AEGIS / VALUE FUND

Portfolio Manager's Letter
Quarter Ended December 31, 2008

January 22, 2009

Dear Value Investor:

Market conditions in 2008 have been among the most turbulent of the last 80 years. In the first half of the year, investors were faced with skyrocketing commodity prices and widespread fears of inflation. The Aegis Value Fund significantly outperformed its benchmark Russell 2000 Value Index during this period. However, the second half of the year brought a remarkable turnaround with increased bank failures, deleveraging, and widespread fears of deflation. The Fund significantly underperformed its Russell 2000 Value benchmark during the second half. We believe a majority of recent declines are technical drops driven by shareholder liquidity, deleveraging, and a rapid shift of investor preference away from equities and toward cash and government securities. The declines are generally not issues of company solvency.

In today's turbulent economy, with its abundance of emotionally draining market volatility, it can be a challenge to retain a healthy investment perspective. Notwithstanding the wrenching experience of recent months, we all realize that successful value investing requires patience and discipline over the long-term. So, despite the near-term results, you can rest assured that we are persisting with the same discipline we have exercised over the past ten years, and we continue to employ the same long-term oriented, fundamentals-driven approach to investing that we have employed since the Fund's inception. In past years, we have written about the difficulties of finding good investment opportunities. Now, the situation has changed. While the economy remains challenging, in many ways the investment opportunities are among the best we have ever seen.

The Current Environment

The past year was surely a difficult one to be an investor. Worldwide, markets declined by an aggregate of approximately $30 trillion. According to Barron's, the roughly 8,500 diversified equity funds in America lost $1.7 trillion in asset value during 2008, starting the year with $4.1 trillion in assets and ending the year with $2.4 trillion. The average U.S. diversified equity fund lost 37.5 percent of its value last year and investors pulled $235 billion from these funds in the year through November. According to TrimTabs, in 2008, hedge-fund assets declined from $1.9 trillion to $1.0 trillion. In December alone, hedge fund redemptions were thought to have reached a record $148 billion, bringing redemptions for the quarter to $237 billion.

In their efforts to reduce risk, and often facing margin calls, investors sold all manner of securities, driving NYSE margin debt levels down from approximately $380 billion in June to near $200 billion by the end of November. These sellers rapidly moved proceeds into cash, bank deposits, and money market funds, even driving treasury-bill yields negative at one point. This capital "strike" has wreaked havoc on the economy as the previous abundance of consumer financing and risk capital dried-up. Now, approximately $8.85 trillion of cash sits on the sidelines in negligible-earning instruments, an amount equal to 74 percent of the market value of all U.S. equities. This is the highest ratio of cash-to-US equity market value in nearly 20 years. The ratio increased by 86 percent in the first 11 months of 2008, the fastest rate of increase since the Federal Reserve began keeping records in 1959.

Many investors continue to focus on the ongoing losses in the banking system, which Goldman Sachs now estimates may reach as high as approximately $1.7 trillion in this cycle with $850 billion already recognized. We believe that the world equity markets decline of $30 trillion in response, over 15 times the level of banking losses, is overdone. Furthermore, future banking system losses are likely to be significantly offset with dramatically increased spread income made possible by the various government guarantee programs which have significantly lowered bank funding costs.

Declines in the quoted prices of small-cap deep value stocks in recent quarters have been particularly steep. In the past 18 months, such stocks have generally lost about 55 percent of their value. This period has been a highly unusual period historically and an almost unprecedentedly poor period for the small-cap deep value style of investing, which has led to questions regarding the overall wisdom of remaining invested in these securities.

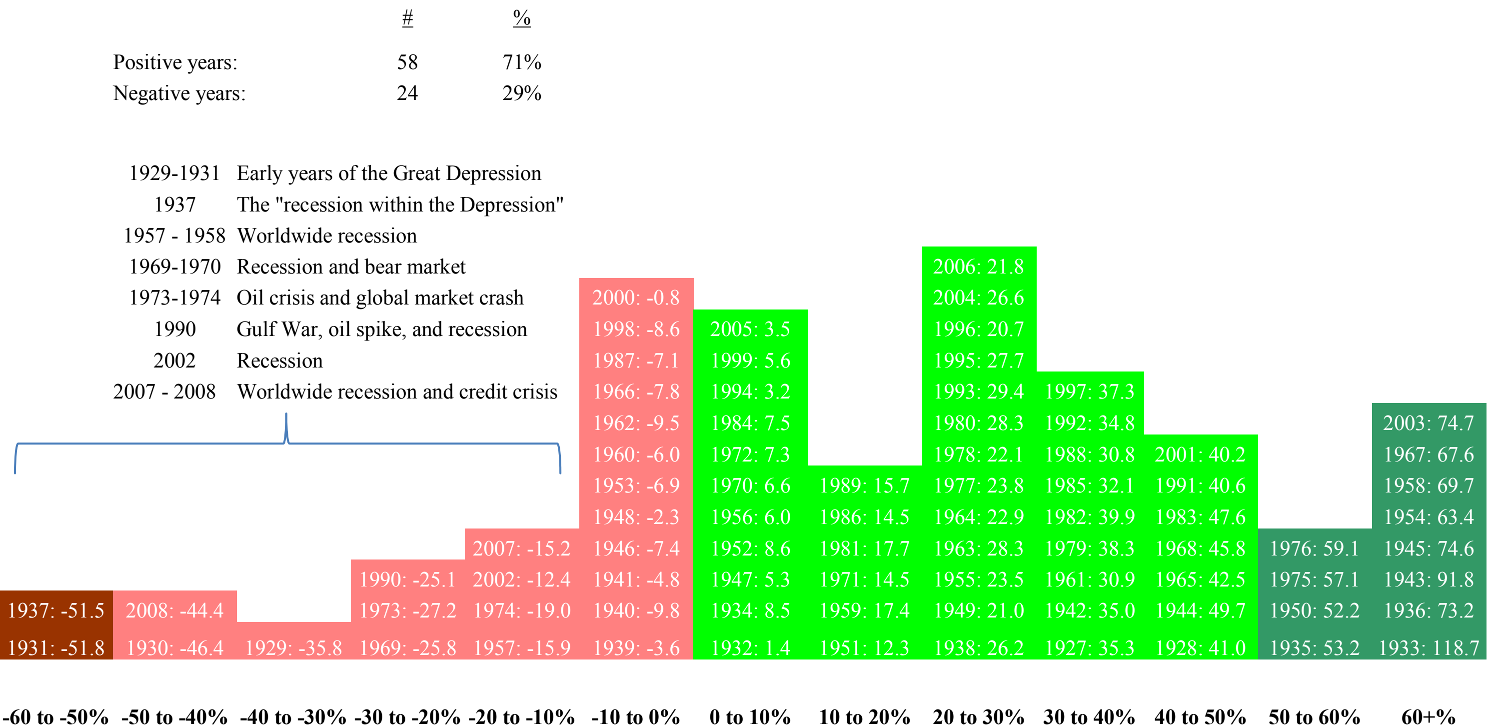
Having evaluated all modern historical periods following the largest declines in small-cap deep value stocks, we concluded that patient investors have typically experienced significantly outsized financial gains in subsequent years. Although no one can be certain when today's market will turn, we believe investors showing patience after this latest, unusually severe 18-month market decline are likely to see long-term benefits.

Historic Context: The 1930's and the 1970's

Last year's decline of the Fama/French Small-Value Benchmark of approximately 44 percent was the worst year for small-cap deep value stocks on record since 1937. This decline was immediately preceded by a decline of 15 percent in 2007, which was the 11th worst

annual performance for the style in the last 82 years. In an effort to provide additional perspective on these declines, as well as to give investors some idea as to how this style has performed in the past, particularly following significant declines, we have provided **Figure 1**, showing the annual performance of the Fama/French Small Value Benchmark over the last 82 years. Evaluating these annual returns, there has only been one other period since the mid-20's when deep value small-cap stocks have performed as badly as in the last two years, and that was when the United States was entering the Great Depression of the 1930's.

Figure 1: Fama/French Small Value Benchmark: 1927 to 2008



Source: Kenneth R. French Data Library, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

As we noted in our October letter, there has been a lot of talk recently that America could be entering a second Great Depression. While the world economy is undoubtedly in the grasp of a banking crisis, we continue to believe that the current economic difficulties will not translate into a repeat of the deflationary Great Depression:

- The Federal Reserve kept monetary policy excessively tight during the early 1930's, damaging the economy as the money supply fell by nearly 1/3 between 1929 and 1933. Spiraling bank failures were one cause of the shrinkage, as investors raced to pull money from banks. By 1933, we understand 11,000 of the 25,000 banks in the United States had failed. In 2008, just 25 banks were closed by the FDIC. As we entered the current recession, the Fed has acted in an unprecedented way to ensure monetary liquidity, including dropping target interest rates to under 0.25 percent, adding more than 12 different lending and liquidity facilities, and expanding the Federal Reserve balance sheet to approximately $2.3 trillion from $1.4 trillion in September. Additionally, federally-backed FDIC insurance insulates the economy against the cascading bank failures seen in the 1930's.

- During the Great Depression, GDP dropped between 1929 and 1933 by 30 percent. Unemployment peaked at 25 percent. GDP in this down-cycle is currently expected to shrink overall by well under 5 percent. Unemployment in this down-cycle is widely expected to peak at 8.5 to 10 percent. Furthermore unemployment insurance today, not present in the 1930's, acts to mitigate the contagious economic effects of unemployment seen in the 1930's.

- In the 1930's the United States government responded to the worsening economic conditions by significantly raising marginal tax rates, with the top brackets nearly tripling from 25 percent to 79 percent between the early 1930's and 1936. Congress also passed the Smoot-Hawley Tariff Act into law in 1930, which increased tariffs on imported goods dramatically and caused other nations to retaliate with similar tariffs in response. Today, the incoming administration has indicated that it is likely to delay the implementation of any marginal tax increases in the near-term. A large portion of the current $825 billion stimulus package working its way through Congress is apparently actually comprised of tax decreases at the lower brackets. Additionally, today there is widespread agreement among world governments that protectionism is counter-productive to fostering recovery.

Overall, we remain more concerned that current policy responses will "overshoot" responsible levels of monetary creation and set the stage for the return of an inflationary environment.

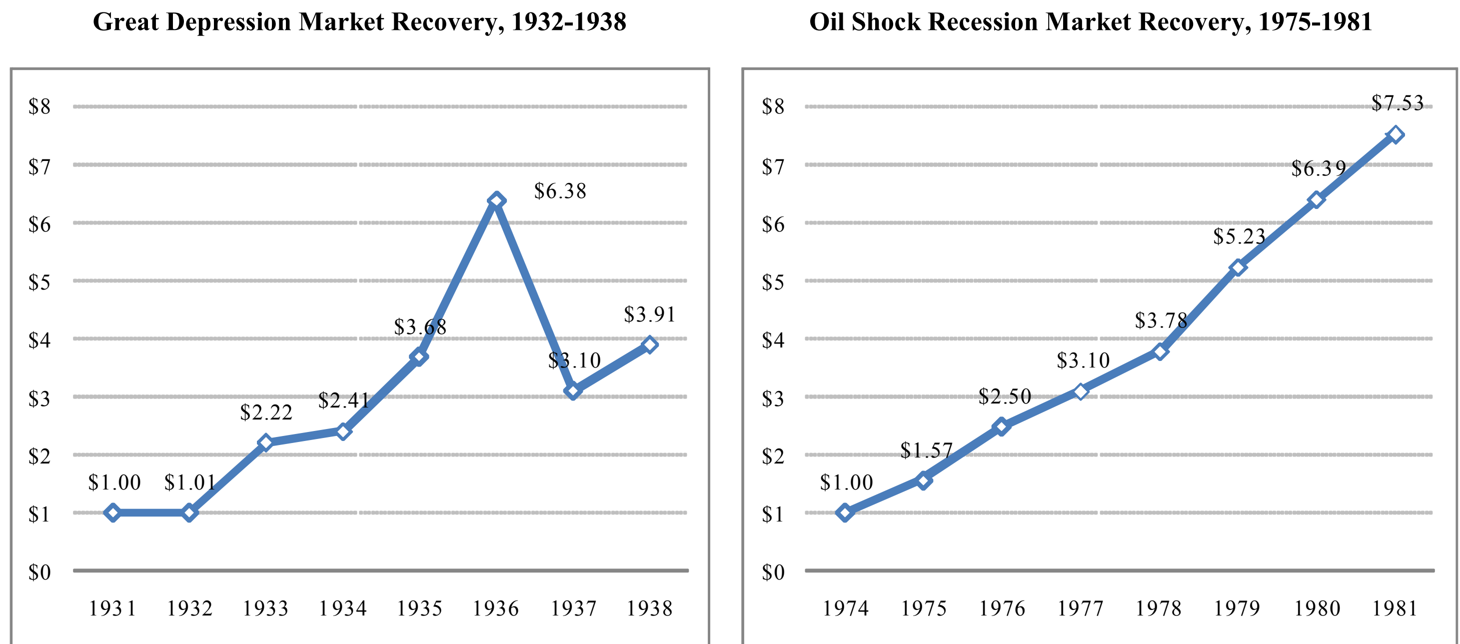
Indeed the economic slowdown is itself now sowing some of the seeds of the recovery. Consumers are likely to increasingly take advantage of artificially low mortgage rates and targeted forbearance policies designed to reduce foreclosures. Savings on interest (and in some cases principal) will be significant for many households.

Also improving the consumer’s cash flow and certain corporate profits is the precipitous decline in commodities prices. With oil prices now down from $150 per barrel in June to $40 today, Americans are enjoying significant savings on the more than 20 million barrels per day of consumption. The $100 drop in oil prices over the last 6 months frees-up $2 billion per day in spending power that can be applied to deleveraging or purchasing additional consumer goods. While the American economy is particularly energy-intensive, the benefits of lower energy prices will be felt by consumers worldwide. Similarly lower prices of foods, metals, and all manner of basic materials will relieve significant pressure from consumers and certain raw material consumption-intensive companies.

Reflecting on the recent “commodity spike” leads us to consider the recession of 1973 and 1974 as a potential historic analog to the current period. This recession occurred following the Arab Oil Embargo as the price of oil more than tripled and badly damaged the economy. The period was one of severe economic and political uncertainty as the United States removed itself from a costly and unpopular Vietnam War and the Watergate scandal was in full swing. While the difficulties of that recession were not compounded with the banking and housing issues faced today, the period did have its own idiosyncratic systemic issues with spiraling inflation and a weakening dollar following the “Nixon Shock” and movement of major world currencies from the Bretton Woods system to floating exchange rates. During the 1973 Oil Shock Recession, GDP declined by a cumulative 2.7 percent while unemployment increased from 4.6 percent to 9 percent. Deep value small-caps dropped significantly in these years, with the Fama/French Small Value Benchmark falling 27.2 percent in 1973 and falling a further 19.0 percent in 1974, for a total 2-year decline of 41.8 percent. Investors dumped equities and, similar to today, rushed into cash, driving aggregate cash on hand to a massive $604.5 billion in September of 1974, a record that stands to this day of 121 percent of U.S. stock market capitalization.

In both the Great Depression and the Oil Shock Recession of 1973-1974, investors who ignored the negative news and bought into the markets following these historically steep declines were well rewarded. As can be seen in **Figure 2**, in the 5 years following 1931, the Fama/French Small Value Benchmark returned a cumulative 538 percent without a down year, or over 44 percent per year. Even including the damaging “double-dip” recession of 1937, the benchmark returned over 21 percent annually for the 7 years through 1938. After market declines in 1973 and 1974, over the next 7 years (1975 through 1981), the Fama/French Small Value Benchmark returned a cumulative 653 percent without a down year, or greater than 33 percent per year. In fact after 1981, the benchmark continued delivering strong returns every year until 1987. Clearly the mid-to-late 1930’s and mid-to-late 1970’s were not periods of particularly robust economic health, but investors in our style experienced long, consistent periods of very healthy returns as securities markets stabilized following large sell-offs.

Figure 2: Fama/French Small Value Benchmark Returns — Growth of $1.00 Invested



Source: Kenneth R. French Data Library, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Having evaluated these historical periods following the largest declines in small-cap deep value stocks, we have concluded that patient investors remaining committed to our style following these declines experienced outsized financial gains in both previous cases. Accurately timing a bottom in the current market, however, is impossible. Indeed, we have a healthy respect for the magnitude of the current economic malaise. We do know in the long-run history has not treated kindly those who project current trends indefinitely into the future. Conversely, it has rewarded those who exhibit the discipline to continue investment during times of market stress.

Portfolio Performance

As can be seen in **Figure 3** below, the Aegis Value Fund declined 47.9 percent in the 4th quarter, underperforming broader market indices, dragged down by heavy holdings of commodity and energy stocks that had boosted returns during the first half of the year. Furthermore, we held significant stakes in industrial stocks, many of which fell rapidly out of favor as the credit crisis began to grip the economy. Because of our disciplined approach in targeting low price-to-tangible book investments, the portfolio has been underweight the best performing sectors of the second half: the defensive sectors such as healthcare, telecommunications services, and utilities. We continue to hold significant positions in commodity stocks, energy stocks and industrials, as we intend to keep the portfolios positioned for the possibility of an inflationary resurgence, a scenario that we believe is not properly considered in today's market.

Figure 3: Aegis Value Fund Performance Summary as of December 31, 2008

		Annualized Return				
	Quarter Ended 12/31/08	1 Year	3 Year	5 Year	10 Year	Since Inception (05/15/98)
Aegis Value Fund	(47.9%)	(51.4%)	(19.3%)	(9.1%)	4.3%	4.0%
Russell 2000 Value Index	(24.9%)	(28.9%)	(7.5%)	0.3%	6.1%	4.4%

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%.

Portfolio	Average Market Cap.	Price/Book	Q4/2008	YTD as of 12/31/08	Trailing 18 Mths as of 12/31/08
Nasdaq 100 Index (1)	44,860 M	2.7	-24.0%	-41.9%	-37.2%
Russell 1000 Growth (2)	57,768 M	2.6	-22.8%	-38.4%	-36.3%
S&P 500 (3)	78,500 M	1.8	-21.9%	-37.0%	-37.9%
Russell 2000 Value (2)	858 M	1.1	-24.9%	-28.9%	-38.2%
S&P 600 Pure Value (3)	294 M	0.3	-36.6%	-41.7%	-54.7%
Russell Microcap Value (2)	284 M	0.9	-27.2%	-34.9%	-45.2%
Fama/French Small Value Benchmark (4)	< 1,924 M	< 1.3	-34.7%	-44.4%	-54.7%
Index: Small-Cap, Under 1.2x Tangible Book Value (5)	1,233 M	0.7	-33.1%	-42.5%	-56.7%
Index: Small-Cap, Under 1.0x Tangible Book Value (5)	987 M	0.6	-34.7%	-45.0%	-60.8%
Aegis Value Fund (6)	309 M	0.3	-47.9%	-51.4%	-60.4%

Source:

1. Bloomberg: valuation data of QQQQ data as of 12/31/08, nasdaq.com and finance.yahoo.com

2. Russell.com: valuation data as of 12/31/08

3. Bloomberg: valuation data of RZV and SPY data as of 12/31/08, and sp-indexdata.com

4. Kenneth R. French Data Library, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html; market cap and price-to-book represent most recent Breakpoint data from the website

5. Indices built by Aegis Financial Corp to simulate passive, equal-weighted investment in small cap value securities; rebalanced quarterly

6. Aegis Financial Corp.

Overall, the Fund declined 51.4 percent in 2008, and 60.4 percent over the last 18 months. While these returns are disappointing, they were similar in magnitude to a 44.4 percent decline in the Fama/French Small Value Benchmark in 2008 and its 54.7 percent decline over the last 18 months. While the Fund performed exceptionally well in the first half of 2008, when looking at the past 12 or 18 months taken as a whole, we clearly did not exemplify ourselves. The data indicates that a large portion of our performance relative to the indices shown above can be attributed to the fact our style involves holding the smaller, low price-to-book value stocks that were at the epicenter of market declines. Several of these investments were heavily held by hedge funds and other leveraged financial players. As these players scaled back bets and exited the market, the prices of small-cap investments with the least liquidity were most impacted.

Unfortunately, our portfolio did not outperform during the year as a whole despite being well positioned to avoid overleveraged banks and other financial enterprises with high leverage and asset quality issues. We were careful throughout the crisis not to take heavy positions in the banks, insurers, and other financials that were the epicenter of the storm. Indeed, a large portion of our investments have strong balance sheets and significant cash-on-hand positions. Nonetheless, even many of these holdings were caught up in the market currents.

Many companies in the portfolio have experienced near-term declines in business levels resulting from the economic slowdown. Management teams are working diligently to bring cost-structures into line with lower revenues, liquidate excess inventory, and conserve

capital as the massive loss of housing and stock market wealth begins to bite into the economy. While many of our holdings are battening down the hatches, some of the fundamental news flow over the quarter has actually been quite constructive:

Allied Defense Group (ADG- $6.63/share)* is a large Fund holding where fundamentals have improved remarkably over the last several months in sharp contrast to the share price, which has declined from $7.16 at the end of August. The company, which has been restructuring it business to divest non-core operations and repay debt, was able to close on the early October sale of its Global Microwave Systems division for $26 million in cash, booking a significant gain and allowing the company to repay most of its pressing debt obligations. Additionally, in early December, the $50 million market-cap armaments supplier won a new $87 million contract, partnering with ATK to supply non-standard ammunition to the Afghan National Security Forces. We believe Allied Defense Group, now with very little debt, currently maintains over a year of sales in backlog and has potential to earn in excess of $1.00 per share next year.

Specialty Underwriters (SUAI- $3.64/share)*, another large Fund shareholding, is a specialty insurance company where fundamentals are gradually improving despite a decline in share price from $5.25 at the end of August. A small, conservative underwriter with a high-grade portfolio of investments, the company trades at a significant discount to its $8.52 book value, and a low forward P/E multiple of its $0.50/share estimated 2009 earnings. The company has built a comprehensive platform for writing and claims adjustment, and has an ample pipeline of opportunities to increase the amount of business it is writing through this platform. In the third quarter, the company won a new piece of business increasing its written premiums more than 30 percent versus a year ago. Recently, an activist group related to Hallmark Financial Services has nominated 3 new directors for the Board after its June offer to acquire the company for $6.50 in Hallmark stock was spurned by SUAI's Board of Directors as inadequate.

Coachmen Industries (COA- $1.56/share)*, a well-managed $25 million market cap company, Coachmen sold-off its challenged recreational vehicle business to Forest River, Inc. in December for $43 million, while retaining its cash-flow positive manufactured housing business. Cash from the transaction provides the company with more than adequate liquidity, as cash and investments net of debt is now in excess of the market capitalization of the company, implying a negative value on its remaining manufactured housing business. A new business line manufacturing uniquely positioned mass transit disabled-access busses on a cost-plus contract should be additive to earnings in 2009. Our understanding is that the company also retains interest as a plaintiff in a lawsuit against a previous RV-unit supplier of flawed sidewall material that is working its way through the courts. While court rulings are never certain, we believe that the facts will lead to sizeable settlement or eventual favorable ruling. Despite the good news of the divestiture, the stock has still declined from $1.81 at the end of August.

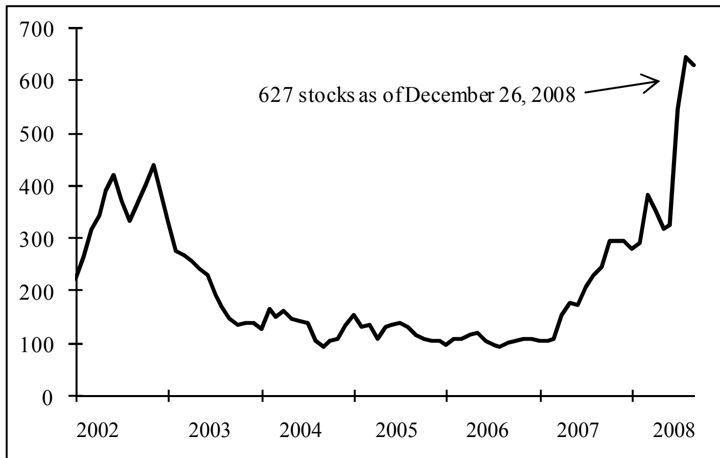
In each of these cases, and in many others, we believe that while share prices declined amid the recent forced selling and shareholder redemptions, company fundamentals were certainly not declining with the same magnitude.

We wish this could be the case with every one of our investments. However, we must recognize that certain investments in the portfolio have suffered a permanent decline in intrinsic value on account of the credit market turmoil and due to company-specific events. Most damaging was the decline in our holdings of Callon Petroleum*, which we sold in late November following word that the company was indefinitely delaying or abandoning its massive Entrada deep water development project. Drilling cost overruns, the steep decline in the price of oil, and a dry hole on the first development well made the project currently infeasible and substantially reduced our estimate of intrinsic value. Our thesis proved incorrect and we sold the position. We also have suffered what is likely to be a permanent decline in value in Spansion*, a company in the business of manufacturing memory chips for cell phones and other applications. We believe the costly new fab built by the company has brought too much capacity into the market, offsetting whatever discipline increased consolidation may have brought to the industry. The depth of the credit crisis and the sharp Q4 drop in consumer spending has made cash-liberating asset sales extremely difficult if not impossible to execute in a timely manner. While a turnaround may still be possible, the asset rich but cash-strapped company has now skipped an interest payment and management may file for bankruptcy if unable to sell. While there have been a few other investments that have soured, Callon and Spansion have clearly been the two investments most responsible for permanent capital loss over the last year.

While investments such as these have dampened performance, from an analysis of our holdings, we have concluded that up to 80 percent of our own fourth quarter declines have not been of this type. Many declines we have experienced do not even appear to us to be related closely to company fundamentals. Instead, we believe a significant majority of our declines have been primarily quotational in nature, arising from the desire of investors to gain liquidity, to meet margin calls, and to pull risk capital from the market. While it is impossible to know when such selling pressure will abate, over the long-run we believe company fundamentals will drive valuations in the market.

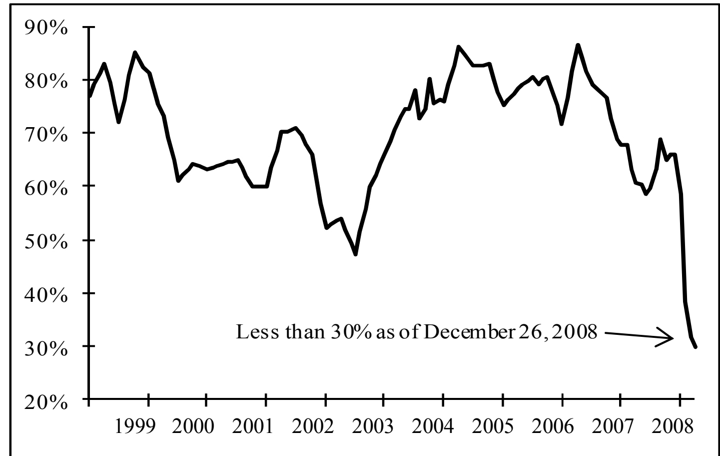
* - *As of December 31, 2008, Allied Defense Group, Specialty Underwriters Alliance, Coachmen Industries, Callon Petroleum, and Spansion represent 5.7%, 3.1%, 1.5%, 0.0%, and 0.5% of total assets of the Aegis Value Fund, respectively.*

Figure 4: Number of Stocks Selling Below Tangible Book Value (Market Cap. Greater Than $70 Million)



Source: Stock Investor Pro

Figure 5: Aegis Value Fund Historical Price-to-Book Ratio



Source: Aegis Financial Corp.

<u>The Opportunity</u>

As investors sold off equities in order to pay down debt and increase holdings of cash, the selling pressure and resulting stock declines have resulted in a record number of stocks on our watchlist. As can be seen in **Figure 4**, the number of stocks trading under tangible book value and with market capitalization above $70 million has now increased to the highest level since we began tracking this statistic in 2002. Additionally, as the prices of investment holdings have declined, and as we have positioned the portfolio to be able to take advantage of a return to more normal conditions, the valuation levels of the Fund have dropped precipitously. **Figure 5** shows the Aegis Value Fund portfolio now trades with an investment weighted average price-to-book value of under 30 percent, an all-time low in the Fund's more than 10-year history. Even if share prices doubled, the price-to-book Fund average would be under 60 percent, still among the lowest in the Fund's history. Clearly, these are very unusual times.

<u>In Conclusion</u>

Even for those who have not been impacted by a job loss or dramatic decline in income, reminders are certainly all around that economic times remain difficult. Seeing the immediate liquidation value of investments marked-down so rapidly on our financial statements is an unnerving experience, to say the least. However history favors investors who can look beyond the emotion of the moment. Given the despondency of investors worldwide, there is now little competition for your hard-earned investment dollar. Solid, sensible investment opportunities are going unfilled. When the great mass of investors calms down and invests in equities with even a fraction of the $8.85 trillion of cash held on the sidelines, the bargains we are seeing today will recede. As for ourselves, we remain personally invested in the Fund for the long-term, we continue to invest new money in the Fund, and we encourage others to do likewise, especially now. Should investors have any questions regarding the Fund or its strategy, our door is open. Please call us anytime.

Scott L. Barbee
Portfolio Manager
Aegis Value Fund

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.

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