

Market Review

Small capitalization stocks staged a strong rally in the first quarter of 2006, confounding many forecasts that they would underperform large capitalization stocks. The Russell 2000 surged 13.94% in the first quarter of 2006, outperforming their large capitalization brethren in the Russell 1000 by almost 10%. The relative outperformance was the largest since the fourth quarter of 2001. Mid-capitalization stocks (which are part of the Russell 1000) also underperformed small capitalization stocks for the quarter. At quarter-end, the Russell 2000 reached an all-time high of 765.14. Table 1 provides a summary of the U.S. Equity markets' performance.

**Table 1: Performance Comparison of Russell Indices\***

	Index	January	1Q06
Small Cap Stocks	Russell 2000 Index	8.97%	13.94%
	Russell 2000 Growth Index	9.65%	14.36%
	Russell 2000 Value Index	8.27%	13.51%
Mid Cap Stocks	Russell Mid Cap Index	5.14%	7.61%
	Russell Mid Cap Growth Index	5.99%	7.62%
	Russell Mid Cap Value Index	4.34%	7.61%
Large Cap Stocks	Russell 1000 Index	2.80%	4.49%
	Russell 1000 Growth Index	1.76%	3.09%
	Russell 1000 Value Index	3.88%	5.93%

\*Source: Frank Russell Co.

Much of the quarter's gain came in January, when the Russell 2000 rose 8.97%. From a historical perspective, strong January performance has signaled very strong annual performance. A Lehman Brothers report issued earlier this year reflected on the best performing January returns and the full-year performance associated with them. Since 1979, there have been six calendar years when the January return of the Russell 2000 has exceeded 8% (the years 1979, 1980, 1985, 1987, 1991, and 1992). The average annual return in those six calendar year periods is 28.1%. In only one instance, the year 1987, was the annual return negative; in that year the Russell 2000 declined -8.8%. Those seeking more bearish historical trends will point to the rarity of 4 consecutive positive years for small capitalization stocks. The Russell 2000 last achieved this when posting five consecutive positive years in the 1979 through 1983 periods. (Source: Lehman Brothers Small Cap Strategy, February 13, 2006)

The first quarter's rally began well before companies began releasing fourth quarter earnings. Earnings reports began to be released at the end of January, and they came in strong - the Russell 2000 year-over-year revenue growth was 13% and earnings growth was 14%. Leading the gains were the Energy and Information Technology sectors, both posting large double digit gains in revenues and earnings.

Investors' attraction to lower-quality companies continued into the first quarter of 2006. Loss-making stocks outperformed stocks with earnings, and companies with an S&P Equity Rating of B or lower edged out those with B+ or higher rankings. Stocks in the Industrials, Materials, Information Technology and Healthcare sectors contributed strongly to the indices' returns.

Looking ahead, equity markets face the challenge of continued increases in interest rates by the new Fed Chairman Ben Bernanke, who appears to be as anti-inflation oriented as Alan Greenspan. With profit margins in the Russell 2000 at near-peak levels, stocks are becoming more dependent on revenue growth to continue the earnings growth rates. We believe the Conestoga Small Cap Growth portfolio to be well positioned relative to the market in this environment, as the companies in our clients' portfolios have demonstrated more stable, organic growth with lower financial leverage.

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## **First Quarter 2006 Performance Attribution**

Given a market environment that favored companies without earnings, with more debt, selling at higher valuations, we were reasonably pleased to keep pace with the market's surge in the first quarter. The market's surge was broad-based, with nearly every sector posting positive returns and nearly every sector rising over 10% for the quarter. The best performing sectors were the Producer Durables and Materials sectors. Several significant sub-sectors of the market posted very strong results, including Semi-Conductors (up over 30%), which is part of the Technology sector. We do believe that our clients' portfolios benefited from maintaining a true small capitalization focus as mid-capitalization stocks underperformed. (Please note that individual account performance will vary slightly due to slight individual issue weighting differences and specific individual client guidelines.)

### **Attribution Relative to the Russell 2000 Growth:**

The strategy modestly underperformed the Russell 2000 Growth for the first quarter of 2006 on a gross-of-fees basis. Our attribution reveals the portfolio's sector allocations provided a modest boost to return, while security selection detracted slightly from performance. Conestoga Capital benefited from overweights to the Producer Durables and Other categories and from underweights to the Consumer Discretionary and Health Care sectors. Our underweight to Technology (especially to Semi-Conductors), Financial Services (especially REITs) and Materials acted as a drag to performance over the quarter. It is worth noting that the Other sector represents less than 1% of the Russell 2000 Growth versus a 4% weighting in the Conestoga Small Cap portfolio, the entirety of which is held in the stock of Raven Industries. Raven was one of the portfolio's best performing stocks.

Conestoga's stock selection was strong in the Consumer Discretionary, Producer Durables and Health Care sectors. SCP Pool Corp (within the Consumer Discretionary sector) and Franklin Electric (within the Producer Durables sector) were two notable performers, and each are reviewed in more detail within the leaders and laggards section on the following page. Stock selection within the Financial Services sector was weak, with World Acceptance Corp being the primary detractor.

### **Attribution Relative to the Russell 2000**

Our strategy slightly outperformed the Russell 2000 for the quarter on a gross-of-fees basis. Calculations of performance attribution relative to this index produced a smaller negative impact from stock selection with sector allocations still modestly positive. Overweights to the Producer Durables and Other sectors, along with an underweight to Financial Services were the strongest positive contributors to sector selection. Versus this index, our clients' portfolios carried a modest overweight to the Technology sector which boosted return marginally. An underweight to the Materials and Processing sector was the largest detractor from relative performance. The marginal negative impact of stock selection was primarily due to the laggard stocks presented on the following section on the following page.

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## Top 5 Composite Leaders

**1. Raven Industries Inc. (RAVN):** One of seven publicly-traded companies headquartered in South Dakota, Raven sometimes suffers from a lack of investor attention. In this quarter, investors took notice of record sales and earnings growth at the mini-conglomerate that provides electronics manufacturing services, reinforced plastic sheeting and flow control devices.

**2. Franklin Electric Co. Inc. (FELE):** In late January, Franklin announced stellar earnings growth of over 20% for the fourth quarter and the full year 2005 with record sales. The real boost in the company's stock came in the second half of March, following the announcement that they would acquire the Little Giant Pump Company, a subsidiary of Tecumseh Products Company. The company's shift to a direct distribution model certainly poses some risks but is in the best long-term interests of the company.

**3. AMCOL International Corp (ACO):** Releasing earnings on January 17, ACO beat consensus estimates by 5 cents per share and rose 10% on that day. The specialty minerals company is primarily known for its bentonite-based products and its geosynthetic clay liner products. Highlighted by market commentators such as Jim Cramer and Motley Fool, the Chicago-based company benefited from increased investor attention.

**4. A.S.V. Inc. (ASVI):** ASVI was a new purchase in the fourth quarter of 2005, and was also a top performer in that quarter. The company continued its winning ways, rising significantly in the first quarter after posting fourth quarter sales and earnings that exceeded expectations. With the recent launch of two new models of rubber-track loaders, we will be watching this stock closely to see if it can meet heightened expectations.

**5. SCP Pool Corp (POOL):** This company is the largest distributor of swimming pool and related backyard products. The company announced earnings per share growth of 26% for the full year 2005 on sales growth of 18%. We visited the company's Riverside, CA facilities in March and we remain confident in this very effective management team. As part of a portfolio management control to reduce exposure to stocks with a market capitalization over \$2 Billion, we reduced our stake in the company at quarter-end.

## Bottom 5 Composite Laggards

**1. Winnebago Industries (WGO):** This manufacturer of recreational vehicles saw its stock decline for the quarter after reporting fiscal second quarter profits that slumped 39% on lower-than-expected sales. The stock's fundamental results were adversely impacted by consumer preferences for Class C vehicles, which carry lower margins as well as rising interest rates and fuel prices.

**2. Kronos Inc. (KRON):** The company's stock slid in the first few trading days of 2006 after management pre-released quarterly results which did not meet expectations. When the company released earnings in late January, it announced that the shortfall was a result of lower than expected professional services and the impact of renewal rates on maintenance caused by new computer systems. The stock rebounded after the earnings release, but fell again later in the quarter on an analyst's downgrade.

**3. World Acceptance Corp (WRLD):** The company had an eventful quarter, beginning with an earnings release showing increased profits but lower credit quality due to recent changes in bankruptcy law. The company's stock fell but quickly recovered. At quarter end, the company announced that Doug Evans, the CEO, was terminated with little explanation. The company immediately appointed Sandy McLean, the longtime CFO as the new CEO. Also, WRLD provided guidance that the next quarter's earnings would come in above expectations.

**4. Knight Transportation (KNX):** Knight began the quarter by posting record results for revenues and earnings, although the stock failed to advance much on the news. Driving into the headwind of higher fuel costs, the company has managed to still produce strong results. Two days before the end of the quarter, the company's stock was hit by an analyst's forecast for lower transportation industry profits on weaker freight volumes in the first quarter of 2006.

**5. Blackboard Inc. (BBBB):** This educational software company reported very good performance for the fourth quarter, but followed the release with a 2006 earnings outlook that did not meet analysts' hopes. Analysts were forecasting 84 cents per share of earnings for BBBB, but the company said a target of 72 - 76 cents was more reasonable. Having completed the acquisition of WebCT, its biggest competitor, during the quarter, we have a strong long-term outlook for this company.

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## First Quarter Buys

**1. Psychomedics (PMD):** Based in Acton, MA, the company is the world leader in detecting drugs of abuse using hair samples. The technique has significant advantages over traditional urine analysis, including the ability to detect drug use over a longer period of time (months versus days) and an estimate of the amount of drug taken. Additionally, the U.S. Federal Government's Drug Testing Advisory Board is considering adding hair drug testing as an acceptable means of drug-abuse detection for federal workers. If adopted, PMD will have enhanced growth opportunities in the next several years. With a market capitalization of just under \$100 million, PMD is a bit smaller than our typical holding.

**2. Rimage Corp. (RIMG):** Based in Edina, MN, Rimage is a leader of on-demand CD/DVD business publishing systems for the creation of discs with customized digital content and labels. We initiated a position in mid/late February after the company announced it would miss "Street" expectations. Two major reasons for the shortfall are expenses associated with a consulting project to help assess long-term growth opportunities and slower-than-expected rollout of its DiscLab product. We viewed both factors as short-term in nature. In the low 20s, we think the stock has a very attractive risk/reward ratio. The company has an outstanding balance sheet and significant long-term growth prospects.

**3. Lojack Corp. (LOJN):** Based in Westwood, MA, LoJack is the leader in wireless tracking and recovery systems for automobiles. The company operates in 24 states in the US and 25 countries in the world. LOJN has a number of attractive qualities, including: 1) strong management 2) a solid balance sheet 3) significant opportunities within US automobile dealers and, 4) international growth via a direct model and licensees. There are further growth opportunities for its tracking technology with mobile assets including construction equipment, hazardous materials and cargo. Despite the strength of its brand name, LOJN is an undiscovered company from a Wall Street perspective.

**4. Surmodics (SRDX):** Based in Minneapolis, MN, SRDX is a medical device company specializing in surface modification and drug delivery systems. The company's products improve the performance of medical devices, such as guidewires, and enable new product development and applications. The company's largest relationship is with Johnson & Johnson's Cordis division for its Taxus stent. SRDX's royalty-based business model is extremely profitable and has

significant operating leverage that we expect to see in the next several years. The company has an outstanding balance sheet with significant cash and no debt.

**5. II-VI Corp. (IIVI):** Based in Saxonburg, PA. II-VI Corp. develops laser and laser-related technologies for industrial, military, medical and aerospace applications. The company has an excellent long-term track record and we expect it to continue for the next several years. Recent results have been hampered by raw material pricing and difficulty absorbing a recent strategic acquisition. We believe the management team has addressed these issues and expect to see significant growth and earnings leverage in the next 12-18 months.

**6. Iconix (ICON):** Based in New York City, ICON is a brand management company with recognizable clothing labels such as Candie's and Joe Boxer. The company has no inventory or manufacturing facilities. It simply owns brands and licenses those brands to various retailers such as KMart. The company's highly profitable business model is guided by Neil Cole, the CEO. We believe this company complements another more conservative brand licensing holding, Cherokee Inc. (CHKE). ICON is focused on driving additional penetration of its current stable of brands but also it is actively seeking to acquire other brands.

## First Quarter Sells

**1. American Woodmark (AMWD):** This company was under review at the beginning of the year after a difficult second half of 2005. Disappointing sales and gross margins on the heels of exiting Lowe's as a supplier, dampened our outlook for the company's future prospects. We sold the stock in the high 20s in February.

**2. Graco Inc. (GGG):** Graco has been a successful investment for Conestoga, initially purchased in 2000. The company's market capitalization rose to over \$3 Billion during the quarter, and we sold the security to re-invest back in to smaller capitalization names.

A number of other portfolio holdings rose above the \$2 Billion market capitalization level during the quarter, and we took the opportunity to trim those names as well: St. Mary's Land & Exploration (SM), Techne Corp (TECH), Polaris Industries (PII), TSX Group (TSX), and SCP Pool (SCP).

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