateralized Debt Obligation) that they were willing to overlook the true riskiness of the securities involved. Those securities were then morphed into derivatives or any number of exotic instruments that barely resemble the original loans. Credit standards did not matter but volume and liquidity did, and 'mortgages' was one product that easily satisfied that criteria.

In general, we find that executives who sugarcoat business realities and embellish results, downplay issues and disguise potential problems to investors may be trying to fool their audience, but eventually they end up fooling themselves. They start believing in their own world of make-believe.

We would be careful about buying any financial stock. It is virtually impossible to find out what toxic brew the financial companies may hold in their balance sheets (either because they may not want you to know the truth or because even they don't know the truth themselves). Financial companies use 'best estimates' for many line items on the balance sheet and when companies are in trouble, they frequently have a chance to downplay the seriousness of the problems. Most of them are honourable but there are a few who use, what I've coined, "the 'DROP' principle" on unsuspecting investors. (D is for dribbling out the bad news slowly, R is for raising money, and OP is for dishing out the most optimistic projections.) Once the money has been raised from investors, these companies will announce a few months later 'the big drop' – that is, to take a big writedown. Yet still, having said that, we are looking for companies that are not involved directly with financials but, instead, have been somewhat tainted by association.

### **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. It is different from volatility, where stocks can go up or down in a given year.

Fortunately, we have over 20 years of performance to show what can be accomplished for investors while employing the “Margin of Safety” concept.

If you look at the following table, in 1999, 1994 and 1990 we had negative years but each time we bounced back. Even if you invested at the high, let’s say in 1998, 1993 or 1989, you would still do reasonably well long term. When you are a value investor, you have no control on short term volatility. While the future is never certain, we have no reason to believe the statement, “If you buy stocks that are undervalued, good things happen to you eventually”, will not be as valid in the future as it has been in the past.

Period Ended	Chou RRSP Fund	
	Growth in \$10,000 Invested	Annual Return
Dec.31, 1986	10,000	
Dec.31, 1987	10,818	8.2%
Dec.31, 1988	12,281	13.5%
Dec.31, 1989	14,350	16.9%
Dec.31, 1990	<b>12,722</b>	<b>-11.3%</b>
Dec.31, 1991	13,284	4.4%
Dec.31, 1992	14,500	9.2%
Dec.31, 1993	16,727	15.4%
Dec.31, 1994	<b>14,961</b>	<b>-10.6%</b>
Dec.31, 1995	17,808	19.0%
Dec.31, 1996	21,735	22.1%
Dec.31, 1997	32,741	50.6%
Dec.31, 1998	38,806	18.5%
Dec.31, 1999	<b>36,217</b>	<b>-6.7%</b>
Dec.31, 2000	42,188	16.5%
Dec.31, 2001	49,370	17.0%
Dec.31, 2002	65,095	31.9%
Dec.31, 2003	72,658	11.6%
Dec.31, 2004	82,362	13.4%
Dec.31, 2005	95,294	15.7%
Dec.31, 2006	104,479	9.6%
Dec.31, 2007	<b>94,817</b>	<b>-9.3%</b>

Rates of return are historical total returns including changes in unit prices and assume the reinvestment of all distributions. These annual compounded returns do not take into account any sales charges, redemption fees, other optional expenses or income taxes that you have to pay and which could reduce these returns. The returns are not guaranteed. The Fund’s past performance does not necessarily indicate future performance.

The current environment reminds us of 1999 – stocks that were expensive became more expensive and stocks that were cheap became cheaper but eventually ‘value will out’ – as the expression goes. As the subprime (mortgage) meltdown and the bursting of the credit bubble play

themselves out, they directly and indirectly affect the prices of almost all debt and equity securities, and the market will be highly volatile for a while. Therefore, the unit value of our Fund will also be volatile. So, this is not the time to get too anxious. Volatility is playing into our hands. We wouldn't be finding stocks or fixed income debts as cheap as they are now if it wasn't for this fear in the market. Market participants that invested in the toxic brew securities are dumping debt and equity securities indiscriminately as they are forced to raise cash to meet margin calls and redemptions. We would encourage our unitholders to review and understand the table as it may help them to not fret too much. As you can see, we have done reasonably well in the long run.

Notwithstanding, the amount of money that investors choose to invest in the Fund should only be to the extent that they can afford to **lose 40%** or more of their investment. This may sound drastic, but sleeping well and not getting too anxious are also important considerations both for the manager and the unitholder.

### **Credit default swaps (CDS)**

In last year's letter, we informed investors of our interest in CDS. We wrote, "In terms of investment ideas in derivatives, we believe that CDS are selling at prices that are compelling. At recent prices, they offer the cheapest form of insurance against market disruptions. In CDS, 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 this type of insurance.... To give you some sense of perspective, in October 2002, the 5 year CDS of General Electric Company was quoted at an annual price of 110 basis points. Recently, it was quoted at an annual price of 8 basis points. To make money in CDS, you don't need a default of the third party's debt. If there is any hiccup in the economy, the CDS price will rise from these low levels. The negative aspect is that, like insurance, the premium paid for the protection erodes over time and may expire worthless."

Subsequent to that letter it took until mid September 2007 for all of our compliance and regulatory approvals to be put into place and by then the prices of CDSs had moved appreciably. In accordance with our prospectus we could invest no more than 5% of the net assets of the Fund, at the time of purchase, in CDSs.

We missed the low hanging fruit, but the good thing is we now have these approvals in place and can exploit the situation next time. The current price of General Electric's 5 year CDS is at 168 basis points, and shows the potential for gain.

### **Other matters**

Foreign Currency Hedging: None existed in 2006 and 2007.

U.S. dollar Valuation: Any investor who wishes to purchase the Chou Funds in \$US is now able to do so.

Independent Review Committee: Under the provisions of National Instrument 81-107 Independent Review Committee for Investment Funds ("NI 81-107"), which came into force on November 1, 2006, it is now required that all publicly offered investment funds, such as the

family of Chou Funds, establish an independent review committee ("IRC") to whom the Manager is to refer all conflict of interest matters for review. This instrument further mandates that the IRC be composed of at least three independent members and requires that they report, at least annually, to the Manager and shareholders in respect of the IRC's duties.

The Manager has established an IRC as required by NI 81-107. The members of the IRC are Sandford Borins, Bruce Kerr and Joe Tortolano.

The IRC report is posted on our website [www.choufunds.com](http://www.choufunds.com). Hardcopies are available, upon request, by contacting Chou Associates.

Management Fees Waived: We waived a portion of the management fees for the Chou RRSP Fund. The MER should have been 1.70% but instead it was 1.62%.

New Location: Effective Thursday, November 1, 2007, we have moved our corporate office to the following location:

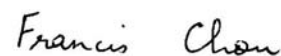
110 Sheppard Avenue East  
Suite 301, Box 18  
Toronto, Ontario M2N 6Y8

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 March 7, 2008, the NAV of a Series A unit of the Fund was \$24.64 and the cash position was 2.1% of net assets. The Fund is down 12.9% from the beginning of the year.

Except for the performance numbers of the Chou RRSP Fund, this 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

## CHOU RRSP FUND

March 2, 2007

Dear Unitholders of Chou RRSP Fund,

After the distribution of \$0.96, the net asset value (“NAVPU” or “NAV”) of a Series A unit of Chou RRSP Fund at December 31, 2006 was \$33.83 compared to \$31.73 at December 31, 2005, an increase of 9.6%, while the S&P TSX Total Return Index returned 17.2%.

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

December 31, 2006 (Series A unit)	Past Year	Past 3 Years	Past 5 Years	Past 10 Years	Past 15 Years
Chou RRSP Fund(\$Cdn)	9.6%	12.9%	16.2%	17.0%	14.7%
S&P TSX (\$Cdn)	17.2%	18.6%	13.1%	10.0%	11.3%

Rates of return are historical total returns including changes in unit prices and assume the reinvestment of all distributions. These annual compounded returns do not take into account any sales charges, redemption fees, other optional expenses or income taxes that you have to pay and which could reduce these returns. The returns are not guaranteed. The Fund’s past performance does not necessarily indicate future performance.

### Factors influencing the 2006 results

Major contributors to the Fund’s performance were Royal Boskalis Westminster, Berkshire Hathaway and CanWest Global Communications. We suffered declines in Danier Leather, Torstar Corporation and Overstock.com.

### General comments on the market

We continue to have problems finding compelling bargains in the marketplace. 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. We would caution all investors that their chances of a large permanent loss of capital are high if they invest in today’s market leaders at current prices.

### Preservation of capital is being given almost zero consideration

The cardinal principle of investing is to think first about preserving capital before thinking about making money. In equities, we try to accomplish that by paying far less than what the company is worth, as 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 is what distinguishes investment from speculation.

Although the methodologies may differ, the same cardinal principle applies when one is investing in other financial instruments. For example, the greater the probability of permanent loss of capital, the greater the spread should be between a particular debt instrument and risk-free treasuries. Currently the spreads between the higher risk securities and U.S. treasuries are at near historic lows. Other indicators also are showing that investors are in a euphoric mood and so are chasing yields and/or

returns without giving due weight to the risk of potential market disruptions which could result in permanent loss of capital.

The following are some examples:

- 1) The spread between U.S. corporate high yield debt and 5 year U.S. treasuries is at a near historic low. The average spread between January 1991 and March 2007 was about 481 basis points (4.81%). Currently it is 270 basis points. At its widest, in November 2002, it was 1,094 basis points (source: Citigroup).
- 2) The spread between U.S. corporate high yield debt and U.S. investment grade bond is approaching the lowest we have ever seen. The average spread is about 436 basis points. Currently it is 187 basis points. At its widest, in November 2002, it was 845 basis points (source: Citigroup).
- 3) 1.6% of global junk-bond debt (by dollar amount) defaulted in 2006, the lowest default rate experienced by this group since 1981. The historical default rate for junk bonds is 4.9%. Junk bonds are debt offerings of companies rated Ba or lower (by Moody's) and involve investment risks which may include the loss of principal invested as a result of the failure of the company (source: Financial Times).
- 4) Consumer debt relative to GDP in the U.S. is the highest ever. Over the past 60 years, the ratio was less than 50%. Currently it is over 90% and trending higher.
- 5) Long term interest rates have been trending down since 1981. In September 1981, the interest rate on 10 year U.S. treasuries was 15.3%. Recently it was at 4.75%. This bull market is 26 years long! Contrarians would instinctively think the trend is due for a reversal.
- 6) Inflation in the U.S. has trended down from its high of 14.8% in 1980 to less than 2.1% currently. Again, this trend is 27 years long and contrarians would instinctively think it is due for a reversal.
- 7) Business school graduates are gravitating in large numbers to hedge funds and private equity funds. Historically, they have been attracted to industries that are about to peak or have peaked.

From these examples, it appears obvious that investors are throwing caution to the wind. Risk is not priced into riskier securities at all. Whenever the majority of investors are purchasing securities at prices that implicitly assume that everything is perfect with the world, an economic dislocation or other shock always seems to appear out of the blue. And when that happens, investors learn, once again, that they ignore risk at their peril.

We continue to diligently look for undervalued stocks and will buy them only when they meet our price criteria – in other words - when they are priced for '**IMPERFECTION**'.

## Derivatives and financial institutions

We remain a keen and interested observer of derivative instruments. 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.

According to the Bank for International Settlements, contracts outstanding worldwide for derivatives at the end of June 30, 2006 rose to \$370 *trillion*. We are alarmed by the exponential rise in the use of derivatives. No one knows how dangerous these instruments can be. They have not been stress tested. However we cannot remain complacent. We believe the risk embedded in derivative instruments is pervasive and most likely not limited or localized to a particular industry. Financial institutions are most vulnerable when (not if) surprises occur – and when they occur they are almost always negative.

As a result, we have not invested heavily in financial institutions although at times their stock prices have come down to buy levels. Some 30 years ago, when an investor looked at a bank, he or she knew what the items on the balance sheet meant. The investor understood what criteria the bankers used to loan out money, how to interpret the loss reserving history, and how to assess the quality and sustainability of revenue streams and expenses of the bank to generate reasonable earnings. In a nutshell, we were able to appraise how much the bank was worth based on how efficiently its bankers were utilizing the **3-6-3** rule.

The **3-6-3** rule works like this: The bank pays 3% on savings accounts, loans out money to businesses with solid financials at 6%, and then the banker leaves the office at 3pm to play golf.

That was 30 years ago and you can see how easy it was to evaluate a bank.

Now, when an investor examines a bank's financials, he or she is subjected to reams of information and numbers but has no way of ascertaining with a high degree of certainty how solid the assets are, or whether the liabilities are all disclosed, or even known, much less properly priced. As the investor digs deeper into the footnotes, instead of becoming enlightened, more doubts may surface about the true riskiness of the bank's liabilities. Those liabilities could be securitized, hidden in derivative instruments or morphed into any number of other instruments that barely resemble the original loans.

We wonder whether bankers are using a rule that is as difficult to understand as their derivative instruments. We call it the **1-12-11** rule, namely, the bank pays 1% on checking accounts, loans out money to businesses with weak financials at 12%, and the banker leaves the office at 11am to play golf with hedge fund and private equity managers where they discuss how to chop and/or bundle the loan portfolios into different tranches and create, out of thin air, new derivative products that are rated triple A (from products that originally were B rated). These products are then sold to institutions (who may be oblivious of the risk involved) that are reaching for yields.

The above example is written tongue-in-cheek and it is not meant to be entirely representative of what bankers do. It is meant to show just how creative participants have been in producing new derivative products, with little regard for a sound understanding of their leverage and true risk characteristics. We may be witnessing a 'tragedy of the commons' where the search for quick individual profits is causing a system-wide increase in risk and reckless behavior.

### **Credit default swaps (CDS)**

In our semi-annual report dated August 11, 2005 we informed investors of our interest in CDS. By way of this letter, we are providing our unitholders with the 60 days notice required by securities authorities so that the Chou Funds may choose to invest in CDS commencing no earlier than May 31, 2007.

With that legal announcement out of the way, we can now continue to discuss the investment merits of CDS. Although they are derivatives, we are willing to look into them provided we find that there is sufficient and ample coverage against counterparty risk.

In terms of investment ideas in derivatives, we believe that CDS are selling at prices that are compelling. At recent prices, they offer the cheapest form of insurance against market disruptions. In CDS, 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 this type of insurance.

To give you some sense of perspective, in October 2002, the 5 year CDS of General Electric Company was quoted at an annual price of 110 basis points. Recently, it was quoted at an annual price of less than 8 basis points.

To make money in CDS, you don't need a default of the third party's debt. If there is any hiccup in the economy, the CDS price will rise from these low levels. The negative aspect is that, like insurance, the premium paid for the protection erodes over time and may expire worthless.

### **Sub-prime mortgage lenders**

Some of the greatest excesses of easy credit were committed by sub-prime mortgage lenders. Credit standards were so lax and liberal that homeowners didn't even need to produce verification of income to be able to borrow up to 100% or more of the appraised value of their houses.

Companies with the most liberal lending practices have started to report serious, even crippling, financial problems. Some optimists believe that the worst is over. However, they may be in for a surprise. Instead of it being the darkest hour before the dawn, it could be the darkest hour before pitch black. It will take a while (and maybe a long while) for the excesses to wring themselves out of the system.

Other matters

Fee Based Series (“F”) units: Due to repeated requests from financial planners and dealers, we introduced a new class of units called Series F units in September 2005. 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: Several currency hedges existed during the year but none existed as at December 31, 2006.

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

New Service Providers: Effective November 6, 2006, Citigroup Fund Services Canada, Inc. (CFSC) and its affiliates are the new service providers of fund operation to the Chou Funds.

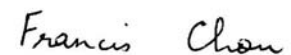
Concentra Financial is providing the Chou Funds with trustee services for registered products such as administering plans for RRSPs, RRIFs, LRIFs and LIFs.

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 March 2, 2007, the NAV of a Series A unit of the Fund was \$34.73 and the cash position was 9.5% of net assets. The Fund is up 2.7% from the beginning of the year.

Except for the performance numbers of the Chou RRSP Fund, this 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

## CHOU RRSP FUND

April 7, 2006

Dear Unitholders of Chou RRSP Fund,

After the distribution of \$1.03, the net asset value (“NAVPU” or “NAV”) of Chou RRSP Fund at December 31, 2005 was \$31.73 compared to \$28.31 at December 31, 2004, an increase of 15.7%, while the S&P TSX Total Return Index returned 24.2%.

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 RRSP Fund(\$Cdn)	15.7%	13.5%	17.7%	18.3%	14.4%
S&P TSX (\$Cdn)	24.2%	21.7%	6.6%	11.0%	10.7%

- 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 2005 results

Major contributors to the Fund’s performance were Boskalis Westminster, Consolidated Tomoka, and GSW. We suffered declines in OCA Inc., Liquidation World and Wescast.

Our average month-end cash balance of 26% 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.

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 \$300 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 RRSP 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 2.26% in 1998 to 1.75% in 2005.

The average MER for a fund in the Canadian equity category is approximately 2.84%.

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 2.84%, 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.

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 RRSP Fund has hedged \$US 20 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 \$33.27 and the cash position was 23.1% of assets. The Fund is up 4.9% from the beginning of the year.

Except for the performance numbers of the Chou RRSP 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

## CHOU RRSP FUND

April 14, 2005

Dear Unitholders of Chou RRSP Fund,

After the distribution of \$0.30, the net asset value (“NAVPU” or “NAV”) of Chou RRSP Fund at December 31, 2004 was \$28.31 compared to \$25.24 at December 31, 2003, an increase of 13.4%. 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 RRSP Fund	13.4%	18.6%	17.9%	18.6%	12.4%
S&P/TSX Total Return	14.5%	8.3%	3.6%	10.1%	7.6%

- 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.

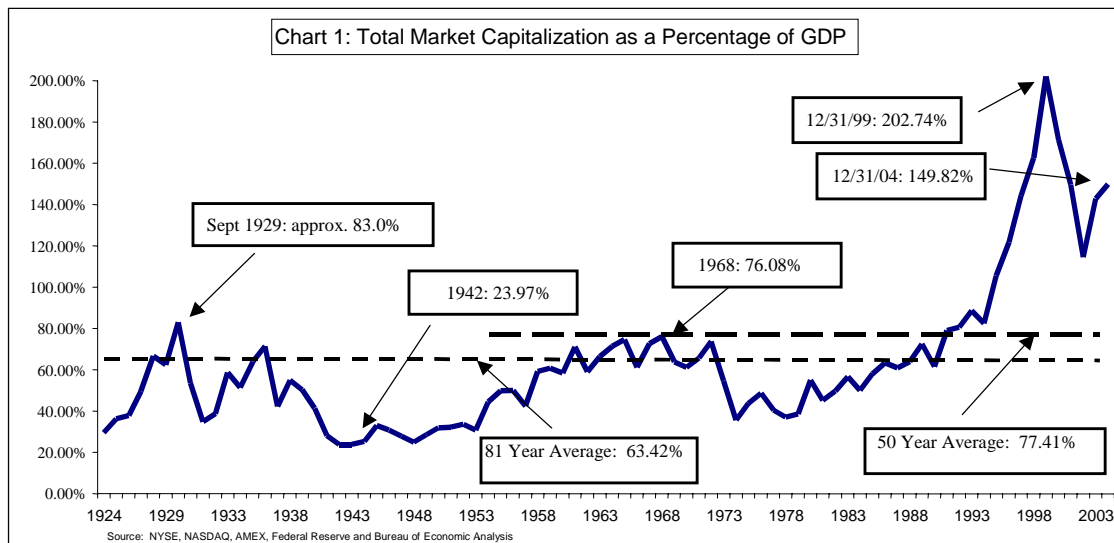
Factors influencing the 2004 results

Cash Position: Our average month-end cash position of 38.4% 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.

Denninghouse Inc.: 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, it was a small holding. Please read the section on “Companies subject to the whims of buyers including retail, restaurants etc”.

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.

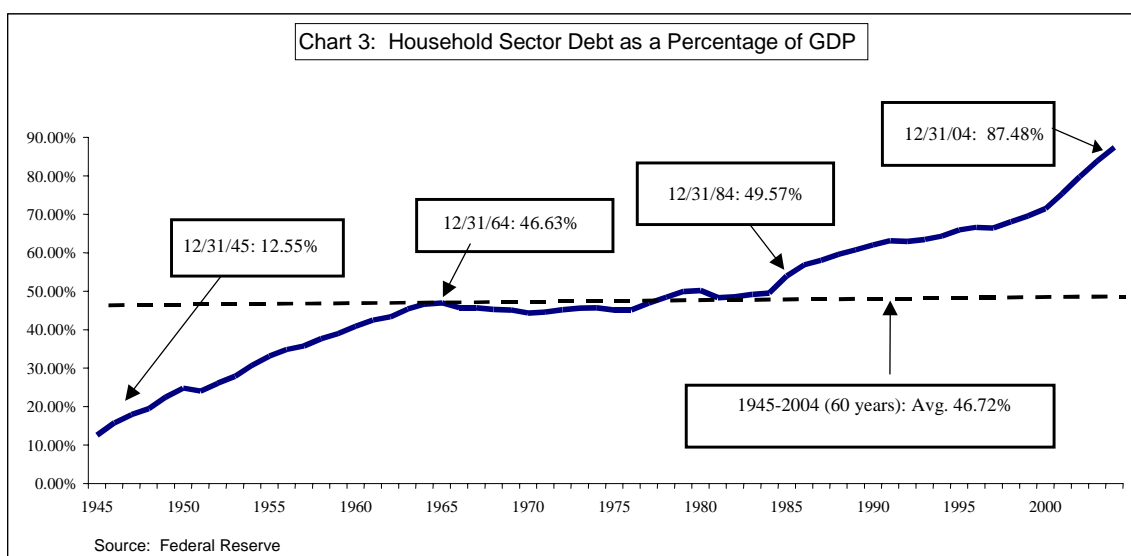
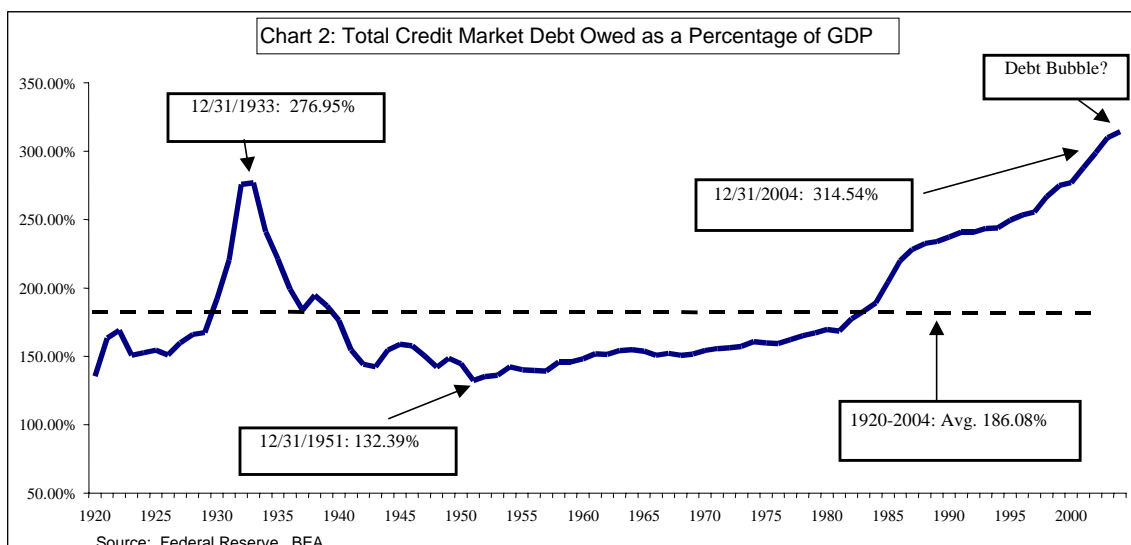


The chart shows that:

- 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.”

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

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.

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.

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<sup>2</sup> John Maynard Keynes

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 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."

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, 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.

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

**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 RRSP 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 2.26% in 1998 to 1.79% 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.

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 \$28.96 and the cash position was 31.2% of assets. The Fund is up 2.3% 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,



Francis Chou

Fund Manager

## CHOU RRSP FUND

April 22, 2004

Dear Unitholders of Chou RRSP Fund,

After the distribution of \$0.52, the net asset value (“NAVPU” or “NAV”) of Chou RRSP Fund at December 31, 2003 was \$25.24 compared to \$23.08 at December 31, 2002, an increase of 11.6%. 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 RRSP Fund	11.6%	19.9%	13.4%	15.8%	12.6%
S&P/TSX Total Return	26.0%	-1.0%	6.5%	8.5%	8.4%

- 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 53% 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.

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.

### **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 revenues were \$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 revenues 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:

- 1) China is an emerging country. Many of the laws, including investor protection laws that we are accustomed to, are non-existent or not enforced.
- 2) 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.
- 3) 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. 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 continue to consider closing the Fund to new investors once its assets reach a certain value. The number being discussed is \$200 million. This number is subject to further review. We are also looking to see whether we can raise the Fund's foreign content limit from the allowable 30% of its assets through the use of a derivative instrument.

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.

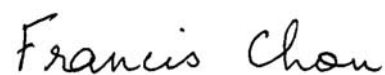
The Fund pays a 1.5% management fees plus other expenses such as custodial, recordkeeping, legal, audit and filing fees. The MER for 2003 was 1.79%.

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 \$27.47 and the cash equivalents were 42% of assets. The Fund is up 8.8% from the beginning of the year.

Yours truly,



Francis Chou  
Fund Manager

## 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

## Chou RRSP Fund

2001 Annual Report

April 29, 2002

Dear Unitholders of the Fund:

After the dividend distribution of \$0.69, the net asset value of Chou RRSP Fund at December 31, 2001 was \$19.42. It has been a difficult market, and yet I am happy to report that in the year 2001 the Fund gained 17.0%. The 3 year and 5 year annual compound return was 8.3% and 17.8% 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 42% 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-poohed. 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 17.8% compounded annually over 5 years (\$1 invested on January 1, 1997 was worth approximately \$2.27 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 14.0% compounded annually (\$1 invested on January 1, 1992 was worth approximately \$3.72 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 16.6% and its MER for the year 2001 was 2.006%.

Yours truly,  
Francis Chou

## Chou RRSP Fund

### 2000 Annual Report

April 27, 2001

Dear Unitholders of the Fund:

After the dividend distribution of \$1.10, the net asset value of Chou RRSP Fund at December 31, 2000 was \$17.18, up 16.5% for the year. The 3 year and 5 year annual compound return of the Fund was 8.8% and 18.8% respectively.

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

#### **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 11% 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 18.8%, 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 2.12% versus 1.74% in 1999. I chose to take a lower management fee in 1999 than allowed.

Yours truly,

Francis Chou

(Manager of the Fund)

## Chou RRSP Fund

### 1999 Annual Report

April 10, 2000

Dear Unitholders of the Fund:

After the dividend distribution of \$0.80, the net asset value of Chou RRSP Fund at December 31, 1999 was \$15.69, down 6.7% for the year. The 3 year and 5 year annual compound return of the Fund was 18.5% and 19.3% 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 1.63% versus 2.11% in 1998. I chose to take a lower management fee than allowed.

Yours truly,

Francis Chou

(Manager of the Fund)

Chou RRSP Fund

1998 Annual Report

April 15, 1999

Dear Unitholders of the Fund:

After the dividend distribution of \$ 6.32, the net asset value per unit of Chou RRSP Fund at December 31, 1998 was \$17.68. The Fund was up 18.5% 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 18.3%, 29.6% and 18.5% 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 2.11% without GST and 2.26% with GST.

Yours truly,

Francis Chou

(Manager of the Fund)

Chou RRSP Fund

1997 Annual Report

March 20, 1998

Dear Unitholders of the Fund:

After the dividend distribution of \$1.67, the net asset value per unit of Chou RRSP Fund at December 31, 1997 was \$20.25. The Fund was up 50.7% for the year.

The return achieved for 1997 was the best ever by the Fund since it went public in 1986. The important factors contributing to the gain were (i) four out of the eleven stocks that we had in the portfolio at the end of 1996 were acquired in 1997 and (ii) Salomon merged with Travelers. At the end of 1997, the market value of 2,712 shares of Travelers that we received in exchange for 1,600 shares of Salomon had more than doubled over 1996. The table shows our average cost per share and the acquisition price of the four stocks:

<u>Company</u>	<u>Average Cost per Share</u>	<u>Acquisition Price per Share</u>
Premier Choix Networks	\$9.47	\$45.00
Telemedia Inc.	\$4.18	\$7.50
Tombill Mines, Class B	\$5.76	\$7.69
Westar Group	\$27.32	\$69.00

I do not expect the Fund to have another year like 1997 unless Haley's Comet revisits the Earth. I do however expect some of the stocks to get acquired but certainly not to the extent it occurred in 1997.

The 1997 performance made our 3 year and 5 year results look respectable. For the 3 years and 5 years ending December 31, 1997, the annual compound return was 29.9% and 17.7% respectively.

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 investments, **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!

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 RRSP Fund stacks up against other mutual funds on the basis of MER.

For the year 1997, the MER of the Fund was 2.02% without GST and 2.16% with GST.

Yours truly,

Francis Chou

(Manager of the Fund)