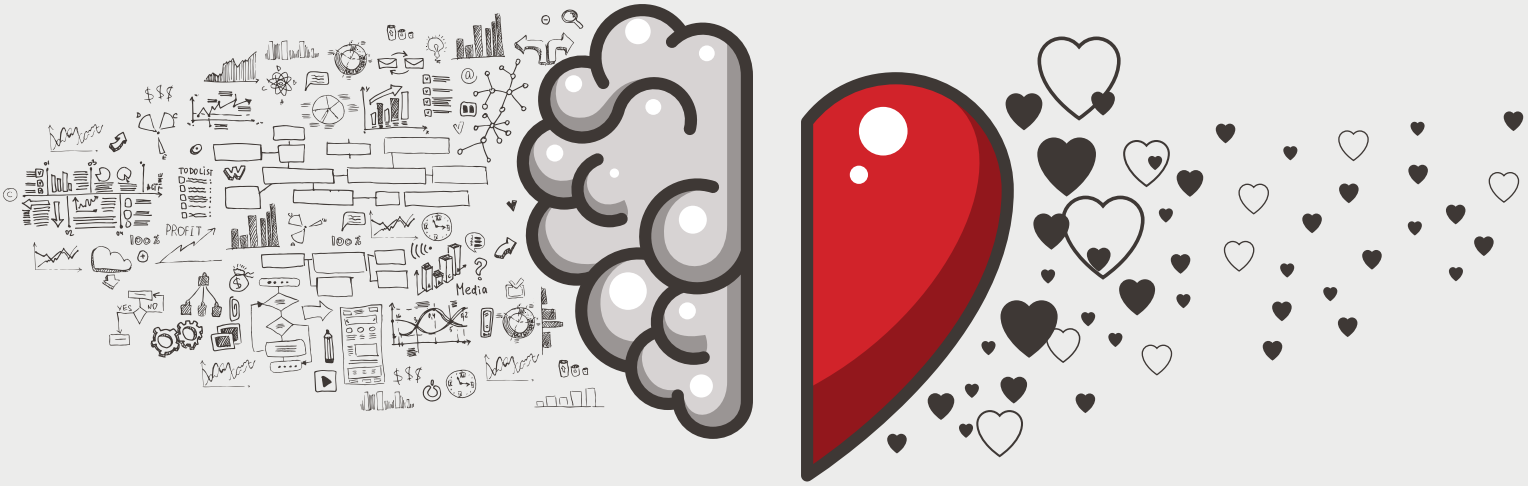
BUFFALO FUNDS



What to Do When Investor Sentiments and Market Fundamentals Don't Align?

We all know investing isn't about the day-to-day swings of the market – it's about long-term performance. Of course that doesn't stop us from compulsively checking our news feeds throughout the day for the latest headlines.

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As a financial advisor, you have the training to look past the hyperbolic headlines and focus on the information that may actually pertain to a given portfolio. However, imagine how your clients, who don't have your training or expertise, feel reading that stocks "surged" one day only to find that they "plunged" the next.

With all the recent volatility, the belief that the market is in a tailspin and it's time to pull out is widespread. *Financial Times* reports that investor expectations are softening not just in the U.S., but also internationally. However, the belief that the stock market is no longer bearing any fruit just isn't justified. To prove that's the case, let's take a look at how the stock market and the economy as a whole are actually fairing.

SENTIMENTS VS FUNDAMENTALS

THE SKY IS NOT FALLING.

Current economic conditions are still fairly strong.

GDP and earnings growth aren't as hearty as they were in 2017 or the first half of 2018, but still solid.

The China/U.S. trade war is closer to being resolved than just a few months ago. This should help investor confidence in global markets.

However, the biggest threat to the economy is arguably investor confidence itself. The act of spooked investors pulling their money out of equities could bring about the very thing they fear – a crash.

In the midst of all this doom and gloom, what's important to remember – and to explain to your clients – is that all these possibilities are still hypothetical. Everyone has predictions, but no one can see into the future. There's always somebody out there predicting something; it's only when they're right that self-proclaimed "gurus" play it up. More often than not, expert predictions are like one economist's infamous 2011 forecast that the Dow would crash to 3,000 by 2013: pure speculation.

As a financial advisor, the main message to your clients right now should be for them to put away their crystal balls and look at how the market is actually doing right now. The most recent data available shows that investors can assuage their worries about the prospects of a recession.

↑ 2%

STRONG GDP GROWTH

GDP growth, although slowing, remained above 2% as of December 2018, though Q1 could see 0% growth as a result of the past and potentially future government shutdown. In any case, this important measure of economic health doesn't indicate a contraction is occurring.

↓ 3.9%

A ROBUST JOB MARKET

December 2018 saw the most hiring in 10 months. Wages increased. The unemployment rate rose slightly from 3.7% to 3.9%, but only because 419,000 jobless Americans that weren't accounted for in previous unemployment rates decided to seek work again. Together, these stats show the private sector, for its part, is seeing plenty of demand for its products and services and expects that to continue at least into the near future.

↑ 10.8%

DOUBLE-DIGIT EARNINGS GROWTH

The annual earnings growth for the S&P 500, often used as a barometer of economic health, is currently estimated to be 10.8% for Q4 2018. Double digit earnings growth is widely considered to be a sign of a thriving private sector.

THE BOTTOM LINE

The thing is, this information is actually relatively well-known among investors – they just aren't comforted by it. That's why we should consider the possibility that something deeper is driving this anxiety. With the 2007-08 financial crisis still fresh in many people's memories, perhaps many of us have been conditioned to associate market downturn and recession with full-on collapse. While it would be overconfident to say that another financial crisis is impossible this time around, it is important to note that of the 33 recessions that have occurred since 1854, only two have earned the moniker "great." In other words, it's unlikely that the next recession will be anywhere near as bad as the Great Recession, and so should be easier to weather.

SET SENTIMENTS ASIDE AND FOCUS ON THE FUNDAMENTALS.

Even ignoring the various indicators pointing to a healthy economy, the stock market is hardly performing as poorly as the headlines might have you think. We have neither seen a decline of more than 20% in the S&P 500 Index nor had two consecutive quarters of decline in the S&P 500. Indeed, after dipping around Christmas time 2018, the stock market began yet another rally in January.

It's generally agreed upon that when there's a disconnect between how someone feels and how things really are, the best response is not to indulge them, but to persuade them that their thinking is unsound. The same is true of investment advisor's relationships with clients. Instead of pulling money out of the market, now may be the time to double down on mutual funds with strong fundamentals. Moving away from certain funds just because they have slid recently is a good way to ruin a strong portfolio. Because, while what an investor might think they're doing is selling while they can still get solid returns, what they really might be doing is losing out on potential gains.

This isn't to say that investors categorically shouldn't sell in this market. There may very well be funds that are unlikely to grow now that the market is more selective in the companies it rewards. But if the underlying fundamentals of the companies in a fund's portfolio are solid, there's no reason to back out of a good fund. Good mutual funds tend to bounce back, and by the time jumpy investors are ready to invest again, they've already missed out on some of the best returns.

However, if your client feels they have good reason to tinker with their portfolio, here are a few suggestions to help you get your clients their best possible returns in this market:

✔ LOOK FOR THE BRIGHT SPOTS

When volatility increases, "defensive-minded" funds can outperform so-called "cyclical" funds. Examples of the former include mutual funds that hold utilities, health care, and food stocks, while examples of the latter include funds that hold durable and non-durables (airlines, appliances, and fashion as well as retail, hospitality and other service sector stocks). Recent data bears the truth of this premise out: Utility and health care stocks saw annual returns of 4.1% and 6.5% respectively last year, compared to the S&P 500's 4.4% loss.

✔ BACK OFF ON PASSIVE STRATEGIES

Passive strategies, such as investing in index funds, may show strong returns in a bull market, but they're easily affected by volatility. Actively-managed funds that focus on company fundamentals, on the other hand, can perform much better during a rocky market. Instead of just tracking industries or indices, they're managed by some of the industry's top investment minds, and can be an easy way to get in on those "bright spots" in an otherwise topsy-turvy market.

✔ DON'T BE AFRAID TO BE A CONTRARIAN

In his intro to investing book "Nobody Knows Anything," author and stock analyst Bob Moriarty devotes an entire chapter to the concept of "contrarian investing." The basic argument is that investing isn't difficult, it just takes some common sense. However, most people follow the herd, and the herd by definition lacks common sense. So one should do the opposite of what the herd is doing. The lesson here is that just because everyone else is selling, that doesn't mean you should be. To repeat: Nobody really knows when the market will rise or fall — so stop worrying about buying low and selling high and start looking at fundamentals. In the long run, the market rewards strong fundamentals.

HOW LONG WILL THIS LAST?

Eventually, one of two things must occur: Either investor confidence will return to a level that actually matches the economy, or else the economy will slip to the level where investors think it is. Until then, savvy investors will continue to follow the strategy that the market dictates, not what the anonymous "investing community" believes is happening.

INTERESTED IN MORE INFORMATION?

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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ABOUT THE BUFFALO FUNDS

The Buffalo Funds are a family of 10 actively-managed mutual funds offering a variety of domestic equity, international equity, and income-generating investment strategies. We believe that patient investing backed by solid, intelligent research is the best way to achieve potential long-term financial rewards. Disciplined investment decisions are made using a distinct, time-tested investment approach guided by trend analysis, rigorous fundamental company research, and strict security valuation parameters.

Our fund family is characterized by a long-term growth investment strategy and a team-based, idea-sharing management style. "Trends and Patience" is our mantra, and our great strength.