

Annual Advisor's Report  
For the Year Ended December 31, 2005

Aegis High Yield Fund

## Advisor's Report

February 16, 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 year ended December 31, 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 year ended December 31, 2005, the Fund posted a total return of 6.26 percent, versus a total return of 2.74 percent for its benchmark, the Lehman U.S. Corporate High Yield Index. From inception on January 1, 2004, the Fund total return is 10.37% compared to 14.17% for the Lehman Index.

The weighted average maturity of the Fund portfolio at year-end was approximately 3.4 years. Importantly, the duration of the Fund portfolio was a short 2.5 years, versus 4.53 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 December 31 was \$10.17 per share versus \$10.14 to start the year. Income distributions totaling 54 cents per share were paid during the year, as well as a capital gain distribution of 5 cents per share in December. As of December 31, the Fund's SEC 30-day annualized yield to maturity was 6.80%.

We discussed in our semi-annual Advisor's Report that yields had increased in the spring of 2005 from their extremely low levels early in the year. At June 30, the Fund was fully invested in high-yield securities, and remained in a virtually fully-invested position for the remainder of the year.

A key to our strong performance during the year was the Fund's investment in defaulted securities. As we discussed in our Report a year ago, defaulted or bankrupt securities can sometimes be less risky than one might think. Particularly later in a bankruptcy when a reorganization plan is taking shape, it is possible to forecast the intrinsic value of the issuer's securities with satisfactory precision. If the company has solid assets that can be reliably valued, an investor can determine if its securities are properly priced in the market.

We owned two defaulted bond issues during 2005: Trico Marine and Southern Energy (now Mirant). We were able to purchase both of those positions at prices that we thought were safely covered by the real economic value of each company's assets, and in both cases were able to enjoy a significant gain on our holdings. We were particularly pleased with the results because 2004-2005 was not a cyclical trough in the high-yield bond market and therefore not a very profitable period for distressed/defaulted/bankrupt securities.

The Fund is currently positioned cautiously, as our outlook for 2006 is similar to 2005, when the Lehman index returned less than 3%. The combination of somewhat higher interest rates and some increase in default rates may put pressure on the high-yield bond market this year. We continue to expect much better opportunities in the 2007-2008 time period, and will keep the Fund portfolio mostly in shorter maturities until those opportunities become available.

### **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**

American economic growth was solid in 2005, with GDP expanding at a 3.5% rate. This result was a slowdown from the 4.4% pace of 2004, but still exceeded the U.S. long-term 3.0% average. Employment rose at a better pace from prior years, and “core” inflation was steady at 1.9%, although prices *including* food and energy rose by 3.5%, the highest rate since 2000.

The positives for the year were that job growth, manufacturing and business spending gathered some strength, and consumers were able to maintain their spending despite high gasoline prices and hurricane disruptions.

Negative factors were the continued rapid growth of credit, as bank loans rose a record \$739 billion during the year, and indications of inflation—gold burst ahead in recent months to exceed \$525 per ounce, an 18-year high, and home and energy prices continued to climb.

The Federal Reserve maintained its “measured pace” of interest rate hikes, but still hasn’t taken strong steps to tighten credit. Money supply (M2) actually grew faster in the second half of 2005 than the first half of the year. Also, the Goldman Sachs Financial Conditions Index continues to show that liquidity is ample in global markets. Central bank reserves, the fuel for global money creation, grew 13% during the year. Banks reported in the third quarter that lending grew at the fastest rate since 1998, and 10% of banks state that they have eased their lending standards over the past year.

For the moment, the credit-driven boom goes on. Corporate profits gained 14% in 2005 and are forecast to show a similar gain this year. Business is strong enough that a survey of small businesses done by the National Federation of Independent Businesses says that 26% more of its members plan to raise prices than to lower prices in the future, the second highest figure since 1986. The ECRI index of leading economic indicators hit a new all-time high of 138.3 a few weeks ago, and industrial commodity prices have experienced sharp increases in recent months. Consumer confidence is also improving, with a 106.3 reading in January. As of February 2, the 4-week moving average of new jobless claims was at its lowest level since June 2000. Consumers have also been fortunate that mild winter weather has kept high energy prices from having a larger impact on household budgets.

The housing industry appears to be receding as a growth engine. Although home values jumped 14% in 2005, most of that increase was in the first half of the year. Homebuilders have seen orders decline, and pricing of new homes actually ended the year with a 3.5% decrease. Home equity loans and mortgage refinancings have also slowed since our last report, putting a damper on potential consumer spending.

One of this year’s unknowns is the economic view held by Benjamin Bernanke, the new Fed chairman. He is believed to be tolerant of bouts of infla-

tion, which he considers less harmful than a period of deflation. It was widely reported in the financial media three years ago when he made a comment that the Fed “could drop money from helicopters” if necessary to avoid an impending deflationary spiral. Now that the global economy is booming and inflation is a rising concern, we will see how he approaches the problem of rapid credit growth.

This year’s likely improvement in industrial output and business capital spending should provide continuing gains in profits, productivity and employment. Growth should continue at a satisfactory rate (around 3% or so) for most of 2006. But we recognize that we are getting ever closer to the time when the Fed will have to get serious about tighter credit, or risk a widespread outbreak of inflation. Our view continues to be that interest rates will be moving higher and credit conditions will be less accommodating.

### **Credit Quality**

As has been the almost continuous trend of the past thirty years, credit quality declined in the American bond market in 2005. The quality of new issues remained comparable to 2004’s low levels, with new issues rated B– or lower representing 42% of new supply. The share of high-yield new issues rated BB is now only 15%, a figure that is down from 25% in 2001 and 70% in 1985. Of all U.S. industrial bond issues, 33% now carry junk ratings.

Because the economy showed solid growth and bank lending was still permissive, the default rate for 2005 was a low 2.2% according to Moody’s. Both S&P and Moody’s forecast that the default rate will rise to 3.3% by year-end, and may be significantly higher in 2007. This would fit into the market’s historic 4-5 year cycle, which points toward much higher defaults in the 2007-2008 period.

Corporate cash flows and profitability have been at record highs, resulting in a slight improvement in the ratio of credit upgrades to downgrades in recent months. Downgrades are still the majority of rating agency actions, but the most recent downgrade ratio was 55.5% versus 57.9% a year earlier. Analysts believe that a somewhat slower economy and higher interest rates will increase the downgrade ratio later this year.

We continue to remain concerned about the “use of proceeds” in many recent bond issues. More deals are being done to fund acquisitions, shareholder dividends or buybacks. These types of transactions historically have resulted in weaker balance sheets and less credit protection. Large acquisitions and shareholder-friendly deals, like the low quality of new issues, are an indication that the high-yield market is still being very obliging to issuers. We would feel more comfortable if companies were using funds to improve their productivity or reduce high-cost debt, actions that have the effect of improving credit protection.

### **Yields**

The Lehman high-yield index finished 2005 with a yield of 8.25%, which represented a significant increase from its 6.76% yield a year earlier. This change was almost entirely due to wider spreads, as the 10-year Treasury bond yield increased only from 4.22% to 4.39% during the year.

Treasury yield volatility remained historically low for the third consecutive year, as the 10-year fluctuated barely beyond a 4-4.5% range in 2005. The “real” yield, after inflation, also remained low by historical standards. Using the average real yield of the past decade, Treasury bonds should be paying around 5.5-6.0%. But they may not get there soon. According to the MOVE index, an index of expected bond price volatility, the expected volatility of yields is only 85 basis points in coming months. This figure is the lowest recorded by the MOVE index since 1998.

As we mentioned in our last report, corporate bond yields jumped in the spring of 2005 as General Motors and Ford disclosed financial troubles and fell to junk bond ratings. During the second half of the year the Lehman index never approached its very low yields of January and February, moving in a range around the 8% level. We expect, barring some unforeseen development, for the index to remain in the 8-8.5% range in the coming months.

Much has been made of the fact that the Treasury yield curve “inverted” several times in recent weeks. An inverted yield curve, where short-term yields are higher than long-term yields, has been a strong predictor of recessions in the past. The theory is that investors forecast a slowing economy and therefore demand less yield from longer-term securities. Given the fact that the inversion was very slight (less than 10 basis points), we would prefer to keep the view that we remain in a flat yield curve period. It is expected that the yield curve would invert more appreciably when the Fed truly does tighten credit. As we mentioned above, despite its rate increases in the past 18 months, the Fed hasn’t really begun to tighten yet.

### **Spreads**

We mentioned that the Lehman Index at December 31 was paying 8.25% and the 10-year Treasury note was yielding 4.39%. The resulting spread was 386 basis points, a sizable increase from 254 basis points at the beginning of the year but little change from the 380 basis points spread noted in our last report. The spread had been as high as 450 basis points for a few days in May. 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.

While high-yield spreads generally widened during 2005, the spreads of various ratings categories showed interesting changes. The market did be-

come more risk-averse later in the year. The spread between B-rated issues and CCC-rated issues widened from 269 basis points to 440 basis points, while spreads between BB and B bonds widened from 85 basis points to 106 basis points. This was somewhat attributable to a very significant widening among the auto parts issuers leading up to the Delphi Corp. bankruptcy in October. It also reflected general concerns about the effects that higher interest rates would eventually have on weaker credits.

This spread widening, combined with the current solid economic statistics, leads us to the conclusion that in the short-run, the lower quality B and CCC issues are better buys than BB and BBB issues. We don't engage in short-term trading as a portfolio strategy, but will be watching the market spreads carefully to position the Fund in the most undervalued segments of the market.

While we suspect that spreads may tighten over the next few months, the poor credit quality in the market today virtually guarantees that spreads will be widening dramatically over the next two or three years. Historical default rates rise a few years after a burst of low quality issuance (like we've had in the 2004-2005 period) and spreads are heavily influenced by default rates. So our longer-term strategy for the Fund portfolio will be to invest cautiously until the market provides us with better opportunities.

### **Supply and Demand**

Do you have a business to sell? You may want to think about finding a buyer this year. American buyout funds raised \$134 billion in 2005, up from \$79 billion the previous year, and at year-end had approximately \$100 billion of cash to be invested in acquisitions.

Private equity purchase transactions in 2005 were \$248 billion compared to \$190 billion in 2004. With this flood of deals, competition for good companies has become fierce and prices are climbing. In the third quarter of 2005, buyouts worldwide were transacted at about 6.1 times operating cash flow, up from 4.8 times cash flow in 2004. It's a great time to sell at a fancy price. Of course, a higher multiple of cash flow means less coverage of interest expense on the acquisition debt and therefore more risk for bondholders.

Assuming that buyout funds can do \$500 billion of purchases in 2006 and 2007, that would imply perhaps \$200 billion of new high-yield bonds to be sold to finance the deals. This potential supply of bond issues will likely be the main source of supply in the high-yield market for the next year or two. In 2005, approximately 40% of new bond issues represented funding for mergers and buyouts, compared to 28% in 2004. We would expect an even higher proportion of 2006 deals to be linked to buyouts.

Total supply in 2005 fell to about \$110 billion from the record \$147 billion of new high-yield bonds sold in 2004. Most of the new issues were in the first quarter of the year, prior to the auto sector meltdown. By the time that Delphi, Delta Airlines and Northwest Airlines filed for bankruptcy in the fall, new issues had slowed to a trickle. October issuance fell to the lowest monthly total since the last market bottom in October-November 2002.

Demand for high-yield bonds was lackluster during most of the year. There was the usual demand from insurance companies and pension funds, but high-yield bond mutual funds experienced \$11.6 billion of outflows in 2005, the highest withdrawals since 1992.

We mentioned in 2004 that hedge funds had recently become more active players in the high-yield bond market. One additional source of demand appeared in 2005—foreign investors. Americans are running a huge trade deficit, particularly with Asia, but much of that money is coming back to this country in the form of large bond purchases. During 2005, foreigners (and this *excludes* foreign central banks) purchased almost \$800 billion of U.S. bonds. Most of these purchases were in high-grade and government bond issues, but it appears that foreigners were also a noteworthy force in the upper tiers of the high-yield market. The search for yield is more global.

We do not expect demand for bonds to be as strong in 2006 as it was in early 2005. Worries about a slower economy and rising defaults will impact the market as the year goes on. With banks aggressively making loans to buyout funds, new bond issues will only come to market if and when conditions are favorable. So supply will likely shrink with demand. We would look for new issues this year to be in line with the figures for 2005, but they could be lower if the economy begins to slow during the second half of the year.

### **Fund Portfolio Strategy**

We are pleased with the composition of the Fund portfolio at year-end. We are positioned with the bulk of our assets in reasonable quality bond issues that mature in 2-3 years, as is detailed on page 7 of the Fund's annual report. We currently expect to largely maintain this portfolio structure through 2006, while continuing to search for any attractive opportunities. Our present market outlook is that this year will be, for the most part, a "coupon clipping" year with Lehman index returns perhaps a bit better than the return of 2.7% that was recorded in 2005.

On a long-term basis, the current prices in the high-yield bond market are satisfactory but not exceptional. As we've discussed, yields are a bit below average, spreads are also below average, and defaults are near all-time lows. Having said that, the situation today is better than it was a year ago, when yields were so low and prices so high that losses were almost assured.

We also have to admit to being impressed with the market's strength in the face of negative news a few months ago, when in a relatively brief time span Delphi, Delta, Northwest and power producer Calpine all filed for bankruptcy. While these bankruptcies had been largely anticipated by the market, the first three companies were significant debtors, and Calpine in particular was one of the very largest high-yield issuers. The Calpine failure could have caused serious disruption in a weak market, as Worldcom did in 2002. The fact that it didn't cause much of a ripple indicates to us that, at least for a while, the market is on solid ground.

We mentioned a year ago the growth of the market for "credit default swaps (CDSs)", derivatives that allow a bondholder to buy default insurance on particular issues. Credit derivatives grew almost 50% in 2005 to a total of \$12 trillion notional value (i.e., face amount). We discussed the fact that in many cases, the volume of bond swaps was substantially higher than the actual bonds outstanding.

This problem was highlighted when Delphi filed for bankruptcy in October with \$2 billion of bonds outstanding. Barclays Bank estimated that a total of \$27 billion of swaps were outstanding on those bond issues at the time of bankruptcy. In the event of a default, swap contracts specify that a swap buyer must deliver bonds to the seller of the swap to receive payment of the principal amount. This requirement resulted in a "short squeeze" in Delphi bond trading that pushed its bond prices up from around 55 to over 70 in the days after the bankruptcy, as swap buyers hopelessly tried to find sufficient bonds to settle their swaps. The International Swaps and Derivatives Association (ISDA) eventually decided to relieve the pressure by holding an auction to determine a price for cash settlement of the swap contracts. The auction process worked well, and the delivery crisis was defused. In December, a similar auction was scheduled to settle swaps on Calpine bonds.

The derivatives market is very large, immature, mostly unregulated, and still untested under *widespread* stressful economic conditions. These cash auctions were an expeditious way to solve the problem of a huge CDS volume on particular issues. But Fitch Ratings reported a year ago that its market survey showed that 14% of defaults in 2004 had resulted in litigation over the settlement terms of derivative contracts. Amazingly, the industry has yet to decide on a standard definition of "default", and transaction paperwork is snarled in a months-long backlog. Yet the profits to dealers from creating and trading these derivatives contracts in a rapidly expanding market segment are so lucrative that \$12 trillion are floating around in global markets.

Steady markets with very low volatility and historically low defaults have postponed, not eliminated, the potential problems in the derivatives market. But any investor should feel nervous about the huge amounts of money tied up in contracts of questionable validity and value, and the true safety of the "insurance" that these swaps provide.

We have mentioned in previous reports that financial regulators and some market participants are getting increasingly concerned about the risks in the credit derivatives market. It's a concern that the volume of these contracts has the potential to turn a financial market downturn into a chaotic crash, much like what happened in the stock market in October 1987. We would not be surprised to see regulators take some steps to slow the growth of the market, or tighten controls over the trading and documentation of these contracts.

Despite the potential long-term problems in the derivatives market, our feeling at the moment, based on its recent performance, is that the high-yield market may hold up better than expected for most of 2006. When the Fund was established in 2004, we thought that 2006 might be the start of a cyclical downturn. Now the indications are that a decline is more likely in the 2007-2008 period. The Fed will continue to tighten credit until the economy slows, and this tightening will put a lot of pressure on segments of the high-yield market in coming months. We still think that all of the historical evidence points to a decline as this market cycle advances. So we will continue to be cautious and vigilant in our approach to a market that could start to unravel before year-end.

## **Conclusion**

As we have discussed, the current outlook is for a steady year in the high-yield market, with the first half likely being stronger than the second half. We expect to use this year to search for any bargains that might appear in certain sectors of the market, and also to begin to more closely study some of the issuers that may present excellent opportunities in another year or two. We have encouraged our shareholders to view the Fund's overall performance over a 3-5 year time frame or longer, and while 2006 may not provide substantial returns, we believe that we can achieve risk-adjusted returns over the next several years that will be very competitive with most other asset categories. We are pleased that our return in 2005 of 6.26% represented a reasonable return in a year that the market performed poorly. Our 5.06% annualized return for the life of the Fund is not exciting, but is largely a reflection of our cautious approach to the prevailing market conditions.

We should stop here for a moment and take a look back at the past few years. Having now passed its halfway point, investors are beginning to recognize that this decade likely will be seen in market history as a low-return environment for most financial assets. There will be periods of opportunity over the next few years, but the 1990's-type markets when returns of 15-20% were common will not return in the near future.

This is obviously disappointing, because very bond high yields and spreads can richly compensate for default risks. Our cautious view over the life of

the Fund has been prompted by high-yield market yields that don't fully reflect historic default rates. And while defaults are low now, we certainly believe that the historic average rates (roughly 5%) remain valid for the long-term. At some point, market yields will adjust higher to reflect the true risks of high-yield securities as well as today's relatively low credit quality.

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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