Buffalo Discovery Fund

QUARTERLY COMMENTARY

September 30, 2023

Capital Markets Review

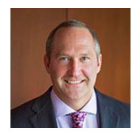
Capital markets pulled back in the third quarter of 2023 as the S&P 500 Index declined 3.27% and the Barclay's Aggregate Bond Index fell 3.23%. Rising bond yields and expectations that the Federal Reserve will maintain interest rates "higher for longer" weighed on investors sentiment. Inflation is trending down; however, it remains above the Fed's target of 2% leading to the central bank's hawkish tilt. Until recently, markets had been forecasting numerous interest rate cuts in 2024, a scenario that now looks unlikely. The yield of the U.S. Treasury 10-year note finished the period at 4.57%, up from 3.9% to start the year. Performance among eight of the ten economic sectors was negative during the period, but energy rallied over 12% as the price of oil surged 27% during the third quarter. Overall, economic growth appears to be slowing, but most economists are not calling for a recession in the near term.

Recapping broad-based index results, the Russell 3000 Index dropped 3.25%. Relative performance deteriorated going down in market capitalization (size) as small caps declined more than large caps in the quarter. Larger cap stocks produced a return of -3.15%, as measured by the Russell 1000 Index, compared to the smaller cap Russell 2000 Index return of -5.13%. The even smaller market cap Russell Microcap Index pulled back by -7.93% in the quarter.

Fund Facts

	Investor	*Institutional*
Ticker:	BUFTX	BUITX
Inception Date:	4/16/01	7/1/19
Expense Ratio:	1.01%	0.86%
Fund Assets:	$793.56 Million	
Category:	Mid Cap Growth	
Benchmark:	Russell Midcap Growth Index	

Management



Dave Carlsen, CFA

Manager since 2004
B.B.A. – Univ. of Wisconsin-Madison

Performance Commentary

The Buffalo Discovery Fund declined 6.20% for the quarter versus a decline of 5.22% for the Russell Midcap Growth Index. Outperformance in the healthcare and technology sectors was offset by underperformance from our energy-related holdings. Companies involved in clean energy and the construction of power transmission systems accounted for some of the fund's worst performers, while our underweight in traditional oil & gas producers was a headwind with crude prices rising nearly 30%. The rise in crude prices came on the heels of an OPEC production cut at a time when the country has record-low levels of inventory in the Strategic Petroleum Reserve. Our focus on innovative growth companies generally keeps us out of cyclical commodity investments such as oil exploration and refining.

Average Annualized Performance (%)

As of 9/30/23	1 YR	3 YR	5 YR	10 YR	15 YR	Since Inception
Investor Class - *BUFTX*	14.78	1.08	5.08	9.01	11.67	8.58
Institutional Class - *BUITX*[1]	14.95	1.23	5.25	9.18	11.84	8.74
Russell Midcap Growth Index	17.47	2.61	6.97	9.94	11.25	8.67
Morningstar Mid-Cap Growth Category	13.25	1.64	5.79	8.98	10.16	6.82

[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.

Beyond the energy sector, stocks were broadly weaker with rising interest rates weighing on equity valuations and investors mulling the mounting headwinds for consumer spending. Defensive sectors—consumer staples, healthcare, and utilities—have now underperformed for two consecutive quarters. This recent weakness appears due to unique issues, however, and not a broader rotation into cyclicals. Within healthcare, rising interest rates and an uncertain regulatory environment are serving to push up the cost of capital for biotech and pharmaceutical investments. There are also long-term concerns around the impact of new weight-loss drugs on companies that treat diabetes and obesity. Within consumer staples, stocks traded lower on reports of weaker grocery volumes and shoppers trading down to private label products.

The good news is that employment remains healthy, wages continue to rise, and inflationary pressures are moderating. Rising rates are creating a flatter yield curve, suggesting the market believes the Fed can tame inflation without inflicting too much damage on the economy. The bad news is the Federal deficit is projected at $2 trillion; that is simply not sustainable and could serve to push interest rates even higher. Leaders in Washington ultimately have some tough decisions to make, but meaningful changes are unlikely ahead of an election year. Through all the noise and uncertainty, the Buffalo Discovery Fund remains focused on its core mission: to invest in high-quality, disruptive growth companies that use innovation to create competitive advantage, all while maintaining a consistent discipline around valuation and risk. We believe this is a strategy that will continue to deliver attractive risk-adjusted returns over time.

↑ Top Contributors

Splunk, Inc. (SPLK) was the largest contributor to performance during the quarter. Splunk provides security and observability solutions, enabling companies to have greater control and insight into their data and digital operations. Cisco announced it would acquire the company for $30 billion, or $157/share, on September 21. Splunk agreed not to solicit other proposals and to pay Cisco a $1 billion termination fee if it chooses to accept a rival offer (although no competing offers are currently on the table). We believe the offer from Cisco is fair and expect the deal to close.

Global Payments (GPN) was another top contributor for the quarter. Global Payments provides payments technology and transaction processing for merchants, as well as software tools and solutions for card issuers. The company surprised investors with second quarter revenue and earnings above expectations. Merchant payment volume growth outpaced peers, assuaging any concerns about its competitive position. Management also raised the low end of its 2023 guidance ranges for revenue and earnings per share, citing a generally stable macro environment. Looking forward, the company should continue to benefit from the ongoing global shift from cash to credit and debit payments.

↓ Top Detractors

Double Verify (DV) was the top detractor for the quarter. The company is a leading software platform for digital media measurement and analytics. Investors had grown increasingly bullish on the stock following the announcement that Meta Platforms – the parent company of Instagram and Facebook – would allow Double Verify to deploy its audience measurement and brand safety tools within its News Feed and Reels products. Online ad spending was rebounding, as well, with the industry lapping changes to Apple's consumer privacy policies. Shares had soared 90% year-to-date into the release of second quarter results. The quarter, however, was simply in line with guidance with revenue rising 22%. Management suggested that recent enterprise account wins would have longer implementation lead times, and that brought down expectations for the third quarter. We continue to own shares of the company and believe it is executing well, bringing in new clients and expanding its product portfolio in digital media verticals such as social, streaming video, and retail. We expect 20%-plus growth will continue as consumer mindshare shifts from traditional media outlets to online platforms, and marketers are increasingly demanding independent analysis of advertising return on investment and brand safety.

MasTec, Inc. (MTZ) was also a detractor during the quarter. MasTec is an infrastructure construction company serving the communications, clean energy, power transportation, and oil & gas industries. The company reduced its revenue guidance for 2023, citing slower deployment of 5G networks and project delays in its power transmission and clean energy businesses. Some of the project delays were related to IEP, a company it acquired less than a year ago. This has investors questioning the depth of management's diligence on the deal. We acknowledge the near-term shortfall but expect revenue growth tied to clean energy and broadband to reaccelerate in 2024. We believe valuation is compelling at current levels.

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Outlook

Despite the recent market pullback, equities have generally performed well year to date, aided by resilient consumer spending and moderating inflationary pressures. Employment growth has not wavered despite tighter monetary policy, allowing the Fed to focus entirely on inflation within its dual mandate of price stability and full employment. Fed Chairman Powell has indicated that one more rate hike is possible this year, but interest rates are sufficiently restrictive to get the job done over time.

The most concerning issues today include the ongoing dysfunction in Washington and the government's lack of fiscal discipline. The U.S. is looking to issue $2 trillion in debt to finance next year's budget deficit. The combination of tight labor markets, the Fed's quantitative tightening, and a rising debt-to-GDP ratio could push long-term rates even higher than current levels. The sharp move in rates increases the risk that something in the economy breaks and we end up in a hard recession. Industries that require financing are already under pressure, including housing and big-ticket durables. We continue to expect cautious guidance from most companies this earnings season.

Against this backdrop, our strategy continues to focus on our favorite innovative growth companies with a heightened awareness of potential cyclical risks. We are investing in industry-leading franchises with strong balance sheets, scalable business models, and wide competitive moats. This long-term, risk-aware view has served us well and we believe it will lead to a continued compounding of attractive returns over time. Thank you for your continued trust and support.

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:

Christopher Crawford
ccrawford@buffalofunds.com
(913) 647-2321

Scott Johnson
sjohnson@buffalofunds.com
(913) 754-1537