AEGIS / VALUE FUND

October 10, 2008

Dear Investors:

We are writing to communicate our thoughts with regard to the recent declines in world equity markets. As you know, investors lately have been subject to a constant barrage of negative economic news. Thus far many of the government and political responses to this news seem to have exacerbated fears rather than calming them. As a result, stock investors around the world have recently become consumed with fear to a degree unprecedented in recent decades. At home, the S&P 500 dropped over 20 percent this first week in October—apparently the worst week for S&P performance in the history of the index, dating back to 1928.

With the total decline in U.S. stocks as captured by the Wilshire 5000 Index down by approximately $7.5 trillion and the S&P 500 Index down approximately 40 percent since the market peaked almost exactly one year ago, it is very natural to feel some fear. Investment marks on Aegis portfolio companies have certainly been affected by the market action of recent days, as the decline has been extraordinarily broad-based. While these are not easy times to make investment decisions, we want to assure you that when making business judgments with regard to our Fund investments, we remain quantitative, logical, thoughtful, and focused. As you contemplate your own financial situation in light of these recent events, we want to make sure you have the benefit of our best thinking as to what we believe is transpiring and how we have positioned our Fund to get through this difficult time.

For those of you with limited time, a summary of our thoughts:

- We are experiencing a banking panic; not a "Great Depression II".
- The vast majority of Fund holdings are not leveraged financial institutions at risk of bankruptcy; in fact many of our top holdings have significant net cash positions.
- Like most stocks, the performance of the Fund has been impacted by "forced selling" as some investors are required for various reasons to reduce leverage and risk exposure.
- In the midst of this turmoil, the Price-to-Book ratio of the Fund has hit a record low. Fund shares are currently cheaper relative to our assessment of fundamental value versus any time since inception of the Fund in 1998.
- Also amidst the turmoil, the number of stocks in the market trading below book value, an indicator we use to gauge the number of investment opportunities available to the fund, has hit a historic high point.
- Patient investors can find good bargains in the current turmoil; near-term volatility should not dissuade investors from keeping a long-term investment horizon.

A Banking Panic – But Not a "Great Depression"

Perhaps most importantly, during these times of turmoil when Great Depression rhetoric abounds, it is important to keep in mind the dramatic differences between that period and today's economic difficulty:

- Currently, 6.4 percent of mortgages in the U.S. are at least one payment behind, and 2.75 percent of mortgages are in foreclosure—a difficult situation to be sure, but a far cry from the 44 percent of first mortgages in default at the end of 1933.
- According to the most recent data, Q3 GDP looks approximately flat, while September unemployment held steady at 6.1 percent. Conversely, between 1929 and 1933, real output in the United States fell by nearly 30 percent while unemployment rose from 3 percent to nearly 25 percent.

While some argue that we are still early in the downturn, we believe significant differences exist today that make a "Great Depression II" unlikely to develop in coming years:

- Most importantly, in the early 1930s the Federal Reserve failed to realize the impact of the dramatic decline in the money supply, which fell by a third between 1929 and 1933. During this period, the Federal Reserve kept monetary policy damagingly tight even in the face of significant deflationary pressure. Today, with keen comprehension of the deflationary impacts of deleveraging, and with a strong understanding that money supply shrinkage was an important root cause of the Great Depression, the Federal Reserve has acted aggressively to ensure that the monetary base does not shrink.
- Not only has the Federal Reserve worked aggressively to counteract deflationary pressures, but central banks globally have also now demonstrated a strong, pro-inflationary response to the crisis. Like the Great Depression, the current crisis is a global phenomenon. However, unlike the Great Depression, we are currently witnessing a massive global response to recapitalize the banking sector.
- During the 1930s, thousands of banks failed after experiencing rapid withdrawals by panicked depositors, which inflicted massive damage on the economy by shrinking the money supply. Today, FDIC insurance (and similar guarantees abroad) significantly reduces the risks of such wide-scale "runs" on banks. Furthermore, the Federal Reserve and the government have demonstrated the willingness to prevent "runs" on money market funds that provide a function similar to deposits in the modern banking system.

While the Great Depression was a singular event, investors should recognize that more contained banking crises are not particularly rare events. An historical comparison of world-wide financial crises recently published by Carmen Reinhard of the University of Maryland and Kenneth Rogoff of Harvard University studied eighteen bank-centered financial crises since the end of World War II. According to this study, real equity prices on average declined substantially during the year of the crisis but rose significantly (as one might expect) in the following years.

During the current crisis, market conditions began to dramatically deteriorate in the days following the September 7th government take-over of Fannie Mae and Freddie Mac. In the following week, we saw the bankruptcy filing of Lehman Brothers and the government bailout of failing insurance company AIG. The last 5 weeks have also witnessed the failure of Washington Mutual and the forced sales of Wachovia and Merrill Lynch. In most of these cases, with the notable exception of Merrill Lynch, shareholders of these entities experienced almost total losses. Fortunately, the Aegis Value Fund did not hold stakes in any of these entities as we were generally avoiding financial companies with high degrees of leverage.

As you have likely read, one consequence of the recent failures has been a freeze-up in lending. While the Federal Reserve subsidized J.P. Morgan's acquisition of Bear Stearns in early March by purchasing nearly $30 billion of Bear's collateralized mortgage-backed obligations of questionable value, it refused to provide adequate assistance to induce a purchase of Lehman Brothers. As a result, Lehman's uncollateralized lenders experienced a near total loss in September when Lehman declared bankruptcy. We believe that the failure to recapitalize Lehman outside of bankruptcy is the spark that set off the most recent 'brush fire' in the equity markets.

One spillover from the Lehman bankruptcy was losses to Lehman's commercial paper lenders. Amongst these lenders was the Reserve Primary Fund, a large money market fund that was forced to "break the buck", an event that the markets had not seen in 14 years. This spooked money market investors, who began to withdraw funds and pile into Treasuries. Managers of money market funds also continued to flee for the safety of government-guaranteed securities, depriving the market of significant risk-oriented capital liquidity and pushing Treasury rates to record low levels.

As a result, funding liquidity for commercial paper and other investments dried up, causing borrowing rates to skyrocket and putting severe stress on General Electric, General Motors, Goldman Sachs, Morgan Stanley and many other companies with business models heavily reliant on capital market access for short-term funding, raising the prospect that these companies might be forced into fire-sale asset liquidations themselves. Many commercial paper borrowers are now directly or indirectly relying on credit from the Federal Reserve for short-term funding access. Fortunately, the funding of Aegis portfolio companies has generally not been directly impacted by a lack of access to commercial paper, as we have been careful to avoid companies requiring steady access to the commercial paper markets.

Market-Wide Equity Liquidations Have Impacted Stock Prices

As noted above, the Fund is not particularly exposed to highly leveraged banks or companies that are struggling in the short-term credit markets. A high proportion of our holdings are net debt-free or very well funded. Of greater impact to the Aegis Value Fund, therefore, was the fact that the failure of Lehman Brothers and the resulting credit freeze led to significant forced liquidations in the stock and bond markets.

It appears to us that several factors are at work in these liquidations. First, previously collateralized lenders to Lehman in the short-term lending markets may be liquidating their collateral. Given that Lehman had $188 billion in short-term collateralized loans at the end of May, the market impact of collateral liquidations could have been significant as these formerly Lehman-owned securities were sold out. Furthermore, in light of the Lehman debacle these collateralized lenders tightened terms on loans extended to the remaining borrowers in the market. This acted to force a painful round of asset sell-offs into a bad market as hedge funds, banks and other financial players faced margin calls as they struggled to readjust to these more stringent lending requirements.

Additionally, the market has become increasingly concerned about contracts known as credit default swaps (CDSs), in which the seller insures the buyer against loss in the case of default on a particular debt obligation in return for a fixed periodic premium over the life of the underlying debt. This unregulated market has grown rapidly in recent years. Now, investors are worried that many financial firms sold CDS contracts at low prices to show good earnings over the last few years without proper attention to the payouts they would require in an environment of heightened defaults. The International Swaps and Dealers Association (ISDA) recently estimated that credit default insurance contracts exist on a gross amount of $54 trillion of underlying debt obligations. Because gross contract value is doubled when counterparties enter into reverse contracts and close out originally written CDSs, the ISDA believes that gross notional values merely track aggregate market activity and real credit exposure is thought to be as much as 95 percent lower. Unfortunately, the market doesn't know for sure how much exposure has been closed out and who retains credit risk.

This first week of October witnessed particularly strong banking concerns over the estimated $400 billion of gross exposure on CDS contracts referencing now defaulted Lehman bonds, the insurance payouts on which may have been as high as $360 billion, as Lehman bonds experienced a drop to less than 10 percent of face value upon bankruptcy. We believe that many of these contracts may have settled on October 10th as the ISDA auction on that afternoon set the payout price. While these capital flows should have no net effect on the overall financial system, as one side gains what the other loses, we believe that certain hedge funds and financial institutions may have been significantly exposed to Lehman's default after incorrectly betting on a Bear Stearns-like Fed bailout. While the market is opaque and it is impossible to know for sure, we believe some funds may have been liquidating stocks in an effort to raise liquidity in recent days to meet CDS payment obligations related to the Lehman settlement. Perhaps more importantly, as the bond markets froze up, the cost of default insurance on bonds skyrocketed, often requiring firms to post additional collateral on their outstanding CDS contracts, further squeezing financial liquidity, causing margin calls and additional liquidations of financial assets. We know that requirements to post additional collateral on CDS exposures were one contributing factor in the AIG failure.

Investor redemptions have also increased liquidation pressure. Investor psychology was severely damaged, particularly after the government's $700 billion "bailout" bill was sold to America by promising economic catastrophe if not passed. Some stock investors have reacted to the uncertainty and significant selling pressure in the market during recent weeks by trying to exit the market and reduce risk. Investors redeemed $43.3 billion from equity mutual funds in the first week of October alone according to TrimTabs, a dramatic increase from the $7.2 billion in redemptions from stock funds in the previous week. September had already seen huge equity fund outflows totaling $50.5 billion. Redemptions from mutual funds in total during September reached $74.5 billion, nearly three times the previous redemption record set in September of 2001. This has required mutual funds to sell holdings into an already very weak market. Reports of poor hedge fund performance in September and significant liquidation requests among hedge fund investors are also weighing on the market, and we would not be surprised to see several of these funds forced to wind down, particularly those that had been long on energy and commodities, after suffering leverage-enhanced losses.

We provide you with this history as we believe it is this forced selling that has impacted recent price marks on holdings in our Fund over the last few weeks as hedge funds and other financial players rapidly exit their investments in a broad set of stocks in a struggle to gain liquidity to meet margin calls and investor redemptions.

Fund Performance

Although the market turmoil in this first week of October has rendered a detailed third quarter performance discussion somewhat dated, we wanted to provide you a few words about the quarter. According to Bloomberg, U.S. stock funds overall fell 11 percent in the third quarter. Our Fund's performance can be seen in Table 1. When looking at Aegis' performance against the benchmarks, the most important recent factor has been our heavy positions in energy and commodity stocks relative to financials when compared to the benchmarks. Energy and commodity stocks dropped significantly in price in recent weeks on this deflationary scare after running-up strongly for much of the first half of the year, which hurt our performance relative to the benchmarks in the third quarter after helping in the first two. We believe that the sell-offs are overdone and are aware that these stocks are at the epicenter of today's current forced liquidations. We believe our holdings represent great value, even at today's commodity prices, and we continue to hold our natural resource and commodity stocks, in part, as a hedge against inflation. After all, it is inflation that is typically a much more serious problem for central bankers to address, and may become an issue given the rapid expansion of the monetary base that is occurring in reaction to this deleveraging scare. Overall, year-to-date through September 30th, we were down 6.7 percent, compared to a loss of 5.4 percent for the Russell 2000 Value Index and a loss of 19.3 percent for the S&P 500. As large shareholders in the Fund, we are certainly disappointed with any sustained period of negative results.

Table 1: Aegis Value Fund Performance Summary as of September 30, 2008

		Annualized Return				
	Quarter Ended 09/30/08	1 Year	3 Year	5 Year	10 Year	Since Inception (5/15/98)
Aegis Value Fund	(8.1%)	(13.7%)	2.0%	5.4%	12.6%	10.8%
Russell 2000 Value Index	5.0%	(12.3%)	2.0%	9.5%	10.1%	7.4%

Performance data quoted include reinvestment of income and capital gains and are presented on a pre-tax basis. 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. For performance data current to the most recent month end, please call us at 800-528-3780 or visit www.aegisfunds.com. The Fund has an annualized expense ratio of 1.42%.

Positioning of The Fund's Portfolio

Despite the recent price declines in our stocks, we believe fundamental values of our portfolio companies remain little changed from 4 weeks ago, despite the increasing chance of economic weakness. Investors should remember that our portfolio holdings were purchased at prices we believed already offered significant discounts to true economic value and at price levels that already discounted tough economic times. After the recent declines, we have a difficult time reconciling the prices of our holdings to anything but the most dire predictions of economic depression. We would encourage you for a moment to put aside "macro"-level thinking and take a "bottom-up" look at some of the largest holdings currently in the Fund:

Horsehead Industries (Ticker: ZINC $3.79 October 9th) *: This $134 million market cap industrial company recycles electric arc furnace dust waste product produced by steel mini-mills into zinc and handles about 50 percent of the EAF dust produced in the United States. This debt-free company carries a cash balance of $69 million, equivalent to more than 50 percent of its market capitalization. The company, which trades at approximately 50 percent of book value, carries property, plant & equipment on its books at $111 million after most of its assets were severely written off in a previous bankruptcy in 2002. We estimate these Horsehead assets have a replacement cost of between $750 million and $1 billion and are now trading in the market at well under 10 percent of replacement value. These assets include a 110 megawatt coal-fired power plant that we estimate is worth $70 million alone. The company trades at 2 times trailing earnings and 6 times forward earnings as the company has hedged a majority of its zinc metal exposure for the coming year at prices significantly above current market levels. While zinc prices are currently depressed, the company is also in the process of cutting an additional $35 million per year out of its cost structure. With revenues of approximately $500 million annually, Horsehead trades for a cash-adjusted 15 percent of revenues. We believe Horsehead is a low-cost producer of zinc and the investment is likely to fare quite well in the future, particularly if zinc prices increase.

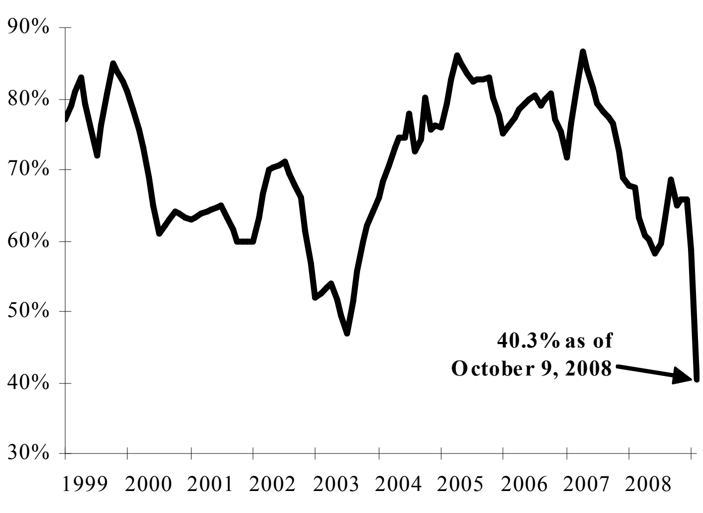
Tecumseh Products (Ticker: TECUA/TECUB $16.20/$15.75 October 9th) *: This $300 million market cap company is an international producer of air conditioning compressors for industrial and commercial applications worldwide. Adjusted for net cash on the balance sheet of $109 million, this company currently trades at approximately 20 percent of worldwide revenues of $1 billion and about 35 percent of its tangible book value of $40 per share. By the close of 2009, we believe net cash balances may be well in excess of $200 million. The company is in the process of collecting $140 million cash from withheld Brazilian tax payments (some of which will likely be used to repay a Brazilian credit line). An additional $35-45 million cash is expected to be released from an over-funded pension plan in the first half of 2009. Sales of excess assets, inventory reductions, and other miscellaneous items may generate an additional $40-50 million of cash in the coming twelve months. Furthermore, recent substantial reductions in the value of the Brazilian Real relative to the dollar are improving the competitiveness of the company's manufacturing footprint. While a weaker worldwide economy may dent unit volume shipments, margin pressure is likely to be relieved by substantial recent declines in steel and copper prices. New, professional management is working to diligently improve operations at Tecumseh, and the company is likely to begin generating more than $50 million in sustainable annual operating cash flow within the next 2-3 years.

American Pacific (Ticker: APFC $11.90 October 9th) *: This $90 million market cap specialty chemicals company holds $32 million of cash and owes $110 million of 9 percent notes, not due until 2015. The high-quality company is the sole domestic producer of ammonium perchlorate, a solid-rocket fuel primarily used in space and military applications. Additionally, American Pacific is active in the rapidly growing non-volatile chemicals segment supplying chemicals used to manufacture pharmaceuticals. The company currently trades at only a slight premium to its book value of $10.50 per share. With significant barriers to entry and long-term production contracts, this recession resistant company produces annual pre-tax operating cash flows in excess of $40 million, and requires approximately $5 million of maintenance capital expense. At current levels of cash flow, we estimate the company would generate enough capital to pay-off its entire debt and repurchase every share within 6 years.

<u>**New Opportunities amidst the Rubble**</u>

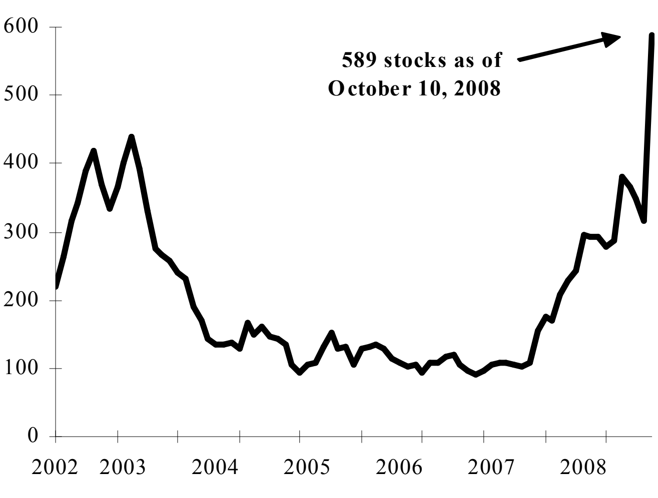
Clearly, these major portfolio holdings are not at all dependent on near-term access to the debt markets to fund any part of their business, and none of these companies have engaged in the self-destructive behavior we saw in the financial sector, yet each of these firms has declined dramatically in recent days. Observing the entire market, we believe there are a large number of companies with great fundamentals trading at historically cheap valuations. For example, when looking at the Fund as a whole, as can be seen in Figure 1, the Aegis portfolio on October 9th traded down to a weighted average 40.3 percent of book value, surpassing the low of 47 percent of book value reached in Q1 of 2003. This is the cheapest level in the Fund's history. As can be seen in Figure 2, our watchlist now includes 589 names, the highest number since we began tracking in April 2002.

Figure 1: Aegis Value Fund Historical Price-to-Book Ratio



Source: Aegis Financial Corp.

Figure 2: Number of Stocks Selling Below Tangible Book Value (Market Capitalization Greater Than $70 Million)



Source: Stock Investor Pro.

In Conclusion

Some subscribe to the view that we are on the cusp of a new Great Depression. We disagree, and we believe there are reasons to be optimistic about selected value stocks in the medium term. Central Banks appear to be properly acting in concert to enhance system liquidity, which will soon be offsetting the current deflationary impacts of deleveraging. While risk appetites are currently depressed, dollar liquidity is plentiful. Record levels of cash have accumulated on the sidelines. The "M2" money supply of currency, checking, savings, and retail money market deposits totals has grown 5.3 percent to $7.7 trillion, which appears to us to be a record high 75 percent of the total market capitalization of the S&P 500 Index. It is also worth noting that the $7.7 trillion M2 figure <u>excludes</u> large time deposits, institutional money funds, and U.S. Treasury holdings at home and abroad. We expect that the owners of this mountain of capital will increasingly reallocate towards investments that offer a better prospect of real returns. We cannot predict exactly when this may happen, but as it does it will impact markets positively in a way no government economic stimulus package can. Furthermore oil prices have dropped by more than $50/barrel since May, providing U.S. consumers with the equivalent of an incremental $1 billion per day to spend, save, or invest. Lower commodity prices and a stronger dollar have for the time being dampened inflationary expectations, which is likely to give a further boost to consumer confidence next year, and which has already given the Fed latitude to further increase liquidity.

We believe at this time it is critically important that investors prevent the current market volatility from distracting focus away from the long-term. We see that in the last few weeks, Warren Buffett's Berkshire Hathaway has just invested a large part of its more than $30 billion cash reserves after sitting and waiting for much of the last decade. For patient investors with long-term capital, the current financial panic has driven stock valuation levels on companies with strong economic fundamentals to historically low levels, and we would encourage our investors to move against the crowd and continue allocating capital into the market.

Sincerely,

Scott L. Barbee
Portfolio Manager
Aegis Financial Corporation

** As of October 9, 2008, Horsehead Industries, Tecumseh Products and American Pacific represent 4.8%, 5.1%, and 4.6% of total assets of the Aegis Value Fund, respectively.*

The Aegis Value Fund is offered by prospectus only. Before investing in this Fund, investors should carefully consider all risks of investing in: stocks in general, "deep value" stocks, stocks of smaller companies, and stocks of foreign companies. Investors should consider the Fund's investment objectives, risks, charges, and expense. The prospectus contains this and other information about the Fund and should be read carefully before investing. To obtain a copy of the prospectus, please call us at (800) 528-3780, or visit our website at www.aegisvaluefund.com, where an online prospectus is available.

Date of first use: October 13, 2008. Fund Distributor: Rafferty Capital Markets, LLC