

Annual Advisor's Report
For the Year Ended December 31, 2004

Aegis High Yield Fund

Advisor's Report

February 23, 2005

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 (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. 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 Advisor's Report, discussing the year ended December 31, 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 December 31, 2004, the Fund posted a total return of 3.86 percent, versus a total return of 11.13 percent for its benchmark, the Lehman U.S. Corporate High Yield Index. The weighted average maturity of the Fund portfolio at year-end was approximately 3.1 years.

Importantly, the duration of the Fund portfolio was a short 2.0 years, versus 4.7 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 year-end was \$10.14 per share. Income distributions totaling 24 cents per share were paid in the period. As of December 31, the Fund's SEC 30-day annualized yield was 3.07%.

We mentioned in our semi-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. In the closing months of 2004 yields continued to fall, and bond prices rose. Thus the Lehman index ended the year with a significantly higher return than the Fund.

This will happen from time to time, because we are managing the Fund for long-term returns and not focusing on short-term performance. In today's speculative market environment, we think it is clearly best to remember the old maxim that the return *on* our principal is less important than the return *of* our principal. The high-yield market had a solid year in 2004, but will likely resume its highly cyclical historical pattern in the next couple of years. As yields improve, we will get more of the Fund's cash invested at more favorable returns.

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. 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 a framework built around the following factors:

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

Economic Conditions

The high-yield bond market operates within the context of the larger financial markets and the overall liquidity in the economy. We discussed last time the huge amount of debt creation currently providing credit in the financial markets and boosting economic growth. At that time, the Federal Reserve was just beginning a series of interest rate increases with the objective of removing its monetary stimulus from the economy. This has caused a minor slowdown in economic gains, but growth still comfortably exceeds a 3% rate (considered a solid long-term number).

However, the recently released minutes of the Fed's December meeting make an ominous point of discussing concerns with "a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in

financial markets evidenced by quite narrow credit spreads....and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums”. The Fed, which typically has been happy to disguise its views and intentions, is now making its best effort to fire warning shots into the air over the crowd of financial and property speculators.

The Fed also can't be pleased that, despite its six rate increases, a Goldman Sachs index of monetary conditions recently showed that credit is actually slightly easier today than last June when the Fed began to tighten. And global liquidity, assets held by central banks around the world, rose over 20% last year, one of the fastest rates ever.

We continue to be very uncomfortable with the level of speculative activity evident in today's economy. Home prices were up by almost 13% for the year ended September 30, the largest annual increase ever recorded by the OFHEO (the people who regulate Fannie Mae and Freddie Mac). You've probably seen that in some coastal areas and resort areas popular for vacation and retirement homes, the price increases were much higher.

Commodity prices have recently been very strong, and the dollar has shown a 20% decline in the past two years. Inflation that has until now been confined to the financial and property markets might soon spill over into the "real" economy and start showing up in reported inflation figures. Already, the CPI increase of 3.3% in 2004 is a bit of a concern, and "core" producer prices recently had the biggest rise in six years. A broad price index which includes housing costs increased 5.5% last year, the biggest gain since 1982. With big global producers like China and India, *The Economist* has stated that today's inflation is no longer a condition of too much money chasing too few goods. It should now be more properly defined as too much money chasing too few assets.

These overall conditions clearly indicate to the Fed that its monetary policy has been too loose. The Fed must continue to tighten credit to avoid much bigger inflation problems several years down the road. The implication of the rapid growth of credit and liquidity is that perhaps a significantly higher level of interest rates will be necessary to remove financial stimulus from the economy.

For the moment, business conditions appear solid, with the operating profits for S&P 500 companies forecast to improve 8% this year. This moderate increase is a slowdown from a 20% increase in 2003 and a 19% gain in 2004. It is unlikely that profits will grow quickly over the next few years. Corporate profits are now 8% of American GDP, a level not seen since the 1920's. The longer-term average is 5-6% of GDP. So it is likely that profits for the remainder of the decade will do well to even match the nominal growth of the economy.

We have not changed our view of the economic outlook: growth is likely to slow over the next year or two. An index of leading economic indicators published by the Economic Cycle Research Institute (ECRI) is virtually unchanged since last April, indicating subdued growth, as does the fact that the U.S. monetary base has declined slightly since September. Underlying weaknesses are also indicated by anecdotal evidence like the October panic in aluminum that included the biggest daily price decline since 1988. And as we mentioned last time, demand for computer chips remains weak.

An environment of waning growth and tightening credit warrants extreme caution. Removing liquidity from the financial system carries some dangers, and we don't believe that today's calm financial markets are fully anticipating the potential problems.

Credit Quality

Default performance was much better than expected during the final half of 2004. The Standard & Poor's ("S&P") calculated issuer default rate for the year was 2.3%, down from 5.5% in 2003. As of June 30 the S&P default rate we reported to you was 3.2%, and S&P was forecasting an increase to 3.7% by year-end. This turned out to be far too conservative. (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 1.8% in 1996.)

Defaults were exceptionally low because economic growth was steady, bank financing was readily available, and interest rates remained very low. Credit conditions were quite easy, helping a number of weak borrowers roll over impending maturities and postpone their day of reckoning. Credit rating upgrades by S&P continued to strengthen versus rating downgrades in the fourth quarter, with downgrades representing 62% of rating actions. This is in line with S&P's 18-year downgrade average.

There is still a question about the overall credit quality of today's high-yield market. At year-end, issues rated CCC or worse made up 19% of the high-yield market, up from just 12% in 2001 and only 5% in the early 1990's. A whopping 42% of the new issues coming to market in 2004 were initially rated B- or lower. As recently as 2002, only 21% of issuers were able to do deals with those kinds of ratings. It's not surprising that the *Bond Week* market letter headlined its 2004 review, "Low Quality Junk Deals Dominate".

Why does this matter? Because lower-rated bonds have a far worse default history than those with better ratings. Historically, the annual default rates on BB bonds are about 2%, on B bonds are about 5%, but are over 8% on CCC bonds. With the market now loaded down with large amounts of poorly rated issues, future default experience could be quite ugly. Some market analysts believe that as many as one-third of U.S. high-yield issuers will default over the next several years.

While we don't believe that there will be serious default problems this year, and Moody's is only forecasting a 2.7% default rate in 2005, our feeling is that things are due to get much worse in 2006 and 2007 based on the market's historical 4-5 year cycles.

How much worse? The overall credit quality of the current market is probably the weakest on record, as we've shown in the statistics above. Bond ratings have been a pretty accurate indicator of future defaults. Therefore, the next downturn should exceed the 12.8% default rate of 2002. And the longer term trend supports our view. Here are the default rates for the past four recessions: in 1975, the default rate was 2.7%; in 1982, it was 3.2%; in 1991 it was 10.2%, and then 12.8% in 2002. We'll probably see a new record sometime before 2008.

Yields

Yields on high-yield bonds at year-end were completely unsatisfactory. The Lehman index finished the year very close to an all-time low yield of 6.76%. How bad is that? We mentioned last time that the average yield on junk bonds has been something in the 11% range. So today we're getting paid not much over half of the long-term average. In a market where, as we just mentioned, credit quality is weak and future default projections are alarming.

As if that isn't painful enough, the reference Treasury yields are also looking extremely skimpy. The 10-year Treasury, which typically serves as the high-yield benchmark, closed the year with a 4.22% yield. This was only 92 basis points over the year's inflation figure (Consumer Price Index). Over the last decade, the 10-year Treasury has paid 290 basis points over inflation, so a fair longer-term yield on the 10-year Treasury is about 6% or so.

Yields have been depressed by various factors including massive demand for Treasuries by foreign central banks, which have added \$1 trillion of Treasury holdings to their portfolios *just since the end of 2001*. Also, portfolio hedging of positions in various "spread products" has created incremental demand for Treasuries. The result is that the base yields don't provide much of a margin over true inflation. At some point, this will change.

We mentioned last time what will happen to a bond price when yields go from 8% to 10%. To update the figures, we will use a hypothetical 10-year high-yield bond with a coupon of 6.75%. If rates climb to 8%, that bond trades at 91; if rates go to 10%, the bond will decline to 80; and at 12% the bond will trade at 70. The potential downside today is even greater than it was when we looked at the market as of June 30.

Spreads

We mentioned that the Lehman Index had a yield at December 31 of 6.76% and the 10-year Treasury note was yielding 4.22%. The resulting spread was

254 basis points. This was down approximately 100 basis points from the beginning of the year. 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.

Assuming that average annual default losses continue to run 245 basis points, which is the long-term loss rate published by Professor Edward Altman, a high-yield investor today is likely to net 4.31% on a 10-year investment. Given that risk-free, noncallable and very liquid Treasuries are paying 4.22%, there is no logical basis for buying the high-yield market index today. The compensation is not adequate for the risks assumed.

The current spread is very low primarily because recent default experience has been so favorable and liquidity has been so ample. Investors have been hungry for any sort of yield and have been willing to accept spreads that are far below the historic norms. Even with current tight spreads, pension funds and insurance companies invested near-record amounts in the high-yield market during 2004. Also, the growth of credit default swaps, which we will discuss later, has created demand for bonds.

We mentioned last time that spreads are a function of market psychology and the appetite for risk. The high-yield market has a history of wide variations in yields, default rates, and spreads. Today's temporarily favorable environment is not enough to persuade us to buy 10-year issues at these spread levels. We continue to take a cautious view.

Supply and Demand

High-yield guru Martin Fridson publishes a weekly market newsletter, *Leverage World*. This week's headline summed up the current market dynamic: "It's Good to Be the Issuer". There have been few times in the past several decades when borrowing terms have been so favorable.

And corporate CFO's were happy to take advantage. According to Professor Altman, total 2004 supply in the market was a record \$147 billion of new issues. This was an increase from the \$131 billion in 2003 and topped the \$138 billion prior record in 1998. Interestingly, most of the money was used to retire existing debt, so the actual net increase in supply was \$53 billion.

As we mentioned before, the quality of the new issues was poor, and the use of proceeds in some cases was questionable. Some companies sold bonds with weak covenants to pay off their outstanding bank loans with strong covenants. In a dozen or so cases, issuers controlled by buyout firms sold bonds to make dividend payments to their owners—sometimes only a few weeks after the closing of the buyout. These types of deals would only be tolerated in a very heated market for new issues.

The market continues strong, as January 2005 issues totaled \$14 billion, the highest figure for that month since 2001. The supply forecast for this year depends on the level of merger and buyout activity, but looks likely to continue at a near-record pace.

Hedge funds remained a force as buyers of high-yield issues, but high-yield mutual funds saw net outflows of \$4.7 billion during the year. Pension funds and insurers continued to be significant buyers, and there was strong activity from foreign investors.

We mentioned last time the increased activity from hedge funds and the use of various derivatives, customized bond issues, and the calculation of “value at risk” (VAR) as new developments in the dynamics of the bond market. We also want you to be aware of the growth of “credit default swaps”, a market that is showing explosive expansion.

Without getting too technical, a credit default swap is a type of derivative contract that can serve as a speculative instrument, or a hedge against bond default risk. Typically, a holder of a bond will enter into a contract with a derivatives dealer and “buy protection” against default. The bondholder pays premiums, representing a spread over some short-term rate, to the dealer and the dealer promises to pay the full par value of the bonds to the holder if there is a default. In effect, the holder has transferred the default risk—at a price—to the dealer.

As described above, the bondholder is hedging the risk of default. But credit default swaps can also be used for speculative purposes. The trading market for swaps has grown dramatically. Hedge funds and dealers are very active participants. The appeal is that an investment in a swap is cheaper and easier than trading the actual bonds.

Nevertheless, the growth of swaps can increase the demand for bonds. Those buying protection have to pay the premiums, and will want to own at least some of the underlying bonds. This is especially important in a market of unique issues like the high-yield bond market. So the growth of swaps, by creating the premium payments and hedging default risk, can stimulate the purchase of high-yield bonds.

We can't say for sure how great the impact of swap contracts has been on the high-yield market, but it could possibly be an additional source of demand that would help to explain the low yields and narrow spreads that we have experienced in the market during the past 18 months.

A significant issue with swaps is that they are traded in a market that is largely unregulated. The impact of a potential problem can't be known, but we have found it instructive that hedge fund consultant Hennessee Group has published a warning about the dangers of hedge funds making large un-

hedged derivative bets, and that the Wall Street Journal reported that major investment firms have revived their Counterparty Risk Management Group, a working committee that navigated the major Wall Street firms through the collapse of a major hedge fund (LTCM) in 1998. When knowledgeable insiders act with this kind of concern, we can conclude that the market's risk level has risen to an uncomfortable point. A market crisis should not come as a surprise to anyone.

Fund Portfolio Strategy

We were hopeful six months ago that the market would regain its senses and yields would increase to a point more amenable to long-term investment commitments. So far, it hasn't happened. We know that at some point the high-yield market will return to yields and spreads closer to its historical norms, but the timing is uncertain. Most likely it will be triggered in the next 12-24 months by an event that clarifies in a painful way the actual risks in the marketplace.

In the meantime, we will be very cautious toward the market. We will be keeping the bulk of the Fund portfolio in shorter-term, better quality issues and waiting for attractive opportunities to surface. This will penalize the Fund's yield and cause us to lag our benchmark index, but we would expect to benefit to a much greater degree when the market turns in our favor.

We expect defaults and bankruptcies to be much higher over the next several years. So we want to use this opportunity to give you our views of defaulted and bankrupt securities. This is important for you to understand as you evaluate our strategy over the long-term. Many high-yield investors have restrictions against investing in defaulted securities and bankruptcies, but we are permitted to make these investments and we believe that the smaller pool of potential buyers gives us more opportunities in these types of securities. We will likely be putting a portion of the Fund's assets into these situations if the potential returns make it worthwhile.

To understand the concept of bankruptcy, it is important to begin with the idea that every business has an intrinsic value derived from its liquidation value, or "going concern" value, or a mix of each. In bankruptcies, the court will establish a business value and then use that value to reorganize the debt and equity of the business. In some cases, the bankrupt securities are trading at an aggregate value significantly below the business value determined by the court. In these situations, we can find investment opportunities that are compelling.

You may have noticed in our annual report that we owned two defaulted securities at year-end, Trico Marine and Southern Energy. These bonds will

likely be converted into new common stock of the respective companies, and we are anticipating a gain on those investments later this year.

Even though we are poised to earn good returns on our two defaulted bonds, not every bankruptcy is an attractive situation. We pay the most attention to situations where there are easily understandable and solid asset values backing the securities. In the case of Trico, the value is represented by a fleet of marine vessels with an active resale market, and Southern Energy operates a group of major electric power plants around the country. We were able to determine a conservative value for these assets, and felt that the valuation was reliable. We became comfortable that the potential returns outweighed the market risks.

This will be the type of analysis that we will do on any possible defaulted or bankrupt security investments. Conservative and reliable asset values will be our most important selection criteria. When we can find securities that give us a high return with acceptable risks, we will invest the Fund's capital. During certain periods we may not own any of these securities, and during other periods such securities may be a noteworthy portion of the Fund's portfolio.

We want you to understand that we view this strategy as one part of our long-term effort to earn a good total return for our shareholders. We wanted to discuss it now because we believe that we might be active in this segment of the market over the next few years.

Conclusion

We continue to be patient and risk-averse. We will attempt to keep the Fund's credit quality and liquidity at a high level as long as market conditions remain as speculative as they are today. This has been a frustrating period, but is just more evidence that markets can occasionally behave in an irrational way.

We hope that you will take a few minutes to look at our website (www.aegisfunds.com) and read about our investment strategy and the history of the high-yield market. You will see that the market has shown quite a bit of volatility over the past two decades, and that it has been a mistake to fully participate in the market when yields are low.

The high-yield bond market is a constant battle between investors and corporate issuers. There has seldom been a time when the issuers have had a stronger hand. We recognize the situation, and understand that we are best served now by positioning the Fund to take the best possible advantage of the next period of opportunity in the market.

Today's market, while unattractive for new investment, is fascinating. On the surface it appears to be steady, solid and calm. High-yield portfolios have enjoyed very nice returns. Yet beneath the surface we know that there is too much borrowed money supporting bond positions, too many "weak hand" investors, too many unhedged derivative contracts, and too much "appetite for risk". We hope that avoiding risks now will give us greater long-term gains.

Our objective continues to be to maximize the long-term total returns of the Fund over a number of years. The Fund is still relatively new, and it will take a few more years to see meaningful results from our strategy. We appreciate your patience and your continued support. As significant shareholders in the Fund, we are pleased to be investment partners with you. We hope that you are as excited as we are about the Fund's 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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