Semi-Annual Advisor's Report
June 30, 2004

Aegis High Yield Fund

Advisor's Report

August 9, 2004

To the shareholders of the Aegis High Yield Fund:

We want to take this opportunity to welcome all of our shareholders to the Aegis High Yield Fund. We are quite excited about this new fund and we appreciate your support. For a more detailed review of the high-yield bond market and the Fund's investment approach, please feel free go to our website at www.aegisfunds.com. For your benefit, we will review the objectives and strategy of the Fund.

The Aegis High Yield Fund seeks to earn consistent total returns in the market that exceed our benchmark over periods of three to five years, while striving for below-average risk compared to our peers. Our long-term investment strategy is based on our total return objective. We use in-depth fundamental analysis of issuers to identify bonds and build a diversified portfolio with the potential for capital appreciation due to improved company performance, ratings upgrades, or better industry conditions. We seek situations where Wall Street's appraisal of a security's value is more negative than we have determined based upon an independent study of the facts. Often these situations occur among bond issues of smaller companies. The bonds we purchase are not necessarily the highest yielding issues in the market. Our goal is to maximize risk-adjusted long-term total return.

We are pleased to present this Aegis High Yield Fund inaugural Advisor's Report, discussing the six-month period ended June 30, 2004. If you are not familiar with some of the terminology used in the bond market, please read the "High Yield Primer" on our website, which explains many of the terms we will be using. If you do not have Internet access, please call our office at 800-528-3780 for a copy.

The Fund commenced operations as of January 1, 2004 with a net asset value of $10.00 per share. For the period ended June 30, 2004, the Fund posted a total return of 0.30 percent, versus a total return of 1.36 percent for its benchmark, the Lehman U.S. Corporate High Yield Index. At June 30, the duration of the Fund portfolio was a short 1.5 years, versus 4.8 years for the Lehman Index. The Fund's SEC 30-day annualized yield at June 30 was 3.35%.

The weighted average maturity of the Fund portfolio was approximately 2.3 years. The Fund's net asset value at the end of the period was $9.95 per share. Income distributions totaling eight cents per share were paid in the period.

The Fund's relatively flat return was largely due to its high cash position during the period. This was a result of two factors: the gradual ramping up of portfolio investments in a new bond fund, and more importantly the exceptionally *unattractive* yields available for much of the period in the high-yield market (which we will elaborate on later in this report).

A Broader Perspective

Before we discuss the current market and our ongoing strategy, it would be useful in our initial report to provide an overview of the Fund by answering the obvious question, "Why did we decide to start a high-yield bond fund?". First, it gives us an opportunity to expand our mutual fund business and reach out to a new group of investors. It also fits well with our value-oriented style of security analysis. But one of the most significant factors in the decision was our feeling that the existing high-yield bond mutual funds have largely not fulfilled the promise of high-yield bonds as an asset class.

The basic rationale for high-yield bond investing is that *a carefully researched, broadly diversified portfolio of high-yield bonds will consistently pay a much higher yield than comparable Treasury securities, more than compensating for the inevitable default losses in the high-yield bond portfolio.*

Because they have more liquidity risk than Treasury securities and carry other risks (like prepayment risk) that aren't present in Treasuries, high-yield bonds must provide a *net* return that is materially higher than Treasury securities. For years now, that has <u>not</u> happened in bond mutual funds.

For the ten-year period ended June 30, 2004, Morningstar (a fund rating service) shows the category average total return of high-yield bond funds was 5.13% per year. For the five-year period ending June 30, the category average return was 3.23%. By contrast, the category average return of longer-term Treasury bond funds exceeded 7% for both time periods.

What happened? First, in our judgment, most high-yield funds apparently buckled to short-term marketing pressures and decided to compete on the basis of a high current yield. With the highest-paying bonds typically being the riskiest, and the reticence to hold cash eliminating a possible buffer, funds exposed their shareholders to excessive risk. The results were predictable.

Second, most funds did a very poor job of properly *diversifying* their portfolios. During the telecom/Internet boom of the late 1990's, many funds indiscriminately became overloaded with those names and unduly suffered in the subsequent industry collapse. The scenario was repeated in 2001-2002 with the funds' heavy portfolio concentrations in the utility business, leading to unnecessarily heavy losses after the Enron collapse.

All in all, it is a substandard performance record for the industry. We hope to do better by consistently striving to be well-diversified, and focusing on long-term total return rather than stretching too far for current income. We also hope to develop a group of shareholders who can readily see the dangers of paying a very high current yield and following the latest market fads. Our shareholders will get better results from the Fund if they feel comfortable making a long-term commitment to a logical strategy that they understand.

Current Bond Market Conditions

Our perspective on today's high-yield bond market is quite cautious. We believe, based on history, that market forces reflect human nature more than economics. Markets therefore swing in a pendulum from fear to greed, depending on the scarcity or surplus of cash and the resulting asset values.

This is not a new idea. An illuminating passage that we thought about as we were writing this report helps to make our point:

"One of the striking features of the past five years has been the domination of the financial scene by purely psychological elements. The "new era" doctrine that good stocks were sound investments regardless of how high the price paid for them—was at bottom only a means of rationalizing under the title of "investment" the well-nigh universal capitulation to the gambling fever. We suggest that this psychological phenomenon is closely related to the dominant importance assumed in recent years by intangible factors of value, *viz.,* goodwill, management, expected earning power, etc. Such value factors, while undoubtedly real, are not susceptible to mathematical calculation; hence the standards by which they are measured are to a great extent arbitrary and can suffer the widest variations in accordance with the prevalent psychology. *The investing class was the more easily led to ascribe reality to purely speculative valuations of these intangibles because it was dealing in good part with surplus wealth, to which it was not impelled by force of necessity to apply the old-established acid test that the principal value be justified by the income* (emphasis added)."

Benjamin Graham and David Dodd
Security Analysis, 1st Edition, 1934

This timeless excerpt from a classic investment text first published in 1934 spells out the difference between prudent investment and speculative trading. We hope that you give it careful thought in relation to today's markets.

Security Analysis made the key points that true investment is based on conservative estimates of principal value and income, while securities speculation is grounded only in various "intangible factors" and "psychological elements". We will discuss later why we believe that today's investing class is populated by many people investing wealth that, while they may not believe it is "surplus", is nevertheless being handled without priority given to the "acid test" of principal value and income.

Let's describe in more detail the environment in which we are operating today. Our website material notes that the modern high-yield bond market, which dates from approximately 1980, has been characterized by pronounced multi-year market cycles. For the Fund to be successful, we must have an understanding of these market cycles and adapt the Fund's portfolio structure according to each phase of the particular cycle.

We look at overall bond market conditions in terms of the following factors:

—Economic Conditions
—Credit Quality
—Yields
—Spreads
—Supply and Demand

Economic Conditions

The American economy has greatly improved over the past year, showing solid growth in the 3-4% range for the past few quarters. But this economic improvement was largely the result of a massive credit binge, with the U.S. budget deficit ballooning to over $400 billion and the Federal Reserve pushing interest rates to extraordinarily low levels in the credit markets. Mortgage rates are below 6%. It's one of the best times *ever* to be a borrower.

As a result, debt throughout the U.S. economy has ballooned, with mortgage-related assets in particular now a record 28% of total bank assets. Household debt payments are a record 13.5% of personal incomes, even with the very low interest rates. Total U.S. debt of over $30 trillion has reached three times GDP, also a record.

The easy availability of money and resulting economic upswing have pushed stock prices up over 30% since the spring of 2003, and the high-yield bond market's total return topped 27% last year. The profits of financial firms (banks, brokers, insurers) account for 40% of all U.S. corporate profits, up from only 5% in the early 1980's. The Fed's quarterly survey of bank lending in the first quarter of 2004 showed that 18% of American banks reported easing their lending standards. This was the highest percentage since the third quarter of 1993. S&P reports that in July, 87% of the companies refinancing their bank loans were doing it *for the second time* in the past year.

It's important to recognize that the very strong performance of the high-yield bond market in 2003 was largely due to this tremendous burst of credit creation experienced in the financial system and the general economy. Many billions of dollars flowed into the financial markets, providing funds for even the most distressed borrowers to refinance their debts and for traders to borrow enormous sums to take larger portfolio positions.

Like a runner at a full sprint, an eventual slowdown for the U.S. economy is not merely likely but inevitable, even if the Fed does not raise interest rates rapidly. We may be seeing the first warning signs, as an unexpected downturn hit the semiconductor industry in June. If you believe, as many do these days, that computer chips are the "raw material of the 21st century" then this may reflect more widespread economic weakness. Last week's news that new jobs slowed for the fourth straight month in July, oil prices hit an all-time high, and consumer spending slowed during the second quarter is more indication that economic growth is on the wane.

Even in a continued lax credit environment, we would expect the economy to take a breather sometime in the 2005-2006 time frame. You can easily see that the homeowners who were able to spend an extra $20,000 this year from proceeds of a mortgage refinancing helped to give the economy a boost. But they won't be able to do the same next year unless they can refinance again for more cash—an unlikely prospect with interest rates so low.

An American slowdown will have negative ramifications for the rest of the world. As leading bond guru Bill Gross of PIMCO has said, "The global economy is more imbalanced than at any time in the past 25-30 years". He expects current strong worldwide growth to eventually recede over the next couple of years, plagued by weak demand and excess supply around the globe. We agree with that outlook, and are concerned that high debt levels will cause some unexpectedly sharp adjustments in the financial markets.

Credit Quality

Not surprisingly, the corporate bond default rate has fallen this year as interest rates have declined and economic growth has improved. From a peak of over 9% in 2002, the Standard & Poor's calculated default rate fell to 3.2% at June 30. This improvement is probably as good as it gets for this cycle as S&P is now forecasting, based on a variety of economic indicators, that the rate will increase to 3.7% by the end of 2004. To give you a frame of reference, the average default rate for the period 1981-2003 was 5.27% and the last bottom in defaults was a 1.8% rate in 1996.

Although credit rating upgrades exceed rating downgrades in the most recent quarter for the first time since 1998, there is still a question about the overall quality of today's high-yield market. At June 30, issues rated a lowly CCC made up 20% of the high-yield market, up from only 5% in the early 1990's. And a whopping 40% of the new issues coming to market in the first half of 2004 were rated CCC. Such a large proportion of low-quality issuance has historically been a good predictor of higher defaults two or three years ahead. With the present new issue calendar being 50% merger and leveraged buyout financing, and new issues of emerging market bonds reaching a record $17 billion during July, overall credit quality will remain a concern.

Defaults have moved in multi-year cycles over the longer term, and while they may remain at below-average levels through 2005, the record suggests that defaults will be a significantly greater problem by 2006 or 2007. The less successful borrowers from 2003 and 2004 will "hit the wall" in that time frame. The news of increasing defaults may shake the confidence of high yield market investors and result in less liquidity and lower prices.

Yields

At June 30, the current yield of the Lehman High-Yield Index was 8.00%. The average yield for the past ten years has been a bit under 11%. The Index hit an all-time low in late January of a skimpy 6.8%, and at the same time the CCC-rated sector of the market fell to a 10.8% yield, the lowest for those poor quality bonds since 1988. Late January will probably prove to be the price peak of this current market cycle. In the ensuing months, yields began to climb as the market became more concerned about rising interest rates.

In the summer of 2002, the Lehman Index yield exceeded 14%. Then, the dollar price of the typical bond was around 80. At the late January high, when the Index yield was under 7%, 80% of high yield bonds were trading above 100 and 63% of the market was trading above its nearest call price.

Today's low yields on corporate bonds present much more price risk than many investors realize. To give an example, buying a new 8% high-yield bond with a 10-year maturity at par can be a losing proposition if yields begin to climb. Assuming that yields rise to 10% a year later (which is still below the decade's average), the bond would trade at around 88. If it took two years for rates to rise to 10%, your bond would trade down to about 89, so the situation would be only slightly better.

If rates move sharply higher, the news gets very grim. Let's assume that yields exceed the long-term average and move to 12%. Then after a year the bond sells at 78, or after two years trades at 80. In this case, an investor would lose more than two years' worth of interest. These figures are important to remember when you evaluate the risk in today's market.

Spreads

At June 30, we mentioned that the Lehman Index had a yield of 8.00%. The 10-year Treasury note was yielding 4.58%. The resulting spread was 342 basis points. This was only a slight difference from the beginning of the year. As a reference range, the spread on high-yield bonds has averaged somewhere around 450-500 basis points over the long-term, depending on the exact time frame and the particular index.

The current spread is lower because recent default experience has been so favorable and liquidity has been more than ample. In 2002, the spread reached a high of over 1,000 basis points. In the 1997-98 time frame, another period when defaults were very low and liquidity was abundant, the spread was below 300 basis points.

Respected market analyst Martin Fridson has stated that based on a comparison of today's actual spread versus the projected appropriate spread derived from an evaluation of economic and market indicators, the high-yield market is now at a record overvaluation. Investors are being far too optimistic about high-yield bonds based on the current economic backdrop. Spreads, like defaults, should bottom out over the next few months and begin to widen as investors anticipate that defaults will start to grow.

It is important to understand that spreads are largely determined by "psychological elements". Common sense will tell us that over the long-term the actual investment risks in the bond market are fairly constant. It's the *appetite for risk* that changes. Today's narrow spreads indicate that there is a very healthy appetite for risk. Again, a reason for us to be cautious.

Supply and Demand

We mentioned that recent months were a great time to be a borrower, and the proof is in the enormous $83 billion of new high-yield issues that came to market during the first half of 2004. Forecasts are for a total of $120-130 billion for the full year. This follows a total of $131 billion in 2003, both years falling just shy of the record $138 billion in 1998.

The flood of new bonds in early 2004 did not collapse prices because much of the proceeds was used to retire older bonds. Net new issuance into the market was only about $50 billion. For the remainder of the year, it may be a different story as a higher proportion of issues should be new supply.

An interesting development in the past couple of years has been the rise of the hedge funds as a source of demand for bonds. Hedge funds, the unregulated pools of capital moving through the global markets, were not much of a factor in high-yield bonds until 2002. They plowed into the market in that year to capture the very generous yields, and have since taken most of their profits. But they remain a very active trading influence in the market, trying to capture smaller gains on short-term trades. By providing some extra liquidity, they could add some stability to the market. However, because hedge funds typically use huge amounts of borrowed money to trade, in a market tumble they might aggravate problems rather than cure them.

The cash from hedge funds also may not be able to offset the lower purchase activity of mutual funds and pension funds. High-yield mutual funds suffered net redemptions of slightly over $5 billion in the first half of 2004, and pension funds have cooled their enthusiasm for the sector. (The final big participants in the market, insurance companies, are a steady influence but their assets are growing relatively slowly.)

Other interesting developments that will bring benefits to the high-yield market are the efforts to develop derivatives contracts and "customized" high-yield issues. Derivatives will enable portfolio managers to hedge or adjust their exposure to the market quickly and easily. For the near future, such contracts will reduce the volatility of the market. But longer term there is a risk that, like the "portfolio insurance" schemes that contributed to the 1987 stock market crash, such derivatives will cause episodes of instability.

This year we are seeing the first steps toward issuing companies using "customized" high-yield offerings. These issues are divided into several "tranches", or portions, for different types of investors. For example, a safer secured piece might be aimed at conservative pension funds and a much more speculative piece designed for aggressive hedge funds.

While still in their early stages, these market developments will help broaden and add liquidity to the high-yield bond market, where liquidity has historically been one of the biggest uncertainties and risks.

Our overall view of supply and demand for the remainder of 2004 is neutral, as we expect the addition of available capital from hedge fund investors to be offset by a still-high supply of new bonds hitting the market.

Fund Portfolio Strategy

Based on the preceding review of the economy and the market, you can see that with a looming slowdown in the economy, interest rates edging higher, credit quality a question mark, yields at 8% rather than the historic 11%, high-yield spreads about 150 basis points below their historic average, and new supply at robust levels, there are many indications of a peak in the current 2002-2007(?) high-yield market cycle. As we mentioned, we believe that the late January plunge in yields to 6.8%, a level that provides practically no compensation for the long-term risks of participation in the high-yield bond market, will be the turning point for this cycle.

In this market environment with so many indications of a cyclical peak, our current efforts are focused on keeping the Fund portfolio more liquid and shorter-term than usual to enhance capital preservation. This means that our yield will be well below that of the Lehman Index for the time being, but we have an opportunity to recoup much greater amounts later on when we are presented with a more compelling market. Remember what happens to today's 8% bond prices if yields climb to 10% or 12%. We think that such a price decline is very possible in the next two years. The huge amounts of borrowed money at work in today's market will be liquidated at some point.

It's important for you to be aware of the risks building up with hedge funds and with the proprietary trading of banks and brokerage firms based on their calculations of "value at risk" (VAR). VAR attempts to compute the likely market risk of a large trading portfolio by using the expected price volatility of the assets held. Basically, it's assumed that less volatile assets or assets not closely correlated will reduce a portfolio's risk. Like any theoretical model, these calculations are only as good as their underlying assumptions. Recently, volatility in the stock and bond markets has been below average. This makes the theoretical VAR lower, giving traders a green light to accumulate ever-larger positions with borrowed funds.

The major banks now use VAR to measure their portfolio risks, using the calculations to nearly triple the size of their trading positions since 2002 *and still showing a low VAR*. The major brokerage firms have followed suit. Among hedge funds, "funds of funds" that allocate their money to selected hedge funds are estimated to have borrowed $80 billion in the past two years to leverage their investments into different types of hedge funds using VAR.

These traders are the "risk amnesiacs". It is this same type of highly theoretical computerized approach that, coupled with huge debt, caused the collapse of the much-touted LTCM hedge fund only six years ago. Author Roger Lowenstein says in his book about LTCM's implosion that "they forgot that, in a financial crisis, all the correlations go to one". In simple terms, all asset prices will move at the same time in the same direction…....down.

We are concerned that today there is just too much speculative borrowed money in the financial markets. It is often run by people asymmetrically compensated—they share the portfolio gains, but not the losses. In such a system they have huge incentives (in the form of pay and prestige) to use VAR to take on ever-expanding leveraged trading risks with investment capital *that belongs to someone else*.

This current market excess is the latest example of Graham and Dodd's "surplus wealth" leading almost inevitably to market speculation. VAR is another "means of rationalizing under the title of 'investment' the well-nigh universal capitulation to the gambling fever". We don't know exactly when or how the current imbalance of risks and rewards will unravel. But we anticipate that, like other "revolutionary" investment concepts, VAR will eventually be discredited by market forces. Unfortunately, given the many hundreds of billions of dollars borrowed against VAR-based portfolio positions today, reinstituting a more rational approach to investment probably can't happen without some temporary upheaval and a significant adjustment in the securities markets.

Conclusion

We have discussed why we are cautious in our approach to the current market environment. We will remain so until the market cycle becomes more favorable and speculative activities cool down. When the time does come for better investment opportunities, we will discuss those opportunities with you using the same analytical framework as used in this report. We do believe that there will be excellent bargains available sometime in the next few years, and perhaps sooner.

Our objective is to maximize the long-term total returns of the Fund over a number of years. We feel that we have a good investment strategy, and have detailed it on our website. You'll find it noteworthy that many top-performing funds have followed a sound strategy, and due to changing market phases these excellent funds have nevertheless underperformed their benchmark perhaps 30-40% of the time. We are in such a time in 2004, when the phase of the market requires us to sacrifice some short-term performance. We hope that you understand our decision and will take the appropriate long-term perspective of your investment in the Fund.

If we've helped you in this report gain a better appreciation of the difference between prudent investment and speculation, and to see the problems with VAR, then the few minutes you've invested should provide an exceptional return for you in the future. Again, thank you for supporting this new endeavor. We are pleased to have you with us.

Aegis Financial Corporation
William S. Berno, CFA
Managing Director, Portfolio Manager

Notes: All historical performance returns shown in this Advisor's Report for the Aegis High Yield Fund are presented on a pre-tax basis. Returns include reinvestment of income and capital gains. Past performance is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. The investment return and principal value will fluctuate so that upon redemption, an investor's shares may be worth more or less than their original cost. The Fund has an annualized expense ratio of 1.20%.

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