

# Buffalo Small Cap Fund

QUARTERLY  
COMMENTARY

September 30, 2021

## Capital Market Overview

Equity market returns were somewhat mixed in the 3rd quarter, but the S&P 500 Index etched out a modestly positive return of 0.58%. The global recovery hit a speed bump during the period as the world dealt with rising COVID-19 Delta variant infections, an energy price spike, and supply chain issues that continued to constrain economic growth. After trading lower earlier in the quarter, interest rates increased later in the period in response to higher-than-expected inflation data and an admission from the Federal Reserve (the "Fed") that they would need to begin removing monetary stimulus from the economy sometime soon.

The Russell 3000 Index declined -0.10% in the quarter. Growth stocks outperformed Value stocks as the Russell 3000 Growth Index returned 0.69% versus a drop of -0.93% for the Russell 3000 Value Index. Relative performance was correlated with market cap size as large caps outperformed small caps in the quarter. The large cap Russell 1000 Index returned 0.21% compared to the Russell Midcap Index return of -0.93%. Smaller market cap indices were even more negative, with the Russell 2000 Index returning -4.36% and the Russell Microcap Index returning -4.98%. Financials were the top performing sector for the quarter, while Industrials and Materials were lagging sectors.

## Performance Commentary

Many small cap growth companies continued to struggle during the quarter as a result of declining gross domestic product (GDP) estimates due to supply chain disruptions and the COVID-19 spike from the highly transmissible Delta variant. Investors gravitated to the relative safety of larger companies, and market capitalization was a meaningful driver of relative performance during the period. The Russell 2000 Index of smaller companies declined -4.36% in the quarter, underperforming the Russell Midcap Index and the larger cap Russell 1000 Index, which produced returns of -0.93% and 0.21%, respectively. Growth companies outperformed Value in the mid and large cap indices during the quarter, but Growth underperformed Value in the smaller cap Russell 2000 Index by 267 basis points. Small cap value has meaningfully outperformed small cap growth year to date. Weakness was seen in all but one sector of the Morningstar U.S. Small Growth Index, as only Energy produced positive returns. Healthcare and Telecom Services were the weakest performing sectors within the index, while Technology and Industrials declined the least.

The Buffalo Small Cap Fund (BUIFX) produced a return of -5.96% for the quarter, underperforming the Morningstar U.S. Small Cap Growth Index return of -4.50%. Healthcare drove most of the underperformance, followed by weakness in Industrials and Telecom Services while Consumer Discretionary, Technology, and Financials outperformed.

## Average Annualized Performance (%)

As of 9/30/21	1 YR	3 YR	5 YR	10 YR	15 YR	Since Inception
Investor Class - BUIFX	42.39	24.22	24.86	19.40	12.36	13.80
Institutional Class - BUISX <sup>1</sup>	42.54	24.40	25.05	19.57	12.52	13.97
Morningstar U.S. Small Growth Index	27.66	12.76	16.67	15.98	11.01	7.43
Lipper Small Cap Growth Fund Index	35.39	15.84	18.78	16.67	10.93	8.57

<sup>1</sup>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 Institutional 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](http://buffalofunds.com).

## Fund Facts

	Investor	Institutional
Ticker:	BUIFX	BUISX
Inception Date:	4/14/98	7/1/19
Expense Ratio:	1.01%	0.86%
Fund Assets:	\$1.20 Billion	
Category:	Small Cap Growth	
Benchmark:	Morningstar U.S. Small Growth Index	

## Management Team



**Jamie Cuellar, CFA**

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



**Bob Male, CFA**

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



Historically, stock selection drives the Fund's relative performance, but attribution analysis this quarter shows that our allocation effect and selection effect detracted by an almost equal amount. The negative allocation effect came from a portfolio overweight to Consumer Discretionary and Telecom Services, two weaker performing benchmark sectors along with a portfolio underweight to Technology and Energy, two better performing benchmark sectors.

## ↑ Top Contributors

**Rush Street Interactive (RSI)** was a significant contributor for the quarter. An online sports betting and interactive casino company, Rush Street shares struggled during the spring and early summer due to weakness in companies that came public through a SPAC, or special purpose acquisition company. Seasonal weakness in online sports betting companies ahead of the pivotal NFL season also weighed on the company's shares. The stock recovered this quarter, as investors grew increasingly excited about online sports betting as the NFL season kicked off. Additionally, the company maintained solid market share in their key iCasino markets, and investors cheered the potential for further consolidation within the group, as a couple of deals were announced with some speculation that RSI could be an acquisition candidate.

## ↓ Top Detractors

**Bandwidth (BAND)** was the largest detractor during the period. Industry consolidation and vertical integration within the Communications Platform as a Service (CPaaS) group drove fears that Bandwidth has a competitive disadvantage, which led to share price declines. Continued tough competition throughout the remainder of 2021, especially in areas where Bandwidth benefited from additional political traffic in 2021, contributed to the selloff. We believe the latter is a short-term phenomenon that will anniversary this upcoming quarter, and Wall Street is failing to give credit for Bandwidth's own acquisition activity, namely the acquisition of Voxbone, which accelerates Bandwidth's entry into Europe.

**Hydroform (HYFM)** was another detractor from performance during the quarter. A distributor of controlled environment agricultural products such as nutrients, consumables and lighting largely used by the fast-growing cannabis industry, Hydroform's stock was weak due to a slowdown in the California market, following an inventory correction from an earlier harvest. We believe this will prove to be a short-term event, and the long-term opportunity for Hydroform, namely more markets approving cannabis usage along with the potential for highly accretive acquisitions by the company, remains intact.

## Outlook

The outlook for small caps remains somewhat mixed, in our view. Investor concerns over rising inflation, a planned reduction in the Fed's purchase of bonds, higher interest rates, a looming debt ceiling vote, uncertainty in Washington, continued economic headwinds from supply chain disruptions, and ongoing fears of additional COVID outbreaks weighs on market sentiment and drives investors to the relative safety of larger cap companies or less risky assets. As one can surmise from the length of the list of concerns, there is definitely a decently sized "wall of worry" impacting investors. We believe many of these concerns are already "baked into the cake," noting that small cap growth stocks have experienced a significant amount of relative underperformance this year. Furthermore, small cap stocks tend to outperform as the economy accelerates and with the worst of the Delta variant seemingly behind us, most economists have 4th quarter GDP picking back up, after ratcheting down 3rd quarter growth expectations due to COVID. We also note that small caps tend to outperform in periods of rising interest rates, as this is generally a sign of an improving economy. The yield on 10-year US Treasury Bonds has started rising after bottoming in July 2021.

While growth stocks may continue to lag value if the economy experiences an acceleration due to supply chain improvements or as COVID fears wane, we remain confident in the outlook for growth stocks in the medium- to long-term, as high government debt levels may eventually weigh on outsized GDP growth, giving growth companies premium positioning with investors. We are cognizant of the negative impact rising interest rates typically have on long duration assets, characterized by high valuations and significant operating losses, and are positioning the portfolio accordingly.

This quarter was noteworthy for the Fund in that, staying true to a small cap focus and investing in smaller market cap companies, did not work as well as hanging on to “winners” which have now become mid-cap companies. In our post-mortem of the quarter’s performance, we noticed that the Fund’s smaller market cap holdings (those under \$1.8 billion in market cap) meaningfully underperformed investments above that cap range. Relative to the benchmark index, the portfolio maintained an overweight to smaller companies (under \$1.8 billion or less in market cap), which contributed to our performance shortfall. We observe that our Fund typically underperforms during significant rotations out of the smaller market cap range and during significant rotation towards value from growth. This quarter was true to form. We take some comfort in that prior periods such as late 2018/early 2019 and late 2016/early 2017, this phenomenon has been short lived. In closing, we remain highly confident in our time-tested investment process, the companies in the portfolio, and the new ideas we continue to uncover. As always, we appreciate your continued support over the long run. ▲

## 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](http://buffalofunds.com). Read carefully before investing.*

### Earnings growth is not representative of the Fund’s future performance.

As of 6/30/21 Buffalo Small Cap Fund top 10 equity holdings were Everi Holdings 2.09%, Cambium Networks 1.97%, Natera 1.89%, ICF Intl 1.87%, Castle Biosciences 1.85%, Phreesia 1.80%, Bandwidth 1.78%, CareDx 1.74%, Adtran 1.72%, Halozyme Therapeutics 1.65%. 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 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 3000 Index measures the performance of the 3,000 largest publicly held companies incorporated in the U.S. based on market capitalization. The Russell 3000 Growth Index is a market-capitalization weighted index that measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth rates. The Russell 3000 Value Index is based on the Russell 3000 Index, of companies with lower price-to-book ratios and lower expected growth rates which measures how U.S. stocks in the equity value segment perform. The Russell 1000 Index is a subset of the Russell 3000 Index and measures the performance of the 1,000 largest publicly-held companies incorporated in the U.S. based on market capitalization. The Russell Midcap Index measures performance of the 800 smallest companies in the Russell 1000 Index. 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 Microcap Index measures the performance of 2,000 small cap and micro cap companies. The Morningstar U.S. Small Growth Index measures the performance of U.S. small-cap stocks that are expected to grow at a faster pace than the rest of the market as measured by forward earnings, historical earnings, book value, cash flow and sales. The Lipper Small Cap Growth Fund Index is an unmanaged, equally weighted performance index of the 30 largest qualifying mutual funds (based on net assets) in the Lipper Small-Cap classification. One cannot invest directly in an index. Gross domestic product (GDP) is the monetary value of all finished goods and services made within a country during a specific period. A special purpose acquisition company (SPAC) is a publicly traded company created for the purpose of acquiring or merging with an existing company. Any investment should align with your objectives, risk constraints, time horizon, liquidity needs, and other factors relevant to your specific situation.

**Mutual fund investing involves risk. Principal loss is possible. The Fund invests in smaller companies, which involves additional risks such as limited liquidity and greater volatility than larger companies. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. This risk is greater in emerging markets.**

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

