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How the Chou Income Fund Got Its Mojo

By Karen Johnson

Francis Chou was a 25-year-old telephone repairman in Canada when he pooled 51,000 Canadian dollars from himself and six co-workers to start an investment club.

Thirty-one years later, Mr. Chou manages more than US$650 million for investors at his firm, Chou Associates Management Inc., and runs the best-performing bond fund in North America.

"It wasn't a big sum," Mr. Chou says of his stock-investment club. "But it did quite well."

Indeed. The Bell Canada co-workers—and some of their parents and friends who also invested early on with Mr. Chou—now are each worth more than $2 million.

Mr. Chou's trajectory to the top of the bond-fund world shows how investors are tweaking tried-and-true strategies to boost returns and overcome chronically low interest rates. When he was starting out, Mr. Chou largely stuck to stocks and the classic value-investing methods made famous by Benjamin Graham and Warren Buffett.

Pawel Dwulit for The Wall Street Journal

RISK DIVERSE: A value investor at heart, Francis Chou runs North America's best-performing bond fund at his eponymous firm in Canada.

"The key idea was to find bargains, and if you could find bargains, you could do quite well," Mr. Chou says in an interview at his unadorned suburban office, far from the bustle of Toronto's Bay Street financial hub.

Bargain-hunting is a skill that Mr. Chou, now 56, honed as a boy. Born in India to Chinese parents, he wandered among food stalls in the small northern Indian city of Allahabad, clutching a shopping list from his mother.

Because there were no refrigerators, milk had to be bought almost every day. While his mother worked as a Chinese-language teacher, the young Mr. Chou would check for freshness, turning the glass bottles to see the milk's color and thickness. He tried to discern which were priced too high, those likely to spoil soon and others that were watered down.

In 1973, Mr. Chou's older brother immigrated to Canada. Mr. Chou joined him three years later, with $200 to his name. Eventually he landed a job as a repairman for Bell Canada. But when Mr. Chou stumbled on an article about value investing, he felt he had found his calling.

A year after starting his club in 1981, Mr. Chou went looking for value-oriented firms. He introduced himself to Bob Tattersall, then at Bolton Tremblay Funds Inc., a Montreal investment-counseling firm that later grew into Canadian fund manager Montrusco Bolton.

"I have two weeks' holiday," Mr. Chou said at the time. "Can I work for you for free?" Mr. Tattersall said yes. He was impressed by Mr. Chou's insights and asked him to analyze auto-parts maker Kelsey-Hayes Canada Ltd.

"He did a good job on the report, and he was pretty excited at the end when we called the CFO, put him on the speaker phone and did a telephone interview," Mr. Tattersall recalls.

For Mr. Chou, the two-week stint was a chance to scout Bay Street investment advisers, especially those who shared his value-oriented philosophy.

In 1984, he left Bell Canada for good, joining investment firm Gardiner Watson Ltd. as an analyst, working beside value investor Prem Watsa. It was Mr. Watsa who pressed for his hire. "My boss asked me to give him 10 minutes. We spoke for a half-hour. I have never been more impressed with anyone than I was in that half-hour."

At Mr. Chou's urging, Mr. Watsa bought control of teetering MarkelMKL +0.75% Financial of Canada, the Canadian unit of insurer Markel Corp. It eventually became Fairfax Financial Holdings Ltd., FFH.T +1.57% of which Mr. Watsa now is chairman and chief executive.

Mr. Chou worked at Fairfax for about a decade, managing the company's surplus cash while running the grown-up version of the investment club launched at Bell Canada.

While never abandoning his roots in value investing, Mr. Chou has branched into riskier bets such as corporate "junk" bonds, which have been luring many investors with returns that are much higher than Treasurys, at least for now.

His investors have been the beneficiaries. The Chou Income Fund, launched in 2010 with $500,000, has been tops among North American bond funds so far this year, with a return of 28%, according to financial-data tracker Lipper. In the same period, the Barclays U.S. Corporate High Yield Total Return index has gained 12%.

Most of the assets in Mr. Chou's fund, which now has $6.3 million under management, are corporate junk bonds, including some issued by MannKind Corp. MNKD -0.53% and Dex One Corp. DEXO -1.48% He typically holds investments for a few years, singling out beaten-up assets that he expects to rebound in value. Junk-bond prices were especially tempting when he launched the fund, he says, but they have become more dangerous to play now as prices have climbed.

In 2004, Mr. Chou was named fund manager of the decade in Canada by fund tracker Morningstar Inc., MORN +1.27% and his Chou Associates Fund swelled in popularity, with assets under management topping $1 billion.

Mr. Chou is unrepentant about taking more risks, but the financial crisis was a painful reminder that even successful investment strategies can be derailed quickly. Chou Associates Fund suffered losses of 10% in 2007 and 29% in 2008. Some investors took their money and ran.

The fund's performance rebounded with strong back-to-back gains. Over the past 15 years, it has risen an average of 8.3% a year, more than double the 3.4% average gain by the Standard & Poor's 500-stock index.

Mr. Chou has never formally marketed his funds to investors. Letters he writes to them have a folksy, humble tone that echoes Mr. Buffett, the billionaire chairman and chief executive of Berkshire Hathaway Inc.

In an August note, Mr. Chou called a bad bet on a Chinese cellphone maker "an unforced error like they say in tennis." His investment was "an unnecessary penalty that would send us to the penalty box if it were hockey."

"The market can whack you," Mr. Chou says, "and remind you that you don't know everything."