Third Quarter 2007 Commentary

Market Review

Since mid-2003, investments in riskier assets such as lower-quality stocks, high-yield bonds, and emerging markets have generally produced returns well in excess of higher-quality assets. The environment has favored these types of strategies, first, as the economy recovered from the 2000-2002 bear market and, later, as investors hungered for more yield and ever-higher returns. The level of volatility in the markets remained low, while profit margins and earnings grew steadily. But in the third quarter, several events combined to increase investors' concerns about future growth, causing an increase in market volatility during July and August.

The events began in mid-July, news that some sub-prime lenders were seeing increased default levels caused the firms that package those mortgages (a process called securitization) to return recently packaged mortgages which were past-due or in default to the original sub-prime lenders. This placed extreme financial pressures on the thinly capitalized lenders, some of which went bankrupt. Concerns spread globally, as fear that the higher-yielding but supposedly safe securitized sub-prime mortgage notes would see high default rates. Then, in August, news that the crisis was creating problems in some hedge funds furthered investors' unease. Bear Stearns announced that two of its hedge funds which invested primarily in sub-prime securities were essentially worthless, and prices for many sub-prime and lower-quality credit derivatives plunged.

Concurrent with the events in sub-prime mortgages, several large hedge funds that employ quantitative models experienced difficulties as their strategies were challenged by unpredicted swings in stock prices. The global head of Lehman Brothers quantitative equity strategies, Michael Rothman, was quoted as saying, "Events that models only predicted would happen once in 10,000 years happened every day for three days." Goldman Sachs' revealed that their Global Alpha Fund and North American Equity Opportunities Funds were down 27% and 25% year-to-date, respectively, and the firm made a $2 Billion cash infusion to try to steady the funds.

All of the market volatility led the new Federal Reserve Chairman, Ben Bernanke, to lower the discount rate (twice) and the Federal Funds rate in an attempt to relieve pressure on the financial sector. The moves allayed concerns, and during the month of September, the market recovered strongly. Large cap stock indices edged out a gain for the quarter but mid-cap and small-cap stock indices were generally flat or negative for the quarter. Notably, Value stocks significantly lagged Growth stocks, continuing a trend that has been in place throughout this year.

Table 1: Russell Indices Performance

Index	3Q 2007	2007 YTD	One Year	Three Yrs*	Five Yrs*	Ten Yrs*
Russell 2000 Index	-3.09	3.16	12.34	13.36	18.75	7.22
Russell 2000 Growth Index	0.02	9.35	18.94	14.10	18.70	3.65
Russell 2000 Value Index	-6.26	-2.70	6.09	12.51	18.70	10.07

Source: Frank Russell Co.   ** Annualized.*

As we enter the fourth quarter, investors seem to be regaining confidence that the market's multi-year rally can continue onward and upward after the summer's "recent unpleasantness". We continue to believe that stocks will face increasing pressures as the combination of peak level profit margins and challenging revenue growth requirements will make for difficult earnings growth at the average company.

The concerns in the market during the third quarter did cause investors to re-focus on earnings and quality, two factors at the heart of Conestoga's investment research and portfolio management process. We were pleased that as market volatility increased, our clients' returns relative to the benchmark improved. We expect this to be a characteristic of the strategy, and it is what we believe makes the style appealing to investors seeking a small cap growth strategy which is less volatile and has better downside protection. While we cannot predict how events will unfold, we do believe that the coming quarters and even years should see investors return to higher-quality, sustainable growth companies.

Performance Review and Attribution

In the third quarter, the Conestoga Capital Advisors' strategy posted returns significantly exceeding both the Russell 2000 Growth and the Russell 2000. Stock selection was the primary contributor to returns, although sector allocations relative to the benchmarks also were meaningful contributors. Year-to-date, the strategy has modestly outperformed the Russell 2000 Growth, and significantly outperformed the Russell 2000. (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

Stock selection within the Technology and Financial Services sectors provided strong performance during the quarter. Within Technology, our research typically focuses on more developed companies with revenue and earnings that we believe will be more recurring and predictable. Examples of these types of firms in the strategy include Ansoft Corp. (ANST), Ansys Inc. (ANSS), and Blackboard Inc (BBBB). These types of companies outperformed as market volatility increased.

Similarly, within the Financial sector, the crisis with sub-prime lending and mortgages most affected banks and lenders. Conestoga's exposure to more diversified and higher-quality bank holding companies such as Boston Private Financial Holdings (BPFH) and Private Bancorp Inc. (PVTB) benefitted returns. One portfolio holding, World Acceptance Corp. (WRLD), did suffer from perceived exposure to lower-quality borrowers and this detracted from returns during the quarter.

Stock selection was more challenging in the Health Care sector, and this detracted from relative return. While two of the strategy's newer holdings, Meridian Bioscience Inc. (VIVO) and Neogen Corp. (NEOG) posted strong returns, several others struggled during the quarter including Computer Programs & Systems Inc. (CPSI) and Psychemedics Inc. (PMD).

Sector allocations also contributed to relative return during the quarter. Concerns that the mortgage crisis would lead the consumer to be reined in by debt service likely caused the Consumer Discretionary sector to underperform. As a result, the strategy's underweight to this sector, especially to the retail, restaurant and real estate investment trust industries, benefitted client returns. A modest overweight to Technology also benefited client returns. The lack of exposure to the low-growth (but perceived as safe) Utilities sector detracted from returns over the quarter.

Attribution Relative to the Russell 2000

Performance relative to the Russell 2000 was also driven by strong stock selection, although sector allocation played a key role as well. The Conestoga strategy's investment bias to Growth stocks factored significantly into the outperformance of the Index; the Russell 2000, which includes both Value and Growth stocks, was dragged down across nearly every sector by the exposures to Value stocks.

As with the performance relative to the Russell 2000 Growth discussed above, stock selection in the Technology and Financial Services sectors were the primary contributors to strong stock selection. Stock selection within Financial Services played a more significant role, as the Index's heavier weighting to stocks more exposed to potential credit problems allowed for the stronger stocks with exposures away from interest rates and credit concerns to outperform. Examples within the Conestoga strategy include PrivateBancorp Inc. (PVTB) and Advent Software Inc. (ADVS). PVTB benefitted from its position as a provider of private banking services to prime borrowers and high net worth individuals (in effect the opposite of sub-prime), while ADVS benefited from a strong earnings announcement.

Also benefitting client returns was strong selection within the Consumer Discretionary sector. The more stable and less leveraged stocks within the Conestoga strategy outperformed weaker names in the Index. Specifically, Rollins Inc. (ROL), the parent company of the Orkin Pest Control services company, and Iconix Brand Group Inc. (ICON), a clothing brand management firm, delivered strong results during the quarter.

Sector allocation was positive across the majority of the Russell Index sectors, with the only meaningful negative contributor being the Utilities sector. The strategy did not hold any stocks within this slower growth sector which performed better than the average Index sector.

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. II-VI Inc. (IIVI): One of the weaker performers in the portfolio last quarter, we re-evaluated this laser-related products company to assess the impact of recent production problems. Our conclusion, that the stock was overly punished for failed attempts at a new production process, proved accurate as earnings released this quarter rebounded. The decision to increase portfolio exposure following the 2Q sell-off was well-rewarded.

2. Ansys Inc. (ANSS): In the midst of the stock market's most volatile days in early August, ANSS released solid second quarter earnings and revenue growth figures. The western-PA based company is a leading provider of engineering simulation software that is critical to the design and testing of new electronics equipment across a variety of industries.

3. Advent Software Inc. (ADVS): It is rare that a new purchase makes such an immediate impact on portfolio performance, but that was the case this quarter when ADVS posted strong quarterly earnings several weeks after initially purchased into client accounts. The San Francisco-based company serves financial and investment companies with its portfolio management software, of which Conestoga Capital Advisors is a client. We believe the company's transition to a term licensing model will generate long-term earnings and cash flow growth.

4. Raven Industries Inc. (RAVN): As with IIVI above, this company was a weaker performer in late 2006 and was subjected to a thorough review earlier this year. We increased its weighting in the portfolio during April, and the stock was the strategy's best performer in the second quarter. The stock continued its winning ways during the third quarter with continued strong earnings and revenue growth. Based in Sioux Falls, SD, RAVN is a mini-conglomerate involved in agricultural and industrial services.

5. Meridian Bioscience Inc. (VIVO): A developer and manufacturer of diagnostic kits for disease testing, VIVO is a good example of a more sustainable growth company that is typical of the Conestoga strategy's holdings within the Health Care sector. The company reaffirmed fiscal 2007 earnings guidance and provided 2008 guidance for approximately 15% revenue growth and 20% earnings growth. The company probably also benefitted from a pick-up in the mergers and acquisition activity in diagnostic industry which serves to raise investor interest in the sector.

Bottom 5 Composite Laggards

1. Rimage Corp (RIMG): This maker of CD and DVD production and duplication equipment reported second quarter earnings that declined 14% from 2Q 2006, disappointing investors. The lower earnings reflected a write-down of lower-end line for desktop use as it focuses on its producer line.

2. POOL Corp. (POOL): Citing the effects of the slowing housing market, POOL lowered its 2007 earnings guidance. As one might guess from the company name, POOL provides supplies for construction and maintenance of swimming pools such as cleaners, filters, pumps and lights. We certainly understood the company was susceptible to slower economic growth, but underestimated the magnitude. The company has a good management team and excellent long-term strategy, and we continue to believe in the company's long-term prospects.

3. World Acceptance Corp. (WRLD): Continuing to suffer from a perceived exposure to sub-prime borrowers, WRLD again lagged the market this quarter. Much of the weak performance occurred during the market volatility in late July and early August as investors focused on financial lenders. We believe the company remains on track to continue delivering strong revenue and earnings growth.

4. Winnebago Industries Inc. (WGO): This well-known maker of recreational vehicles saw it stock continue to slide through the summer on fears of higher gas prices and a weaker consumer budget. We visited with the company on-site in Forest City, IA, and continue to believe management can grow revenue and earnings to improve the stock's performance.

5. Computer Programs & Systems Inc. (CPSI): After rebounding earlier this year with better-than-expected earnings, CPSI disappointed analyst estimates for second-quarter earnings. A health care information systems company based in Mobile, AL, CPSI provides data management software to smaller, more rural hospitals. The company has maintained its $0.36 per share quarterly dividend, but investors remain concerned that the company may need to reduce the dividend.

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Third Quarter Buys

1. Advent Software Inc. (ADVS): This developer of software for investment accounting and portfolio management services became attractive to us as it shifted its business from a perpetual license to term license model. As users of the software (ADVS is the leading provider of this type of software to investment management organizations), we were very familiar with the firm's capabilities and dominant market position. The shift to term licensing created an opportunity as it had the effect of lowering current accounting earnings while raising cash flow and long-term revenue. As discussed above in the Leaders section, this stock made an immediate positive impact on performance for the quarter.

Several positions were increased in the quarter, including Somanetics Corp. (SMTS) and Innovative Solutions & Support Inc. (ISSC). Each of these stocks was purchased earlier this year.

Third Quarter Sells

No holdings were sold in their entirety during the quarter, but we did trim three stocks. AMCOL International Corp. (ACO) was reduced after rising sharply during the late July and early August market volatility. Long-term holding FactSet Research Systems Inc. (FDS) was trimmed as its market capitalizations continued to move towards the mid-capitalization level.