

AEGIS Value Fund



Portfolio Manager's Letter

Quarter Ended September 30, 2012

October 26, 2012

Dear Aegis Investor:

Equity markets shifted into forward gear in the third quarter, delivering strong gains after the second quarter's lull, courtesy of further worldwide central bank intervention. The Aegis Value Fund gained 7.88 percent in the quarter, outperforming the Fund's primary benchmark, the Russell 2000 Value Index, which gained 5.67 percent. Past performance data for the Aegis Value Fund and the Russell 2000 Index are presented in **Table 1** below:

Table 1: Performance of the Aegis Value Fund as of September 30, 2012

	Annualized						
	Three Month	Year-to-Date	One Year	Three Year	Five Year	Ten Year	Since Inception*
Aegis Value Fund	7.88%	16.76%	31.17%	16.07%	4.57%	9.46%	10.52%
Russell 2000 Value Index	5.67%	14.37%	32.63%	11.72%	1.35%	9.68%	6.75%

* Aegis Value Fund Inception 5/15/98

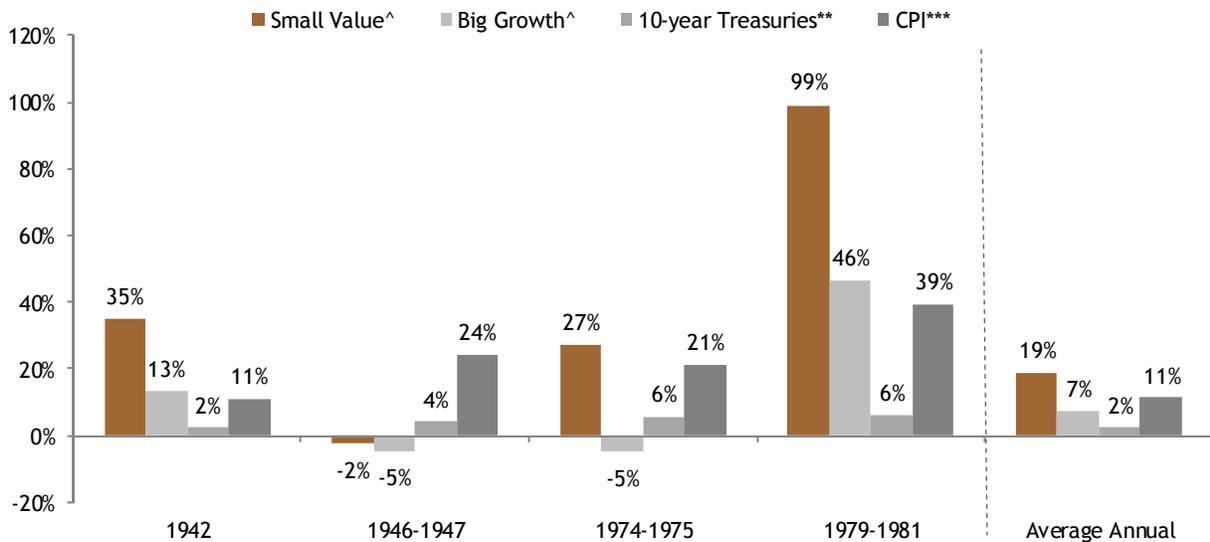
Performance data quoted represents past performance and does not guarantee future results. Current performance may be lower or higher than the performance data quoted. The investment return and principal value will fluctuate so that upon redemption, an investor's shares may be worth more or less than their original cost. For performance data current to the most recent month end, please call us at 800-528-3780 or visit our website at www.aegisfunds.com. The fund has an annualized expense ratio of 1.48%.

Equities began to firm-up in late July as European Central Bank (ECB) President Mario Draghi pledged to do "whatever it takes to preserve the Euro." Draghi's promise was followed in early September by the ECB's announcement of an aggressive new sovereign bond purchase program, known as Outright Monetary Transactions (OMT). Under the new program, the ECB is now able to print new Euros to facilitate the unlimited direct purchase of increasingly distressed EU member-state sovereign bonds on the secondary market, with the caveat that participating sovereign bond issuers now begin to meet certain budgetary conditions. After the plan was announced, bond yields on Spanish and Italian debt plunged as the market began to anticipate the ECB intervention and markets improved as investor fears over a systemic deflationary melt-down of the European financial system receded. The ECB was not alone in its move towards additional monetary accommodation in the quarter as central banks across the globe continued the 4-year easing campaign, with the Bank of England unveiling a plan to expand its own money printing program by GBP 50 billion and the Bank of Japan also announced an additional \$126 billion debt-repurchase program.

Not to be left out, in mid-September the United States Federal Reserve announced a third round of money printing of its own under which the Fed would purchase up to \$40 billion of agency-issued mortgage backed securities monthly. While the previous two quantitative easing programs had been announced with both a defined end date and a defined amount of Fed balance sheet expansion, the new program was surprisingly open-ended, with the Fed indicating it would last until the labor markets show substantial improvements, and could, in fact, grow larger, earning the program the derisive moniker "QE-Infinity." The Fed also suggested that it would leave its rates near zero through mid-2015 (from late 2014). As though these actions alone weren't damaging enough to its price stability mandate, the Fed also announced that it "expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens."

As central bankers around the world turned-up the digital printing presses and increased the rhetoric in a manner abandoning any pretext of monetary discipline, investors, fearing monetary debasement, predictably began to move to protect capital from inflationary risks. With yields now being continually suppressed by the Federal Reserve to levels under the rate of inflation, savers have been increasingly penalized for holding cash as the Fed works to prod investors into equities, high-yield bonds, and other "risk assets." Given the Fed intervention, and with inflationary concerns on the rise, it is no surprise that the S&P 500 generated a 6.35 percent quarterly gain. Gold, the classic inflation hedge, performed even more robustly, rebounding from second quarter's losses to deliver a strong gain of 10.45 percent, closing the quarter at \$1,771 per oz. Precious metals equities funds ended Sep-

Figure 1: Cumulative Performance During Periods of High Inflation*



* Periods of high inflation are defined as calendar years with greater than 8% average monthly year-over-year inflation.

** 10-Year Treasury performance based on starting period yield, with price adjustments for changes in interest rates.

*** Cumulative average monthly year-over-year change in CPI (not seasonally adjusted).

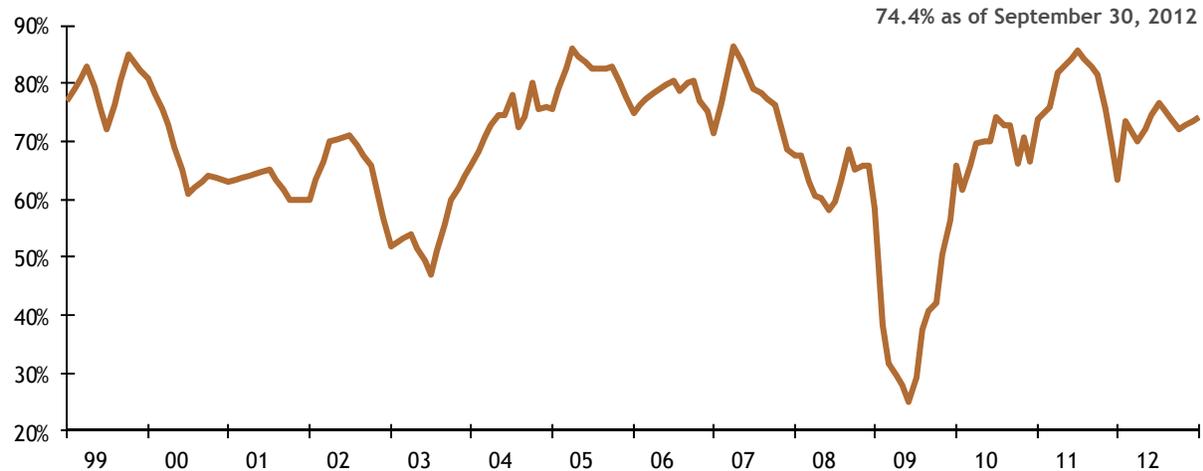
[^] “Small Value” and “Big Growth” return data for the years shown are the returns for “Small Value” and “Big Growth” within the “Fama/French Benchmark Portfolios” data series compiled by Dartmouth Professor Kenneth French using stock performance and attribution statistics provided by the Chicago Booth School Center for Research In Security Prices (CRISP) for all stocks on the NYSE, AMEX and NASDAQ markets for which data is available. In this return data series, all stocks are sorted at the beginning of each period into “Big” and “Small” by the median NYSE equity market-cap breakpoint. Further sorts by price-to-book are made into Growth (highest 30% price-to-book), Value (lowest 30% price-to-book), and Neutral (middle 40% price-to-book). Each period’s benchmark category performance for each of the 6 resultant portfolios is determined by calculating the return of an equal investment in all stocks sorted to a particular benchmark portfolio at the beginning of a particular period. The benchmark portfolio return data series, available at (http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html), begins in 1927 for the annual period series returns.

tember as the top-performing Lipper classification, leaping 22.39 percent over the quarter. The energy complex also experienced a predictably strong quarter, with crude oil prices rebounding 8.51 percent to close the quarter at \$92.19 per bbl. The Aegis Value Fund benefited in particular from its material positions in energy service, exploration & production, and refining companies during the quarter, with gains on holdings in these industries positively impacting third quarter performance by 3.5 percentage points.

Fortunately, for savers seeking to avoid portfolio damage from inflation and currency debasement, we believe applying a deep value approach offers an attractive risk/reward proposition. Given the volatility in the markets, and particularly in small-cap stocks since 2007, many investors, still scarred by the credit crisis, remain intractably on the sidelines despite all the inflation-prone prodding of the Federal Reserve. Today, these investors on the sidelines hold nearly \$9 trillion in bank deposits and another \$2.5 trillion in money market funds at miniscule yields. Perhaps worse, trillions more has been invested in long-dated high grade bonds, which have attracted capital on account of consistent appreciation in recent years as interest rates declined. While we believe defaults of high-grade bonds are not likely to be problematic in the near-term, investors in these instruments today are likely to be shocked at how fast their bond values may be eviscerated as rates rise. In our view, equities and in particular small-cap value stocks are likely to perform much better by comparison during the coming, potentially inflationary years. As can be seen in **Figure 1**, since 1927, during previous years of high inflation (defined as high CPI change), small value stocks materially outperformed 10-Year Treasuries as well as large-cap growth stocks, and generally delivered returns well in excess of inflation.

Figure 2:

Aegis Value Fund Historical Price-to-Book Ratio



Source: Aegis Financial Corp.

With so much of the public sitting on the sidelines or engaged in a dangerous chase for yield in long-duration corporates, there is also less competition for our deep value stocks. As can be seen in **Figure 2**, the small value stocks in our Fund at quarter-end traded at 74.4 percent of book value, which while up slightly from last quarter, remains at only 1/3 of the multiple of the S&P 500, which trades at 220 percent of book. We are pleased to report that the companies in our portfolio are generally continuing to perform up to our expectations, and several are taking advantage of low equity valuations, using cash generated from company operations to repurchase shares. At last count, approximately 50 percent of our portfolio holdings have been recently engaged in share repurchases.

Most positively impacting the Fund, contributing approximately 2.21 percentage points to the quarter's return, was our investment in **Tesoro Corporation (TSO: \$38.35)**. Tesoro owns and operates refineries with a crude oil capacity of 665,000 barrels per day (bpd) as well as a retail gasoline distribution segment with 1,285 retail stations. The \$5.2 billion market cap, Texas-based company has been generating outstanding margins as pipeline constraints and environmental delays are resulting in a glut of low-priced, mid-continent crude, giving Midwest refineries very low crude oil input costs. Over the last year, as margins have remained surprisingly high, Tesoro has significantly reduced its debt load, with the company ending the second quarter with only \$380 million in net debt after generating EBITDA of \$765 million in just the second quarter alone. While the market is fixated on the prospects for Midwest refining margin erosion, we believe that the company, trading at just 3 times trailing EBITDA, has been overly discounted. Tesoro has also been selling logistics assets to yield starved investors at high multiples. Its Long Beach terminal and other Martinez refinery assets, were recently divested to its 47.5 percent owned public master limited partnership, Tesoro Logistics LP (TLLP), at a premium multiple of 10 times EBITDA, generating \$285 million in proceeds. Furthermore, Tesoro has been debottlenecking its facilities and engaging in high return capital projects, much of the benefits of which have yet to show up in Tesoro's results. These include an expansion of Tesoro's Midwestern Mandan refinery as well as a build-out of crude-takeaway rail logistical capacity that can now deliver price and quality advantaged Midwest crude to its West Coast Anacortes refinery. During the quarter, Tesoro entered into an agreement to purchase BP's 266,000 bpd Carson refinery and 800 dealer locations for just under \$2.5 billion. After adjusting for a proposed subsequent sale of logistical assets to TLLP and working capital, the net purchase price for the refining and marketing business is a bargain-priced \$175 million. The price looks particularly good when considering that Carson generates \$225 million annual EBITDA and \$250 million of additional annual synergies are expected from integrating the plant, which sits immediately adjacent to Tesoro's 97,000 bpd Wilmington refinery. Tesoro has also begun returning capital to shareholders in the form of both a \$0.12/share quarterly dividend and a recently announced \$500 million share repurchase program.

Most negatively impacting Fund performance in the quarter was our largest holding, **Alliance One International (AOI: \$3.12)**. Alliance One, a \$260 million market-cap tobacco leaf processor with operations spanning the world, including the USA, Brazil, and several African countries, is a company undergoing an operational turnaround. Trading near tangible book value, the company has come under pressure in recent years as a few customers decided to vertically integrate into the business of tobacco leaf processing for themselves, and competitors also started picking up market share. Corporate expenses at Alliance One were high and uncompetitive. Additionally, the company had been dealing with falling tobacco prices, which required markdowns on its uncommitted inventories, pressuring margins. Making shares of Alliance One significantly more volatile in the risk-on, risk-off markets of recent years has been the company's high debt-load. With \$1.3 billion in net debt, Alliance One is perhaps the most highly indebted of all of our investments. Fortunately, the company's debt load is well-termed, and well-backed by committed tobacco inventories and receivables from customers with good credit profiles, mitigating leverage risk. An impressive new CEO, Mark Kehaya, a large Alliance One equity investor with a resume demonstrating prior experience in both tobacco-leaf operations and private-equity turnarounds, has been cutting overhead and streamlining operations, which is enabling the company to profitably recapture lost market share. Furthermore, the market for tobacco leaf appears to now be strengthening on the back of increasing Chinese demand for high quality American-blend tobaccos. We believe the company is on track over the next few years to meet its future goal of debt reduction and EBITDA growth, which would result in annual earnings in excess of \$1.50 per share as the company improves performance and captures additional tobacco processing volumes. Recent share price volatility we believe unrelated to long-term fundamentals has resulted in a 6.6 percent decline over the last quarter, impacting the Fund's third quarter performance by 43 basis points.

During the quarter, our largest purchase was a new position in **American Greetings Corporation (AM: \$17.15)**. This \$580 million market cap greeting card distributor has been in business for over 100 years, and currently shares an overwhelmingly dominant portion of the greeting card market with Hallmark, generating \$1.6 billion in annual revenues. The company, with approximately \$200 million in net debt, has come under selling pressure in recent months as investors have grown unduly concerned about a secular decline in the greeting cards business driven by a consumer transition to technology-based greetings solutions. In addition to the perceived secular issue, shareholders have also become alarmed over the company's comprehensive \$150 million information technology upgrade as well the controlling family's unusually expensive \$175 million project to build a new corporate headquarters. Furthermore, the company recently purchased a failing greeting-card retail chain in England, which had formerly been a large customer, leaving investors worried about the company's retail management prowess and its cash flow prospects. Upon inquiry, we concluded that the IT upgrade was likely to result in substantial cost savings and the expensive new headquarters was actually highly subsidized by local grants and tax incentives that made the project a better bargain for shareholders than we had initially thought. American Greetings' newly acquired retail stores in England are being managed by a private-equity group that had, in fact, turned-around the company's domestic retail stores following their divestment several years ago. Furthermore, we were impressed with the company's valuable collection of intellectual property, including artwork, pictures, designs and music. With the company generating \$200 million in normalized EBITDA, we believe the stock is worth significantly more than our \$13.88 purchase price. Apparently, the controlling family agrees with our assessment, as they just recently announced an interest in taking the company private with a wholly inadequate offer of \$17.18 per share.

We continue to work diligently to keep the portfolio invested in companies offering good risk/reward characteristics that we believe are among the cheapest bargains the market. Employees here own in excess of \$10 million in Fund shares. We continue to carefully monitor for developing risks in the portfolio. Should you have any questions, please feel free to call the shareholder reps at (800) 528-3780. You are also welcome to call me personally at (571) 250-0051.

Best regards,



Scott L. Barbee
Portfolio Manager
Aegis Value Fund

The Aegis Value Fund is offered by prospectus only. Investors should carefully consider the investment objectives, risks, charges and expenses of the fund. The Statutory and Summary Prospectuses contain this and other information about the fund and should be read carefully before investing. To obtain a copy of the fund's prospectus please call 1- 800-528-3780 or visit our website www.aegisfunds.com, where an on-line prospectus is available.

Mutual fund investing involves risk. Principal loss is possible. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. Value stocks may fall out of favor with investors and underperform growth stocks during given periods.

Diversification does not assure a profit or protect against a loss in a declining market.

An investment cannot be made directly in an index.

The letter refers to three issues held by the Fund: Tesoro Corporation, Alliance One International, and American Greetings Corporation. As of September 30, 2012, these stocks represent 5.3%, 5.9% and 1.5% of total Fund assets respectively. Fund holdings are subject to change and should not be considered a recommendation to buy or sell a security. Current and future portfolio holdings are subject to risk.

Price to Book: A ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share. **Book Value:** A company's common stock equity as it appears on a balance sheet. **EBITDA:** Earnings before interest, taxes, depreciation and amortization expense. **S&P 500 Index:** An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. **Russell 2000 Value Index:** A market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 2000 Index, which measures how U.S. stocks in the equity value segment perform. **CPI (Consumer Price Index):** A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. **Cash Flow:** An accounting statement called the "statement of cash flows", which shows the amount of cash generated and used by a company in a given period. It is calculated by adding noncash charges (such as depreciation) to net income after taxes. Cash flow can be attributed to a specific project, or to a business as a whole. Cash flow can be used as an indication of a company's financial strength.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice.

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