Buffalo Large Cap Fund

QUARTERLY
COMMENTARY

September 30, 2022

Capital Market Overview

The stock market extended year-to-date losses during the 3rd quarter and has now fallen for three consecutive quarters. The S&P 500 Index retreated by -4.88% from July 1st to September 30th bringing the YTD total return to -23.87%, which is bear market territory. Stubbornly-high inflation, aggressive interest rate increases, rising fear of a recession, and expectations for softer corporate earnings in the upcoming reporting period were the main headwinds. The Federal Reserve's hawkish stance on inflation resulted in two more oversized federal funds rate hikes during the quarter, bringing the target rate to 3.00%-3.25%. Federal Reserve officials also signaled for additional rate hikes moving forward and holding higher rates for as long as necessary to curb inflation, even if it leads to economic pain. Short-term Treasury yields (two-year notes) are higher than long-term yields (10-year notes) and the yield curve is now inverted by the most since 2000, an indication of a potential recession.

The broad-based Russell 3000 Index declined -4.46% in the quarter and has fallen -24.62% year-to-date. Value stocks fell more than growth stocks during the quarter as the Russell 3000 Value Index returned -5.56% versus a return of -3.37% for the Russell 3000 Growth Index. Relative performance improved going down in market cap size as small caps declined less than large caps in the quarter. Larger cap stocks, as measured by the Russell 1000 Index, returned –4.61% compared to the smaller cap Russell 2000 Index return of –2.19% and the Russell Microcap Index return of -0.48%.

Performance Commentary

For the September quarter, the Buffalo Large Cap Fund (BUFEX) declined -4.17% versus a decline of -3.60% for the Russell 1000 Growth Index. Relative underperformance in the quarter entirely reflects underweight positions in Apple and Tesla, which advanced 1.3% and 18.2%, respectively. Apple represents more than 13% of the Russell 1000 Growth Index weight and Tesla is more than a 4% position. While we own both companies, we believe it's prudent within a "diversified" fund mandate, as categorized by the Securities and Exchange Commission (SEC), to monitor concentration risk within a particular company or sector. The extreme volatility exhibited by Tesla on a quarter-to-quarter basis, which has been twice as volatile as the S&P 500 Index, is exhibit A for owning high growth innovative companies but managing the position size to neutralize extreme moves higher and lower. Importantly, and something we consider as another important performance metric, the Fund performed in-line with the Morningstar category of other large cap growth funds (our peer mutual fund group).

Average Annualized Performance (%)

As of 9/30/22	1 YR	3 YR	5 YR	10 YR	15 YR	Since Inception
Investor Class - *BUFEX*	-24.20	6.93	9.20	12.58	8.45	9.41
Institutional Class - *BUIEX*[1]	-24.10	6.78	9.37	12.75	8.61	9.57
Russell 1000 Growth Index	-22.59	10.67	12.17	13.70	10.10	9.54
Morningstar U.S. Large Growth Index	-38.87	3.11	8.02	11.26	8.39	–
S&P 500 Index	-15.47	8.16	9.24	11.70	8.03	–
Morningstar Large Growth Category	-27.10	6.77	8.95	11.36	8.06	8.23

[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:	BUFEX	BUIEX
Inception Date:	5/19/95	7/1/19
Expense Ratio:	0.93%	0.78%
Fund Assets:	$84.26 Million	
Category:	Large Cap Growth	
Benchmark:	Russell 1000 Growth Index	

Management Team

Ken Laudan

Manager since 2021
B.S. – Kansas State Univ.

On a year-to-date basis, the Buffalo Large Cap Fund continued to perform better than the peer average (by 173 basis points), ranking in the top 39th percentile among 1250 Morningstar Large Growth Funds.

As typically done every quarter, we stress that while the Buffalo Large Cap Fund is not directly measured against the S&P 500 Index, we highlight its performance also, as you may use it as a natural comparator for broad market equity returns. As you may know, the core difference between the Buffalo Large Cap Fund and the S&P 500 Index is the latter has much larger weightings in cyclical sectors of the U.S. economy, namely Energy, Financials, and Industrials.

↑ Top Contributors

Amazon (AMZN) is the world's largest retailer while also being a "titan" provider of public cloud data centers around the globe via its Amazon Web Services division. Shares appreciated 6.4% in the 3rd quarter, which, combined with our large position weighting of 7% of assets, produced the largest single contribution to performance. Candidly, we feel that Amazon's performance in the quarter was more of a bounce back from tough first half performance along with an expectation of accelerating sales into the second half of 2022, and a decision by management to reduce capex spend following two years of heavy investments in new warehouse facilities. We expect Amazon shares to mark time from here until macro headwinds abate and we get a sense of the durability of accelerating revenue growth for the year.

Enphase Energy (ENPH) is novel solar energy company that has rapidly become one the leading global manufacturers of microinverters for solar panels used for residential and small commercial businesses. Key to the company's leading market share has been its own proprietary integrated circuit, which has resulted in lower energy costs and increased solar energy features for homeowners.

Beyond seeing sharp accelerating demand in Europe for residential and small business solar panel installations related to the Russia invasion into Ukraine, we're equally positive on the company's entrance into the important solar battery storage segment. Having the ability to store, rather than lose excess solar energy to the grid, we believe provides a compelling holistic energy management system for customers while increasing the company's revenue potential from $2,500 to $8,500 per home. Akin to last quarter, Enphase's shares appreciated well ahead of the market, rising 42% during the 3rd quarter.

Tesla (TSLA) shares rose 18.2% in the 3rd quarter mostly on the back of the formal signing of the Inflation Reduction Act (IRA), which provides direct tax credits for buyers of electric vehicles combined with a strong 2nd quarter earnings report, where automotive gross margin and net income exceeded expectations, where inflationary cost concerns had kept estimates in check. Tesla is the global leader in manufacturing electric battery vehicles and now has as many as seven million vehicles on the road. The next big thing for Tesla will be to monetize these cars with full self-driving software beyond the beta version released in North America.

↓ Top Detractors

Microsoft (MSFT) shares declined 9.1% in the quarter on continued weakness across the technology and software complex, owing to the Federal Reserve's ongoing effort to raise short term interest rates, and to a lesser effect of pressure on the company's top-line from the strength of the U.S. dollar, which diluted international revenues. Microsoft's fundamentals remain positive as they continued to take share in cloud hosting/software stack and their core Microsoft Office productivity and gaming franchises, which remain the global leaders in their respective categories.

Alphabet (GOOG-Google) shares continued to decline in the 3rd quarter, similar to Microsoft and other large tech companies, falling 12.2%, following a 16% decline in the 2nd quarter. Google is the market share leader in internet driven paid advertising and paid search. Much of the advertising and paid search is related to ecommerce retail goods and services. Retailers for the last year have been struggling through supply chain headwinds and now face a more challenged consumer both at the low- and mid- to high-end owing to ongoing inflation and creeping economic softness.

Partially offsetting the slower retail/eComm issues for the company is travel, which remains the second largest contributor to their large paid advertising platform and is seeing a renaissance of sorts with solid underlying demand. Moving forward, we will continue to monitor the slope of eComm growth (consensus is for 10% increase from 2021) to see if Google's operating environment becomes less favorable.

NVIDIA (NVDA) shares slid 19% in the 3rd quarter as the semi-conductor sector fell due to concerns of a slowing global economy and possible over-supply of chips within the consumer PC and gaming market.

NVIDIA is a fabless semi-conductor manufacturer that designs hardware and software aimed at various graphics applications used in gaming and industrial design (professional visualization/design simulation). The company is the leader in graphic processing units (GPUs) used in high performance computing and is also the global leader in the production of integrated circuits used for AI and machine learning. NVIDIA currently possesses the largest market share of AI/ML GPUs embedded in servers located in the large cloud and enterprise data centers. Notwithstanding the current pall overhang, we still view the company as uniquely well positioned to capture the leading GPU share in the emerging market for virtual reality, autonomous driving in addition to an emerging, and large market opportunity in cloud-based AI/ML.

The underlying, intermediate-to-long-term opportunity for all three of the company's mentioned above remains significant and durable. Coupled with well-below historical valuations, we believe that selling these positions without a structural change or outlook of the fundamentals wouldn't be constructive. While none of these companies are immune to a global recession, or marked economic slowdown, they are companies that would likely suffer less earnings headwinds and financial stress than large companies in many other industries lacking the novel product offering, large customer base, margin profile or balance sheet strength to quickly rebound when the macro headwinds begin to abate.

Outlook

Key takeaways: global growth slowing with inflation peaking; market pivoting to 2023 earnings outlook. What's the likely outlook over the next 3-6 months?

- Equity and bond markets continue to toil with broad-based concerns about the global financial and economic outlook. With inflation in the U.S. accelerating to levels not seen since the 1970s, the Federal Reserve (the "Fed") has been resolute in moving short term rates higher to "tame the beast" resulting in a bear market across the U.S. and global equity complex.
- The labor market remains tight (e.g. low unemployment at 3.5%) with inflation still well above target levels. However, there are leading indicators showing the inflation "rate of change" is beginning to reverse within important Consumer Price Index (CPI) components now declining on a rate of change basis. Prices from used vehicles, steel, aluminum, shipping container costs, housing, and even natural gas have begun to cool.

- Once the lagging effects of bigger CPI components such as housing and rents move through the economy, this cooling of prices will show up in the key inflationary indexes by late 2022. How quickly inflation declines to the Fed's 2% inflation target is unclear, but safe to presume it will take well into 2023 before inflation approaches this much lower Fed target. Interestingly, as more evidence points to inflation nearing or at its peak, some have postulated the Fed may have moved unnecessarily aggressive with their rate hikes and proposed quantitative tightening. Time will tell.

- While inflation and slowing economic growth have been key focus points for investors in 2022, the attention is now shifting to the implications of slowing inflation with slowing global growth and what that means for revenues, margins, and profits in 2023. Our own prevailing bias is revenues and margins will be negatively-impacted in this economic transition, post peak inflation. If we're correct, we would expect 2023 S&P earnings-per-share (EPS) estimates to compress from the current projection of $239 to something closer to $200 to $210 as we move through the last part of this calendar year and into the first part of 2023.

- During this second economic phase of Fed rate tightening, we expect the equity markets to continue to be choppy and volatile until 2023 earnings estimates reset, at which point, we can start to be more constructive about the outlook for the U.S. equity market. Keep in mind, the stock market is a forward-looking mechanism, so market valuations and prices could bottom six-months or so before S&P earnings bottom. This makes it at least plausible stocks could bottom by the spring of 2023.

What does all this mean for growth-oriented investors?

For the time being, it means continuing with outsized positions in Consumer Staples, Healthcare, and other more defensive sectors with a particular focus on dividend-paying companies with strong balance sheets. Also, the cash position in the Fund also remains defensively elevated, ranging from 6.5% to 7.5% of net asset value (NAV), more than double the long-term normalized level of 2% to 3%.

Since no economic or profit recession cycles are the same and because we have persistent inflation with this current bear market, the Fund has also increased exposure into materials, chemicals, and commodity sensitive sectors such as oil and gas and lithium-based refiners.

While one can rationally envision a scenario of the equity markets beginning a bottoming process in the first half of 2023, we would stress if the world and U.S. economy enter a deeper-than-expected recession or geo-political events carry-over to other geographies, the timing of a market reversal could be pushed out to 2024, albeit that's not our base case today.

Regarding the above comments, we maintain a close eye on the Ukraine/Russia conflict, the economic and energy situation in Europe, and the on-going trade/geo-political tensions between the U.S. and China, as well as remaining cognizant of the upcoming winter season and any unexpected indications of increased severity of COVID-19 infection levels that might impact the pace of an economic rebound.

While there is no shortage of macro and global challenges to ponder, we remain deeply engaged talking to analysts and companies every week, making sure we're owning the best, high growth investment opportunities that will help change the world in a durable way over the long run while risk-managing sector and individual company position exposures.

We believe the market will remain choppy with further downside risk owing to 2023 earnings estimates that currently remain too high. However, we also recognize than when market valuations do eventually bottom, we believe it will be high quality, high growth companies that most likely will lead the equity markets higher. Many investors don't fully appreciate the substantial gains that have occurred in the subsequent 12 months after the market reaches its lows.

As always, we appreciate your continued confidence in our investment strategy and approach. It's one that has historically demonstrated a track record of long-term outperformance through various market challenges and opportunities.

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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