



## 2007 Market Commentary

### Market Review

Markets began 2007 continuing the strong performance that has driven equity prices higher around the world since mid-2003. The first two quarters saw revenue and earnings growth generally meet or exceed expectations. But in mid-summer, several factors combined to reverse the market's course. News that loans to sub-prime borrowers were experiencing higher default rates fed into increasing fears about weakness in the housing market. Several large hedge funds and quantitative investment strategies posted very poor results and some were closed as a result. Market volatility spiked higher in July and August as investors re-considered their outlooks. Markets recovered smartly in September and October after the Federal Reserve twice lowered interest rates, but November proved to be one of the market's most difficult months in some time. At year's end, many investors looked back at the year unfavorably; however, most markets around the world did produce positive returns for the full calendar year (see Table 1).

*Table 1: Comparison of Asset Class Returns*

Market	Index	4 Q 2007	Full Year 2007	Three Years *	Five Years *
Cash	Citigroup 3 Month T- Bill	0.99%	4.74%	4.16%	2.95%
Bonds	Lehman Bros Aggregate Bond	3.00	6.96	4.56	4.42
Large Cap Stocks	S&P 500	-3.33	5.49	8.62	12.83
Small Cap Stocks	Russell 2000	-4.58	-1.57	6.80	16.25
International Stocks	MSCI EAFE	-1.75	11.17	16.83	21.59
Emerging Market Stocks	MSCI Emerging Markets	3.66	39.78	35.60	37.46

*Source: Informa IS, Russell Investment Group, Citigroup, Standard & Poor's, MSCI. \* Annualized.*

In our client, advisor and consultant meetings over the past few years, we have frequently discussed two headwinds affecting the strategy during this market advance. Stronger performance by Value stocks, a trend that began during the market decline in 2000, was the first headwind the strategy encountered. Growth stocks finally turned the tables in their favor this year as investors sought stocks with better revenue and earnings growth outlooks. Table 2 provides a review of Growth versus Value stocks over recent years. The Conestoga strategy, which has a growth bias, benefited from the better performance by Growth stocks, and we are optimistic this may be a multi-year trend.

*Table 2: Russell Indices Performance*

Index	One Year	Two Yrs*	Three Yrs*	Five Yrs*	Ten Yrs*
Russell 1000 Growth	11.81%	10.43	8.68%	12.10%	3.83%
Russell 1000 Value	-0.17	10.47	9.32	14.63	7.68
Russell 2000 Growth	7.05	10.15	8.11	16.50	4.32
Russell 2000 Value	-9.78	5.55	5.27	15.80	9.06

*Source: Frank Russell Co. \* Annualized.*

The second headwind our strategy has encountered is the better relative performance by Low-Quality stocks. While the higher volatility levels of July and August pushed investors back to High-Quality stocks, by the end of September there was little to no sustainable shift towards High-Quality. There is no shortage of ways to gauge the relative performance of quality, but two quick tests that we use are the performance of the S&P 600 (generally a higher quality benchmark due to its committee selection process) versus the Russell 2000, and the performance of the higher ranked S&P Equity stocks versus lower ranked and unrated S&P Equity stocks. Neither of these measurements show a meaningful advantage by High Quality stocks for the fourth quarter or the full year 2007. This headwind has been as challenging as the Value headwind, but we are optimistic that this also will inevitably change, especially if the economy slows, the credit crunch becomes deeper or more prolonged than current expectations, or if another unforeseen development impacts the economy or geopolitics.

*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.*

Client accounts have maintained their emphasis on high quality companies with the following characteristics: sustainable earnings growth, strong management teams, significant insider ownership, strong business models, returns on equity of at least 15%, and conservative balance sheets. At year-end, a comparison of our composite of accounts versus the benchmarks reinforces this relative strength (see table below).

**Table 3: Conestoga Portfolio vs. Comparative Indices**

Portfolio Characteristic	Conestoga	Russell 2000 Growth	Russell 2000
Price - Earnings Ratio (1-Year Forward)	22.7 X	20.6 X	17.2 X
Long-Term Earnings Growth	18.1%	20.7%	16.7%
Price Earnings to Growth Ratio	1.3 X	1.0 X	1.0 X
Return on Equity	20.1%	10.1%	9.2%
Long-Term Debt to Capitalization	13.0%	26.0%	29.0%

Source: FactSet Research Systems.

The last two rows of the above table, Return-on-Equity and Long-Term Debt to Capitalization, are two of the key measures of quality that we use when evaluating a company. Return-on-Equity, or ROE, is defined as a company's net income divided by shareholder's equity, and reflects the company's earnings per dollar of invested equity capital. A company's ROE is dependent on its profit margin, sales volumes, and financial leverage. One commonly used measure of financial leverage is the ratio of Long-Term Debt to Capitalization, which indicates how much a company is using borrowed money to finance its operations. While borrowing money can greatly increase returns to equity investors, it is a double-edged sword and can also decrease return significantly when a company's sales volumes or profit margins decrease. Reviewing the table above, the strategy's ROE is roughly double that of the comparable indices, with much lower Long-Term Debt to Capitalization. We expect these characteristics of the account to benefit our shareholders during times of economic uncertainty and/or market volatility. Currently, we continue to believe that stocks will face increasing pressures as the combination of peak level profit margins, challenging revenue growth requirements, and an uncertain economic outlook will make for difficult earnings growth at the average company.

As we begin the New Year, we are confident that the emerging trends of 2007 will continue in to 2008. We expect the outperformance of Growth stocks over Value stocks will continue, and we believe that High Quality remains very attractive relative to Low Quality. We expect the coming years to reward clients that maintain a long-term investment focus on higher-quality, sustainable growth stocks.

*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.*

## **Performance Review and Attribution**

During the fourth quarter, the Conestoga strategy underperformed the Russell 2000 Growth while outperforming the Russell 2000. For the full calendar year 2007, the strategy modestly underperformed the Russell 2000 Growth, while posting a large advantage over the Russell 2000. (Please note that individual account performance will vary slightly due to slight individual issue weighting differences and specific individual client guidelines.)

### **Fourth Quarter Attribution**

Sector allocations relative to both the Russell 2000 Growth and the Russell 2000 added to returns during the quarter. Concerns about the direction of the economy and the consumer drove investors towards sectors that were perceived to be less cyclical. The strategy's overweight to Health Care, combined with an underweight to the Consumer Discretionary, benefited from this trend and added to returns versus both indices. The strategy's roughly 12% weighting in Financial Services stocks added to returns relative to the Russell 2000 which has significantly more exposure to traditional banks and real estate investment trusts. Relative to the Russell 2000 Growth, the Financial Services weighting had no material impact as the sector weighting was neutral to the benchmark. Sector allocations to the Technology and Materials & Processing sectors detracted modestly from returns during the period. The Technology sector, which was overweighted relative to both indices, was plagued by concerns that a slowing economy would derail spending on technology by large companies and consumers alike. In contrast, the underweighted Materials & Processing sector was one of the market's better performing sectors as commodities prices continued to rise, in turn raising profits for many raw material companies.

Stock selection proved challenging during the quarter as the strong performance of several names in the portfolio was offset by disappointing performances in others. Selection effect was strongest in the Consumer Discretionary sector where both Ritchie Bros. Auctioneers Inc. (RBA) and Rollins Inc. (ROL) delivered strong results. Both names are considered better suited than the typical Consumer Discretionary stock to withstand a slowing economy. RBA is the leading auctioneer of industrial equipment and continues to deliver organic growth in its worldwide auctioning network. ROL, based in Atlanta, is best known for its Orkin Pest Control subsidiary. The company has delivered steady growth, with the prospects of higher earnings on an improved logistics system for delivering its services. An underweight to the retail and restaurant industries within the Consumer Discretionary sector also benefited returns. Stock selection was also strong in the Health Care sector with several names posting strong results. Somanetics Corp. (SMTS), and Abaxis Corp (ABAX) were among the top 5 performers for the quarter and are discussed in detail on the following page. Joining them in producing strong returns for the quarter were SurModics Inc. (SRDX), Neogen Corp. (NEOG), and Meridian Bioscience Inc. (VIVO).

Stock selection was poor within the Other Energy, Producer Durables and Technology sectors. Innovative Solutions & Support Inc. (ISSC), a holding within the Technology sector, announced a delay in customer orders that dampened expectations for near-term revenues. Carbo Ceramics (CRR), one of our holdings in the Other Energy sector, declined while many stocks in this sector moved higher on continued demand for petroleum and energy services. Within Producer Durables, Simpson Manufacturing Co. (SSD), a supplier of specialty building products primarily for residential construction, declined on fears of a worsening U.S. housing environment.

### **Full Year 2007 Attribution**

The themes reviewed in the Market Review section were manifest in the returns of the strategy relative to the Russell 2000 Growth and Russell 2000. For the full year, the strategy modestly lagged the Russell 2000 Growth as lower-quality stocks continued their run of strong performance with only brief interruption during the market's mid-summer slump. The strategy posted a wide margin of outperformance relative to the Russell 2000, benefitting from the bias towards Growth stocks which outperformed Value stocks by over 15% for the year.

Sector allocations were positive overall relative to both benchmarks with overweights to Technology and Health Care, combined with underweights to the Consumer Discretionary sector, boosting to returns. Within Financial Services, the strategy's underweighting in real estate investment trusts and traditional banks benefited returns. Stock selection was negative relative to the Russell 2000 Growth but strongly positive relative to the Russell 2000 for the full year. The strategy's lack of exposure to more aggressive growth stocks generally detracted from returns over the full year versus the Russell 2000 Growth, while the underweighting to more value-oriented stocks, particularly Financials, was of great benefit to return relative to the Russell 2000.

*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. Ritchie Bros. Auctioneers Inc. (RBA):** One of the best performing stocks in the portfolio for the full year, RBA continued its string of strong results during the fourth quarter. Operating at over 30 sites worldwide, RBA conducts unreserved auctions of industrial equipment. The company has continued to build market share in what has historically been a very fractured service, and they are benefitting from global demand for their services.

**2. Somanetics Corp. (SMTS):** Purchased earlier in the year, SMTS is a health care company that manufactures and distributes a device to measure blood oxygen levels in the brain. Employed during surgery, the device allows for more effective use of anesthesia, which in turn speeds up patient recovery and shortens hospital stays. SMTS is a good representative of the type of Health Care stock Conestoga seeks for investment. It is currently profitable and has sustainable earnings growth expectations, versus the binary outcomes (succeed wildly or fail completely) that frequently occur with unprofitable biotech companies.

**3. Ansys Inc. (ANSS):** Selling to customers such as Motorola (MOT) and Boeing Inc. (BA), this firm provides software that allows designers to simulate how electrical systems will perform under stress. The company announced continued strong earnings growth during the quarter and offered better-than-expected guidance for fiscal 2008. First purchased into the strategy in 2005, we expect continued growth from this company over the next several years.

**4. Abaxis Inc. (ABAX):** A new purchase early in the quarter, this Northern California-based company has created a blood testing device that allows for faster testing of blood samples at doctor's and veterinarian's offices. After struggling with some manufacturing issues during the past year, ABAX turned things around in 2007 and began to deliver better operational results. The stock surged in October after releasing better-than-expected fiscal 2Q results.

**5. Blackbaud Inc. (BLKB):** Based in Charleston, SC, this company provides customer relationship management software for charitable organizations to manage donors, events, and coordinate fundraising campaigns. BLKB has established itself as the premier provider of this service with little competition and a solid recurring revenue stream. Earnings released during the quarter were in-line with expectations and the stock moved steadily higher throughout the quarter.

## Bottom 5 Composite Laggards

**1. Innovative Solutions & Support Inc. (ISSC):** This maker of new replacement kits for airplane cockpits stands to benefit for demand for its technology from major airlines seeking to update their fleets and from new plane development by smaller airline companies. During the fourth quarter, the stock lagged as Eclipse Aviation, a major customer using the ISSC kits in its new Eclipse 500 jet, announced delays in production which in turn delays revenues for ISSC.

**2. Carbo Ceramics Inc. (CRR):** After reaching recent highs in August and early October, CRR fell on disappointing revenue and earnings results announced in late October. Additionally, CRR's stock was weighed down by declining gas prices which influence its customers' drilling activity. The company manufactures and sells a ceramic bead called a proppant which is used to improve production by oil drillers.

**3. Ansoft Corp. (ANST):** While announcing strong fiscal 2Q results during this quarter, with revenue growth of 14% and net income growth of 41%, the stock generally lagged throughout the quarter. Based in Pittsburgh, the company designs electronic design automation software that assists electrical engineers in the design of new technologies. We believe the company's long-term fundamental outlook remains strong, particularly given that the majority of their sales are from international customers.

**4. II-VI Inc. (IIVI):** While a solid performer for the full calendar year 2007, this stock was a bit volatile in the fourth quarter. After recovering from production problems in its crystals division, the manufacturer of laser components produced results in line with analyst expectations and forecasted strong earnings for 2008. Our confidence in the company remains high, and it is among our highest weighted positions in the portfolio.

**5. Financial Federal Corp. (FIF):** As a lender to companies and small businesses financing their purchases of construction and transportation equipment, FIF was impacted by growing concerns of an economic slowdown. After being downgraded by one analyst firm, the company reported fiscal 1Q earnings growth of 9% and the stock sold off steadily through the quarter. We believe they have the financial strength and excellent credit profile to sustain their growth through a slowing economy.

*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.*

## Fourth Quarter Buys

**1. Abaxis Inc. (ABAX):** We began following this medical diagnostics company in 2006, and our research intensified in 2007. Following an on-site meeting with company management, including the CEO, we initiated a position for client portfolios. Based south of Oakland along the East Bay, this company manufactures blood testing tools for use by both medical doctors and veterinarians. The machines allow for fast results (typically about 15 minutes) and can be operated without significant training.

In addition to the above new purchase, we added modestly to our position in Tesco Corp. (TESO), an oil and gas equipment services company.

## Fourth Quarter Sells

**1. AMCOL International Corp. (ACO):** We trimmed this producer of specialty chemicals and minerals during the summer of 2007 as it began to reach levels beyond our valuation estimates. After being driven even higher by the forces of global demand benefiting many raw materials companies, we sold the position in its entirety late in the fourth quarter. ACO stands as a very successful multi-year holding of the Conestoga Small Cap Growth strategy.

**2. Select Comfort Corp. (SCSS):** After a tumultuous year in the strategy, we removed SCSS from the portfolio during the fourth quarter. The company has continued to struggle with the re-tooling of its marketing message and the results have been lowered expectations of future earnings. Despite a very strong business model, we no longer have confidence that the problems facing SCSS can be resolved in the near- to mid-term.

**3. Trimble Navigation Ltd. (TRMB):** After producing several years of very strong growth in its revenues and earnings, TRMB has moved from a small capitalization company to a mid-capitalization company. As part of our ongoing process of removing companies that have grown well beyond our investment universe of small cap, we sold the position in early October. At the time of sale, TRMB's market capitalization had grown to over \$4 billion.

*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.*