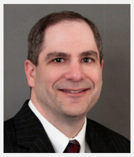
Outlook on High Yield Markets

"Views from a defensively-minded, high yield fixed income team"

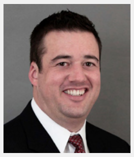
HIGH YIELD MARKET RECAP

BUFFALO HIGH YIELD FUND MANAGEMENT TEAM

Paul Dlugosch, CFA
Portfolio Manager



Jeff Sitzmann, CFA
Portfolio Manager



Jeff Deardorff, CFA
Portfolio Manager

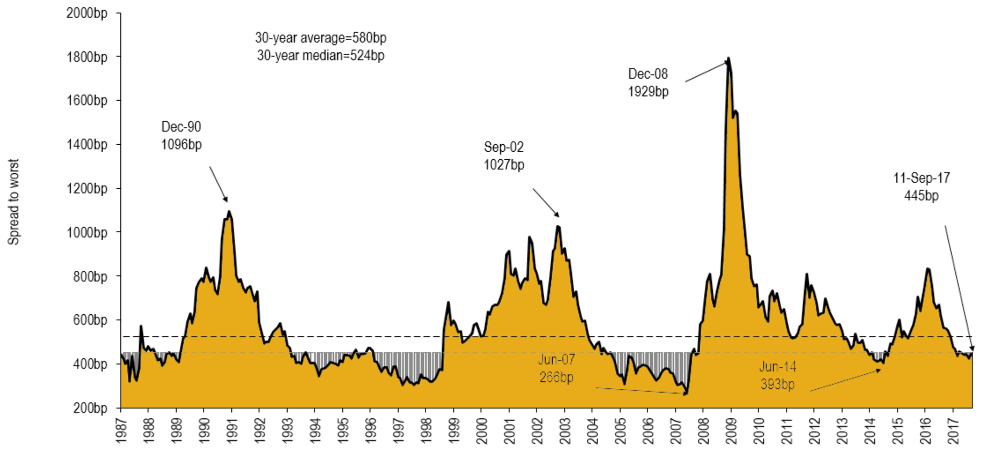
The high yield market (as measured by the BofA Merrill Lynch High Yield Master II Index) has rallied significantly since February 2016 and notched 20 consecutive months without posting a loss of 50 basis points (bps) or more. This has not occurred in over 20 years (February 1997).

According to data from JP Morgan (see Chart #1), high yield bond spreads have compressed from over 800 bps in early 2016 to 445 bps currently. Spreads now reside near cycle lows and below the 30-year average of 580 bps, as represented by the upper dotted line.

In our view the spread compression and high yield performance has been driven by numerous factors, including:

- A rebound in crude oil prices and improved access to capital for energy issuers has created an opportunity to recapitalize balance sheets and push out debt maturities;
- While modest, continued economic growth of the U.S. gross domestic product (GDP) has resulted in low default rates;
- Equity market indexes are continuing to reach record highs;
- A healthy labor market is creating additional jobs and the unemployment rate is near cycle lows.;
- Benign inflation has kept interest rates relatively low;
- The Federal Reserve is maintaining a gradual pace of increasing interest rates and timing of the plan to reduce their balance sheet;
- An improved economic outlook associated with anticipated new policies (e.g., lower taxes, deregulation, etc.) from the new Trump administration.

Chart #1 - High Yield Bond Spreads



(source: JP Morgan)

Past performance does not guarantee future results.

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MARKET DRIVERS

These favorable market conditions have resulted in investors buying riskier assets. The BofA Merrill Lynch High Yield Master II Index has increased 4.91% year-to-date through September 30th following a gain of 17.49% in 2016.

Looking at the results a bit closer, we see that certain risk trades have driven the high yield market's performance over the past year or so. Defaulted credits, the lowest quality grouping of issuers, which have violated their credit agreements/bond indentures, have outperformed the rest of the credit spectrum by a wide margin. Defaulted credits have returned about 44% over the last 12 months followed by CCC and non-rated segments with returns of 21% and 19.5%, respectively.

Metals and Mining companies led the industry sectors returning nearly 23% over the period as many defaulted credits mentioned above reside within that group. Metals and Mining companies are inherently one of the most risky to analyze and invest in due to the volatile nature of the underlying commodities, as well as the difficulty these companies have in producing consistent positive cash flows to service their debt obligations.

OUR VIEW ON TODAY'S HIGH YIELD MARKETS

We now believe the high yield market offers more risk than reward. While we are not forecasting an imminent recession, numerous factors could result in wider credit spreads down the road.

First and foremost, we are approaching 10 years since the last downturn in the business cycle, and this economic expansion is the second longest on record. We are likely in the back half of the current business cycle. The market for high yield securities remains well bid as yields and spreads bounce around cycle lows. The slowdown in new issuance activity has reduced the supply of bonds available for purchase, while slowing default rates have reduced investor's risk premium requirements. Credit quality remains decent but underwriting standards have weakened as illustrated by more covenant lite loans and a robust primary market.

OUR AREAS OF CONCERN

- Significant **bankruptcies in the retail space** that may result in substantial job losses
- The **Federal Reserve** taking a more aggressive tightening policy stance (i.e., a policy mistake by the government or monetary authorities)
- Fiscal **stimulus policy** not coming to fruition
- Continued **energy price declines**
- Escalation in **geopolitical issues** such as with North Korea
- Increasing **protectionism**

ACTION ITEMS FOR INVESTORS

Cautious positioning could be key. With spreads near cycle lows and many high yield bonds trading above par, we have been allocating a greater portion of our portfolio to higher quality credits. Our approach has historically been on the cautious end of the high yield credit quality spectrum, focusing primarily on the BB and B portions of the market.

We remain focused on credit quality and emphasize relatively short maturity bonds (those within 5 years) as a way to mitigate rising interest rates. Within this environment of low spreads and yields, our bias is on higher quality, non-investment grade issuers with defensive business models and manageable credit metrics.

Although higher quality debt may not appear "cheap" these days, we believe the time to upgrade quality is when market conditions are fairly stable rather than waiting to sell troubled credits in the midst of a market correction.

Additionally, new banking regulations limit the amount of inventory dealers are able to hold. Therefore, finding a willing buyer at attractive prices may be more difficult in the next downturn relative to the past. We believe securities with shorter durations and less cyclical business models will outperform the high yield group as a whole during times of distressed selling.

THE APPEAL OF BANK LOANS

We have increased exposure to bank loans in the past year as we feel this asset class offers a better risk/reward trade-off compared to traditional high yield notes. Bank loans also offer senior positioning in the capital structure and floating interest rates.

We believe bank loans currently have the potential to offer similar yields to traditional non-investment grade bonds while paying floating rates, which reduces interest rate risk if the Federal Reserve continues to increase the Federal Funds target rate, and global monetary authorities reduce their balance sheets as they begin to reverse their quantitative easing programs.

BE AWARE OF HIGH YIELD INDEX RISKS

With high yield credit spreads as tight as they are, there is less margin for error. Prudent investors should also be cognizant of sector and industry weightings within high yield benchmarks. Sector sizes for the most commonly used bond indexes are determined by the total debt outstanding within that group and not on the underlying fundamentals of those issuers.

> *"We believe security selection should be at the forefront of investment strategy, not sector selection based on the total amount of debt issued from a particular industry, by companies that may or may not survive the next downturn."*
>
> **Paul Dlugosch,** Portfolio Manager

For example, the energy sector accounts for roughly 15% of the BofA Merrill Lynch US High Yield Master II Index, and most energy credits are highly correlated to movements in the price of crude oil, which tends to be fairly volatile. Therefore, we have chosen to be underweight energy relative to the benchmark and to focus on companies who either hedge a majority of their oil production or operate in low-cost areas like the Permian Basin.

OUR APPROACH TO HIGH YIELD MARKETS

We take a cautious approach with our investment philosophy. We are willing to sacrifice some upside market potential while hedging in down markets, in order to potentially produce compelling risk-adjusted performance over a full market cycle.

We understand there is a trade-off involved with this philosophy, and, as a defensively-minded, high yield manager, this trade-off is acceptable.

Risk-adjusted returns matter to us. Our goal as managers of the Buffalo High Yield Fund is to generate higher total returns than the investment grade universe over the long run with low volatility. ◀

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ABOUT THE AUTHORS

Paul Dlugosch, CFA, Portfolio Manager, Buffalo High Yield Fund

Paul joined the Buffalo Funds in 2002 and has 20 years of professional investment experience. Previously Paul worked at Antares Capital as an associate and at LaSalle National Bank as an analyst. At the Buffalo Funds, Paul works with equity and fixed income portfolios. Paul received a B.S. from the University of Iowa.

Jeff Sitzmann, CFA, Portfolio Manager, Buffalo High Yield Fund

Jeff joined the Buffalo Funds in 2002 and has 30 years of professional investment experience. From 1997 to 2002, Jeff worked at BancOne Investment Advisors as a Fixed Income Analyst. From 1992 to 1997, he worked at Anthem as a Fixed Income Analyst. From 1987 to 1992, Jeff worked at Duff & Phelps as a Co-portfolio Manager and Investment Analyst. At the Buffalo Funds, Jeff works with both equity and fixed income portfolios, and his focus areas include media, consumer staples, and industrials. Jeff received a B.B.A. from the University of Toledo and an M.B.A. from the University of Chicago.

Jeff Deardorff, CFA, Portfolio Manager, Buffalo High Yield Fund

Jeff joined the Buffalo Funds in 2002 and has 20 years of professional investment experience. From 1997 to 2001, Jeff worked at Koch Industries in Convertible Arbitrage and as a Money Markets Trader. At the Buffalo Funds, Jeff works with fixed income and equity portfolios, and his focus areas include communications, energy, and financial sector. Jeff received a B.S. from Kansas State University.

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. Located in Mission, Kansas (a suburb of Kansas City), employee-owned Kornitzer Capital Management, Inc. (KCM) has been the exclusive investment advisor to the Funds since inception in 1994.

At KCM, 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.

"Seeking Growth Through Innovation"

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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Opinions expressed are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Definitions: "Basis points" (bps) are one hundredth of a percentage point (0.01%). A "spread" is the difference between the bid and the ask price of a security or asset. "High yield bond spreads" are the average risk premium offered by non-investment grade bonds compared to the yield on a 10-year U.S. Treasury note. "Spread to worst" measures the difference from the worst performing security to the best, and can be seen as a measure of dispersion of returns within a given market or between markets. The BofA Merrill Lynch HY Master II Index is an unmanaged index that tracks the performance of U.S. dollar denominated, below investment-grade rated corporate debt publicly issued in the U.S. domestic market. It is not possible to invest directly in an index. "Cash flow" is a measure of the cash produced by a firm in a given period on behalf of equity holders. The true measure of the value of a firm's equity is considered to be the present value of all free cash flows.

Credit ratings are grades given to bonds that indicate their credit quality as determined by a private independent rating service such as Standard & Poor's. The firm evaluates a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. In limited situations when the rating agency has not issued a formal rating, the independent rating service will classify the security as non-rated.

Diversification does not assure a profit or protect against loss in a declining market.

Past performance is not a guarantee of future results. Index performance is not illustrative of fund performance. Please visit buffalofunds.com or call (800) 49-BUFFALO for fund performance.

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

Mutual Fund investing involves risk. Principal loss is possible. The Fund invests in small and mid-cap companies, which involve additional risks such as limited liquidity and greater volatility than large-cap companies. The Fund invests in foreign securities which involve greater volatility and political, economic, and currency risks as well as differences in accounting methods. Past performance does not guarantee future results.

The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory prospectus contains this and other important information about the investment company, and may be obtained by calling (800) 49-BUFFALO or visiting buffalofunds.com. Read carefully before investing.

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