2020 Forecast for Small Cap Stocks

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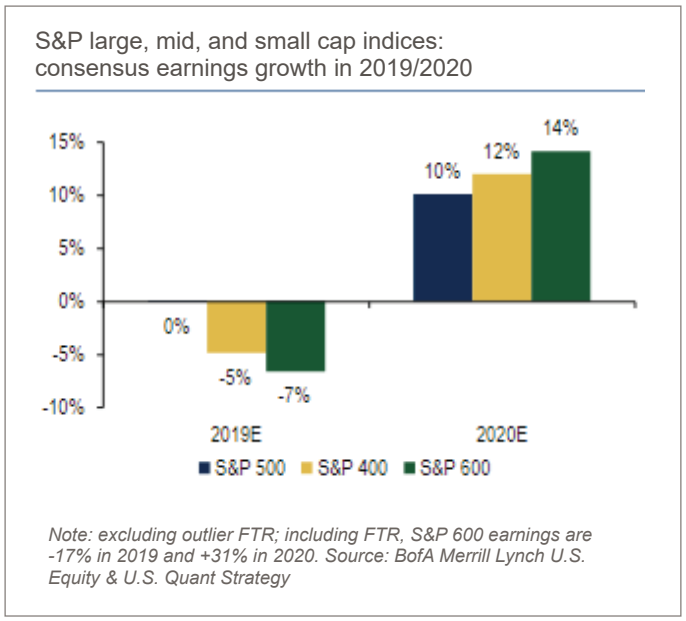
U.S. small cap stocks posted solid performance in 2019 advancing 25.52%, as measured by the Russell 2000 Index, but lagged behind the S&P 500 Index return of 31.49%. Small cap stocks have now underperformed large cap stocks the previous three calendar years and five out of the last six years. Considering small caps have historically outperformed large caps, though with greater volatility, to underperform over several years like this is unusual.

However, as of August 2019, the month after the U.S. Federal Reserve (the Fed) began lowering interest rates, small caps have outperformed their larger brethren. This turnaround for small caps is likely due to a more accommodative monetary policy, which helps long-duration asset prices and provides the potential for improvement in economic growth. Recession fears abated in the second half of 2019, and increased optimism over a trade agreement increased investors' willingness to move further out on the risk spectrum, which benefits small cap stocks.

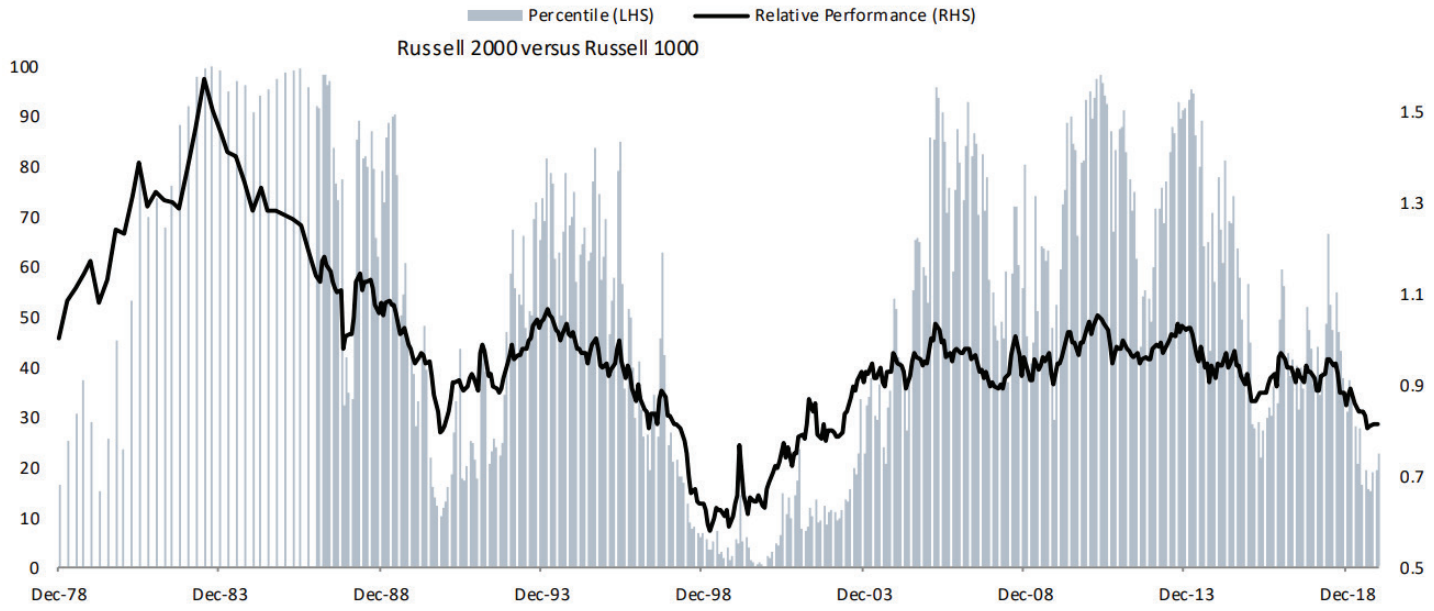
EARNINGS GROWTH AND RELATIVE VALUATION

Small cap earnings actually declined in 2019 as a slowing economy weighed on revenue growth and operating margins. However, we believe small cap earnings are poised to reaccelerate in 2020. Per Bloomberg, consensus estimates call for the small cap Russell 2000 Index to grow earnings in excess of 30% in 2020, materially faster than the large cap S&P 500's 10% forecasted earnings growth rate.

While these estimates may be too optimistic and will likely come down in the next few months, as companies update their forward outlooks, we believe earnings growth in the mid-teens is possible for small caps as trade fears subside, Gross Domestic Product (GDP) growth accelerates, and capital expenditures improve. Consensus estimates for the S&P Small Cap 600 Index, which has fewer negative-earning companies than the Russell 2000 Index, currently call for earnings growth of 14%, topping both mid (S&P 400) and large cap (S&P 500) indices, as shown to the right.



Despite faster earnings growth, small caps are trading at attractive valuation levels relative to large caps, in our view. While the market is not at trough relative valuation levels compared to large caps, we are at a low enough level to where small caps have typically outperformed (a rising black line in the chart below) according to a relative valuation model used by Jefferies.



** Price to cash flow started in 2002.*
Note: from March 31, 2016 forward Jefferies estimates. Source: FactSet; FTSE Russell; Jefferies

VALUE VERSUS GROWTH

Small cap growth has outperformed small cap value five out of the last six years; some strategists are calling for a reversal of this trend and for value to begin to outperform growth. The last period of value outperformance was in 2016, when fast-growing software stocks were weak early in the year, followed by a post-election rotation into value, inspired by expectations of an accelerating economy due to President Trump's promise of reduced regulation. While GDP growth picked up to just over 2% in 2017, it was not strong enough for value to maintain leadership, and growth strategies resumed their period of outperformance.

It is interesting to observe the market's preference for value stocks during the second half of 2019. Since the end of August, the Russell 2000 Value Index produced a return of 13.13% and outperformed the Russell 2000 Growth Index return of 10.17% by nearly 300 basis points (through 12/31/19). During this period, momentum investing stumbled as the Invesco S&P SmallCap Momentum ETF (XSMO) was up only 4.87% over the same period. We witnessed a difficult period by more momentum-focused small cap peers during these months, and we believe this illustrates the importance of incorporating a valuation discipline as part of a growth-focused investment process.

Although value stocks outperformed growth within small caps from September to year-end, we believe the U.S. economy will need to accelerate much faster than the consensus projection of 1.8% in 2020 (per a Bloomberg economist survey), in order for value to retain its leadership position. While we expect the economy to improve in 2020, the uncertainty around who will win the election likely puts a cap on a meaningful upside scenario in economic growth (i.e. greater than 3% GDP growth) until after the election. In our opinion, this scenario would allow growth stocks to post solid performance relative to value.

Furthermore, for value to lead, traditional value-oriented sectors like Financials and Energy will need to post strong gains, accompanied by simultaneous underperformance from the traditional growth-oriented areas like Technology and Healthcare.

FINANCIALS & ENERGY

Although small cap bank stocks performed well during this latest period of value outperformance, which coincided with the Fed lowering short-term interest rates, continued outperformance will likely require accelerated economic growth to spur a sustained increase in loan growth and earnings. A flurry of consolidation could provide upside to community banks this year, but the specter of increased regulatory risk from a potential progressive president likely keeps buyers of financial companies on the sidelines.

Meanwhile, Energy remains in a "show me" period where investors (and lenders) want to see improved free cash flow from companies like the U.S. shale drillers. To accomplish this, drillers will be very mindful of their capital expenditure levels keeping reserve growth limited. Depressed stock prices could be in order for the group until energy companies can prove to investors that they can deliver on free cash flow.

With that said, sentiment in Energy is extremely low, and the stocks are likely under-owned due to several years of underperformance and exclusions from ownership by ESG (Environmental, Social, and Governance) investors. Global demand for oil remains positive, and investor focus on free cash flow has curtailed supply growth in U.S. shale. The U.S. assassination of Iranian general Qasem Soleimani has likely increased the probability of continued conflict between the U.S. and Iran, which could support higher oil prices.

TECHNOLOGY & HEALTH CARE

Regarding Technology, faster global growth should help accelerate revenue growth for component companies, lifting them out of the tail end of an inventory correction and slower growth period. In addition, companies barred from doing business with Huawei or other Chinese customers, because of the ongoing trade war, may be able to start shipping products to these customers again with a trade resolution. Meanwhile, technology software companies continue to experience solid demand, as digital transformation continues and companies move away from legacy, on-premise solutions, shifting market share to smaller, cloud-first providers. However, valuations for some software companies are still relatively expensive, by our analysis, so it is wise to tread carefully in this area. Information Technology Services companies also continue to experience strong demand as they assist their customers in this digital transformation.

In Healthcare, pharmaceutical and biotechnology stocks are in the early stages of recovery as investors take some comfort with the view that "Medicare for All" is not economically sustainable or politically feasible. While lower pharmaceutical prices have bipartisan support, so far the political rhetoric has not led to lower drug prices outside of a few high profile products. Meanwhile, exciting new drugs in areas such as immuno-oncology and gene therapy continue to come to market at relatively high prices, and payers have shown a willingness to pay for these drugs because they lower the overall cost of care. Furthermore, Healthcare stocks rallied late in 2019 due to increased merger activity, with meaningful acquisitions of at least six small- and mid-sized biotechnology companies, including ArQule, Synthorx, The Medicines Company, Ra Pharmaceuticals, Achillion Pharmaceuticals, and Audentes.

We remain positive on suppliers into pharma and biotech companies as these companies benefit from the same trends, yet have less binary event risk and have better cash flow characteristics. These include companies that help in drug discovery, production, and commercialization. We are also positive on diagnostics, where incorporation of multi-omic (e.g. genomic, proteomic, transcriptomic) data into well-reimbursed screens and tests is improving the accuracy and functionality of testing, while changing the competitive landscape and offering new market and product drivers for many innovative companies.

INITIAL PUBLIC OFFERINGS

Turning to initial public offerings (IPOs), a traditional area of interest for growth investors, the marketplace has experienced a shift, following the failed listing and subsequent write down of WeWork, as well as the less-than-stellar offerings of other high profile but unprofitable companies like SmileDirectClub, Uber, and Lyft. Ironically, this happened during a period of greater risk acceptance in the public markets.

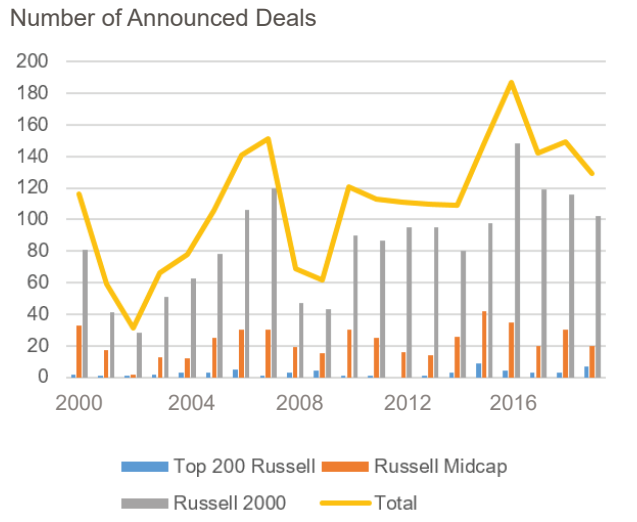
Our takeaway is that these developments seem to have increased the market's focus on profitable growth, and we hear about many private companies "slimming down" in response to this new reality. We believe both private and public companies are more cognizant of their path to profitability, and, as investors of smaller companies that must show "the Street" a path to profitability in order to invest, we applaud this move.

MERGER & ACQUISITION OUTLOOK

Furthermore, as we approach a U.S. Presidential election that remains tight, with two Democratic contenders who are quite progressive and support much higher tax rates, we believe there could be an increased amount of merger and acquisition (M&A) activity.

Companies that are frustrated with their public market valuation, that have activist involvement, or are founder-led with high insider ownership that do not want to gamble on potentially higher capital gains rates in 2021, might feel compelled to sell during a period when the economy is strong,

valuation multiples are solid, and private equity and strategic buyers are flush with cash. In fact, as seen in the chart below, there was an acceleration in M&A during the last presidential election cycle of 2016, when capital gains rates were relatively low at 23.8% despite being led by a Democratic president for the previous eight years.



Note: through 12/11/19. Source: FactSet, Bloomberg, FTSE Russell, Jefferies

WHERE COULD WE BE WRONG?

Historically, small caps have outperformed coming out of a recession or after stock prices have been driven to extremely low levels during a risk off period in the market. As we begin the second decade of the current economic expansion, we are far from the early economic recovery stage where small caps typically outperform. We are likely in the later innings of an abnormal economic cycle that has produced below-trend growth and a longer expansionary timeline compared to historical averages.

With that said, we are of the opinion that economic cycles do not simply die of old age, but rather from speculative excess or global shocks that are oftentimes spurred by a tightening of monetary policy. We do not currently see any speculative excess that could seriously disrupt financial markets. While we have concerns about fund flows into late stage private equity and resulting lofty valuations, it seems the air is slowly coming out of this asset class, per our previous comments about recent IPOs and private companies moving to profitability quicker.

While high growth software valuations in the public markets have been elevated for some time, these valuations have started to decline, with some companies growing into their valuations as time passes due largely to their very high rates of growth.

Fortunately, the recent interest rate tightening cycle from late 2015 to late 2018 managed not to cause any major global shocks. There are certainly plenty of global macro concerns that could cause financial market disruptions -- income inequality, increased populist nationalism, climate change, domestic political polarization, Great Britain's exit from the European Union (Brexit), continued unrest in the Middle East, and conflict escalation with North Korea – however, it is always difficult, if not impossible, to assess potential impact and timing on financial markets.

A policy misstep by the Fed or from key political figures continues to be our largest concern. In 2019, the Fed's pivot on monetary policy demonstrated a willingness by our nation's central bank to be flexible and "data-dependent" by cutting rates three times when there were signs of slowing economic activity. While trade dynamics seem to change on a daily basis, the rhetoric has died down considerably, and the U.S. and China appear set to ink a phase one agreement in January. With the presidential election less than a year away, we think it is unlikely President Trump re-escalates the trade war again before November.

Meanwhile, the impeachment of President Trump has had little to no impact on the market, and given near certain death in the Senate, it should be a non-issue. We also note that historically, the market has performed well in the reelection year of a sitting president.

However, if a very progressive Democrat is nominated and ultimately elected, the forward uncertainty would likely cause considerable volatility in the market, specifically in sectors with high regulatory scrutiny like Energy, Healthcare, and Financials. Large cap technology companies could also face the possibility of increased regulation or even forced break-ups.

IMPACT ON THE BUFFALO SMALL CAP FUND

What does all of this mean for domestic small cap stocks and the Buffalo Small Cap Fund? We believe 2020 could be a solid year for small caps, and one where they could revert back to their long term outperformance relative to large cap. While 2019 was an ideal backdrop for our style of investing – growth with a valuation discipline – we believe the market backdrop is still moving in a direction that favors premier companies with the potential to benefit from long-term trends trading at attractive valuations. A positive earnings environment should be a tailwind for smaller companies, and GDP growth should accelerate, but not fast enough for value stocks to take a leadership position.

The growth trends that underlie our investment decisions are long-term in nature and unlikely to change in the short run. Mergers and acquisitions could accelerate given potentially higher capital gains tax rates, and, similar to our investment positions in Acacia Communications, Cambrex, InterXion, and Medidata in 2019, a few of our investments could gain the attention of either strategic or financial buyers in 2020.

As always, we continue to believe that active management is the best way to exploit the inefficiencies inherent in the small cap asset class. We thank you for your continued support and remain committed to finding the best opportunities in which to grow your capital over the long term.

Buffalo Small Cap Fund Management Team

Jamie Cuellar, CFA

Co-Manager since 2015
27 years experience
M.B.A. – Southern Methodist
B.B.A. – Univ. of San Diego

Bob Male, CFA

Manager since Inception
33 years experience
M.B.A. – Southern Methodist
B.S. – University of Kansas

Alex Hancock, CFA

Co-Manager since 2017
21 years experience
B.A. – Dartmouth College

ABOUT THE BUFFALO FUNDS

The Buffalo Funds are a family of 10 actively-managed mutual funds, founded in 1994, offering a variety of domestic equity, international equity, and income-generating investment strategies. We believe that patient investing backed by solid, intelligent research is the best way to achieve potential long-term financial rewards.

Disciplined investment decisions are made using a distinct, time-tested investment approach guided by trend analysis, rigorous fundamental company research, and strict security valuation parameters.

Our fund family is characterized by a long-term growth investment strategy and a team-based, idea-sharing management style.

INTERESTED IN MORE INFORMATION?

For questions or to speak with a relationship manager about adding any of the 10 Buffalo Funds to your portfolio, contact:

Christopher Crawford
ccrawford@buffalofunds.com
(913) 647-2321

Scott Johnson
sjohnson@buffalofunds.com
(913) 754-1537

DEFINITIONS & DISCLOSURES

Opinions expressed are subject to change at any time, are not guaranteed, and should not be considered investment advice.

The Russell 2000 Index is an unmanaged index that consists of the smallest 2,000 securities in the Russell 3000 Index, representing approximately 10% of the Russell 3000 total market capitalization. The Russell 3000 Index measures the performance of the 3,000 largest publicly held companies incorporated in the U.S. based on market capitalization. The S&P 500 Index is a capitalization-weighted index of 500 large capitalization stocks which is designed to measure broad domestic securities markets. The Russell 2000 Value Index is an unmanaged index with a market-capitalization weighted equity based on the Russell 2000 Index, which measures how U.S. stocks in the equity value segment perform. The Russell 2000 Growth Index is an unmanaged index that measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values. The S&P Small Cap 600 Index is an unmanaged index that consists of 600 domestic stocks chosen for market size, liquidity, bid-asked spread, ownership, share turnover and number of no-trade days and industry group representation. The S&P MidCap 400 Index is an unmanaged capitalization weighted index that measures the performance of the mid-range sector of the U.S. stock market. The Russell 1000 Index is an unmanaged capitalization-weighted index of approximately 1,000 of the largest companies in the U.S. equity markets. One cannot invest directly in an index. A basis point or BPS is one hundredth of a percentage point (0.01%). Duration is a measure of the sensitivity of the price of a fixed income investment to a change in interest rates. EV stands for enterprise value and is a measure of a company's total value, often used as a more comprehensive alternative to equity market capitalization. Free cash flow is a measure of the cash produced by the firm in a given period on behalf of equity holders. The true measure of the value of a firm's equity is considered to be the present value of all free cash flows.

Diversification does not guarantee a profit or protect from loss in a declining market. Earnings growth is not a measure of the Fund's future performance.

As of 9/30/19 the Buffalo Small Cap Fund top 10 equity holdings were Kornit Digital 2.54%, Natera 2.50%, MasTec 2.49%, CyrusOne 2.46%, ICF Intl 2.38%, PROS Holdings 2.35%, Monolithic Power Systems 2.12%, Hamilton Lane 1.95%, Air Transport Services 1.93%, Bio Techne 1.88%. Top 10 holdings for the quarter are not disclosed until 60 days after quarter end.

Mutual fund investing involves risk; Principal loss is possible.

The Funds may invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility than larger companies. The Funds may invest in foreign securities which will involve political, economic and currency risks, greater volatility and differences in accounting methods. This risk is greater in emerging markets. The Funds may invest in lower-rated and non-rated securities which presents a greater risk of loss to principal and interest than higher-rated securities. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities.

The Funds' investment objectives, risks, charges, and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information about the investment company and may be obtained by calling (800) 49-BUFFALO or visiting buffalofunds.com. Read carefully before investing.

Kornitzer Capital Management is the advisor to the Buffalo Funds, which are distributed by Quasar Distributors, LLC.

Trends & Patience is our mantra, and our great strength.

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