

Annual Advisor's Report
For the Year Ended December 31, 2006

Aegis High Yield Fund

Advisor's Report

February 20, 2007

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, 2006. If you are new to our Fund, please feel free to study our website (www.aegisfunds.com) for more detailed information about the high-yield bond market and the Fund's investment approach. We will briefly review the objectives and strategy of the Fund:

The Aegis High Yield Fund seeks to earn consistent total returns that exceed its benchmark index over periods of three to five years, while striving for below-average risk compared to its peers. The Fund's long-term investment strategy is based on its total return objective. We use in-depth fundamental analysis of issuers to identify bonds and build a 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 purchased for the portfolio 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 information about the high-yield bond market. If you feel that you need an introduction to the securities, please read "About High Yield Bonds" located at a tab on our Fund website, which explains some of the history of the market and its structure.

For the year ended December 31, 2006, the Fund posted a total return of 15.13%, versus a total return of 11.85% for its benchmark, the Lehman U.S. Corporate High Yield Index. From inception at January 1, 2004, the Fund's annualized total return is 8.31% compared to 8.49% for the Lehman Index.

The weighted average maturity of the Fund portfolio at December 31 was approximately 3.8 years. The duration of the Fund portfolio was 3.07 years, compared to 4.43 years for the Lehman Index. Duration is a measure of the sensitivity of a portfolio's value to changes in interest rates. The Fund's short duration makes it less sensitive to interest rate risk than the Lehman index.

The Fund's net asset value at December 31 was \$10.69 per share versus \$10.17 a year earlier. Income distributions totaling 76.1 cents per share and net capital gains of 20.3 cents per share were paid during the year. At December 31, the Fund's SEC 30-day annualized yield to maturity was 6.53%.

The Fund's outperformance for the period was driven by robust returns in several lower-grade holdings in the portfolio, as well as a defaulted security,

Calpine convertible bonds. Some of the notably strong performers during the year were Del Laboratories, Sungard Data, Great Lakes Dredge and Alliance One. The sole problem issue in the portfolio was Sea Containers, which was sold at a loss as that company tumbled into bankruptcy in October.

The Fund's attractive annual return was helped by overall strong market conditions for the high-yield bond market during 2006. The economy posted solid growth and credit conditions remained very favorable, resulting in continuing low interest rates and very low default rates. The Fund maintained a fully invested position for most of the year and was able to benefit from a decline in the Lehman Index yield from 8.25% to 7.70% during the year. (As yields fall, bond prices rise.)

For reasons that we will discuss on the following pages, the Fund continues to be positioned cautiously in its portfolio holdings. We remain in a period when yields and spreads in the credit markets are not particularly generous. We are now primarily focused on preservation of capital, but will continue to look for attractive opportunities that may be presented in the months ahead. We continue to see evidence that the economy is gradually slowing, and believe that the current low level of defaults is not sustainable over the next few years.

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 monitoring these market cycles and adjusting the Fund's portfolio structure to each phase of a particular cycle is a key element of the Fund's performance.

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

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

Economic Conditions

The American economy showed moderating growth during the past six months. This was in line with our expectation that GDP growth would slow from a pace well above 3% in early 2006 to a rate of perhaps 2% by the middle of 2007.

Housing and high energy prices continued to place downward pressure on growth, but expanding trade and manufacturing output led to higher employ-

ment and income figures. Retail sales softened late in the year and the latest consumer confidence figures were somewhat lower. Overall, it is a mixed picture and shows an economy that is downshifting from the huge fiscal and monetary boost it received in 2002 and 2003.

Consumer durables are showing the most conspicuous weakness. Auto production is forecast to decline 8.4% in the first quarter of 2007, and housing starts fell 18% in 2006, which will have an impact on many housing-related sectors during 2007. The shrinkage of these major sectors will be a significant drag on economic expansion.

Our expectation continues to be that GDP growth will be in the 2.0-2.5% range this year, a rate that is somewhat below par from a long-term perspective and could well create some stress in certain sectors of the economy. It will also hurt the growth of profitability. After several years of better than 10% annual earnings increases, American companies may only produce profit growth of 6-7% this year. This will impact investors' view of credit quality.

The benefit of gradually slowing economic growth is that inflation should remain in an acceptable range. The core CPI rose 2.6% during 2006, and we may see it fall to within the Fed's preferred range of 1.5-2.0% by the end of this year. It's very possible that the Fed will reduce interest rates later this year if growth slows too much, although we think that short-term rates should be relatively steady over the next 12-18 months.

The robust growth of trade and exports has been a major driver of our economy over the past year. Exports have been increasing at a double digit rate and have pushed industrial capacity utilization above its 81% long-term average. International markets continue to expand, particularly in Asia, which is helping to limit the dangers of the economic imbalances we spoke about two years ago. Even with the slower growth of the American economy this year, global GDP expansion is forecast to remain close to the 5% level.

At the moment, asset values, employment levels and incomes are showing steady increases. The Treasury recently reported that federal tax revenues for the first four months of fiscal 2007 are 9.7% higher than the prior year, and S&P reported that, despite all of the media coverage of the housing slump, home prices in its latest survey actually increased 1.7% over the prior year in the country's twenty major housing markets.

Despite recent signs of some slowing in manufacturing, the ECRI index of leading economic indicators hit a high of 141.7 in early January, continuing an uptrend that began last summer, and stock prices have been making annual highs in recent weeks. Productivity in the fourth quarter of 2006 was an excellent 3.0%. Manufacturing inventories continue to be lean, which bodes well for production levels later in the year.

We believe that 2007 may prove to be a transition year toward more balanced and sustainable growth for the U.S. economy. After little expansion early in this decade, the economy grew faster into the summer of 2006, but no longer benefits from the stimulative kick provided by the 2003 tax cuts and the extremely low interest rates of that period. Credit growth is also slowing from the very high levels of two years ago, and that is an almost flawless indicator of slower economic progress.

As we will discuss in a moment, the slower pace of economic growth will eventually be reflected in the high-yield bond market, as concerns are raised about future credit quality and the appropriate level of risk spreads in an environment of lower profit growth.

Credit Quality

We continue to be concerned about the long-term decline of credit quality in the American corporate bond market. But many long-term trends have pauses and countermoves, and 2006 was a year when credit quality strengthened and became less of a concern to bond investors.

Defaults again were historically low during the year, with the 1.3% year-end default rate reported by Standard & Poor's dropping further below even the prior year's low 1.8%. Easy credit conditions and strong profit growth almost eliminated major defaults during the year. At the moment, S&P is forecasting that the default rate in 2007 will rise to only 2.3% by year-end, still a very low number compared to the 4.54% annual average since 1982.

It is possible that with only a mild slowdown in economic growth, defaults in 2007 will remain below a 2% rate. Nevertheless, it is clear that credit quality is in the process of making a cyclical peak, and that the next two or three years are far more likely to show a deterioration of credit strength rather than an improvement.

Currently, corporate credit quality is excellent. But not all sectors of the broader fixed income markets are seeing strong results. In recent months, significant problems have surfaced in the "subprime" home mortgage market. These mortgages are typically made to homebuyers with poor credit histories and low or volatile incomes. We have been closely watching the troubles unfold because many of the "new finance" strategies that propelled the subprime mortgage market in recent years are similar to the strategies that have dramatically boosted the corporate high-yield bond market. An unraveling of the subprime mortgage market will give us a preview of how the lower-quality credits in the corporate market may behave under stress.

Like the corporate bond market of recent years, subprime mortgages were driven by the desire of mortgage brokers to expand the market to less credit-worthy customers, and to earn high fees for creating "product" that could be repackaged (or "securitized") for sale to institutional investors. Because

investors were so hungry for more generous yields in the 2003-2006 period, the market for these pools of securitized mortgages saw explosive growth.

The Mortgage Bankers Association reported that 19% of all mortgages made in 2006 were in the subprime category. Of this total, 38% were purchases that required no down payment, 27% were “non-traditional” mortgages that typically had very low “teaser” interest rates in the early years, and 45% required no verification of income or home appraisal report.

The mortgage market became dangerous because investors had an appetite for risk and were willing to speculate on the particularly dicey parts of securitized mortgage pools, the “equity” tranches that often paid yields of 12% or more. As long as there was a sellers’ market for mortgage securities, and the lucrative fees were based on increasing loan volume, it is no surprise that a lot of very bad mortgages were made. In some cases, mortgages are becoming delinquent within just 120-180 days after closing.

The inevitable jump in defaults is now creating huge turmoil in the subprime market. Many groups are calling for greater regulation of mortgage lenders (presumably because the *six* different federal agencies that are already charged with oversight of the mortgage lending industry need to further expand the scope of their activities).

The subprime mortgage market parallels with the corporate bond market involve: (1) the similar huge appetite for the riskiest securitized products, and (2) the similar enormous fees earned by generating higher volumes of lending. We have mentioned in previous reports the “new finance” creations of CDOs, CLOs and CDSs that permit risk to be sliced up and dispersed among many institutional investors. The question is how these instruments, which have been created in recent years when the economy has been favorable, will perform in a less forgiving credit environment. We won’t know for sure until the next downturn, but it is reasonable to assume that, like the mortgage lenders, bond underwriters have made some very bad deals.

Yields

Yields fluctuated in a narrow range during 2006, and we expect that scenario to repeat in 2007. The Lehman Index started 2006 with a yield of 8.25%, climbed to 8.58% at midyear, then fell to 7.70% at the end of the year.

Treasury bond yields slightly increased, with the 10-year bond beginning at a 4.39% yield, climbing to 5.14% in the middle of the year, then falling to 4.71% at year-end. There was an inflation scare in June and July that pushed yields up to their highs for the year, as investors began to doubt that new Fed Chairman Benjamin Bernanke was a staunch inflation fighter. This brief panic was calmed when oil prices began to recede and housing permits showed considerable weakness, easing inflation fears.

The Treasury yield curve continues to be inverted, meaning that short-term interest rates are higher than longer-term rates. This is an almost foolproof predictor of slower economic growth. If the market were anticipating strong future growth, the yield curve would be normalized with long-term interest rates holding their usual position at levels above short-term rates. We have not seen an upward sloping yield curve since the latter months of 2005.

The bond market is currently very calm and is forecasting steady inflation and steady interest rates. The TIPS (inflation-indexed) Treasuries are priced to reflect a forecast of 2.4% inflation over the next ten years. This level is within their 2.3-2.6% range for most of the past three years. The MOVE index that reflects anticipated changes in Treasury bond yields recently dove to a new low of 55 basis points, down from 75 basis points two months ago.

Barring a significant change in the market environment, we would expect the remainder of 2007 to give us a relatively stable interest rate backdrop, and therefore the returns on high-yield bonds will be mostly dependent on changes in their yield spreads.

Spreads

At the end of December, the Lehman Index had a 7.70% yield and the yield on the 10-year Treasury bond was 4.71%, resulting in a spread of 299 basis points. So far in 2007, spreads have narrowed further to the 270 range, continuing the trend of the past year when spreads steadily fell from 386 basis points at the beginning of 2006.

Spreads narrowed (or “tightened”) primarily because corporate credit quality turned out to be much better than had been anticipated at the start of the year. As we previously mentioned, defaults were very low in 2006, and appear to be set to remain at a low level in 2007. Wider spreads a year ago accompanied by an environment of low defaults were a “free lunch” that investors seized upon as the year progressed and the economy continued to perform well.

We mentioned in our last report that spreads perhaps would not tighten more because investors were worried about a possible significant jump in the default rate looming for 2007. It has subsequently become apparent that the default rate for this year will likely still be below average, so high-yield spreads have come down about 50 basis points during the past six months.

We don't believe that today's spreads will tighten much further. They dropped to a nine-year low of 257 basis points a few weeks ago and are very close to the all-time low of 244 basis points in October 1997. A reasonable expectation is for spreads to widen out to around 300 basis points or higher as this year unfolds and defaults likely start to trend a bit higher. That would make it a year of skimpy total returns for the high-yield market in 2007.

Supply and Demand

There were a number of surprises in the high-yield market during 2006. We have already mentioned the unanticipated robust returns, very low default rate and tightening spreads that were witnessed during the year. Another surprise was the enormous supply of new issues that hit the market. According to Bloomberg, thanks to a very busy calendar late in the year, a record \$184 billion of high-yield bond issues were sold during 2006. This total easily surpassed the previous record of \$147 billion set in 2004.

Last year turned out to be the busiest financing year on record, even topping the activity level of the “dot-com” boom in 2000. In addition to the high-yield bond issuance, banks lent an enormous \$682 billion of “leveraged loans” to non-investment-grade companies, and merger advisors completed a record \$3.6 trillion of mergers and acquisitions with over \$500 billion of those backed by private equity funds.

Even in the face of this enormous supply of new securities, another surprise during the year was that demand easily absorbed the available supply. There were some grumblings late in the year of “not enough supply” in the market to satisfy investor demand for high-yielding securities. The high-yield market became an investor sweet spot, as attractive yields were (at least for one calendar year) not accompanied by significant default losses. We mentioned in our last report that the market has been encouraging risk-taking by providing high yields along with strong price appreciation and few defaults. As long as this environment endures, the market risk level will continue to rise.

We previously mentioned the explosive growth of what we term “new finance”, or what Wall Street refers to as “structured finance”. These terms generally refer to various types of securitized pools of loans or other investment vehicles that cater to specified investment objectives. In previous reports we discussed the booming CDO/CLO market and the CDS market. We now have a new item, the “constant proportion debt obligation” or CPDO. This highly complex security type allows investors to borrow approximately \$15 of debt for every \$1 of equity (the actual cash investment) to receive yields on the pooled portfolio that are somewhat above high-grade bond yields. We don’t claim to have a deep understanding of these securities, but admit to having serious concerns about the market distortions of investors purchasing (and someday possibly abruptly selling) 15 times the amount of securities that they can afford to own outright on a cash basis.

The rapidly growing leverage prevailing in the bond market today creates an enormous demand for securities, and that demand has barely been satisfied even in a boom year like 2006. So far, 2007 is shaping up as another year of possibly record-high supply and continuing high demand. We expect buyout activity to remain strong, and the growth of structured finance to create an increasing demand for securities. Predictions are for mergers and buyouts exceeding \$4 trillion this year, which would imply that we would see over

\$200 billion of high-yield issuance in 2007. Several years ago, we would not have dreamed of those sorts of numbers. But 2006 showed that the high-yield market is capable of giving us a few surprises.

Fund Portfolio Strategy

Obviously, the Fund portfolio performed very well during the calendar year 2006, with a better than 15% total return and the Fund finishing in the top 1% of all corporate high-yield bond funds tracked by mutual fund reporting service Morningstar, Inc. Therefore we don't want to do too much tinkering with a formula that has been working.

However, 2007 will likely be a more difficult year in the market and we expect to make some adjustments. Credit quality may very well be passing its peak for this cycle, and we will carefully look for any signs of impending weakness. At December 31, the Fund was mostly invested in shorter-term bonds of average quality, with about 25-30% of its assets invested in more aggressive situations for higher total returns. We were fortunate in 2006 that our aggressive investments worked very well, and in hindsight it can be seen that we should have been more aggressive. But we think our current posture is appropriate for the environment we are facing in 2007.

We have often discussed the repetitive cycles that have been seen in the modern high-yield bond market. Over periods of 4-7 years, the market has typically moved from periods of very low defaults and very narrow spreads to much higher defaults and much higher spreads. Properly handling these cyclical changes in the market is vitally important to the investment success of the Fund.

We want to repeat that our long-term strategic objective for the Fund is to maximize its risk-adjusted total return. We are focused on overall returns, not necessarily the current yield on the portfolio. This will become more important for you to understand as we move into the tougher part of the credit cycle. In the coming downswing, it is crucial to the Fund's long-term objectives to sacrifice current yield and emphasize capital preservation. This tactic puts the Fund in good position to be aggressive near the bottom of the cycle and reap the maximum benefit from a future cyclical upswing.

An examination of the facts we have presented in this report clearly argues for a cautious approach to the market. There is plenty of anecdotal evidence that the economy is slowing, that profits will not show strong growth, and that credit quality is likely to resume its long-term decline.

For example, the most recent Federal Reserve survey of bank lending officers shows that bankers are "notably more cautious" about the quality of their loan portfolios in 2007 than they were during 2006. There is a feeling

in the financial community that the credit expansion of the past several years has mostly run its course. The lending pullback in the subprime mortgage market may be the first move toward a broader retrenchment in consumer and commercial lending. Such tightening of credit will almost inevitably widen the spreads in the high-yield bond market. As a result, we will be using a particularly sharp pencil this year to evaluate the quality of our holdings and any potential purchases. As each month goes by, we are that much closer to the next downturn in the cycle.

We can't predict the timing, but if we had to guess we would say that it is still 18-24 months away. We make this projection for three reasons. First, 2008 is an election year in America, and the Fed will lower interest rates if necessary to keep the economy together until next November. Second, even if a downturn starts soon, it would take a matter of months to fully unfold. Third, in 2008 China will host the Summer Olympics, and therefore that important economy will be stimulated by a heavy dose of related capital investments and to some extent will pull the global economy along with it.

Our current view is that 2007 is a year to prepare for a possible storm. We are still experiencing prosperous times, but are drawing closer to the inevitable downswing of the credit cycle. As we mentioned in our last report, the next recession in America could push bond defaults to unprecedented record highs, based on a study of the credit quality of the existing universe of bond issues. The large volume of low-quality bonds sold since 2003 will eventually begin to default and have an impact on the larger credit markets.

We want to protect the Fund as well as we can from a damaging environment. But we also want you to start anticipating that we may be presented with the bond market's best buying opportunity of our lifetimes in the next several years. In order to properly play the cycle, the Fund will first have to be cautious and then later be very aggressive. We will continue to communicate our overall strategy to you as it evolves with the necessary changes.

Conclusion

The Fund has now completed its first three years of operations and therefore has a performance record that is publicly reported by various fund rating services. We are pleased to state that, according to Morningstar, the cumulative returns over its life place the Fund in the top 10% of its peer group. We are happy that the Fund has shown strong returns in a market that, for value seeking investors like us, has been very difficult. Keep in mind that the Lehman Index has been yielding 7-8% for a good part of the Fund's life compared to the 10-11% yields that it has paid for most of the past twenty years.

We continue to be concerned about the widespread use (and misuse) of financial leverage in the credit markets. The products of the "new finance"

have never been tested in a truly tough environment. Keep in mind that the economy has not had a significant recession since 1990-91, almost a full generation ago. We may be lucky enough to avoid a serious recession for the next few years, but the markets are leveraged to a degree that does not realistically anticipate the credit crunch that a deep recession will cause. Unfortunately economic history has taught us that credit expansions often end in a very painful way.

One final item that we want to mention to you. We are substantial investors with you in the Fund. The Fund portfolio manager and fellow employees of the Advisor have now invested well over \$1 million in the Fund, and therefore will be personally sharing in a significant way in the Fund's future performance. We are continuing to focus on protecting your investment in Fund shares, and ours.

Thank you for your confidence in the Fund and we look forward to sharing a rewarding future with you.

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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