

Conestoga Small Cap Fund Investors Class CCASX

Analysis

A conservative approach pays off for this fund and its firm.

By Tony Thomas 10/12/2017

Conestoga Small Cap continues to roll along despite a few changes at the advisor and a looming capacity issue. Still, this team's steady hands at the wheel should help it navigate these issues, and we retain the fund's Morningstar Analyst Rating of Silver.

The firm's small investment team hasn't missed a step despite two recent retirements. William Martindale, who co-founded the firm and served as this fund's comanager, retired in mid-2014. David Lawson, comanager of Conestoga SMid Cap CC-SGX, retired in early 2016. In both cases, the firm telegraphed its succession plans. The remaining team members, led by Robert Mitchell, the firm's other co-founder and a longtime comanager here, have executed these plans faithfully at this employee-owned firm. Mitchell provides consistency through these transitions, and Martindale handed the baton to new comanager Joseph Monahan gradually--allowing the team to proceed with minimal disruption.

These seamless transitions have helped the fund continue to outpace its peers. The fund's 12.3% annualized total return from its October 2002 inception through September 2017 surpassed 90% of its small-growth Morningstar Category peers. Mitchell and Monahan stuck to their process, which favors steady growers with high returns on equity and low debt, during an abysmal 2014. Staying the course paid off: after a bottom-decile category finish in 2014, the fund's 16.7% annualized return from January 2015 through September 2017 ranked near the top of its class.

Such strong performance draws admirers, and capacity is the managers' next challenge. An estimated \$200 million flowed into the fund in the 12 months ended September 2017. The new money, plus some separate accounts, brought this strategy's total assets to just over \$2 billion as of September 2017, within striking distance of the

managers' \$2.5 billion estimated capacity. True to form, the firm is already planning for what would be the first fund closure in its history. Provided that it executes well, investors should continue to be rewarded over the long term by this team's conservative approach to investing.

Process Pillar: Positive

This team's process is straightforward and it has executed it well, earning the fund a Positive Process rating.

The managers take a relatively conservative approach to the small-cap universe. They like firms with strong growth characteristics, including the ability to grow earnings and returns on equity at a 15% clip over the next three to five years. They also prefer firms with debt/capital ratios under 40%. Significant insider ownership (usually 10% or more) also gets their attention. Overall, the team's goal is to pick stocks that have the potential to appreciate by at least 100% over the next three to five years.

The managers invest with conviction. They typically keep the number of holdings within a narrow range (45-55), and they tend to hang on to their picks for three to four years, on average. By mandate, the team must keep 80% of its assets in firms with rolling three-year average market caps of \$2.5 billion or less at the time of purchase, though they're willing to hold a company as it grows into mid-cap territory if they like its fundamentals. While the portfolio is generally well-diversified across individual holdings and sectors, the managers can deviate from their Russell 2000 Growth benchmark's sector weightings by up to 25% of assets or twice the index's sector weighting (whichever is least). They also like to stay fully invested, often keeping cash levels below 5%.

The managers have built a portfolio that scores relatively well on their own key quality metrics. Given their preference for high returns on equity, the

Morningstar's Take

Morningstar Analyst Rating



Morningstar Pillars

Process	 Positive
Performance	 Positive
People	 Positive
Parent	 Positive
Price	 Positive

Morningstar Analyst Rating

Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum

 Gold  Silver  Bronze **Neutral**  Negative

Fund Performance

	Total Return %	+/- Category
YTD	3.00	-0.85
2017	28.44	6.94
2016	14.06	2.87
2015	8.03	10.44
2014	-8.05	-10.49

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August 2017 portfolio's average ROE was 14.2%, 57 basis points higher than the small-growth category average and 6.6 percentage points above the benchmark Russell 2000 Growth Index. Their aversion to debt-ridden companies stands out more sharply, with the portfolio's 32% debt/capital ratio well below the peer average of 42% and the index's 40%.

Sector weightings can veer widely from the benchmark. The fund's 38% technology stake in July 2017 was well ahead of the benchmark's 25%. On the other hand, the fund is often significantly underweight financials. The team finds that financials, including financial technology firms and banks, don't often meet their growth criteria. Only one financials firm was in the July 2017 portfolio: Westwood Holdings Group WHG, an asset manager and advisor.

The team is willing to hold its best picks as they grow into mid-caps. It pared back and finally exited long-term holding Align Technology ALGN in July 2017 after Align's market cap nearly doubled to \$14 billion in the first half of 2017. Typically, however, the managers will exit positions as they reach a threshold of about \$6 billion to keep the fund squarely in the small-cap space. Over 87% of the July 2017 portfolio was in small-cap stocks.

Performance Pillar: + Positive

This fund's solid performance since inception, coupled with a relatively smooth ride, contributes to its Positive Performance rating.

The fund has put up some attractive long-term numbers. From its October 2002 inception through September 2017, its annualized 12.3% gain handily beat the small-growth category average return of 10.1% and edged the Russell 2000 benchmark's 11.7% return. In fact, the fund's returns ranked in the top decile of its category over the past one, three, five, 10, and 15 years through September 2017.

This consistent outperformance owes to the fund's conservative risk/reward profile. It has been less volatile than either its peers or the index since its

inception, with its 16.7% standard deviation coming in below the peer average of 17.8% and the index's 19.2%. It has fallen only 78% as far as its index in down markets. The fund's Sortino ratio, a measure of risk-adjusted returns, is over 22% higher than the benchmark's from October 2002 through September 2017.

One recent hiccup interrupted the fund's otherwise steady performance, but it didn't last long. The fund lost 8% in calendar year 2014 and landed near the bottom of its category thanks to misses in the managers' technology, healthcare, and energy picks. It rebounded from January 2015 through September 2017, however, when the fund beat 98% of peers.

People Pillar: + Positive

This fund's investment team has handled recent turnover well, earning the fund a Positive People rating by keeping an experienced group at the helm and carefully adding new pieces to flesh out its resources.

Comanager Robert Mitchell brings experience and continuity to the team. A 22-year industry veteran, Mitchell co-founded Conestoga with William Martindale in 2001. Together they comanaged this fund from its 2002 inception until Martindale retired in mid-2014. The firm conducted a yearlong transition during which Joseph Monahan eased into Martindale's place alongside Mitchell. Monahan brings 35 years of industry experience to the team.

More recently, David Lawson, who had comanaged Conestoga SMid Cap with Mitchell, retired in early 2016. While not a portfolio manager here, he was part of the firm's general research process. Again, the firm laid out plans for Lawson's retirement in advance and gradually transferred his duties to Derek Johnston, who joined Conestoga in 2015 with 20 years of experience.

The firm has added new research resources as its assets have grown. In mid-2013, Conestoga hired its first dedicated analyst, David Neiderer, a relative newcomer who came with three years' experi-

ence in the industry. In 2015, the team added 17-year industry veteran Larry Carlin to its analyst ranks.

Parent Pillar: + Positive

The small Pennsylvania-based team at Conestoga Capital Advisors prides itself on a long-term approach to investing as well as its own governance. Its success at both earns the firm a Positive Parent rating.

The firm has handled its rare personnel departures with careful planning and execution. Only three people have left since its 2001 founding, including co-founders Chris Maxwell in 2008 and Bill Martindale in 2014. All three were retirements. In each case, the employee-owned firm announced detailed plans for buying out the retirees' shares, and they've executed well so far. Currently, four managing directors control the firm, led by co-founder Bob Mitchell.

Mitchell comanages the firm's flagship fund, Conestoga Small Cap. The bulk of the firm's assets are in this low-turnover strategy that favors high-quality, small-cap companies. The firm's only other mutual fund, Conestoga SMid Cap, replaced a liquidated mid-cap fund in early 2014. With a target market-cap range of \$500 million to \$10 billion, the team believes the new fund better suits the firm's focus on smaller-cap investing.

Manager investment in the funds is modest, but much of the managers' capital has been put toward buying out the stakes of departing team members. That ownership ties the managers to their offerings' long-term health. The fund board has also kept fees competitive through perennial fee waivers.

Price Pillar: + Positive

Fee waivers keep this fund's expense ratios reasonable, and as long as these remain in place, the fund earns a Positive Price rating.

The fund's two share classes charge below-average fees after their waivers. The no-load Investors

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shares, which hold 53% of the assets, levy 1.10%, 9 basis points below the median for similarly distributed shares. The 0.90% expense ratio on the Institutional shares is 10 basis points below its peer median.

Generous fee waivers are set to expire in January 2018, but the managers expect these to be renewed. The current arrangement knocks 0.4 and 0.2 percentage points from the Investor and Institutional expense ratios, respectively.

Performance as of 12/31/17*

	QTD	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception 10/1/2002
CCASX	3.60%	28.44%	28.44%	16.54%	16.78%	14.12%	11.35%	12.39%
Russell 2000 Growth	4.59%	22.17%	22.17%	10.28%	15.21%	12.34%	9.19%	11.80%
Russell 2000	3.34%	14.65%	14.65%	9.96%	14.12%	11.62%	8.71%	11.29%

Gross expense ratio: 1.54%, Net expense ratio: 1.10%; Conestoga Capital Advisors, LLC (the Adviser) has contractually agreed to limit the Fund's net annual operating expenses to 1.10% of the Fund's average daily net assets until at least January 31, 2019, subject to termination at any time at the option of the Fund. There is no guarantee that the agreement to limit the Fund's annual operating expense will be renewed or extended.

** Performance returns are annualized after 1 year. Performance is based upon closing NAV calculation on listed dates and represents past performance. Past performance does not guarantee future results and current performance may be lower or higher than the performance quoted. Performance data includes reinvestment of dividends. Investment returns and principal value of an investment in Conestoga Small Cap Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. For the Fund's daily NAV, list of additional holdings, total return as of the most recent month-end and a copy of the Fund's prospectus, please visit www.conestogacapital.com or call 1-800-320-7790.*

Mutual Fund Investing involves risk, principal loss is possible. Investment in the Fund is subject to investment risks, including, without limitation, equity risk, market risk, management risk, small company risk, foreign investment risk, currency risk, large redemption risk. Funds that invest in small and mid-cap stocks are often more volatile than large cap stocks. Smaller companies generally face higher risks due to their limited product lines, markets and financial resources. For more information about the Fund, including the Fund's objectives, charges, expenses and risks (including more information about the risks listed above), please read the prospectus.

An investor should consider investment objectives, risks, charges, and expenses carefully before investing. Download a prospectus, which contains this information or call toll free 1-800-494-2755. Read the prospectus carefully before investing or sending money.

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Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. An individual cannot invest directly in an index.

A rate of return (ROE) is the gain or loss on an investment over a specified time period, expressed as a percentage of the investment's cost. Gains on investments are defined as income received plus any capital gains realized on the sale of the investment.

Standard deviation is a measure of the dispersion of a set of data from its mean. If the data points are further from the mean, there is higher deviation within the data set. Standard deviation is calculated as the square root of variance by determining the variation between each data point relative to the mean.