

Annual Advisor's Report  
For Fiscal Year Ended August 31, 2005

Aegis Value Fund

## Advisor's Report

October 14, 2005

To the shareholders of the Aegis Value Fund:

We are pleased to present the Aegis Value Fund Advisor's Report for the year ended August 31, 2005.

Since inception of the Aegis Value Fund on May 15, 1998, performance has been strong relative to benchmark indices. The Fund has posted a cumulative gain of 165.0 percent through October 14, 2005, compared to cumulative gains of 88.2 percent in our primary small-cap benchmark, the Russell 2000 Value Index. During this period, the Russell 2000 Index of small-cap stocks posted cumulative gains of 47.3 percent and the S&P 500 posted cumulative gains of 19.7 percent.\*

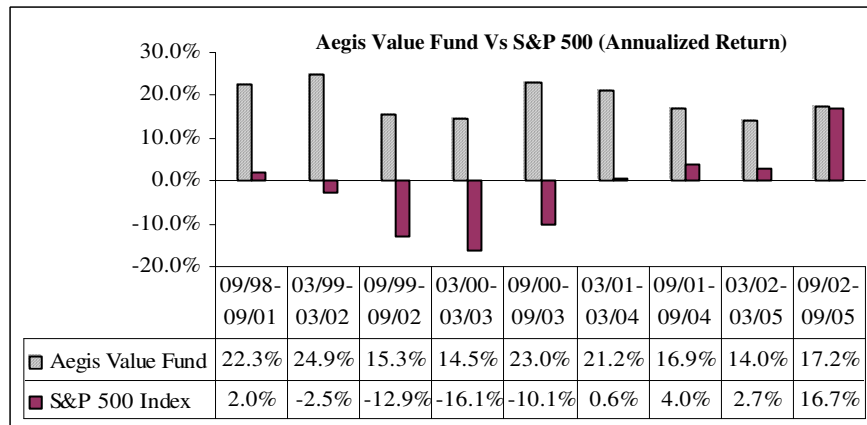
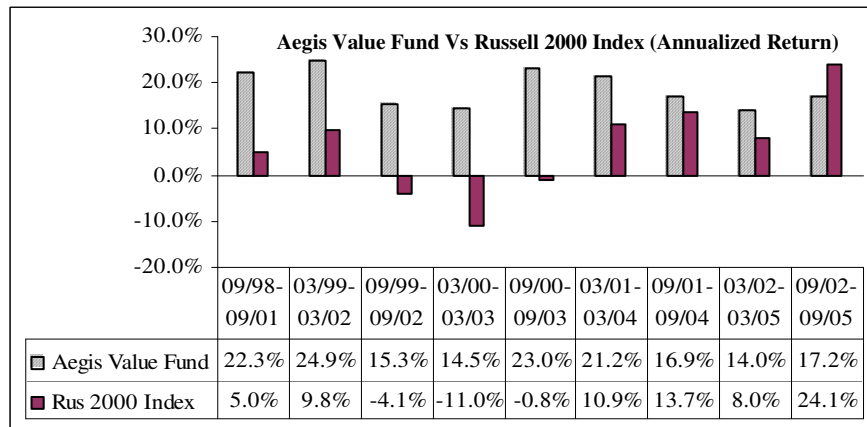
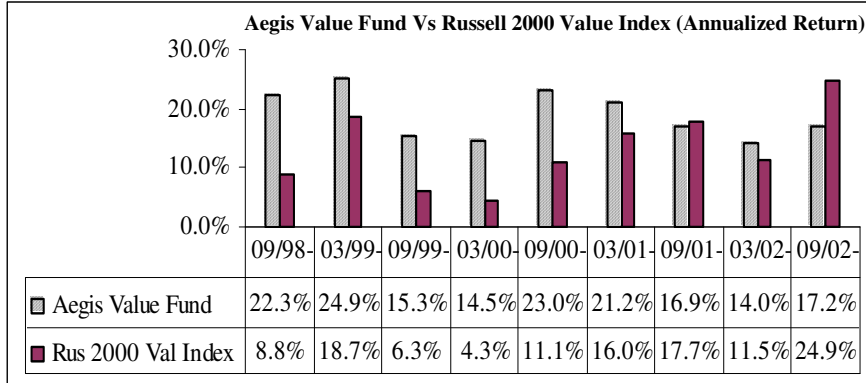
For the year ended August 31, 2005, the Aegis Value Fund posted a gain of 9.7 percent, versus a gain of 22.6 percent for the Russell 2000 Value Index. The Russell 2000 Index returned 23.1 percent, while the S&P 500 Index returned 12.6 percent. Our shortfall against the benchmarks has primarily been driven by the dampening impact of high Fund cash levels, averaging 48.5 percent over the year.\*

As we've noted in the past, when good values do not present themselves in the market, we believe it is more prudent to hold cash than remain fully invested in overvalued securities, regardless of how tempting it may be to try to realize short-term gains by investing in more speculative securities over the short-run.

Our goal remains to exceed our benchmarks and deliver positive returns over periods of three or more years, a time which is usually, but not always, sufficient to experience a variety of market conditions. **Figure 1** shows the performance of the Aegis Value Fund against the Russell 2000 Value Index during every 3-year semi-annual period since inception of the Fund. Observing the graph, it is clear that we have achieved an absolute return for the most recent three years that is within our typical range. Unfortunately, however, this return has not been sufficient to outpace our benchmarks over the period.

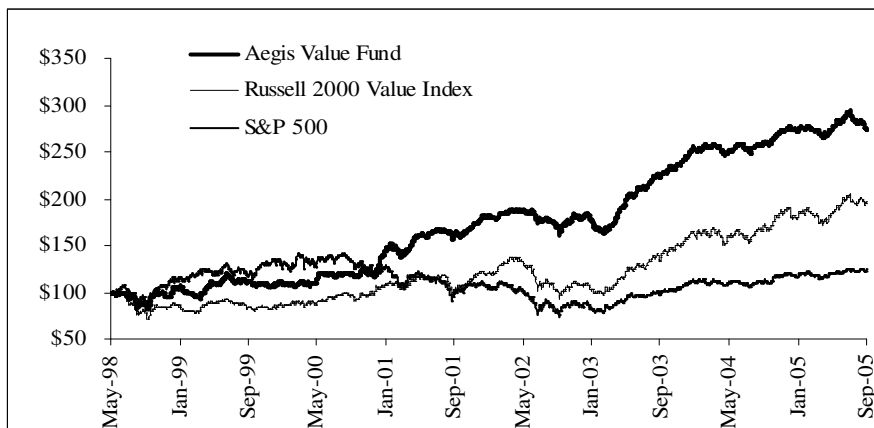
Although holding cash in the Fund has lowered our overall market risk, the average cash balance over the most recent 3 years of 41.2 percent of Fund assets has led to the vast majority of the relative underperformance since September 2002. However, as can be seen in the graph of our recent relative performance against the averages in **Figure 2**, fund performance has been particularly lacking in the third calendar quarter of 2005. The most important theme in our poor third quarter performance was the negative impact on the portfolio caused by rising energy prices. The energy component of the S&P 500 Index, representing 8 percent of index value, is up more

**Figure 1: Aegis Value Fund Rolling 3-Year Performance Record**



than 40 percent year-to-date and 20 percent in the third quarter alone. On the whole, the investments we have chosen on a stock-by-stock basis are generally positioned to benefit from a declining energy pricing environment, as we have already sold the vast majority of our energy-related stocks that we judged to be too richly valued, and we have continued to invest in industrial and transportation companies that are suffering from high energy costs that as yet have not been fully passed on to customers. As the domestic energy supply infrastructure recovers from the impact of recent hurricanes and energy prices begin to moderate, these companies could see appreciable margin improvement.

**Figure 2: Aegis Value Fund, S&P 500 and Russell 2000 Value Index (Growth of \$100)**



See performance data disclosure at the bottom of Figure 1

### Investment Thoughts

While the impact of high energy costs this quarter was an important factor in our relative performance against our benchmark indices, we also experienced an unusually high number of large holdings with significant third quarter price declines: Alliance One International, Sea Containers, Dominion Homes and PXRE Group. We are monitoring each of these investments closely and in each case have reached the conclusion that the companies merit continued investment. In several cases, we've increased our positions as the companies have dropped in price. The following is a summary of our thinking on each of these situations:

*Alliance One International (AOI (former ticker DMN) - \$3.19/share):* This \$275 million market-cap company is the result of a merger earlier this year between Dimon and Standard Commercial, the second and third largest tobacco leaf processors in the world. At the time of the friendly merger in May of 2005, three shares of Dimon trading at \$6.45 per share were issued for each share of Standard Commercial, and the companies were combined to form an enterprise with a market-cap of \$559 million. As the price dropped by nearly 50 percent following the merger, our position declined in value to approximately \$22 million, impacting overall Fund performance by approximately 2 percent year-to-date.

Investors have recently been focused on several significant near-term issues impacting the company. First, both predecessor companies were forced to call in their debt above par value upon merging, compelling the expenditure of \$65 million in debt premiums. Combined with \$35 million in banking fees, \$10 million in consulting and other fees, and merger consolidation charges that are expected to total approximately \$70 million, the merger carried an unexpectedly hefty price tag of approximately \$180 million. These costs added significantly to the new company's debt burden. Alliance One proceeded to refinance its debt, unsuccessfully attempting to enter the high-yield market just as General Motors was experiencing credit downgrades, and the demand for high-yield bonds was plummeting. The company expanded its bank lines and issued a \$100 million subordinated bond with a very high interest rate, placed primarily with a single large investor. Complicating matters, a drought in Brazil impacted the quality of the crop this year, which, combined with an unforeseen 20 percent strengthening of the Brazilian currency, materially impacted profitability, leading to fears that the company may breach its bank lending covenants. The company's Board of Directors responded to these adverse conditions by cutting the dividend by more than half. Unfortunately, this action triggered a substantial decline in the equity price.

We know that the September quarter is likely to be ugly for Alliance One as a large portion of the low margin Brazilian crop runs through the financials (we estimate a possible \$30-50 million negative earnings impact this year compared to a year ago). However, we believe that the reward in this investment outweighs the risk, and we intend to hold on to our position. We believe the profitability of the Brazilian crop is likely to rebound in future years. Perhaps most compelling is management's view that there will be significantly in excess of \$60 million in annual cost-savings associated with the merger. In addition, we believe that the consolidation may bode well for the ability of the company to gain some degree of additional negotiating leverage with its customers and suppliers. Any leverage gained is very significant as each percentage point increase in margin delivers shareholders approximately \$20 million in pre-tax earnings. Our outlook is for improved business terms with the cigarette manufacturers and future normalized earnings in excess of \$1.00 per share, a good potential return on our \$5.64 per share cost basis and a superior potential return on current value of \$3.19 per share. The stock is currently at a discount to tangible book value of \$3.50 per share as of June 30, 2005. We believe our thesis is still intact. However, our 4 percent Fund position in Alliance One will take some time to play out and patience will be required.

*Sea Containers (SCRA - \$11.63/share):* This \$320 million market-cap, highly levered conglomerate currently trades at a significant discount to tangible equity value of \$685 million (\$24.80/share). The stock price of Sea Containers is down from a price of \$20.85 at the end of February and now trades below our cost basis of \$13.55 per share after reporting \$71 million in operating losses in its Ferry Division in the nine months ended June 30. This loss was a result of high fuel costs and government-subsidized competition on some of its routes. The company also operates GNER, a UK-based rail business that has been impacted by a

temporary decline in ridership after the London subway bombings. The firm also conducts a sea-container leasing business through GE-Seaco, a successful joint-venture with General Electric that has recently been publicly contentious and could lead to a sale of the business. Finally, the company also owns 9.9 million shares of publicly-traded Orient-Express Hotels (ticker: OEH) currently valued at \$280 million.

While in hindsight, it would have been nice to have liquidated our position earlier this year at a nice gain, we believe many of the issues confronting the company are short-term in nature, and that the liquidation value of the firm is in excess of \$24 per share. Significantly, Sea Containers is planning the reorganization of its ferry business, and should stem the losses in this division by reallocating assets out of the competitive North Sea or merging with a competitor. This reorganization could create an earnings swing of nearly \$2 per share. We believe that equity value could be written-down by \$2-3 per share in the reorganization. However, we think the GE-Seaco and GNER divisions are worth significantly more than book value, and could more than offset any write-downs in the ferry business in a liquidation scenario. While our holding of Sea Containers has negatively impacted Fund performance by approximately 0.8 percent year-to-date, we believe the company is currently trading at only 30-40 percent of liquidation value, has the potential for a material earnings turn-around, and currently represents excellent long-term value. The Fund currently holds 4 percent of its assets in Sea Containers.

*Dominion Homes (DHOM - \$11.63/share):* We featured this \$95 million market-cap homebuilder in our February Semi-Annual Advisor's Report. We purchased a 10 percent stake in the company over the last year at just under \$18 per share, a significant discount to tangible book value of approximately \$23 per share (approximately \$192 million). The company builds entry-level homes in parts of central Ohio and Kentucky, regions that are experiencing economic weakness because of a decline in the manufacturing base. The company's stock is under pressure because Dominion over invested in real estate, and may break debt covenants if slowing regional home sales do not provide it with cash flows required by its creditors. However, Dominion's \$206 million in bank debt is well covered by the company's collateral, consisting of approximately \$426 million in its inventory of homes under construction and land in various stages of development. Because of Dominion's strong balance sheet, we believe its lenders are likely to work amicably with the company to get through its difficulties. The company is planning to liquidate a portion of its inventories and use the capital raised to repay debt. We believe that the equity, at its current value, should be covered in a liquidation scenario, especially given the region's less speculative real estate market and the commensurate reduced risk that property is on the company's books at inflated prices. Although the poor performance of Dominion hurt the Fund's performance by 0.6 percent year-to-date, we believe the stock is likely to recover as inventories are reduced and debt is paid-down. We continue to have close to 2 percent of Fund assets in Dominion.

*PXRE Group Ltd. (PXT - \$12.61):* We purchased a \$19 million position over the last 24 months at an average price of \$21.60 in this Bermuda-based reinsurance company. The company, which was trading at a very slight premium to book value at the time of purchase, provides property and casualty insurance to other insurance companies. We sought to capitalize on the strengthening market after 4 hurricanes made landfall in Florida last year, a year of high wind-storm frequency by historical standards. We believed that the company could earn out-sized returns on the order of 20 percent on equity as insurance rates increased following the bad hurricane season. Unfortunately, this year turned out to be one of the worst hurricane seasons on record, with hurricanes Katrina and Rita causing between \$230 and \$320 million of losses in the third quarter in what the company believed may have been a 1 in 70-year event, dropping book value down from the low 20s to between \$13.10 and \$15.75 per share. After suffering losses of this magnitude, the ratings agencies forced the company to immediately raise replacement capital, or risk a ratings downgrade that threatened to place the company into run-off liquidation. A large portion of this capital was raised by issuing new private placement shares at \$11 per share, which further diluted book value per share. We believe the company currently trades around book value, depending upon final loss estimates from this year's storm season. While we realize that returns in this investment are likely to be quite lumpy, we believe that rates are increasing significantly in this market, and PXRE Group is well positioned to earn 20 percent returns on equity over the next few years (\$2-3 per share), even if the hurricane season is 15 percent worse than the 10-year average. While PXRE Group has impacted Fund performance by 0.6 percent year-to-date, we continue to keep 2 percent of Fund assets in the stock.

While it has been unusual to have as many companies experience price declines concurrently as we have had in the third quarter of 2005, it is not at all unusual for us to experience periods where certain of our holdings undergo periods of illiquidity and/or quotational decline. Remember that in early 2003, Fund performance was negatively impacted by our position in the Luby's restaurant chain, which had declined significantly from our average purchase price of \$4.03 to a low of \$1.05 per share on March 26, 2003. At the time, Luby's was in violation of bank covenants and investors were concerned about the viability of the business. We believed our thesis remained intact: an excellent new management team and valuable real estate at Luby's would result in a price rebound. We purchased additional shares during the uncertainty. The stock's strong performance over the last few years has bolstered our returns, and we have recently sold a portion of our position at prices in excess of \$12 per share. Not every investment will work out as well, but we hope for a good proportion of winners among our current crop of companies currently quoted at distressed price levels.

#### Our Position on the Market

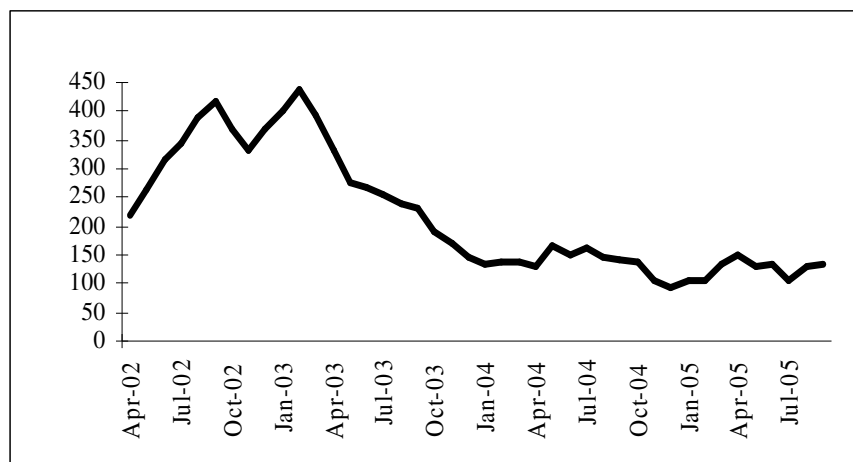
There is not a significant amount of new material to cover with respect to the overall market. The percentage of cheap stocks available continues to be abnormally low relative to pre-2004 levels, although the situation may be improving. We continue to believe that there may be significant fault lines in today's rela-

tively robust economy, several of which we've discussed in previous reports: the demise of the housing bubble, increasing inflation and the prospect for significant additional Fed rate increases, the highly debt-burdened domestic consumer, unprecedented leverage in the financial system, spiking energy prices and the prospect of a rapidly declining dollar should foreign central banks change strategy. It is no doubt difficult to predict the odds of any of these events occurring. Clearly movement on some of these fault lines may preclude movement on others. However it is worth noting that a change in current market perception on any of these issues is enough to cause significant market disruption, with the possibility of many additional investment prospects being exposed during any market tremors.

### View From the Trenches

While it remains a challenge to find investments for the Fund that satisfy our strict criteria for investment, the climate appears to have gradually improved since August 2004. As can be seen in **Figure 3**, the number of companies with market-caps greater than \$70 million and priced at less than tangible book value has increased from 93 at the beginning of the calendar year to 132 as of September 30. Thus far in October, we have witnessed a steep 4.7 percent drop in the Russell 2000 Value Index, further increasing the number of stocks on our watchlist to 151 today. We note that this number still remains well beneath the 438 companies we experienced on our watchlist in March of 2003.

**Figure 3: Number of Securities Selling at or Below Tangible Book Value (Greater than \$70 Million Market Cap)**



*Source: Aegis Financial Corporation and Stock Investor Pro Stock Screener*

We purchased \$163 million of stocks during the last 12 months ended August 31, 2005 at prices we believe represent good value. Significant new additions to the Fund since February include:

*Superior Industries International (SUP):* This \$546 million market-cap aluminum wheel manufacturer is perhaps the strongest player in the beleaguered auto supply sector. This industry is facing tremendous pricing pressures from the auto manufacturers as they strive to wring costs out of the supply chain. With \$120 million of cash on its balance sheet, no debt, an overwhelmingly non-unionized work force, and a significant portion of its manufacturing facilities located in low-cost Mexico (more than 50 percent by mid-2006), Superior is well-positioned to ride out the difficulties in the sector. While the company may face write-downs in the future from the closure of a few of its high-cost domestic facilities, we should be somewhat protected by the stock's low trading value, which already discounts \$63 million from tangible book value of \$609 million. During the 5-year period 2000-2004, earnings per share averaged approximately \$2.50, implying that the current \$20 per share price is just 8 times historic earnings power. When \$6.22 of low-earning cash and liquid investments per share are deducted from the share price, the historic multiples are even more favorable. Given the current challenges in the auto industry, the near-term earnings picture is clouded. However, as additional Mexican capacity comes on line, and as less efficient competitors are forced to raise prices or shut down, we believe the long-term outlook is bright for Superior.

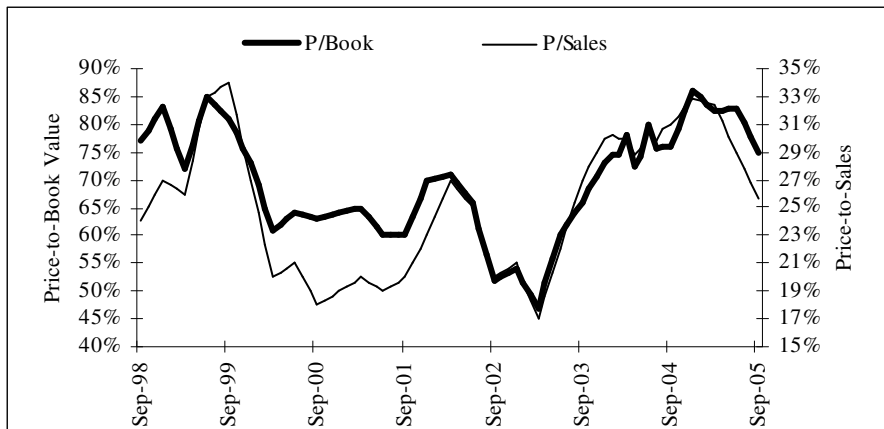
*Dillard's (DDS):* This \$1.6 billion asset-rich retailer owns 264 of its 329 stores. When debt, net of cash, of \$1.4 billion is added in, the company's enterprise value of \$3.0 billion is a low 4.9 times its EBITDA (pre-tax, pre-interest expense operating cash flow) of approximately \$600 million. While institutional investors are irritated by this family-controlled company's worst-in-class investor relations effort and the company's exposure to a possible consumer spending downturn, we believe these irritations and risks are offset by the low trading multiples at the company, at only 72 percent of tangible book value. This compares to our calculation for Wal-Mart of approximately 9.4 times EBITDA and 504 percent of tangible book value. We also thoroughly appreciate the company's massive repurchase of 28.2 million shares at discounted levels over the last 7 years, shrinking share count by 23 percent, a move that we believe is extremely accretive to continuing shareholders. In April, the company announced a further \$200 million repurchase authorization. We have had previous success with retailers and restaurants holding large real estate positions that traded at a discount (Toys-R-Us, ShopKo, and Luby's), and we believe Dillard's may provide a similar opportunity. We suspect the Dillard's family may wish for investment liquidity at some point over the long-term and wonder if the repurchases could be a prelude to a company sale.

In addition to these and other new stock purchases, we also added significantly to certain existing holdings.

We sold \$115 million of equities over the year ended August 31, 2005, realizing \$49.3 million of gains as we sold off several positions that had reached our estimates of intrinsic value. Our largest gains over the year came from Toys-R-Us, where we realized a \$10.2 million gain on our \$18.6 million sale when the company was bought-out. We also realized an \$8.3 million gain on a \$10.1 million

sale of our stake in Nash Finch Company. Our biggest loss over the year was a \$1.8 million loss incurred so far on the sale of \$0.7 million of our holding of Horizon Offshore Inc. We have been liquidating Horizon Offshore after it became evident that non-controlling shareholders would be severely diluted in a recapitalization of the company in which debt owed to a large hedge fund with prior representation on the company's board was converted into equity at an extremely low conversion price.

**Figure 4: Historical Price-to-Book Value and Price-to-Sales**



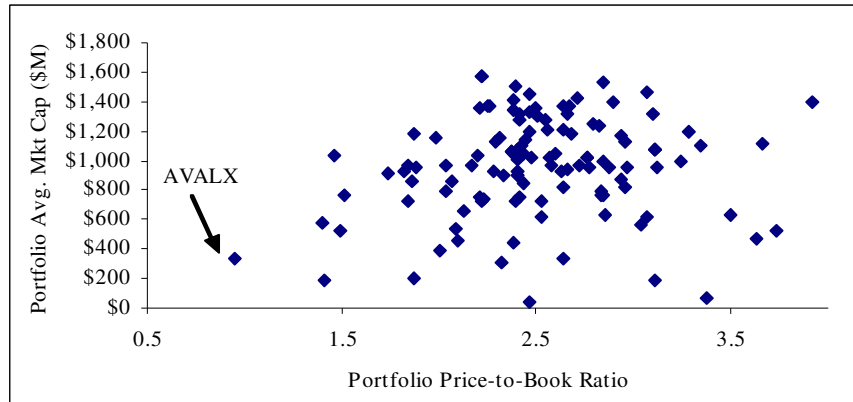
Source: Barra and Aegis Value Fund<sup>1</sup>

The Fund's cash levels have also been impacted by net shareholder redemptions of \$92 million over the year ended August 31, 2005. These outflows have been consistent since the closure of the Fund almost a year ago and have accelerated since July as the market softened. As a result, cash levels in the Fund today stand at approximately 29 percent, down from 54 percent on August 31, 2004.

As we continue to make new purchases at low valuations, and sell out positions that have appreciated to higher values, the average valuations of Fund investments has been dropping. As can be seen from the historical valuation analysis of the Fund in **Figure 4**, average price-to-book value and price-to-revenue levels in the Fund have experienced a significant decline over the last six months through September. This decline will almost certainly continue in October. At the end of September, the Fund traded at 75 percent of book value and 26 percent of revenues, approximating the average trading multiples since the Fund's inception in 1998, and significantly underneath the S&P 500 (288 percent of book value and 148 percent of revenues) and the S&P 600 Value (171 percent of book value and 79 percent of revenues). As **Figure 5** also shows, the Aegis Value Fund continues to hold stocks in its portfolio that trade at valuation levels significantly lower than the rest of Morningstar's small-cap value universe.

While lowered cash levels at the Fund may lead to increased Fund price volatility in the near-term relative to recent years, we believe that the significant number of Fund investments today trading at attractive valuation levels offers investors ac-

**Figure 5: Aegis Trades at Lowest Price-to-Book Value of Morningstar's Small-Value Universe**



Source: Morningstar, Aegis Financial Corporation

ceptable risk-return prospects. Given the decline in small-caps occurring since July, I have concluded it is a better time to deploy new capital and have personally made recent additional purchases of Fund shares.

Please know that we take our fiduciary obligation to you very seriously and work diligently to ensure our shareholders are treated properly and earn a good return on their hard-earned capital. We continue to handle shareholder communications internally and welcome your call with any questions. We continue to have the overwhelming portion of our assets invested either in the Fund, or in a similar manner, so we remain committed to our investment approach.

**Aegis Financial Coporation**

Scott L. Barbee, CFA

Managing Director, Portfolio Manager

<sup>1</sup> *Price/Book: The inverse of the capitalization-weighted average of the individual constituent Book/Price ratios. The individual company Book/Price ratio is the total common equity for the latest quarter divided by current company capitalization.*

*Note that taking the average of the individual asset P/B ratios will yield a different result. Our method is mathematically equivalent to taking the capitalization of the index and dividing by the book value of the index. This is more consistent with the spirit of the index ratio than is a capitalization-weighted average of the individual asset P/B ratios and is also a more stable quantity.*

*Price/Sales: The inverse of the capitalization-weighted average of the individual constituent Sales/Price values. The individual company Sales/Price ratio is the sum of the most recently available four quarters of net sales divided by current company capitalization.*

*Aegis Value Fund ratios exclude any consideration of non-equity holdings (e.g., cash). We believe this is consistent with Morningstar, Inc. practices.*

*\* Notes: Aegis Value Fund's one-year, three year, five year, and since inception (5/15/1998) average annual returns for the period ending September 30, 2005 are 5.9%, 17.2%, 18.0%, and 14.7% respectively. Russell 2000 Value Index one-year, three-year, five-year, and since inception (AVALX-5/15/1998) average annual returns for the period ending September 30, 2005 are 17.8%, 24.9%, 15.2%, and 9.7%.. All historical performance returns shown in this Advisor's Report for the Aegis Value 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 1.41%.*

*This article refers to six stocks held by the Fund. As of August 31, 2005 the percentage of total assets of the Fund these stocks represent respectively is as follows: Alliance One International Inc. 3.79%, Sea Containers Ltd. 2.72%, PXRE Group Ltd. 2.58%, Dominion Homes Inc. 2.06%, Superior Industries International Inc. 2.06% and Dillard's Inc. 1.81%.*

*This Advisor's Report is for the information of shareholders of the Aegis Value Fund Inc. Information contained herein has been obtained from sources we believe to be reliable, but can not 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, lesser-known companies may be more volatile than those of larger companies. In addition, investing in foreign securities involves additional risks beyond the risks of investing in U.S. securities. These risks involve economic and political considerations not typically found in U.S. markets, including currency fluctuation, political uncertainty, different financial standards and regulatory environments, and overall market and economic factors present in foreign countries. 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 that includes more complete information, please call us at (800) 528-3780, or visit our website at [www.aegisvaluefund.com](http://www.aegisvaluefund.com), where an online prospectus is available.*

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*The Aegis Value Fund seeks to achieve long-term, above market returns while minimizing risk of capital loss. Our strategy is to invest in well-researched, small-cap equities trading at a fraction of their intrinsic worth. We believe the equity markets are often inefficient, and we are contrarian, bottom-up stock selectors. We generally buy stocks trading at low price-to-book and price-to-earnings ratios, a segment of the market where academic research shows historical returns to be significantly higher than the overall market. We look for indications of strong corporate governance and ethical stewardship as evidenced by high insider ownership, proper use of corporate profits including bargain-priced share repurchases, and appropriate executive salary and options levels. We tend to purchase companies when they are misunderstood, out of favor, or neglected, and hold these companies until share prices reach our estimates of intrinsic value.*