# AEGIS **Value Fund**

**Portfolio Manager's Letter**
**Quarter Ended June 30, 2012**

July 27, 2012

Dear Aegis Investor:

The Aegis Value Fund lost 1.95 percent in the second quarter, outperforming the Fund's primary benchmark, the Russell 2000 Value Index, which declined 3.01 percent. Past performance data for the Aegis Value Fund and its primary Russell 2000 Value benchmark is presented in **Table 1** below:

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

| | | | Annualized | | | | |
|---|---|---|---|---|---|---|---|
| | Three Month | Year-to-Date | One Year | Three Year | Five Year | Ten Year | Since Inception* |
| **Aegis Value Fund** | -1.95% | 8.22% | -2.96% | 26.92% | 0.39% | 7.60% | 10.12% |
| Russell 2000 Value Index | -3.01% | 8.23% | -1.44% | 17.43% | -1.05% | 6.50% | 6.46% |

** 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%.*

The second quarter marked a reversal from the strong gains shown in the first quarter as softer economic data out of the United States and concerns of a Eurozone collapse and a hard-landing in China reignited investor fears. Stocks and other "risk" assets sold-off in a "flight to quality," with the S&P 500 Index of large-cap stocks losing 2.75 percent over the quarter. Energy prices fell, with oil down approximately 17.5 percent, which dampened inflationary concerns. Year-over-year reported inflation actually moderated somewhat to 1.7 percent in May. Deep value stocks as a group performed poorly, with the S&P 600 Pure Value Index of deep value small-cap stocks delivering a significant quarterly loss of 7.44 percent.

We continue to manage the Fund applying our consistent deep value principles while keeping a careful eye on the unresolved economic and structural issues that are building in the United States and abroad, as we believe these issues could result in significant market tremors and dislocations. The most obvious area of risk has been the Eurozone, where a banking and sovereign debt crisis has been building for some time. The governments of many Euro member countries are experiencing difficulties reigning in their deficit spending, a process that is becoming more difficult as the market becomes less willing to finance ever-increasing sovereign debt loads. The fact that many European banks are thinly capitalized and have gorged themselves on perilous Eurozone sovereign debt complicates the situation. Consider that French bank BNP-Paribas now reports a massive $2.4 trillion balance sheet backed by only $74 billion of tangible common equity, with tangible equity capital levered a massive 32 times. The top 3 French banks now have approximately $5.8 trillion in assets, more than 2 times the entire GDP of France. While conventional wisdom views Germany as the Eurozone's strongest player, even Germany's banking system appears to us to be precariously levered. For example, Deutsche Bank, with nearly $2.5 trillion in assets, has nearly $38 in assets on its balance sheet for every dollar in tangible common equity capital. As Bear Stearns and Lehman can attest, when banks are levered to this extent, even small declines in asset values can effectively wipe out equity values and lead to dramatic market selling pressures and bank nationalizations as governments step-in to stop the selling.

One of the culprits behind the highly levered European banks appears to be the politically-formulated Basel banking standards, which may have actually been designed with an eye toward accommodation of sovereign government deficit spending. Under Basel, banks are not required to hold a capital cushion against holdings of most Eurozone sovereign debt, which are often considered risk-free and when performing are not typically required to be marked-to-market. With sovereign holdings making up an increasingly material portion of bank assets in recent years, Deutsche Bank, incredibly, has not been required to put-up equity capital against $2.1 trillion of its total $2.5 trillion book of assets. As the markets have begun to conclude that bank holdings of sovereign bonds can be significantly more risky than the Basel standards have dictated, bank depositors and wholesale lenders have been withdrawing funding from European banks.

While this activity would typically lead to a wave of asset liquidations and write-downs, many European banks have thus far been able to successfully avert asset sales by obtaining emergency funding from the European Central Bank, which has essentially printed Euros and made sovereign collateralized loans to the banks. Unfortunately, this activity exposes the ECB to significant credit risk and could complicate future efforts to fight inflation. Over the intermediate term, we believe the whole situation is precarious. Increased bank nationalizations, asset fire sales, capital controls and heightened inflationary effects are all clearly potential outcomes.

While Europe certainly captured investor mindshare this quarter, other potential fault lines around the world include China, where political lending to state-owned enterprises has left Chinese banks significantly undercapitalized and capital controls of questionable sustainability currently prevent significant capital flight from its banking system. We are also concerned about the economic backdrop in Japan, where government debt now totals a massive 230 percent of GDP. With Japan's government debt at these levels, even small increases in Japan's interest rates could quickly result in debt service payments consuming a massive portion of Japan's entire fiscal budget.

Although the US banking system appears to be in significantly better shape than that of the Europeans, the Chinese or the Japanese, it is difficult to argue that the US economy is healthy. Today, the Federal Government shows little appetite for reigning in its own colossal fiscal deficit spending programs. US public debt aggregates to approximately 71 percent of GDP, and is growing at an unsustainable rate of about 8 percent of US GDP per year. Although the second quarter witnessed the dollar strengthen materially against the Euro and saw interest rates drop as capital fleeing Europe sought a safe-haven in US denominated assets, long-run risks to the integrity of the dollar remain. In the intermediate term, the lack of fiscal discipline and the change occurring in the size and composition of the Federal Reserve's massive balance sheet are both likely to diminish future confidence in the value of the dollar as well.

Given the backdrop of economic imbalances worldwide, we would not be surprised to see a continuation of higher market volatility as governments around the world wind their way down the likely path of monetizing debt through systematic currency debasement. While we believe a resulting inflationary washout is apt to drive equity prices significantly higher in dollar terms over the intermediate term, we are also mindful that over the shorter term, given the high banking leverage and debt in the system, we must also be prepared for periods of uncontrolled liquidations and forced deleveraging.

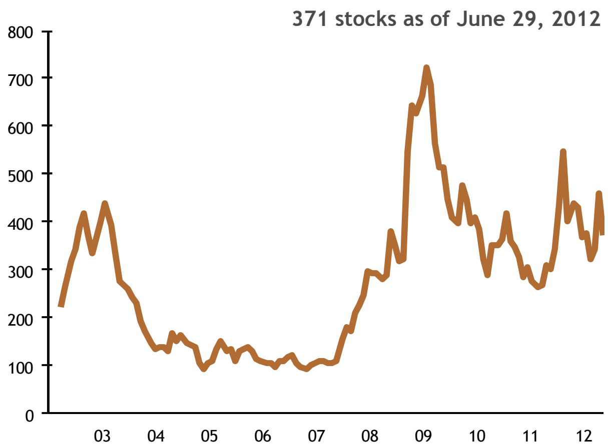
While today's unusual macroeconomic environment is volatile and unpredictable, our fundamentals-focused, deep value approach remains steady. We continue to work diligently to find stocks trading among the cheapest in the market and are buying companies where we believe individual company fundamentals and discounted valuations will eventually prevail over the economic and political headwinds that are currently bearing down on the market. We are currently underweight in banks, given new regulatory burdens, the potential contagion effects from deleveraging and the often unquantifiable exposures to big interest rate movements or counterparty defaults. We have instead focused the Fund on a variety of well-financed companies in other industries including energy, refining, chemicals, industrials, agriculture, and insurance.

In our security selection, we concentrate on companies trading at significant discounts based on book value or cash flows. But perhaps as importantly, we are also focused on companies that have strong balance sheets and either little debt or manageable levels of well-termed debt. Fortunately for us, many investors now prefer to sit it out on the sidelines holding cash or high-grade long-term bonds perilously exposed to interest rate increases. As a result, today there is much less buying competition in the equity markets and as a result we believe many stocks appear undervalued (see **Figure 1**, which tracks the currently elevated number of watchlist stocks). While stock prices bounce around unnervingly, the underlying fundamentals at many of our portfolio companies are quietly strengthening. Many of our holdings have been significantly deleveraging in recent years through internally generated cash flow, reducing exposure to a less dependable banking system. Several of our holdings, including White Mountains, Aircastle, Aspen Insurance, Patterson— UTI Drilling, Resolute Forest Products, Bassett Furniture, Sypris Solutions, and Western Refining have been taking advantage of low stock valuations in today's highly volatile investment climate to repurchase discounted shares using company cash flow in an efficient manner we believe will prove highly accretive to remaining long-term investors.

Most positively impacting Fund performance during the quarter was our investment in **American Pacific (APFC - $10.44)**. Shares of this $80 million market cap specialty chemical company were up approximately 40 percent

**Figure 1:**

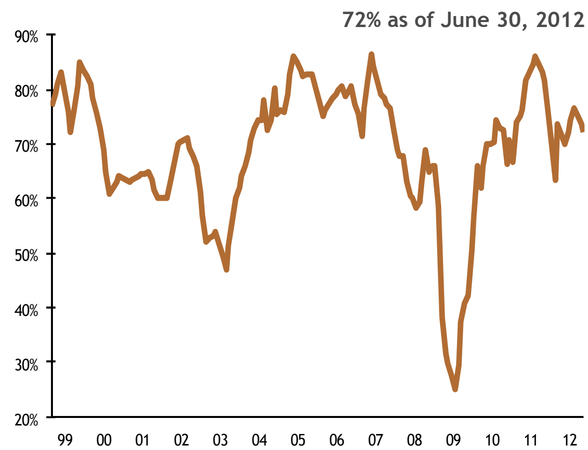
**Number of Stocks Selling Below Tangible Book Value**
(Market Cap. Greater Than $70 Mil)




*Source: U.S. public equity market statistics from Stock Investor Pro.*

**Figure 2:**

**Aegis Value Fund Historical Price-to-Book Ratio**




*Source: Aegis Financial Corp.*

during the quarter as the company announced a definitive agreement to sell its non-core Aerospace Division to Moog for $46 million in cash – a healthy valuation nearly 9 times the approximately $5 million in EBITDA the division generated in 2011. The move should allow American Pacific to refinance its expensive $105 million debt issue outstanding and focus on its core pharmaceutical chemicals business, which has been picking-up business in recent quarters. With nearly $36 million in EBITDA expected this year, we believe the company remains undervalued. Gains in shares of American Pacific improved Fund performance by approximately 1.1 percent in the quarter.

The holding most negatively influencing Fund performance in the second quarter was **Sanmina-SCI Corporation (SANM - $8.47)**, which impacted returns by 0.8 percent. Sanmina is a $710 million market-cap company providing electronic design and manufacturing services for a variety of machinery and equipment used in communication networks, computing/storage, defense, medical, multimedia, and automotive applications. The stock sold-off in the quarter as the company released news of compressed margins from sales challenges within the higher margin components and defense segments. As long-term investors, the near-term volatility in Sanmina stock based on one quarter's earnings is not overly concerning. We take comfort in the fact that the company trades at a low multiple of only 23 percent of tangible book value. Furthermore, Sanmina has been paying down debt to the tune of $500 million over the last 4 years, and now has debt remaining, net of cash, of approximately $550 million. With trailing EBITDA of slightly above $300 million, the company also trades at a modest multiple of cash flow, which we believe can grow to $400 million as the company gains traction on its operating initiatives. As the company delevers, we believe shareholders could see significant upside as the firm gains operating leverage benefits from increased end-market demand and growing penetration of high-margin components sales.

Overall, we continue to hold a portfolio of securities that we believe are valued among the cheapest in the market. As can be seen in **Figure 2**, stocks in the Aegis Value Fund trade at a weighted average 72.3 percent of book value at quarter-end, down slightly from the previous quarter. This Fund valuation remains roughly one-third that of the S&P 500. We continue to work diligently sifting through the market looking for bargains unearthed in today's volatile markets. Employees own in excess of $10 million in Fund shares, and we continue to carefully monitor for emerging risks within our portfolio companies. Should you have any questions, our shareholder services reps are available at (800) 528-3780. You are also welcome to call me personally at (571) 250-0051.

Best regards,

Scott L. Barbee

Scott L. Barbee
Portfolio Manager
Aegis Value Fund

**Please see the following page for important information.**

*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 eleven issues held by the Fund: White Mountains Insurance Group, Air Castle Ltd., Aspen Insurance, Patterson— UTI Drilling, Resolute Forest Products Inc., Sypris Solutions Inc., Bassett Furniture Industries, Western Refining Inc., American Pacific Corp., Moog Inc., and Sanmina-SCI Corp. As of June 30, 2012, these stocks represent 3.0%, 4.3%, 4.2%, 2.7%, 1.6%, 2.4%, 4.3%, 1.0%, 3.9%, 0.0% and 2.1% 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. **S&P 600 Pure Value Index: :** An index maintained and selected by the S&P Index Committee. It contains companies with market caps in the range of US$ 300 million up to US$1.4 billion and with public floats of at least 50% and with strong value characteristics.

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

***Fund Distributor: Quasar Distributors, LLC. Quasar Distributors, LLC is affiliated with US Bancorp Fund Services, LLC.***