

Buffalo Small Cap Fund

QUARTERLY
COMMENTARY

December 31, 2018

Capital Market Overview

The 4th quarter of 2018 was a rough period for equity markets, with steep declines dragging full year returns into negative territory. The S&P 500 Index declined -13.52% during the quarter, driven by fears of tightening monetary policy, escalating trade tensions, slowing global economic growth, and margin pressure from higher labor and freight costs. Investors sought safety in government bonds, driving the yield on the 10-year Treasury down from 3.06% at the end of the 3rd quarter to 2.68% at the end of the 4th quarter.

In a reversal of the year-to-date trend, value outperformed growth in the period, as the Russell 3000 Value Index declined -12.24% compared to a -16.33% drop in the Russell 3000 Growth Index. Large companies held up better than smaller companies during the quarter, as the Russell 1000 Index fell -13.82%, the Russell Midcap Index was down -15.37%, and the small cap Russell 2000 Index was down -20.20%. The only sector to post a positive return in the 4th quarter was Utilities. Real Estate, Consumer Staples, and Health Care were down but outperformed the market. Energy was the worst performing sector, driven by steep declines in crude oil. Technology, Industrials, and Consumer Discretionary also underperformed the broad market.

Performance Commentary

There were very few safe havens for small caps in the 4th quarter, as the asset class went from being a beneficiary of investor dollars due to having less international exposure during a period of trade wars... to the victim of a risk-off trade caused by all of the issues listed above. Furthermore, tax loss selling also forced some stocks to trade significantly lower during a period of low liquidity at year-end. Companies with higher debt levels and high growth stocks underperformed as one might expect, but surprisingly, lower valuation stocks did not outperform higher valuation stocks during the quarter.

The Buffalo Small Cap Fund declined -24.60% during the quarter versus the Morningstar U.S. Small Growth Index's decline of -21.44%, and ended the year just about in line with the Index at -5.78% vs the Index at -5.67%. While the Fund outperformed in Energy, Technology and Industrials, relative weakness largely in Health Care, Financials, Consumer Discretionary, and Materials weighed on relative returns.

Average Annualized Performance (%)

As of 12/31/18	1 YR	3 YR	5 YR	10 YR	15 YR	Since Inception
Buffalo Small Cap Fund	-5.78	8.34	2.57	11.61	8.02	10.67
Morningstar U.S. Small Growth Index	-5.67	8.57	5.53	13.89	8.14	5.35
Russell 2000 Growth Index	-9.31	7.24	5.13	13.52	7.96	5.38

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.

Fund Quick Facts

Ticker:	BUFSX
Inception Date:	5/21/2004
Net Assets:	\$428.03 Million
Expense Ratio:	1.01%
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



Alex Hancock, CFA

Co-Manager since 2017
B.A. – Dartmouth College



↑ Top Contributors

Air Transport Services Group (ATSG) provided the greatest contribution to the Fund, with the stock gaining 6% during the quarter. A provider of aircraft maintenance and support services and a beneficiary of the trend towards more e-commerce, ATSG had a late year move as Amazon inked a deal to lease 10 more planes from them, as Amazon continues to build out its own logistic capabilities for faster delivery to its customers.

↓ Top Detractors

Ligand Pharmaceuticals was the largest detractor from performance during the quarter. The company had been a large outperformer earlier in the year, and its financials benefited from a couple of larger milestone and license payments that will cause a tougher comparison for 2019. Some bears on the stock have also been critical of the company's pipeline of opportunities going forward. We continue to believe that the company's monoclonal antibody discovery platform (OmniAb) is not being appropriately valued in the company's share price.

Penn National Gaming also detracted from the Fund's performance this quarter. We believe Penn was weak during the quarter due to increased debt levels brought about by their recent purchase of Pinnacle Entertainment and possibly some concern over whether the company would be able to achieve the synergies they expect from the acquisition. We remain bullish on the fundamentals for regional casinos and Penn in particular as industry consolidation has brought about very rational marketing spend. Higher interest rates will likely help the traditional gaming customer, and sports betting should increase traffic as it gets implemented over the next few years.

Outlook

While the quarter was a disappointment to an otherwise solid year, we remain very excited about the companies in the Fund's portfolio. Valuations have become more attractive and sentiment around small caps has normalized. We believe the market has priced in a recession, and while we believe economic growth will slow in 2019, we do not believe we are headed for recession, unless the trade war and government shutdown last for an extended period of time or the U.S. Federal Reserve (Fed) gets too aggressive on interest rate hikes. We believe the Administration is sensitive to market movements and the risk declining markets can have on the overall economy, and would therefore prefer to make a deal with China. We also believe the Fed has suffered from poor communication about the likely path of future interest rate increases, but Chairman Powell is quickly learning from his mistakes. We have used this period of market weakness to take advantage of more attractive valuations in some existing positions and have started some new positions in stocks we missed at lower levels. We appreciate your continued confidence in us and look forward to hopefully better market conditions in 2019. ▲

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 it carefully before investing.

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

As of 9/30/18 the Buffalo Small Cap Fund top 10 equity holdings were Twilio 2.91%, The Trade Desk 2.28%, HMS Holdings 2.28%, Bio Techne 2.11%, Paylocity 2.07%, Dave & Busters Entertainment 1.98%, CyrusOne 1.95%, CoreCivic 1.92%, HealthEquity 1.91%, Exact Sciences 1.91%. 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 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 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 1000 Index is a subset of the Russell 3000 Index, which 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 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 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. It is not possible to invest directly in an index.

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.

