Conestoga Capital Advisors — Second Quarter 2006

Market Review

Markets around the world became more volatile in the second quarter, with most markets turning sharply downward in May. Small capitalization stocks as measured by the Russell 2000 hit an all-time high on May 5th and the Dow Jones Industrials Average closed 83 points shy of its all-time high on May 10th. While many of investors' concerns in the market, namely inflation and stock valuation levels, did not change during the quarter, there were increasing concerns about how to interpret the new Federal Reserve leadership. Ben Bernanke took the reins from Alan Greenspan earlier this year, and markets have been adjusting to the new relationship. Mr. Bernanke's comments in April led many to believe that the Fed would be taking a pause from interest rate hikes, but he clarified in May that he had been misunderstood. The "change" sent markets down sharply as investors re-evaluated just how high U.S. short-term rates might go. The Russell 2000 fell 5.6% in May, and the Russell 2000 Growth fell 7.0%. Small capitalization stocks bottomed on June 13, with the Russell 2000 giving back almost all of its gains for 2006, and the Russell 2000 Growth in negative return territory. Large-capitalization and value stocks fared better than small capitalization and growth stocks, as is often the case when investors become more defensive. It was not until late June, after another quarter-point rise in rates and calming comments from the Federal Reserve that the market stabilized. In the last two days of the quarter, stocks jumped significantly with the Russell 2000 rising over 5%, allowing the Index to post a positive return for the month. Returns for the capitalization and style components of the Russell indices are provided below:

Table 1: Russell Indices Second Quarter and Year-to-Date Returns

	Index	Second Quarter	Year-to-Date 2006
Small Cap Stocks	Russell 2000 Index	-5.02%	8.21%
	Russell 2000 Growth Index	-7.25%	6.07%
	Russell 2000 Value Index	-2.70%	10.44%
Mid Cap Stocks	Russell Mid Cap Index	-2.58%	4.84%
	Russell Mid Cap Growth Index	-4.69%	2.56%
	Russell Mid Cap Value Index	-0.56%	7.02%
Large Cap Stocks	Russell 1000 Index	-1.66%	2.76%
	Russell 1000 Growth Index	-3.90%	-0.93%
	Russell 1000 Value Index	0.59%	6.56%

*Source: *Frank Russell Co.*

Whether the events of this quarter foretell a sea change in market sentiment remains to be seen. Markets have been moving higher since mid-2002, fostered in part by low interest rates around the world. Until the sell-off this past May, riskier asset classes such as emerging markets equities and high yield bonds have been among the strongest performers. U.S. corporate profit growth has been strong since mid-2002, although future growth is becoming very dependent on revenue growth as operating margins are now at peak levels. Put another way, most companies must rely more on increasing sales to generate higher profits because their businesses are being run very efficiently.

We do believe that investors may now begin rotating back to higher quality stocks – if so, this should favor our style. We define "high-quality" stocks as those with strong business models, less volatile earnings growth, and conservative balance sheets. These types of stocks have been out of favor since mid-2003, as many investors have been willing to take significant investment risk in hopes of greater return. This trend has created a tough investment environment for our strategy, as the more sustainable growth companies we invest in are "passed over" by the market. We continue to find small capitalization companies which we believe offer strong growth potential. As discussed in prior letters and communications, we emphasize growth companies with the following characteristics: (1) demonstrated earnings that we believe can be sustained at annual growth rates of 15% to 20%, (2) Return on Equity in excess of 15% and (3) debt-to-capitalization less than 40%. It is exactly these characteristics which provide most companies with the financial strength to continue their growth through economic cycles, interest rate cycles, and swings in investor sentiment.

Second Quarter 2006 Performance Attribution

The Russell 2000 reached its peak for 2006 on May 5th with a year-to-date return of 16.51%. From May 5th through quarter-end, the Russell 2000 fell 7.12% and the Russell 2000 Growth fell 8.83%, as concerns over the direction of the new Federal Reserve Chairman rattled investors. Were it not for a very strong surge in stock prices on the last two days of the quarter, small capitalization stocks would have likely erased all of the gains achieved in the first quarter. Most affected within the small capitalization indices were the semi-conductor and electronics technology industries within the Technology sector, and the biotech and pharmaceutical industries within the Health Care sector. All of these industries are characterized by little or no current earnings, and a higher degree of speculation on when they will produce earnings in the future. As one would expect, the most defensive sectors of the market held up the best during the quarter. Although they only make up a small portion of the total Index, the Consumer Staples, Other Energy, and Autos and Transportation sectors did manage to provide positive total returns for the quarter. All of the other nine sectors of the Russell 2000 Index posted negative returns for the second quarter. Three sectors (Technology, Health Care and Other) posted double digit negative returns. (Please note that individual account performance will vary due to slight individual issue weighting differences and specific individual client guidelines.)

Attribution Relative to the Russell 2000 Growth:

Conestoga's strategy outperformed the Russell 2000 Growth for the quarter, and our attribution reveals stock selection as the primary source of excess return. Our sector weightings relative to the benchmark had little effect, with most major sector weightings positioned similarly to the Index. Our most significant sector deviation was in Financial Services, where client portfolios were positioned with an approximate 5% overweighting (17.5% versus 12.1%), which benefited performance modestly during the quarter.

Stock selection was strongest in the Technology and Consumer Discretionary sectors. Within Technology, our emphasis on developed technology companies benefited performance, as companies such as Blackboard (BBBB), Trimble Navigation Ltd. (TRMB) and II-VI Inc (IIVI) performed better than the average technology company in the Index. In the Consumer Discretionary sector, there was significant concern on how the Federal Reserve's rising rate policy would effect consumer spending. Retail and restaurant industry stocks sold-off significantly, however two retail companies in the Conestoga strategy held up well: Cherokee (CHKE) and Iconix (ICON). These two brand management firms offer exposure to the consumer sector without the inventory and store management issues that can often cause difficulties in economic downturns. Stock selection was weakest in the Producer Durables, where ASV Inc. (ASVI) and Plantronics Inc. (PLT) detracted from returns. ASVI moved lower after very strong fourth quarter 2005 and first quarter 2006 returns, while PLT missed earnings and lowered guidance. For a full review of the portfolio's leaders and laggards, please see page 3.

Attribution Relative to the Russell 2000

Our strategy underperformed the Russell 2000 during the second quarter, as the value stocks within the Index posted stronger returns than the growth stocks. This effect was manifest in the sector effect within the attribution. The Russell 2000's lower exposure to Technology and Health Care, two of the poorest performing sectors, provided better protection against the market's downward move. At the same time, the Russell 2000's higher weighting in the defensive Consumer Staples and Other Energy sectors generated underperformance for the Conestoga strategy. We estimate that three-quarters of our underperformance versus the Russell 2000 Index was due to sector allocations.

While sector allocation detracted the majority of return relative to the Index, stock selection was also a modest negative. Stock selection in the Producer Durables sector was weak, as Raven Industries Inc. (RAVN) and Plantronics Inc. (PLT) both dragged down returns. RAVN was the highest-weighted stock in the portfolio, and has been one of the best performing stocks over the past several years. Its missed earnings report caused a sell-off this quarter (see the following page for a full review). The strategy did benefit from stock selection in the Technology and Consumer Discretionary sectors as described under the Russell 2000 Growth attribution. Within the Health Care sector, our emphasis on device companies and health care service providers generated better-than-index returns. Psychemedics (PMD) and SurModics (SRDX) were two examples of companies that outperformed.

Please note: the specific securities identified and described in this report do not represent all of the securities purchased, sold or recommended for advisory clients, and you should not assume that investments in the securities identified and discussed will be profitable in the future. As you are aware, one cannot assume that past results are indicative of future performance.

Top 5 Composite Leaders

1. World Acceptance Corp (WRLD): This Greenville, SC – based small-loan consumer finance company announced record revenue and net income in late April. The CEO cited strong loan growth, lower provisions for loan losses and improved operating margins. Additionally, a comparable public company, (Ace Cash Express), was recently acquired by a private equity firm for a substantial premium. We think investors may be speculating that WRLD is a takeover candidate.

2. FactSet Research Systems Inc. (FDS): Conestoga Capital Advisors was originally (and presently is) a client of this financial information software company. We added the stock to client portfolios in the fourth quarter of 2002. The company's software is used by investment managers, banks and other financial firms to analyze investment portfolios, which creates a strong recurring revenue stream. The company had a strong quarter, reporting better-than-expected earnings and guiding annual revenue and earnings higher.

3. Ritchie Bros. Auctioneers Inc. (RBA): Specializing in industrial auctions at over 100 sites in 25 countries, this company has produced steadily growing revenues and earnings. The company reported outstanding quarter results and continues to invest in its M07 initiative to double the capacity to support long-term double-digit revenue growth.

4. Iconix Brand Group Inc. (ICON): Iconix and Cherokee (see below) are two interesting plays in the consumer sector. Both companies own, market and license brands; however, neither carry inventory or manufacturing facilities. ICON is best known for its Candie's and Joe Boxer brands, which it licenses to mass market retailers such as Kmart. Interestingly, ICON and Cherokee competed to acquire Mossimo Inc. (MOSS) during the quarter, with ICON ultimately acquiring MOSS.

5. Cherokee Inc. (CHKE): As mentioned under Iconix above, CHKE is also a brand management firm. Cherokee is best known for its exclusive arrangement with Target Stores to use the Cherokee brand in its clothing lines. CHKE lost its bid to acquire Mossimo Inc. during the quarter, but the company will receive $33 million from ICON upon its closing of the MOSS acquisition. This payment is essentially the net present value of the 15% royalty rate CHKE was to receive in perpetuity from sales of Mossimo brand products in Target Stores.

Bottom 5 Composite Laggards

1. Raven Industries Inc. (RAVN): RAVN reported weaker-than-expected earnings in 3 of 4 business units and higher-than-expected capital expenditures; however, they maintained their annual earnings/revenue guidance. It appears to us that momentum investors sold on the earnings miss, and we remain optimistic on the company's long-term prospects. This quarterly shortfall is not totally unexpected given RAVN's long term oriented management team.

2. Plantronics (PLT): PLT reported weaker-than-expected earnings and lower guidance for future quarters. The company experienced a contraction in the gross margin from: 1) increased competition in its call center segment (which historically had higher gross margins) and 2) the fastest growing segments of its business (mobile and consumer) are systemically lower margin businesses. This quarterly short fall does concern us and we are re-evaluating the company.

3. Computer Programs & Systems Inc. (CPSI): We believe CPSI declined due to the announcement that the CEO would step down. David Dye had been the public face of the company since its initial public offering in 2002. The change caused concern, however Dye was made Chairman. Boyd Douglas (COO since 1999) will succeed as President/CEO. We are comfortable with the new CEO, having met him on a visit to company headquarters in 2004. The health care information technology company reported solid earnings and revenue growth for the quarter.

4. Simpson Manufacturing (SSD): SSD, which designs and builds systems to strengthen a homes' ability to withstand earthquakes and high winds, fell on concerns of a slowing housing market. Earnings released during the quarter were strong, with sales growth up over 17% from the year earlier quarter. The company's earnings release included carefully crafted language by an attorney causing speculation that SSD's relationship with its largest customer, Home Depot (HD), was strained. We will monitor this issue, but given SSD's superior products we do not believe HD has real alternatives.

5. Boston Private Financial Holdings Inc. (BPFH): BPFH reported a solid quarter, with cash earnings up almost 19%. The company's stock appeared to be pressured by factors including 1) the stock market's decline could shave a penny or two off quarterly results from the asset management division, 2) investors' concerns about the impact of rising rates and the potential negative impact on lenders. We believe BPFH's diversified businesses in private wealth management, asset management, and banking, as well as its geographical diversification will protect the company through an economic downturn and/or a rising rate environment.

Second Quarter Buys

1. Select Comfort Corp. (SCSS): Select Comfort manufactures, markets and sells adjustable-firmness, a.k.a. air mattresses, in the United States and Canada. Best known for its infomercials that were its original sales strategy, the company now markets and sells at retail stores as well. The company's business model is very strong, with all mattresses shipped direct to the consumer from its Utah production facility, eliminating the need for inventory in the retail chain. This structure produces significant free cash flow. Additionally, the company has no debt, and should produce 20% revenue and earnings over the next three-five years.

Second Quarter Sells

1. Yankee Candle (YCC): Yankee Candle was sold mid-quarter to fund the purchase of Select Comfort. While the stock remained relatively flat during our holding period, we were concerned about increasing debt levels. Through our process of continually seeking better opportunities for client portfolios, we were convinced that Select Comfort offered a better business model, a stronger financial position, higher growth prospects and traded at a comparable valuation. Overall, we believe the trade raised the quality of the portfolio.

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