

Semi-Annual Advisor's Report
For the Period Ended June 30, 2006

Aegis High Yield Fund

Advisor's Report

August 29, 2006

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, 2006. If you are new to our Fund, please feel free to go to our website (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 the Fund at 800-528-3780 and request that a copy be mailed to you.

For the six months ended June 30, 2006, the Fund posted a total return of 6.07 percent, versus a total return of 3.14 percent for its benchmark, the Lehman U.S. Corporate High Yield Index. From inception on January 1, 2004, the Fund's annualized total return is 6.52% compared to 6.77% for the Lehman Index.

The weighted average maturity of the Fund portfolio at June 30 was approximately 3.5 years. Importantly, the duration of the Fund portfolio was a short 2.71 years, versus 4.61 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 less sensitive to a rise in interest rates than the Lehman index.

The Fund's net asset value at June 30 was \$10.44 per share versus \$10.17 to start the year. Income distributions totaling 24 cents per share were paid during the period. As of June 30, the Fund's SEC 30-day annualized yield to maturity was 7.16%.

With index yields at a more satisfactory level above 8.5% at June 30, the Fund portfolio was over 90% invested in high-yield securities, and held minimal cash during the first half of 2006.

The Fund's strong performance in the first half of the year was primarily a result of appreciation in several of our holdings. Our Southern Energy bonds were converted to Mirant Corp. stock that we sold at an additional gain in the early months of the year. We also benefited from better operating results at North Atlantic Trading and Del Laboratories that improved the value of those portfolio holdings.

An additional factor in our performance was the unusual absence of credit problems in the portfolio. During the period, we had only one notable case of deterioration in credit quality, Sea Containers. This is an element of good fortune that we attribute in general terms to a very low default rate in the marketplace, and in more specific terms to the relatively conservative composition of our portfolio during the period.

The Fund continues to be positioned cautiously, as we remain in a period when yields and spreads in the bond market are not particularly generous. We continue to see evidence that the economy is slowing, and believe that 2007 could bring a rise in yields and defaults. We are currently focused on preservation of capital, but continue to look for attractive opportunities that may be presented in the market.

Current Bond Market Conditions

As we have done in the past, we will 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, excluding housing, performed well in the first half of 2006, with significant gains in industrial production, employment and export sales. Importantly for bondholders, corporate profits continued to expand at above-

average rates, with earnings up more than 10% over 2005 figures. Housing and construction activity declined, but this shrinkage was more than offset by higher manufacturing output and trade. Global growth has been so strong over the past year that overseas trading partners are buying greater amounts of goods from the U.S., but this good news has been somewhat masked by substantially higher expenditures on our imported oil.

The U.S. manufacturing base, despite weak auto production and mediocre technology spending, is finally beginning to show a strong rebound from the recessionary period early in this decade. Industrial production has grown by a robust 4.9% in the year ending July 31, far better than its longer-term average of 3.0% annual growth. Capacity utilization has risen to 82.4% in July, compared to an 81% average over the past twenty years. Manufacturing output is crucial to employment, incomes and consumer spending because it typically creates higher-paying jobs than the service sector. The recent good news from the manufacturing sector is a very positive indicator.

Energy prices have moderated in recent months, which along with solid job creation this year, should bolster consumer spending. Even if energy costs remain flat in coming months, that would be a significant improvement over the skyrocketing fuel prices of the past two years. Retail sales have been softer so far in 2006, but if holiday shopping shows a bit of strength, real growth of around 3% is still a reasonable forecast.

If energy prices continue to show strength, inflation will become a great concern. The Consumer Price Index for the year ended June 30 was up 4.3%, a far larger increase than the average 2.8% over the past decade. We are also concerned about recent strength in gold prices, which have climbed from the \$450 range to roughly \$650 in less than two years, and industrial commodity prices. These are inflationary signs that should not be ignored.

Looking at financial conditions, it appears that Fed Chairman Bernanke, after a few months at the helm, is taking a moderate approach to the glut of global liquidity. We have noticed that the Fed has reduced the growth of the money supply from 5% in 2005 to a rate around 3.5% in recent months. It also appears that the Fed has been doing some jawboning of bankers concerning lending standards, as only 10% of bank loan officers surveyed say that they have eased credit standards in the most recent quarter. The comparable figure was 40% in 2004. Nevertheless, credit conditions are just moving from loose toward neutral. We haven't seen signs of a real tightening.

The gradual slowing of credit growth in the U.S. is one of the reasons that we expect a sluggish economy in 2007. Changes in credit conditions and money growth typically take 12-18 months to impact economic growth. Even if helped by an improvement in energy prices, it appears that the American economy, which grew at a 3.5% pace in 2005, will expand at around 3% this year and perhaps only 2-2.5% in 2007.

On the positive side, a moderate slowdown will help improve an inflation outlook that is becoming more worrisome, and possibly help reduce the American trade deficit. Chairman Bernanke has shown that he prefers slight inflation to the threat of deflation, so will very likely reduce interest rates if an economic slowdown accelerates.

The debate over the next year or two will be whether policymakers can engineer a “soft landing” and allow the economy to gradually cure its imbalances and remove the inflation threat, or whether these imbalances and threats persist and eventually prove to be a cause of greater problems.

Credit Quality

Repeating what we mentioned in our last report, keeping in place the continuous trend of the past thirty years, credit quality declined in the American bond market in the first half of 2006. The quality of new issues remained comparable to 2005’s low levels, with new issues rated B– or lower representing 43% of new supply. A record \$50 billion of CCC-rated bonds have now been sold since the start of 2003.

In spite of this, defaults continue to be extremely low, with the June default rate reported at only 1.72%, compared to a 4.66% long-term average. Rating agencies did not report much recent change in their ratio of debt upgrades to downgrades, and corporate leverage ratios improved a bit over the past year from higher corporate cash flows.

While Moody’s forecasts a default rate of 3.3% by year-end and 3.5% by the end of 2007, credit problems have been relatively rare and only a handful of companies have defaulted so far in 2006. The credit environment has been benign. This is likely to continue for the next several quarters, as Standard & Poor’s reports that the level of “distressed debt”—defined as a bond near default trading at a yield more than 1000 basis points over Treasuries—represents only 3.2% of all high-yield issues at June 30. This is the lowest figure since 1998 and is down from 7.4% two years ago.

Therefore, we have few current worries about defaults, and believe that the overall decline in credit quality of U.S. corporate bonds is a factor that will not hurt investors until the time inevitably comes that it does, in fact, hurt many investors. High-yield expert Martin Fridson has forecast, based on the credit rating mix of today’s bond issues, that a recession comparable to the 1990-91 period will cause a record default rate exceeding 17%. This huge number compares to the previous record 12% rate seen in 2002 after the Enron and Worldcom collapses.

Such a cataclysm will be painful, but it will also provide great opportunities to properly positioned investors and help restore, at least temporarily, some much-needed lending discipline to the marketplace.

Yields

The Lehman high-yield index started 2006 with a yield of 8.25%, a level that eventually climbed to 8.58% at June 30. This increase was almost entirely due to higher Treasury yields, as the 10-year Treasury bond yield jumped from 4.39% to 5.14% during the first half of the year. Growing concerns about inflation were the primary cause of the rising Treasury yields.

“Real” yields, the excess of Treasury rates over the inflation rate, were quite low during the first half of 2006. As we mentioned, the inflation rate was 4.3% through June. Yet, Treasuries paid less than 5% for most of the period. This left a “real” yield of only around 70 basis points, far below the 325 basis point average for the past decade. TIPS (Treasury Inflation Protected Securities) seem to indicate that inflation will be falling and longer-term real yields are more generous. TIPS are now forecasting a 2.6% inflation rate over the next ten years, only a slight increase from 2.3% at the end of 2005.

Another of the factors keeping yields low is the strong buying of U.S. securities by foreign investors. Much is made of the purchases of Treasury securities by the central banks of Europe and Asia, and whether America can count on these buyers continuing to support our bond market. But the growth of foreign demand for Treasuries in the past three years has come largely from private overseas investors. Global growth is the strongest for any period since the early 1970's, and many wealthy foreigners would rather own assets in the U.S. than to trust their personal fortunes to the often shaky local government. This non-economic rationale for a large group of buyers helps to explain why there is strong demand for fixed-income assets even at yields that are far below historical norms.

With its recent increase in the funds rate to 5.25%, the Fed is showing that it wants to restrain growth and the rising inflation threat. For the first time in over twenty years, the Fed is setting the funds rate at a level that is above the *entire* Treasury yield curve. This is a rare circumstance. In the past, these episodes have been associated with eventual declines in economic growth and inflation expectations.

If the economy is truly robust, longer-term yields will continue to climb toward the funds rate. If the economy is weaker than it appears, growth will be slowing and the Fed will reduce interest rates in 2007.

Bond market speculators do not appear to be expecting a dramatic change. The MOVE index, the bond option index that forecasts interest rate volatility, recently fell below 60. This means that the current outlook is for a change in Treasury yields of no more than 60 basis points over the next year. We'd be surprised, given the uncertainties about the inflation rate and economic growth rate, if such very low volatility actually occurs.

Spreads

We mentioned that the Lehman Index at June 30 was paying 8.58% and the 10-year Treasury note was yielding 5.14%. The resulting spread was 344 basis points, a notable decline from the 386 basis points at the beginning of the year, but still an attractive level compared to the 254 basis points at the beginning of 2005. As we have discussed in previous reports, 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.

As we noted above, the default rate has been exceptionally low in recent months. This factor has helped to tighten spreads, yet the market has not reduced spreads too dramatically. We believe that buyers, while feeling comfortable in the short-term, are reluctant to project today's very low default rates beyond more than a few more quarters. Therefore, investors have not bid spreads down quite as much as might be expected.

Another factor holding up spreads is the continuing trend of various "shareholder-oriented" moves by bond issuers. Unlike 2004 and 2005, when corporate debt levels declined, debt has actually increased 8% in the first half of the year. Companies started the year with better balance sheets and better cash flows than two years ago, so are using current earnings for expansion and are more willing to take on new debt. This is particularly evident among high-yield issuers, where earnings are up 12% over the past year, but capital expenditures have jumped 25%.

The other shareholder-friendly trend is the increase in dividends and share buybacks. Companies are enjoying strong cash flow and many are feeling pressure to return some of the earnings to shareholders rather than reducing debt. Some also are pursuing acquisitions. This willingness to part with cash is a phenomenon that is fairly typical as the business cycle matures.

Our feeling is that the prospect of rising defaults and less disciplined use of corporate cash will keep some upward pressure on spreads in the coming months. We wouldn't be surprised to see spreads approach 400 basis points within the next 12 months.

Supply and Demand

Two trends in recent months have had the biggest influence on supply and demand in the high-yield bond market. The corporate buyout boom has created the potential for a large supply of new issues. But the continuing growth of innovation in "leveraged finance" has had a substantial impact on investor demand and has helped keep spreads at relatively low levels.

Buyout funds have continued to gear up for ever-larger deals. In recent weeks, a buyout of HCA Inc. has been announced. At \$31 billion, it is the largest corporate buyout in American history. All indications are that HCA

will not hold the record for very long. Buyouts have accelerated from \$190 billion in 2004 to \$248 billion last year and at least \$400 billion this year. If the markets remain accommodating, deals could approach \$600 billion by year-end. There are a number of reasons for this rapid growth, but the primary driver of the deal volume is the ample liquidity in global markets. Many of the takeovers announced this year simply would not be possible in an environment of tighter credit.

The deals are getting larger, and also represent more risk. Buyouts in 2003 were accomplished with debt levels representing four times annual cash flow. So far this year, the average deal is borrowing 5.2 times cash flow. This amount of leverage exceeds the figure from the late 1980's, Wall Street's last buyout binge. Thus it's no surprise to see the deterioration in the market's average credit quality that we mentioned earlier.

You would think that this flood of deals would be accompanied by an enormous supply of bond issues. It hasn't happened. New issues, which provided a record \$147 billion of new supply in 2004 and \$110 billion in 2005, are projected to increase only slightly this year to \$120-130 billion. The gap in funding has been filled by "leveraged loans". Lately, what the bond market offers to issuers is less attractive than what the banks offer.

The area of "leveraged finance" continues to boom. We have mentioned the enormous growth of CDSs (credit default swaps). The past year has seen very rapid growth in a type of security known as a CLO (collateralized loan obligation). A CLO is a form of CDO (collateralized debt obligation) that is created from bank loans rather than corporate bonds.

The CLO market has become extremely popular with institutional investors and hedge funds. Because bank loans typically have stricter covenants, better seniority and often more collateral protection, they have less risk than bonds in the event of default. Banks have been more willing to increase their lending limits in the past several years, knowing that often they won't actually hold the loans—many will be repackaged as CLO securities. CLO volume is forecast to be \$70 billion in 2006, up from \$58 billion in 2005.

The growth of leveraged finance has dramatically increased the demand for fixed income investments. The combination of CDS, CDO, and CLO securities taking larger shares of institutional portfolios has stimulated the market for corporate bonds and loans. The shift away from bonds to loans this year has limited the supply of new bond issues and kept yields at lower levels than would be expected given the volume of corporate financing activity.

As we have mentioned before, these securities should perform to expectations in an environment of relatively stable interest rates and credit performance. But the area of leveraged finance has not been tested by a period of unexpected volatility. With hundreds of billions of dollars of these swaps

and securities held by major investors, a market shock will have an amplified impact on prices and liquidity. Leveraged finance is still in its infancy and its long-term value will have to be determined over a full market cycle.

Fund Portfolio Strategy

We felt that the Fund portfolio was well-positioned for market conditions at the beginning of 2006. While yields have increased slightly during the first half of the year, the overall environment has not shown much change in the past six months. We continue to take a conservative approach to the market, keeping the bulk of the portfolio in shorter-term securities with somewhat lower yields. We still believe that this market, with yields and spreads much closer to historic lows than highs, requires some caution.

It stands to reason that the most exceptional investment opportunities in any market will be available in a highly volatile and uncertain period. The past three years have been noteworthy for their unusual lack of volatility in the financial markets. We were fortunate to find a few high-yield situations that represented true bargains, but feel uncomfortable about the fact that the markets have generally seemed too easy. Whether it has been stocks, foreign securities, bonds, real estate, or commodities—everything has gone up. The market will remind us, at some point, that things can also go down.

The current market outlook is satisfactory, and we feel that conditions indicate that 2006 could turn out to be a solid year for high-yield bonds. Nevertheless, the market cannot hide the fact that a huge number of low-quality bonds have been issued since 2003, and historically a very high percentage of these bonds have defaulted in five years or less. Therefore, we are concerned that the 2007-2008 period could be much more difficult. To continue to enjoy stable, steady performance in the market for another two or three years would be unprecedented. We prefer to go with the better odds and keep the portfolio in a conservative posture.

We repeat once again our concerns about the “innovations” of leveraged finance. We have discussed the financial concepts of credit default swaps, “value at risk” and the CDO/CLO market. Without going into too much complexity about the details, the typical purpose of leveraged finance is to allocate different investment risks and returns to different investors, with conservative investors getting higher yields that are in effect “paid for” by speculative investors taking on much higher risks.

Thanks to the tranquil markets of the past few years, this structure has provided a financial “free lunch”. The investors in the high-grade securities have earned higher yields, but the lower-ranking subordinated investors have also earned even higher yields without major losses. This result has encouraged more risky behavior by speculative investors. The free lunch will not

last, and when there is some unforeseen market event that causes unexpected losses, we would expect to see the leveraged finance segment start to unwind, bringing substantial selling pressure and much lower bond prices.

The Fund portfolio at June 30 had a weighted average maturity of 3.5 years and a duration of 2.7 years. It is a portfolio that is relatively defensive. In a market break when yields become very attractive, you can expect the maturity and duration to go to much higher numbers. If we are given a chance to lock in very generous yields for a long period of time, we will do it. But, as a point of reference, the Lehman high-yield index was yielding 8.58% at June 30; even after recent years of lower interest rates, the 10-year average yield on the index is still a lofty 10.40%. So rates will have to move significantly higher before we become aggressive. We don't know the timing but suspect that a jump in yields, when it does arrive, may happen very quickly.

We continue to feel that the Fund portfolio at June 30 was well-positioned and do not expect dramatic changes in the next six months. Our strategy remains the same as at the beginning of the year. Roughly two-thirds of the portfolio is in shorter-term securities of reasonable quality, and approximately one-third is in situations giving the Fund the potential of high total returns. Even if we don't anticipate significant changes, we will be closely watching the market in hopes of an opportunity to strengthen the overall composition of the portfolio.

Conclusion

The Fund performed well compared to its peer group in 2005 and is off to a good start in 2006. We are pleased that the Fund has been able to provide reasonable returns while we have tried to keep the risk level of the portfolio at moderate to low levels.

At this point in the credit cycle, when defaults may have already seen their lows and are possibly beginning to increase, we believe that capital preservation becomes an even more important objective. We will try to exercise extra caution in our security selection to be sure that we are keeping our risks relatively low and earning returns that are truly commensurate with the underlying risks. Our longer-term goal remains to earn total returns that exceed the broad high-yield market return, and provide a competitive current yield to our shareholders.

The Fund is small and still in the early stages of its life. However, in a few more months it will have a full three-year performance record that can be evaluated by the mutual fund rating services and other analysts. We want the Fund to build a long track record of consistently superior returns for its shareholders. Having a complete three-year performance record will be a significant early signpost on that journey.

We again encourage you to look at our website (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%.

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