Buffalo Large Cap Fund

QUARTERLY
COMMENTARY

December 31, 2022

Capital Market Overview

Capital markets rallied modestly in the 4th quarter as the S&P 500 Index gained 7.56%, the only positive quarter for 2022. Cooler inflation readings, resilient consumer spending, and better-than-expected corporate earnings buoyed markets during the first two months of the 4th quarter before pulling back in December. Much of the focus remains on the path of future interest rates, recession fears, and the economic and market impact those events may generate in 2023.

Despite the 4th quarter advance, the stock market recorded its worst calendar year since 2008, with a decline of -18.11% for the S&P 500 Index, and a loss of -32.54% for the growth-oriented and technology-heavy Nasdaq Composite Index. Large cap technology stocks and the more interest-rate sensitive assets suffered the most, while value stocks outperformed. In the end, nine of the S&P 500 Index's 11 economic sectors declined. Energy stocks were the bright spot, recording a gain of 65.72% for the sector while Utilities eked out a gain of 1.57% in 2022.

The damage wasn't isolated to the stock market as the investment-grade bond indices suffered double-digit losses for the year as well. In fact, a traditional balanced investment portfolio of 60% stocks and 40% bonds suffered the 4th worst drawdown in the past 100 years.

Recapping quarterly results, the broad-based Russell 3000 Index advanced 7.18% in the period. Value stocks significantly outperformed growth stocks to close out 2022, as the Russell 3000 Value Index returned 12.18% versus a return of just 2.31% for the Russell 3000 Growth Index. Relative performance was mixed going down in market cap size as small caps advanced less than large caps in the quarter, while mid cap stocks outperformed both large and small caps. Larger cap stocks returned 7.24%, as measured by the Russell 1000 Index, compared to the smaller cap Russell 2000 Index return of 6.23%, while the Russell Midcap Index produced a return of 9.18% in the quarter.

Performance Commentary

The Buffalo Large Cap Fund (BUFEX) produced a total return of 2.52% in the quarter and outperformed the prospectus benchmark Russell 1000 Large Cap Growth Index return of 2.20%. Outperformance in the quarter largely reflects the Fund's overweight positions in Visa, which advanced 17%, Microsoft, increasing 3.25%, and ASML, up 32%. In addition to benchmark relative results, we consider Morningstar Large Growth category results as another important performance metric for the Fund.

Average Annualized Performance (%)

As of 12/31/22	1 YR	3 YR	5 YR	10 YR	15 YR	Since Inception
Investor Class - *BUFEX*	-28.61	4.86	8.37	12.33	8.94	9.42
Institutional Class - *BUIEX*[1]	-28.51	5.01	8.53	12.50	9.10	9.58
Russell 1000 Growth Index	-29.14	7.79	10.96	14.10	10.32	9.53
Morningstar U.S. Large Growth Index	-40.36	0.20	6.74	11.68	8.56	–
S&P 500 Index	-18.11	7.66	9.42	12.56	8.81	–
Morningstar Large Growth Category	-29.91	4.72	8.30	11.77	8.34	8.29

[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:	$85.74 Million	
Category:	Large Cap Growth	
Benchmark:	Russell 1000 Growth Index	

Management Team

Ken Laudan

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

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The Buffalo Large Cap Fund slightly underperformed the Morningstar Large Growth equal-weighted category average return of 3.10% in the quarter. Think of this as our mutual fund peer group. However, for all of 2022, the Buffalo Large Cap Fund outperformed the Morningstar Large Growth equal-weighted category average return by 1.30%. For the year, the Fund also outperformed the prospectus benchmark Russell 1000 Growth Index by 0.53%.

As we do in every quarterly commentary, we stress that while our large cap growth fund is not directly measured against the S&P 500 Index we highlight its performance as a natural comparator for 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 more cyclical sectors of the U.S. economy, namely Energy, but also Financials and Industrials. The S&P 500 Index produced a return of 7.56% in the 4th quarter and a return of -18.11% for calendar year 2022, outperforming the Buffalo Large Cap Fund over both periods.

↑ Top Contributors

As mentioned above, the top contributors to Fund results for the quarter were Visa, Microsoft, and ASML.

Visa is the world's most widely used credit and debit card payment company that uses a global network of merchants and banks to facilitate consumer purchases. Visa outperformed as a relatively safe haven stock given the favorable backdrop of consumer credit purchases increasing strongly in the most recent quarter. The strength was further helped by strong growth in travel and cross-border transactions, which carry high fees for Visa.

Microsoft was another top contributor to Fund results, however nothing stands out as to why the stock performed reasonably well in the quarter. It is the portfolio's largest investment so even a small amount of outperformance relative to the index can have an outsized impact (benefit) to Fund performance.

ASML is the leading photolithography machine manufacturer used to produce computer chips including both trailing and leading-edge chips. Arguably, ASML is the most important company you may have never heard of. Without ASML we would not have the technology to produce the most advanced chips used for artificial intelligence/machine learning or take high resolution pictures, or to play high resolution games on your smartphone or PC. ASML is one of the Fund's largest overweight positions and the stock advanced nearly 32% in the 4th quarter following an investor day that reconfirmed a strong short- and near-term backlog and financial outlook. In the first half of 2022, ASML shares had been hit in sympathy with weakness across the technology complex and concerns about moderating growth within the semi-conductor cap-ex sector, specifically.

↓ Top Detractors

Meanwhile the top detractors from Fund results for the quarter were Amazon, Tesla, and Apple. Amazon is the world's largest eCommerce and retailer in the world. It also operates with the largest market share of public cloud hosting services for enterprises and small businesses through its growing Amazon Web Services division. Shares declined an "eye-popping" 26% in the quarter owing to worse than expected quarterly revenue and earnings guidance in both the retail and the AWS divisions. The latter being the most surprising to Wall Street given its strong market position and the ongoing thrust to the cloud by large enterprises and government entities.

While the financial guidance was disappointing, we don't see any structural change in either its leading position in the global retailing space, or within its AWS positioning. We believe enterprises will continue to look for more efficiencies and cost savings within the business model and that's the strong use care provided by AWS.

Moreover, with Amazon's large capital expenditure investments on the retail or eCommerce side, we think the company retains the ability to continue to take share via its broad inventory availability, low price and fast, same day delivery. It will be important for company management to convey an increased level of confidence to investors that the fundamental value drivers mentioned above, along with better cost management, should improve performance going forward.

Outlook

While we are bottoms-up investors, we must remain "macro" aware and sensitive to key shifts that define the investing environment. Accordingly, we are positioned for a structurally different market dynamic in 2023, but with a keen expectation for ongoing equity market volatility as both an earnings and economic recession have become our base case outlook for the year.

While inflation and slowing economic growth were key focus points for investors in 2022, the attention is now shifting to the implications of slowing inflation coupled with declining global growth (in rate of change terms) and what that means for revenues, margins, and profits in 2023. As we stated in the 3rd quarter commentary, our prevailing bias was that revenues and margins will be negatively impacted in this economic transition to slower growth. This remains our perspective today. If this indeed becomes the case, likely in the first half of 2023, we expect 2023 S&P consensus earnings per share estimates to compress from the current projection of $229/share closer to $200 to $205/share, or at least directionally closer to this range.

As a result, we expect the equity markets to continue to be mixed (and messy) until 2023 earnings estimates properly reset, at which point, investors can begin to turn the page from this idiosyncratic and volatile cycle and perhaps become more constructive about the outlook for the U.S equity market into 2024. We remain mindful that the stock market is a forward-looking mechanism, so market valuations and prices are prone to bottom six-months, or so, before S&P earnings bottom. This makes it plausible that stocks could bottom sometime in the first half of 2023, presuming the recession outlook is tapered and moderate although there is no real way to assess that outcome today.

What if we are wrong on the earnings and economic recession scenario? One of the key tenants of investing is realizing that markets deal in probabilities not certainties. Therefore, while our current base case impacting portfolio positioning is for an earnings and economic recession in 2023, we do have a playbook that addresses a range of different outcomes. We are prepared to respond if the key variables change. Investing is hard and complicated, but we have 30 plus years of institutional investing experience along with a repeatable process we believe should help minimize exposure to a single outcome.

Markets today (mid-January), appear to be pricing in a soft landing for the economy resulting in a very mild or even no recession. As noted, we believe that call is overly optimistic given that both GDP and inflation will be declining, in terms of rate of change. These negative rate of change factors are almost always a headwind for corporate revenues, margins, and earnings. Moreover, the economy might not feel the impact from the Federal Reserve's aggressive rate hikes implemented in 2022 until later in 2023 making the rate of change even more dramatic over the next several months.

So what does our "recession" base case scenario mean for portfolio positioning? First, it means continuing with key positions in Consumer Staples, Health Care, and other more defensive sectors with a particular focus on dividend paying companies with strong balance sheets. It also means continuing to reduce the Fund's exposure to the high growth tech sector. Currently, the portfolio is about 700 bps underweight Technology compared to the Russell 1000 Growth Index's sector weight. Finally, as was the case in 2022, portfolio cash remains defensively elevated, ranging around 6% to 7% of assets, more than double the longer-term normalized level of 2% to 3% of assets.

While one can envision a scenario where equity markets beginning a bottoming process in the first half of 2023, however we would stress if the global economy enters a deeper than expected recession, or if geopolitical events carry-over to other geographies, the timing of a market reversal could be pushed out to 2024, albeit that is not our base case today.

As always, our investment process requires us to "risk manage" the portfolio first and only then try to be more offensively oriented when it comes to specific sectors and company exposures.

Similar to 2022, there will likely be no shortage of macro and global challenges to navigate in 2023. Whether it's sticky inflation, concerns about growth and earnings outlooks or even large counter-intuitive market moves, we will continue to be adaptable while retaining a long-term investing bias towards high quality, durable growth companies that can be both important and impactful to the world in a positive way.

We appreciate your continued confidence in our investment strategy and approach. It's one that has historically demonstrated a long term track record of 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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