# Buffalo Small Cap Fund

QUARTERLY COMMENTARY

December 31, 2019

## Capital Market Overview

The combination of a U.S. Federal Reserve (Fed) interest rate cut, an improving economic outlook, and easing trade tensions, sent equity markets sharply higher in the 4th quarter. The S&P 500 Index advanced 9.10% during the period, which brought the full-year (2019) gain to 31.49%. The Fed cut interest rates three times in 2019, erasing the brief yield curve inversion and assuaging fears of a recession. The economy continued to add new jobs at a strong pace and unemployment declined to 3.5%. Consumer spending remained healthy, and there is optimism for better business investment following the announced "phase one" trade deal with China.

Similar to the S&P 500 Index, the broad-based Russell 3000 Index returned 9.04% during the quarter. Growth outperformed value, as the Russell 3000 Growth Index returned 10.62% compared to a return of 7.41% for the Russell 3000 Value Index. Smaller companies outperformed larger companies, as one would expect in a "risk-on" period. The Russell Microcap Index surged 13.45% and the Russell 2000 Index advanced 9.94%. Large company benchmarks such as the Russell 1000 Index advanced 9.04% while the Russell Midcap Index produced a return of 7.06%. Technology and Health Care were the best performing sectors in the quarter, while more defensive areas of the market lagged such as Real Estate and Utilities. Higher long-term interest rates weighed on high-quality bond proxies – the safe haven 10-year U.S. Treasury Bond produced a return of -1.74% during the quarter.

## Performance Commentary

The Buffalo Small Cap Fund produced a return of 12.99% during the quarter, outperforming the Morningstar U.S. Small Growth Index, which gained 9.11% during the same timeframe. Stock selection in Information Technology and Consumer Discretionary were key drivers of relative outperformance. Results were offset, in part, by weakness in the Real Estate and Telecom sectors.

For full year 2019, the Fund returned 40.97%, outperforming the Index return of 27.60% by over 13%. Calendar year outperformance was broad-based, driven by strong stock selection in Information Technology, Health Care, and Industrials. Results were slightly offset by weakness in Consumer Discretionary and Real Estate.

### Average Annualized Performance (%)

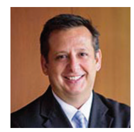
| *As of 12/31/19* | 1 YR | 3 YR | 5 YR | 10 YR | 15 YR | Since Inception |
|---|---|---|---|---|---|---|
| Investor Class - *BUFSX* | 40.97 | 19.06 | 11.36 | 11.89 | 8.67 | 11.91 |
| Institutional Class - *BUISX*[1] | 41.17 | 19.24 | 11.53 | 12.06 | 8.83 | 12.07 |
| Morningstar U.S. Small Growth Index | 27.60 | 14.21 | 10.26 | 13.42 | 8.99 | 6.28 |
| Lipper Small Cap Growth Fund Index | 30.25 | 16.01 | 10.80 | 12.89 | 8.51 | 7.26 |

*[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.*

## Fund Facts

| | *Investor* | *Institutional* |
|---|---|---|
| Ticker: | BUFSX | BUISX |
| Inception Date: | 4/14/98 | 7/1/19 |
| Expense Ratio: | 1.01% | 0.86% |
| Fund Assets: | $555.49 Million | |
| 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

During quarter, the sectors contributing the most to the Index's return were Health Care, Technology, and Consumer Discretionary. Health Care was particularly strong after experiencing weakness in the September quarter. The rebound in Health Care was driven by several factors including significant merger and acquisition (M&A) activity, which included six small- and mid-sized biotechnology companies during the quarter that lifted valuation multiples across the sector. Additionally, moderate Democrats, who are perceived to be friendlier to health care stocks, regained the polling lead over more progressive candidates in the Democratic primary, which reduced investor concern over pharmaceutical pricing pressure.

## ↑ Top Contributors

eHealth was the Fund's top contributor, with the stock increasing by 44% for the quarter. The company provides an online exchange where individuals and small businesses purchase health insurance. Strong performance has been driven by improved productivity from its sales force, solid enrollment growth in all segments, and optimism that recent investments will help sustain growth into the future. We remain optimistic about the long-term outlook for the stock as the company pursues the fast-growing Medicare-related health insurance market.

## ↓ Top Detractors

CyrusOne was the largest detractor to results during the quarter. The data center operator has reported consistently-strong operating performance, and its shares were bid up heavily in the September quarter on anticipation that it would be acquired. The stock sold off in October when company management reported they are not currently pursuing a sale and subsequently the potential "M&A premium" was let out of the share price.

## Outlook

Looking forward, we remain optimistic about the environment for small cap growth stocks in 2020. While absolute performance was strong in 2019, the small cap asset class lagged behind large caps overall. The S&P 500 Index returned 31.49% in 2019, which outperformed the Morningstar U.S. Small Growth Index return of 27.60% by nearly 4%. Although earnings of small cap stocks are poised to grow at a faster rate than large caps in 2020, we believe small caps are trading at relatively-favorable valuation when compared to large caps. This disparity could be a source of outperformance for the small cap asset class if valuations revert to more normalized levels.

In terms of portfolio positioning, Technology and Health Care are the two largest sectors in the Fund. Within Technology, component companies appear poised for accelerated growth out of an inventory correction, and many service and software companies are benefiting from digital transformations of corporate customers and a shift away from legacy, on-premise solutions to cloud-first providers. In the Health Care sector, we are positive on diagnostic companies due to more accurate tests and screens from newer, less-invasive technologies. We also favor suppliers into pharma and biotech companies as the research and development spending environment from these companies remains strong. Suppliers typically have less binary-event risk and better near-term revenue and cash flow characteristics than their customers, a risk-reward trade-off we prefer.

In spite of the overall optimistic tone in the marketplace, we recognize several factors that could drive volatility and downside risk. A policy misstep by the Fed or from key political figures are leading concerns. In 2019, the Fed's pivot on monetary policy demonstrated willingness by our nation's central bank to be flexible and "data-dependent" by cutting rates three times when there were signs of slowing economic activity.

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While trade dynamics seem to change on a daily basis, the rhetoric has died down considerably, and the U.S. and China appear set to ink a phase one agreement. With the presidential election less than a year away, we think it is unlikely President Trump re-escalates the trade war again before November. We believe that we are likely in the later innings of an abnormal economic cycle that has produced below-trend growth and a longer expansionary phase compared to historical averages. Signals that this economic expansionary period is slowing or ending would likely lead to significant market volatility. Furthermore, after the strong returns of 2019, many small caps are now trading at high absolute valuations as we enter 2020. These elevated valuations could serve to enhance small cap volatility as these factors play out.

Within this context, we have been managing the Fund actively, seeking to deploy capital into stocks that we believe have the most favorable risk/reward trade-offs. The Fund finished the year with 76 holdings (excluding cash), up from 73 at the end of the 3rd quarter. We continue to identify investment opportunities in smaller companies with strong secular growth opportunities that, in our opinion, could benefit from long-term trends trading at attractive valuations. As always, we appreciate your continued support and confidence in our investment capabilities over the long haul.


### 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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As of 9/30/19 the Buffalo Small Cap Fund top 10 equity holdings were Kornit Digital 2.54%, Natera 2.50%, MasTec 2.49%, CyrusOne 2.46%, ICF Intl 2.38%, PROS Holdings 2.35%, Monolithic Power Systems 2.12%, Hamilton Lane 1.95%, Air Transport Services 1.93%, Bio Techne 1.88%. Top 10 holdings for the quarter are not disclosed until 60 days after quarter end.



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 Microcap Index is an unmanaged capitalization weighted index of 2,000 small cap and micro cap companies. 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 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 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.