

Semi-Annual Advisor's Report  
For the Period Ended June 30, 2005

Aegis High Yield Fund

## Advisor's Report

August 12, 2005

To the Trustees of the Aegis High Yield Fund:

We are pleased to present this Aegis High Yield Fund Advisor's Report, discussing the six-month period ended June 30, 2005. If you are new to our Fund, please feel free to go to our website ([www.aegisfunds.com](http://www.aegisfunds.com)) for more detailed information about the high-yield bond market and the Fund's investment approach. 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. 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.*

You may not be familiar with some of the terminology used in the bond market. If so, 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 and request that a copy be mailed to you.

For the six-month period ended June 30, 2005, the Fund posted a total return of 1.70 percent, versus a total return of 1.11 percent for its benchmark, the Lehman U.S. Corporate High Yield Index. The weighted average maturity of the Fund portfolio at mid-year was approximately 3.6 years.

Importantly, the duration of the Fund portfolio was a short 2.6 years, versus 4.6 years for the Lehman Index. Duration is a measure of the sensitivity of a portfolio's value to changes in interest rates. The Fund portfolio is far less sensitive to a rise in interest rates than the Lehman index.

The Fund's net asset value at June 30 was \$10.11 per share versus \$10.14 to start the year. Income distributions totaling 20 cents per share were paid in the period. As of June 30, the Fund's SEC 30-day annualized yield to maturity was 6.03%.

We mentioned in our annual report that available yields in the high-yield bond market were exceptionally unattractive. Therefore, the Fund was taking a

very cautious and defensive position. That proved to be a good strategy, as General Motors stunned the financial markets in mid-March with a very poor profit forecast that led to the company being downgraded to junk ratings, the largest “fallen angel” in history.

Between mid-March and mid-May, the high-yield market was in tumult as auto-related issues were savaged and rumors of problems with hedge fund portfolios raced through trading desks. It was a near-meltdown that avoided reaching critical mass only when Moody’s and Fitch both decided to maintain Ford Motor Company at investment grade, calming the market.

Nevertheless the episode illustrated the historic volatility of the high-yield market, which had largely been absent in the prior 18 months. The Lehman index shot from a yield of 6.7% to 8.6% in less than ten weeks. On a price basis, this represented a decline from an average market price of roughly 104 to approximately 90 for typical ten-year high-yield bonds.

With the current outlook for credit quality and default rates, we believe that the spring market distress was “a preview of coming attractions”. It’s our view based on the market outlook that a fair yield for the high-yield index today is in the 8.50-9.50% range. We barely got there in May, and may have some other opportunities in the near future. The high-yield bond market is continuing to follow its historic credit cycle, which means that the next downturn should arrive sometime in the 2007-2008 timeframe. With that in mind, we will keep the maturity of the Fund portfolio relatively short and maintain a fairly cautious view of the market.

The brief market opportunity in May allowed us to make some timely purchases of bonds with our cash holdings. We also had to use some cash to meet share redemptions. The combination of these factors virtually eliminated our net cash position at June 30. Thus, the Fund has fully participated in the rally off the May lows and has seen its portfolio yield increase from less than 4% to over 6%. With the Lehman index now yielding 7.7%, we believe that being more invested, albeit cautiously, is the proper position.

### **Current Bond Market Conditions**

As we’ve done in the past, we’ll describe in more detail the environment in which the Fund is 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. We believe that we can improve the Fund’s performance by working to understand these market cycles and adjusting the Fund’s portfolio structure to each phase of the particular cycle.

We look at overall high-yield bond market conditions in a framework built around the following factors:

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

### **Economic Conditions**

The economy continues to push ahead in the credit and consumer spending binge that we discussed a year ago. Overall demand in June and July, as indicated by final sales, was fairly strong. It is safe to say as of mid-August that GDP growth for 2005 will likely finish only slightly below 2004's 4.4% figure. Economic reports, particularly with respect to industrial production and employment (figures that have a strong relationship to the performance of high-yield bonds), seem to indicate a recovery from a slight slowdown in the spring. Government reports have persistently shown slow growth in jobs, but the IRS recently reported that individual income tax receipts are up 15% in this fiscal year-to-date, telling us that incomes are quite healthy.

Housing appreciation has been a big driver of economic growth in the past few years, boosted by very low mortgage rates. In the cyclical recovery since 2001, about 40% of all new jobs created in America have been housing-related. The real estate boom has also contributed mightily to consumer spending. Goldman Sachs estimates that 7.4% of total personal disposable income in 2004 was represented by cash sourced from home equity, and 5.7% of GDP was residential construction, a figure near a 40-year high. In all, an astonishing 90% of GDP growth in this recovery has been from residential construction and consumer spending.

We remain concerned about excessive worldwide liquidity, as evidenced by soaring asset prices and extremely low bond yields around the globe. Oil's jump to over \$65 per barrel is somewhat due to tight supplies, but also a result of huge amounts of cash flowing into the energy futures market. The Fed is aware that credit needs to be tightened, but after ten increases in the Fed Funds rate, the Goldman Sachs Financial Conditions Index still shows liquidity little changed from June 2004 when the Fed began to raise rates. It appears that short-term rates will have to move aggressively higher to begin having an effect on credit availability.

The financial markets seem to recognize that a persistent global credit tightening is in the cards. Long-term Treasury bonds are paying about 4.5%, showing little fear of loose credit leading to an inflationary outburst. Gold, another inflation barometer, has been trending flat to down this year. Stock prices have been dormant, commodity prices (ex-energy) have been softening, and the dollar has strengthened a bit since early 2005.

The imbalances that have plagued the global economy in the past few years still represent a longer-term risk. Americans are spending too much and exporting too little, while Asians are generally spending too little and exporting too much. This has long-term effects on global trade that are unsustainable. While we expect the economy's results to be reasonable through 2005 and into 2006, there are growing risks that simmering trade disputes, an oil supply shock, or some type of financial crisis could disrupt growth. We don't believe that the markets provide a sufficient risk premium for the current uncertainties in the global outlook.

### **Credit Quality**

Default performance was again better than expected during the first half of 2005. The Standard & Poor's ("S&P") calculated issuer default rate for the year ended June was an extremely low 2.0%, down from 2.3% in 2004. (To give you a frame of reference, the average default rate for the period 1981-2004 was 5.2% and the last bottom in defaults was 1.8% in 1996.)

As in 2004, defaults continued to be very low because economic growth was steady, bank financing was readily available, and long-term bond yields remained moderate. Credit rating upgrades by S&P stabilized versus rating downgrades compared to a year ago, with year-to-date downgrades representing 57.4% of rating actions versus 57.9% a year ago. This remains in line with average historical levels. Using its proprietary models, S&P is forecasting a 2.6% default rate at mid-2006, and Moody's has a similar projection.

While defaults are not a current concern, an in-depth look at the credit quality of today's high-yield market has to give pause to a thoughtful investor. The percentage of new issues coming to market with ratings of B- or worse was a whopping 47% in the first half of 2005. This compares to 42% in 2004 and 31% in 2003, years defined by exceptionally easy credit conditions. We are getting to that stage of the cycle when highly speculative issues are becoming a significant percentage of the market, something to be kept in mind as we review yields and spreads.

Not only is the character of the existing high-yield market becoming more risky, but the names being added to the junk bond list are becoming more discomfoting. In the past couple of years, investment-grade names with storied histories like AT&T, General Motors, Ford, and Amerada Hess have ignominiously been dumped into the high-yield legions by at least one rating agency. If they can't prosper in today's recovering economy, how bad will things get when the inevitable recession occurs? As Rich Karlgaard recently opined in *Forbes*, what he has coined the Cheap Revolution of cheap technology, a global labor pool, and Internet pricing transparency will double the chances of a leading business declining from its perch. Perhaps future defaults will be substantially higher than the market is currently expecting.

We also don't like the increasingly aggressive financial approach of various bond issuers. Market activity in 2003 and 2004 was largely driven by refinancing existing debt and lowering interest costs. The market in 2005 is seeing more financings aimed at acquisitions, share buybacks, shareholder dividends and large leveraged buyouts. These activities, contrary to the balance sheet strengthening deals of prior years, raise the financial risks of the business and are another reason to expect defaults and spreads to rise in the future.

### **Yields**

Yields remain relatively low by historical norms in the high-yield market, although the extreme lows of February have been replaced by more competitive rates. At June 30, the Lehman index was yielding 7.72%, an increase of almost a full percentage point from the 6.76% yield at December 31. The market's rally into the summer reduced yields from the 8.6% peak seen on May 17.

Treasuries rallied in the spring, as always seen as a safe haven when the markets are in turmoil. The 10-year bond fell from a 4.22% yield in January to a 3.92% yield at June 30. On an inflation-adjusted basis, this was significantly below the "real" yield levels of the past decade. With a trailing year inflation rate, as measure by the Consumer Price Index, of 2.5%, the real yield was 1.42%. This is substantially less than the average 2.90% real yield seen over the last decade. The market subsequently corrected during July, and the 10-year Treasury has recently climbed to a 4.3% yield.

Most significant for high-yield investors is the pronounced "flattening" of the yield curve. Long-term rates on average run 100-200 basis points above short-term rates, mostly due to the greater uncertainties of holding long-term bonds. The yield curve is described as "flat" when there is no significant difference between short and long rates. With the 2-year Treasury note now only 20 basis points below the 10-year bond, the curve has flattened very significantly over the past year.

This is negative for high-yield bonds. A flat curve often presages a slowing economy, and also causes dealers to trade bonds with wider spreads because holding sizable bond inventories is less profitable with a flat curve. We would expect to see spreads on high-yield issues eventually increasing if we remain in this period of rising short-term interest rates.

There are some observers who believe that today's relatively low long-term interest rates indicate an expectation of slow growth. We would characterize it more as a function of the vast liquidity available in the global markets today. Asset prices have increased at a dramatic pace, and this has had a spill-over effect even into the enormous international bond market. We believe that the amounts of liquidity are so huge that they have inflated fixed-income

markets worldwide. Without the extra liquidity attributable to America's credit binge, Treasury bonds would be trading somewhere closer to a 6% yield based on historical spreads and prospective inflation rates. As credit conditions eventually tighten, we would expect to see government bond yields in that range.

### **Spreads**

We mentioned that the Lehman Index at June 30 was paying 7.72% and the 10-year Treasury note was yielding 3.92%. The resulting spread was 380 basis points, a notable increase from 254 basis points at the beginning of the year. The spread actually reached 450 basis points for a few days in May. As we discussed last time, 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. So for a brief period in May, the high-yield market approached reasonable value for the first time in about 18 months.

We have mentioned before that spreads are largely a function of market psychology and the appetite for risk. The trauma of the GM downgrade showed that spreads can jump almost instantaneously when psychology becomes negative and the market adopts risk-averse behavior. As we just discussed, the recent flattening of the yield curve and a more prudent view of risk have prevented spreads from dipping back to their lows of early 2005.

The financial indicators are pointing toward somewhat lower spreads in the remaining months of 2005. The flat yield curve will be a negative influence, but the growth of incomes, employment and output should keep defaults at a low level and push spreads a bit lower.

Nevertheless, we believe that gradually tighter credit conditions and the poor credit quality of today's high-yield market will lead to an upswing in defaults sometime in the 12-24 month time frame. As defaults begin to climb, spreads will follow. It is possible that, as in 2002, we could see spreads in a couple of years that are double the historical norms.

### **Supply and Demand**

After a super-heated new issues market in 2004, things have been merely busy during the first half of 2005. New high-yield issue volume was approximately \$65 billion in the first six months of this year compared to \$83 billion in 2004. Most of the 2005 new issue volume was in the first quarter, as the market dried up after the automotive meltdown in March. It appears unlikely that this year's total new issue volume will outstrip the record \$160 billion recorded in 2004. However, the recent addition of General Motors to the high-yield category means that the overall supply of bonds will increase by a previously unanticipated \$45 billion and the total size of the market will show noteworthy growth this year.

Rather than refinancing old debt, many of the 2005 issues will be new debt raised for buyouts or some form of payments to shareholders. Through April, buyout firms had launched 127 deals with a total value of \$17.6 billion, compared to 88 deals valued at \$11.9 billion last year. Goldman Sachs raised the largest institutional buyout fund ever at \$8.5 billion, only to be topped weeks later by Blackstone Group raising \$12.5 billion. Assuming that Goldman and Blackstone put 30% equity into their typical buyout deals, there is the potential for \$70 billion of takeovers *from just those two funds*.

One of the factors contributing to lower high-yield issuance this year is the continued generous lending terms of the banks. A June 2005 survey showed that 24% of banks are now easing lending standards for corporate borrowers versus a year ago. This on top of extremely permissive standards in 2004. S&P reports that some buyout firms are now forsaking the bond market and tapping the loan market to raise funds. In the first quarter of the year, leveraged loan issuance was \$16.2 billion, the highest figure since 1998.

The demand for bonds is unlikely to grow much from 2004. Mutual funds have seen net outflows of cash in 2005, hedge fund growth has slowed, and the issuance of CDO's may decline. The flattening yield curve will also induce dealers to reduce their bond inventories.

We discussed in our last report the growth of CDSs, or credit default swaps. You should also know about the growth of CDOs, or "collateralized debt obligations", another Wall Street creation that stimulates demand for bonds. A CDO, in the simplest terms, is a leveraged portfolio of bonds that is sliced up into various pieces, or "tranches" of varying risk. The "senior" pieces are very well-secured and normally will get high investment-grade ratings. The subordinated pieces will have some minor risk and will get moderate investment-grade ratings. The "equity" pieces have the most default risk and price volatility from the portfolio, and are used by banks, brokers and hedge funds as speculative income and trading vehicles. CDOs have enjoyed explosive growth in the past few years, with the market growing in 2004 by \$125 billion, or 67%. The creation of CDOs adds some incremental demand for bonds from CDO managers who are simply repackaging the issues for sale to institutional investors.

Our concern is that the structures of CDO portfolios are largely based on the historical credit quality and correlations of the underlying bonds. Like the VAR analysis that we discussed last year this is a bit too "black box" for us, and we expect to someday see problems with the equity tranches of CDOs that could possibly cause the failure of a hedge fund or broker. We have heard that the collapse of GM bonds in March caused terror in the CDO community, and that a few stronger players were fortunately able to ride to the rescue. Things may not work out so well the next time around.

## **Fund Portfolio Strategy**

As we entered this year, we continued to be cautious toward the market given the unsatisfactory level of yields. The GM debacle gave us a chance to get money invested at attractive yields. The yield on the Fund portfolio is now over 6%, a level that we are satisfied with in the current market conditions. Our view is still relatively cautious, even though we are fully invested. Most of the portfolio is invested in shorter-term issues with a maturity under four years and lower predicted volatility. We expect to keep the portfolio tilted toward shorter maturities for at least another six months and possibly through next year.

We do have some money invested in potentially higher-return situations and have tried to find attractive opportunities when available. This has been difficult for most of the life of the Fund, and we still have well less than one-third of our assets invested in securities with exciting upside. The market is cyclical and we have been operating in an unfavorable stretch of the cycle. It remains our view that the next market trough will be most likely in the 2007-2008 time period and that ample opportunities will be available to be far more aggressive when the accompanying wave of defaults hits the market. Until then, we are intentionally keeping a somewhat defensive posture.

For high-yield bond investors, the crucial debate over the next year concerns the eventual resolution of today's excess liquidity problem in the world's financial markets. As we mentioned in our last letter, virtually everywhere around the globe there is too much money chasing too few assets. Today we see a dangerous amount of leverage in the markets, with U.S. brokerage lending at an eye-popping record \$3.5 trillion as of June 30. There are some observers who feel that interest rates can't continue to increase because it would soon cause great disruption to indebted consumers and investors. Others believe that rates must go higher to force unwinding of leveraged positions and provide yields that are fair compensation for investment risks.

We can see both sides of the argument, but prefer to support higher rates. Whether voluntarily or involuntarily, rates must move high enough to discourage risky borrowing. In the past two decades, American growth has been assisted by continuing declines in interest rates, and investors have witnessed repeated episodes of financial bailouts constructed for insolvent borrowers deemed "too big to fail". Naturally the market impulse after all these years has been to borrow more and more, expecting that 1) interest rates will be lower in a few years, and 2) if you become a particularly huge borrower, then you are "too big to fail".

Today, we have an almost overt "game of chicken" between aggressive borrowers (whether it be on houses or securities) and the Federal Reserve. We mentioned in previous reports that banks have tripled their trading positions since 2002, hedge funds have borrowed hundreds of billions of dollars

against their portfolios, and even “emerging market” issuers have been on a borrowing binge. Huge debts carry much less stigma than a few decades ago, because the Fed has shown a willingness to quickly bail out anyone and everyone.

At some point, the Fed must truly tighten credit or run the risk of creating even greater “moral hazard”, encouraging future ever-riskier behaviors. With each passing year, more and more institutions will jump into the “too big to fail” category and yet will be *much more likely to fail* as their debts grow. Greater financial discipline will somehow be restored to the markets. It won't be painless but it is a necessary step. As Frank Borman famously said after running struggling Eastern Airlines, “Capitalism without bankruptcy is like Christianity without Hell”.

It is a touchy situation for the Fed. Moves must be made to gradually tighten credit, but at a pace that won't send asset values into a real nosedive. Chairman Greenspan has sent a clear signal to investors, saying that those who are not prepared for higher rates “are desirous of losing money”. It will be up to his successor next year to set a longer-term strategy for dealing with the world's excess liquidity.

Right now credit conditions are just beginning to tighten a bit and this process will take at least a year or two. At the moment, money is still quite cheap by recent historical standards. In contrast, we will be most aggressive with the Fund portfolio during the times when money is very dear.

## **Conclusion**

The high-yield market plunge of a few months ago has been healthy for the near-term outlook. The imbalance between conditions for issuers and buyers of bonds early in the year has swung a bit closer to equality. Continued corporate profit growth, low defaults, and lower supply should keep the high-yield market in decent shape for the remainder of this year.

Nevertheless, we will be careful in our management of the portfolio as long as yields and spreads are below average. We can't emphasize enough the historical cyclical nature of the high-yield bond market. The structure of the market and its place in the world of corporate finance seem to conspire to create a market that is notorious for volatility. Despite its strong performance of the past two years, it would be foolish to think that the high-yield market has been able to change its most basic nature.

It is also this cyclical nature that makes a long-term perspective so critical to evaluating high-yield investments. Our goal continues to be to provide above-average returns over periods of 3-5 years or more, which would represent a full cycle in the high-yield market. We focus on that longer-term ob-

jective, a focus that we believe gives us the best chance for success over periods of many years.

The Fund is still very early in its life. It has been frustrating that almost all of that life has been spent in a relatively unfavorable market environment. But over the course of several years, we believe that there will be times of exceptional opportunity. We will always try to be positioned to take full advantage of those opportunities.

We again encourage you to look at our website, [www.aegisfunds.com](http://www.aegisfunds.com), for more information about the Fund and the high-yield bond market. We hope that an understanding of the market and our strategy will give you greater confidence in your Fund investment.

We also want to mention again that your portfolio manager and his colleagues continue to be significant investors in the Fund. We appreciate your continued support and are excited about the outlook for the future.

**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%.*

*This Advisor's Report is for the information of shareholders of the Aegis High Yield Fund. Information contained herein has been obtained from sources believed to be reliable, but cannot be guaranteed. The views of the Advisor are subject to change without notice, and are not a guarantee of future results or a forecast of future events. Any recommendation made in this report may not be suitable for all investors. The Advisor's Report does not constitute a solicitation or offer to purchase or sell any securities. Its use in connection with any offering of fund shares is authorized only in the case of a concurrent or prior delivery of a prospectus. The securities of small, less well-known companies may be more volatile than those of larger companies. In addition, investing in high-yield securities involves additional risks beyond the risks of investing in investment-grade securities. These risks involve dependence on economic growth, default risks, lower liquidity, prepayment risks, and greater volatility, as well as other risks. Investments in foreign securities present currency risks and other risks not present in the U.S. securities markets. Investors should consider the Fund's investment objectives, risks, charges, and expenses. The prospectus contains this and other information about the Fund. For a prospectus including more complete information, please call us at (800) 528-3780, or visit our website at [www.aegisfunds.com](http://www.aegisfunds.com), where an online prospectus is provided.*

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