# Buffalo High Yield Fund

QUARTERLY
COMMENTARY

December 31, 2020

## Capital Market Overview

The U.S. high yield sector continued its rally in the quarter, driving bond yields to record lows. Amid stimulus and vaccine optimism, high yield bond prices continued their recovery from the COVID-19 sell-off in March. The high yield market posted positive returns in each month of the quarter (+0.51% in October, +3.93% in November, +2.04% in December) pushing yields to a record low of 4.71%. The 10-year Treasury Bond returned -1.82% during the quarter, while the S&P 500 Index logged a return of 12.15%.

Following a record $47.3 billion inflow in the 2nd quarter of 2020 and a $10.7 billion inflow in the 3rd quarter, high yield funds reversed course, experiencing $3.4 billion of cash outflows in the December quarter. Interestingly, in the months from April to August, high yield funds posted five consecutive months of inflows totaling $59.1 billion, which included the two largest inflows ever recorded in May ($20.5 billion) and April ($17.1 billion). High yield new issuance volume was $99 billion during the quarter, after posting record-setting levels in both the 1st and 3rd quarters of $145.5 billion and $131.9 billion, respectively. Refinancing continued to be the primary use of proceeds, accounting for ~68% of transaction volume in 2020. According to JP Morgan, split BB or B rated issues accounted for the bulk of activity in the quarter (48%) with the heaviest volume coming from Energy (12.7%), Healthcare (12.7%), and Financial (8.8%).

During the quarter, the yield on the 10-year Treasury Bond increased 24 basis points (bps) from 0.68% to 0.92%. Every sector in the U.S. high yield universe and every credit rating silo produced positive returns during the 4th quarter. According to data from JP Morgan, the lower quality end of the high yield credit spectrum (i.e., split B/CCC, non-rated, and defaulted issues) performed better than the higher end of the quality spectrum. The split B/CCC segment produced the largest gain of 9.10% and the BB segment was the worst performer, with a still solid 2.56% gain.

According to data from JP Morgan, the U.S. high yield market's spread to worst for the period was 444 bps, 159 bps tighter than the preceding quarter and 161 bps tighter than its 20-year historical average of 605 bps. The yield to worst for the high yield market at quarter-end was 4.71%, below the 20-year average of 8.45%, and below the yield of 6.32% at the end of the 3rd quarter.

## Performance Commentary

The Buffalo High Yield Fund (BUFHX) increased 7.55% for the quarter, beating out the ICE BofAML U.S. High Yield Index, which gained 6.48% for the period. The Fund also outperformed the Lipper High Yield Bond Funds Index return of 6.44%.

### Average Annualized Performance (%)

| *As of 12/31/20* | 1 YR | 3 YR | 5 YR | 10 YR | 15 YR | Since Inception |
|---|---|---|---|---|---|---|
| Investor Class - *BUFHX* | 9.27 | 6.25 | 6.28 | 5.81 | 6.38 | 7.08 |
| Institutional Class - *BUIHX*[1] | 9.43 | 6.38 | 6.42 | 5.96 | 6.53 | 7.24 |
| ICE BofAML U.S. High Yield Index | 6.17 | 5.89 | 8.43 | 6.62 | 7.35 | 7.19 |
| Lipper High Yield Bond Funds Index | 4.81 | 5.14 | 7.44 | 5.93 | 6.15 | 5.95 |
| Morningstar High Yield Bond Category | 4.91 | 4.74 | 6.75 | 5.55 | 6.10 | 5.90 |

*[1]For performance prior to 7/1/19 (Inception Date of Institutional Class), performance of the Investor Class shares is used and includes expenses not applicable and lower than those of Investor Class shares. Data represented reflects past performance and is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original value. Current performance may be lower or higher than the performance quoted. Performance current to the most recent month end may be obtained by visiting the Funds' website at buffalofunds.com. Each Morningstar category average represents a universe of funds with similar objectives.*

## Fund Facts

| | *Investor* | *Institutional* |
|---|---|---|
| Ticker: | BUFHX | BUIHX |
| Inception Date: | 5/19/95 | 7/1/19 |
| Expense Ratio: | 1.03% | 0.89% |
| Fund Assets: | $266.14 Million | |
| Category: | High Yield Bond | |
| Benchmark: | ICE BofAML U.S. High Yield Index | |

## Management Team

**Paul Dlugosch**, CFA

Co-Manager since 2007
B.S. – University of Iowa

**Jeff Sitzmann**, CFA

Co-Manager since 2007
M.B.A. – Univ. of Chicago
B.B.A. – Univ. of Toledo

**Jeff Deardorff**, CFA

Co-Manager since 2015
B.S. – Kansas State Univ.



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## Fund Composition by Asset Class

| | 12/31/19 | 3/31/20 | 6/30/20 | 9/30/20 | 12/31/20 |
|---|---|---|---|---|---|
| Straight Corporates | 55.6% | 60.1% | 55.4% | 60.6% | 61.0% |
| Convertibles | 17.7% | 16.7% | 20.1% | 17.6% | 14.7% |
| Bank Loans | 16.2% | 19.1% | 16.6% | 16.3% | 17.2% |
| Preferred Stocks | 1.1% | 1.3% | 1.7% | 1.5% | 1.2% |
| Convertible Preferreds | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Common Stocks | 1.7% | 1.0% | 0.6% | 0.4% | 0.1% |
| Cash | 7.6% | 1.8% | 5.6% | 3.6% | 5.8% |
| TOTAL | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

## Approximate Rate & Contribution of Return in 4Q20

| | Unweighted Return | Contribution to Return |
|---|---|---|
| Straight Corporates | 5.9% | 3.73% |
| Convertibles | 20.2% | 3.36% |
| Bank Loans | 2.8% | 0.48% |
| Preferred Stocks | 9.1% | 0.13% |
| Convertible Preferreds | 0.0% | 0.00% |
| Common Stocks | 31.0% | 0.08% |
| TOTAL | | 7.55% |

## ↑ Top Contributors

During the quarter, 137 out of the 138 issues in the Fund produced positive returns. The top three contributors were **Cerence** 3% convertible bonds, **Nuance Communications** 1.5% convertible bonds, and **MPLX** 6.875% corporate bonds. Cerence and Nuance are both technology-driven enterprises that reported better-than-expected earnings or guidance during the quarter, and the underlying stocks benefited from the strong demand from investors to own the technology sector. MPLX is a mid-stream energy operator that benefited from a rally in the entire high yield energy sector throughout the quarter.

## ↓ Top Detractors

The **K12 Inc.** 1.125% convertible bond position was the only security with negative performance during the quarter. Although the company reported strong quarterly results, the convertible bonds were under pressure due to on-going concerns about the sustainability of enrollment trends (boosted by COVID-19) and a few operating challenges (a lost contract and a cyber-attack).

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## Outlook

Until March 2020, the United States had been enjoying a growing economy with modest inflation that had created a favorable environment for risky assets. However, near the end of February and early March, the COVID-19 pandemic and plummeting crude oil prices wreaked havoc on the markets. The U.S. high yield default rate increased to 3.54% in March, which was up 91 bps from the 2.63% level in December 2019. The trend continued through July, peaking around 6.2% before declining to 5.8% through August and September, before return to peak level of 6.2% during the December quarter. Overall, 88 companies defaulted on $129.6 billion of bonds and loans in 2020.

We are concerned first and foremost about the ongoing COVID-19 pandemic and the fallout on global economies, with the transition to the Biden administration being a secondary focus. We are managing the Fund cautiously yet actively, focusing on high-quality issuers with defensive business models and manageable credit metrics. We will continue to deploy cash in opportunities that we believe offer the most appealing risk/reward tradeoff, with a bias toward shorter durations and less levered credits. Additionally, we believe bank loans offer a more defensive position as they provide senior positioning in the capital structure. Finally, we continue to look for opportunities in convertible bonds and preferred stocks. We ended the quarter with 138 positions, unchanged from the previous quarter's level (excluding cash).

## Interested in more info?

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

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*The Fund's 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 can be obtained by calling (800) 49-BUFFALO or visiting buffalofunds.com. Read carefully before investing.*

**Earnings growth is not representative of the Fund's future performance.**

As of 9/30/20 the Buffalo High Yield Fund top 10 holdings were Open Lending (1 mo LIBOR + 6.500%, 3/11/27) 2.84%, Nuance Communications (1.500%, 11/1/35) 2.24%, Consolidated Comm. (6.500%, 10/1/22) 2.05%, MPLX (6.875%, 8/15/23) 1.86%, Michaels Stores (8.000%, 7/15/27) 1.72%, Builders FirstSource (5.000%, 3/1/30) 1.70%, Treehouse Foods (4.000%, 9/1/28) 1.66%, J2 Global (1.750%, 11/1/26) 1.55%, Cerence (T/L B, 9/30/24), Diebold Nixdorf (8.500%, 4/15/24) 1.50%. Top 10 holdings for the quarter are not disclosed until 60 days after quarter end.

The opinions expressed are those of the Portfolio Managers and are subject to change, are not guaranteed and should not be considered recommendations to buy or sell any security. Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security. The 10-year Treasury bond is a debt obligation issued by the United States government that matures in 10 years. A basis point (bps) is one hundredth of one percent (0.01%). Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value. Yield to worst is the lowest potential yield that can be received on a bond without the issuer actually defaulting. Spread to worst measures the difference from the worst performing security to the best, and can be seen as a measure of dispersion of returns within a given market or between markets. Duration is a commonly used measure of the potential volatility of the price of a debt security, or the aggregate market value of a portfolio of debt securities, prior to maturity. Securities with a longer duration generally have more volatile prices than securities of comparable quality with a shorter duration. A coupon or coupon payment is the annual interest rate paid on a bond, expressed as a percentage of the face value and paid from issue date until maturity. 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 ICE BofAML U.S. High Yield Index is an unmanaged index comprised of over 1,200 high yield bonds representative of high yield bond markets as a whole. The Lipper High Yield Bond Funds Index is a widely recognized index of the 30 largest mutual funds that invest primarily in high yield bonds. One cannot invest directly in an index. The LIBOR (London InterBank Offered Rate) is a benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans. A Standard & Poor's Rating of B means an obligor is more vulnerable the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. A Standard and Poor's Rating of BB means an obligor is less vulnerable in the near term than other lower-rated obligors. A Standard and Poor's Rating of CCC means an obligor is currently vulnerable, and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments. The highest rating is AAA and the lowest rating is D. A Standard & Poor's Rating of BBB– or higher represents investment grade securities. In limited situations when the rating agency has not issued a formal rating, the Advisor will classify the security as nonrated.

**Mutual fund investing involves risk. Principal loss is possible. Investment by the Fund in lower-rated and non-rated securities 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. Investments in foreign securities include additional risk such as greater volatility, and political, economic, and currency risks, as well as difference in accounting methods.**

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

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