

Market Review

U.S. equities staged a modest recovery in the third quarter, although small capitalization companies generally failed to keep pace with larger capitalization companies. Following an early slide in July, stocks began to recover after the Federal Reserve hinted it may “pause” the cycle of rate increases, citing moderating economic growth. Investors took a cautiously optimistic attitude as the quarter’s economic news was mixed. On the positive side, oil prices fell significantly over the quarter (down 15%) and unleaded gasoline fell even further (down 30%). Price swings in natural gas caused major losses at some hedge funds, most notably Amaranth Advisors, although once again the events appeared limited to a few firms, rather than widespread across the hedge fund sector. Unemployment remained low, and personal consumption expenditures held firm. More troubling for the economy, in September, the National Association of Realtors reported that the median home price had fallen 1.7% in the prior twelve months. This raised speculation that the economy may suffer as households feel “less wealthy” as the values of their homes decrease. The Federal Reserve held rates at 5.25% at its August and September meetings, and long bonds rallied through the quarter.

Large capitalization stocks strongly outperformed small capitalization stocks over the summer. For the year to date, small cap stocks remain ahead of their large cap brethren, but only by a modest margin. Large cap stocks have outperformed small cap stocks by a wide margin in two successive quarters, leading some market forecasters to predict the beginning of a cyclical turn favoring large cap stocks. Meanwhile, Value stocks have continued to outperform Growth stocks and defensive, less economically sensitive industries led the rally in the third quarter. Among small capitalization stocks in the Russell 2000, the Utilities and Financial Services sectors were the two best performing. The more cyclical Autos and Transportation, Producer Durables and Materials and Processing sectors, along with Other Energy, were the weakest performing sectors.

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

	Index	Third Quarter 2006	Year-to-Date 2006
Small Cap Stocks	Russell 2000 Index	0.44%	8.69%
	Russell 2000 Growth Index	-1.76	4.21
	Russell 2000 Value Index	2.55	13.25
Mid Cap Stocks	Russell Mid Cap Index	2.11	7.06
	Russell Mid Cap Growth Index	0.89	3.47
	Russell Mid Cap Value Index	3.53	10.80
Large Cap Stocks	Russell 1000 Index	5.06	7.95
	Russell 1000 Growth Index	3.94	2.97
	Russell 1000 Value Index	6.22	13.19

*Source: Frank Russell Co.

Looking more closely at the stocks in Conestoga Capital Advisors’ strategy, we feel more optimistic on the strength of the individual companies. We have continued to find new companies with attractive characteristics at reasonable valuations. Higher quality companies (which we define as those with more sustainable earnings growth, lower debt levels and higher returns on equity) as found in our clients’ portfolios have not participated as fully in the rally since mid-2003, but we believe they are better positioned to continue growing through a more difficult economic and/or stock market environment.

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Third Quarter 2006 Performance Attribution

Value stocks and Growth stocks continued their recent performance differential in third quarter. Within the small capitalization universe, the Russell 2000 Value Index rose 2.55% while the Russell 2000 Growth Index declined -1.76%. Year-to-date, the Russell 2000 Value is up 13.25% and the Russell 2000 Growth is up only 4.21%. This performance differential becomes more apparent within certain sectors, such as Utilities, Consumer Staples, and Financial Services, which have more “value” type characteristics. These sectors have generally outperformed the typical “growth” sectors such as Technology and Health Care. The performance of the Conestoga Capital Advisors strategy was significantly impacted by this Value/Growth split. The strategy outperformed the Russell 2000 Growth Index, but underperformed the Russell 2000 (which holds both Value and Growth stocks). Note: 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 sector allocation and stock selection combined to deliver outperformance versus the Russell 2000 Growth in the third quarter. The strategy’s most significant overweight is in Financial Services, as has been the case throughout this year. This benefited performance for the quarter, as did the overweight to Technology and underweight to Other Energy. Overweights to the Other and Consumer Discretionary sectors were modest detractors from relative return.

Stock selection was strongest in the Technology sector. Ansoft (ANST) and II-VI Inc. (IIVI) were two strong performers, each benefiting from better-than-expected earnings. Both of the two new purchases into the strategy, Blackbaud (BLKB) and Quality Systems Inc. (QSII), were in the Technology sector, and both stocks performed well over the quarter. Stock selection was also strong within the Financial Services sector, where World Acceptance Corp. (WRLD) and PrivateBancorp Inc. (PVTB) contributed to relative performance.

The Health Care, Producer Durables, and Materials and Processing sectors proved more difficult this quarter, and our stock selection detracted from returns in these three sectors. Computer Programs & Systems Inc (CPSI) dragged down performance in the Health Care sector, while A.S.V. Inc. (ASVI) detracted from performance within the Producer Durables sector. Within Materials and Processing, Simpson Manufacturing Co. (SSD) fell on concerns about the housing industry slowdown. All of these companies are discussed in more detail on the following page.

Attribution Relative to the Russell 2000

The strategy underperformed the Russell 2000 in the third quarter, as Value stocks and more defensive industries continued their leadership over Growth stocks, which are the consistent focus of the strategy. Value stocks, both large and small capitalization, have outperformed growth stocks in every year this decade with the exception of 2003, and we believe this trend can not continue indefinitely.

At the sector level, underweights to Utilities and Financial Services detracted from returns during the quarter. The Russell 2000 Utilities sector rose over 8% for the quarter, and the strategy held no stocks in this low growth sector. Financial Services, approximately 17% of client portfolios versus over 24% of the benchmark, also caused relative underperformance during the period. The underweight to two industries within the Financial Services sector, commercial banks and real estate investment trusts (REITs), detracted from returns. The strategy’s overweight to Technology benefited returns only modestly.

Stock selection versus the Russell 2000 was again strongest in the Technology sector. In addition to Ansoft (ANST) and II-VI (IIVI) discussed above, another strong contributor was Avocent Corp. (AVCT), which benefited from the completion of an acquisition and rising earnings expectations. Stock selection was weakest in the Health Care, Materials and Processing, and Producer Durables sectors. Within Health Care, the strategy’s holdings in Computer Programs & Systems Inc. (CPSI), Psychomedics Corp. (PMD), and Integra LifeSciences Holdings Corp. (IART) detracted from returns.

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Top 5 Composite Leaders

1. **Ansoft Corp. (ANST):** This Pittsburgh-based company creates software used to aid in the design of technology devices such as cell phones, circuit boards, and networking systems. In late August, the company announced fiscal first quarter profits exceeding analyst expectations, on higher-than-expected revenue growth.

2. **II-VI Inc. (IIVI):** This company was purchased into client accounts in the first quarter of 2006. Prior to purchase by Conestoga Capital Advisors, the company's performance had been hampered by raw material pricing and difficulty absorbing a recent strategic acquisition. The company posted solid fiscal fourth quarter results while writing off a portion of goodwill associated with its troubled acquisition. Excluding the goodwill charge, earnings for the full fiscal year rose 22%, and we expect continued strong growth ahead for II-VI.

3. **World Acceptance Corp. (WRLD):** This small-loan consumer finance company was among our second quarter top performers also, and its strength continued into the third quarter. Revenue and earnings growth released in late July exceeded expectations, and the company's stock continued to rise steadily over the course of the quarter. As mentioned in last quarter's review, we believe some investors may be speculating that WRLD is a takeover candidate, although this is not one of our reasons for holding the stock. Of note, we have modestly reduced the position as a result of its increasing market capitalization.

4. **Avocent Corp. (AVCT):** This company makes switching systems and connectivity devices for network servers, desktop computers and wireless devices. In April, the firm announced the acquisition of LANDesk Group, an information technology software firm. The acquisition was approved in August, and the company's tender was completed. As a result of the acquisition, the company raised guidance for the coming two quarters, and the stock appreciated strongly over the quarter.

5. **Mentor Corp. (MNT):** This Santa Barbara, CA-based maker of breast implants and other medical devices announced fiscal first quarter earnings in excess of estimates and closed on the sale of its urology business, reaping a strong one-time gain. Its offer to purchase medical aesthetics company Medicis (MRX) was rejected early this year, and the next key point for the company is the pending approval from the FDA on the use of its silicone implants. In the U.S., these devices are currently allowed only for reconstructive surgery such as after a mastectomy.

Bottom 5 Composite Laggards

1. **Simpson Manufacturing Co. (SSD):** This building systems manufacturer continued to suffer from investors' concerns about the housing market. Second quarter earnings were still up modestly, rising 9.5% from the year-earlier quarter. Sales growth rose 7.5% versus second quarter 2005. We remain confident on SSD's ability to grow, and take comfort in the strength of the company's balance sheet. SSD has almost no debt, a return-on-equity of 20%, and cash on the books of \$2 per share.

2. **Carbo Ceramics (CRR):** Second quarter earnings at CCR fell short of expectations, and investors' confidence waned as oil prices fell. The Irving, TX-based company makes a ceramic bead, called a proppant, which facilitates more efficient pumping of oil from wells. While North American demand was strong and the company was able to pass on modest price increases, this region's sales levels did not meet expectations and the stock sold off as a result.

3. **Computer Programs & Systems Inc. (CPSI):** While little negative news was released, this company saw its stock continue to fall over the quarter. The company announced second quarter earnings growth of nearly 20%, with increased sales of 7.5%. We believe that investors may be adjusting to the new CEO, who as mentioned in the prior review, is a long-time employee of the company. We remain optimistic on CPSI, which carries a very strong balance sheet with no debt, a 3% dividend yield, and a forward price-earnings ratio of 17.9.

4. **A.S.V. Inc. (ASVI):** Despite record sales and strong earnings growth in the second quarter, ASVI stock sold off following the release. This company, which makes a rubber track suspension system for use in track-driven vehicles, was likely affected by concerns about a slowing residential construction market. We believe that the company's patented technology will continue to take market share even through a more difficult market, and the company has the financial strength to weather more modest growth levels. We conducted an on-site meeting with management in Grand Rapids, MN, this quarter, and remain confident in this company's long-term growth prospects.

5. **Knight Transportation (KNX):** Despite meeting analysts' expectations for earnings on 20+% earnings growth, KNX slipped over the quarter. KNX is a Phoenix, AZ-based trucking company focused on short- to medium-hauls. Investors concerns over a weakening economy fueled pessimism regarding future revenues and earnings.

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Third Quarter Buys

1. **Blackbaud (BLKB).** This company has created a software solution for use by not-for-profit entities to better manage their fund-raising efforts. Based in Charleston, SC, the company's lead product "The Raiser's Edge" is gaining acceptance in the market. With a market capitalization of about \$1 billion, we believe this company offers sustainable growth via a strong market position and very sound business model.

2. **Quality Systems Inc. (QSII):** Through its subsidiary NexGen Healthcare Information Systems, QSII provides healthcare information technology to medical and dental offices. The software, called NexGen3, assists doctors and dentists in managing their practice and records. We have been researching this company for over one year, and as we became more comfortable with the company's valuation, we initiated a position.

In addition to these new purchases, we added modestly to one position during the quarter. The strategy's holding in Lo-Jack Corp. (LOJN), was modestly increased to take advantage of the stock's recent price decline, which we believe was caused by investors' misunderstanding management communications concerning gross margin trends.

Third Quarter Sells

1. **Plantronics Inc. (PLT).** This telecommunications headset maker was a weak performer in the second quarter and announced changes in its business plans different from our investment thesis. We have concluded that Blackbaud (BLKB) and Quality Systems Inc. (QSII) offer better return opportunities, and sold PLT as a result.

2. **Hutchinson Technology Inc. (HTCH):** A maker of disk-drive assemblies, HTCH has been unable to capitalize on its dominant market share position to retain pricing power, preserve its margin, and earn a return above its cost of capital. With an increasing capital investment requirement and a competitor's warning of lower expectations, we feel our client's capital could be deployed more effectively elsewhere.

Two companies were reduced in exposure this quarter as their market capitalizations (the total value of all outstanding shares) rose beyond \$2.5 billion. Both World Acceptance Corp. (WRLD) and Trimble Navigation (TRMB) were pared back modestly to fund the new purchases of smaller company stocks.