

October 2008

Dear Shareholders, Friends of Needham, and Prospective Shareholders:

We are pleased to report in Exhibit A (attached) the performance results for the Needham Small Cap Growth Fund (“NSCGF,” or the “Fund”), NASDAQ symbol NESGX, for the quarter ended September 30, 2008 (“3Q08”), the 12 months ended September 30, 2008 (“1 Year”), the three-year period ended September 30, 2008 (“3 Years”), the five-year period ended September 30, 2008 (“5 Years”), and from May 22, 2002 to September 30, 2008 (“Since Inception”). The Fund was down 4.12% for 3Q08, down 10.56% for the 1 Year, down 0.21% for the 3 Years, up 4.39% for the 5 Years, and up 10.34% Since Inception, compounded annually.

Investment returns and principal value will fluctuate, and when redeemed, shares may be worth more or less than their original cost. Shares held less than 60 days are subject to a short-term redemption fee of 2%. The results contained in this report represent past performance of the Fund. Past performance does not guarantee future results and current performance may be higher or lower than these results. Current month-end performance is available at www.needhamfunds.com.

Investment Strategy

The Fund seeks long-term, tax-efficient capital appreciation by investing primarily in equity securities of smaller growth companies that the Fund believes are trading at a discount to their underlying value yet have the potential for superior long-term growth. Under normal conditions, the Fund invests at least 80% of its net assets in equity securities of domestic issuers that have market capitalizations not exceeding \$2 billion or the highest market capitalization in the Russell 2000[®] Index, if greater, and that are listed on a nationally recognized securities exchange or traded on the NASDAQ System. The highest market capitalization in the Russell 2000[®] Index as of September 30 was \$3.789 billion. Central to the Fund’s investment strategy is a sound valuation discipline that seeks to acquire growth companies at reasonable prices. The Fund seeks tax efficiency by offsetting capital gains on the sale of securities with capital losses, but where there is an uncovered gain, it will be a long-term capital gain taxed at more favorable rates.

Investment Profile

As of September 30, 2008, NSCGF’s sector holdings consisted of the following:

Sector	Long ⁽¹⁾	(Short) ⁽¹⁾	Total ⁽¹⁾⁽²⁾
Healthcare	2.3%	(0.5)%	1.8%
Energy	–	–	–
Industrial	4.8%	–	4.8%
Financial Services	–	–	–
Business Services	7.2%	–	7.2%
Consumer	0.9%	(0.8)%	0.1%
Technology	43.7%	(1.7)%	42.0%
Telecommunications/Cable	11.6%	–	11.6%
Cash	32.5%	–	32.5%
			100.0%

(1) Based on percentage of total investments as of 9/30/08, which includes all stocks plus cash minus all short positions.

(2) Total represents the difference between the long exposure and the short exposure, which produces the net exposure.

NSCGF's top ten holdings at September 30 (in descending order of market value) were Hutchinson Technology, Inc., ICx Technologies, Inc., Airvana, Inc., Brooks Automation, Inc., Compton Petroleum Corp., Entegris, Inc., Parametric Technology Corp., Tessera Technologies, Semitool, Inc. and Actuate Corp. The top ten holdings represented 45.87% of total investments versus 37.87% on June 30, 2008. Please note that these portfolio holdings may not be indicative of future portfolio holdings and may change at any time. At the end of the third quarter, the market value of stocks sold short represented 3.00% of the total investments held by NSCGF.

Investment Analysis

As we entered the third quarter after a disappointing June, we remained cautious in our investment strategy as the credit crisis continued to spread from region to region and the potential severity of a global recession seemed greater every day. We visited with management teams and grew ever increasingly more concerned that both the credit and economic situation would further deteriorate. Consequently, we continued to avoid direct investments in retail, consumer discretionary and financial companies as these industries remained most at risk. We exited high multiple valued companies and avoided those exposed to excessive leverage and weak balance sheets. We remained invested in companies that could benefit from essential/required capital investment programs. These primary industries included server and data storage, wireless infrastructure, semiconductor capital equipment and software.

As we have discussed in prior quarterly letters, we have been fortunate to make opportunistic investments in broken IPOs of quality companies. This strategy delivered four of our top ten positive contributors for the quarter and included our top performer, Super Micro Computer (SMCI), a company that designs, develops, manufactures and sells server solutions based on modular and open-standard architecture. Another example of this strategy was our investment in Netezza (NZ), which we profiled in our last quarterly letter. The other two names were Airvana (AIRV) and ICx Technologies (ICXT). We have now positioned ICXT as our second largest holding as the company continues to execute on its long-term strategy by receiving further surveillance and detection contracts.

Arris Group (ARRS), a supplier in the roll-out of DOCSIS 3.0 within the cable industry, was a positive contributor throughout most of the quarter. We were able to enter the position at a reasonable valuation during the early part of the year. However, as the quarter progressed and we began to see risk to capital budgets, we exited the position before a substantial slide in the stock price. We would expect to return to the name once we have better clarity on capital budgets and an attractive valuation.

Throughout the quarter, as markets continued to decay, we raised our cash positions to preserve capital and minimize the impact of the dramatic downturn, which ultimately arrived in September and accelerated in early October. Although we were able to exit positions most susceptible to a deleveraging market, there were a few names that were disappointments. The two worst performing investments were in the energy sector. Compton Petroleum (CMZ) posted the most significant decline when we expected the name to maintain value due to its announcement of a data room to sell the entire company. This process seems to be continuing into the middle of October and should hopefully prove to be a long-term winner for the Fund. Another area that we exited was investments that had significant exposure to the budgets of colleges, municipalities and hospitals. These three buyer groups faced increased capital constraints as the credit markets and auction rate crisis continued. Two names that we reduced or exited were Tomotherapy, Inc. and Aruba Networks.

Investment Outlook

Although governments around the world have recently taken more direct actions to stabilize credit markets, we do not believe the negative ripple effects of the crisis are over and may have lasting repercussions. We will continue to remain vigilant during these turbulent markets. October has started off as one of the worst periods in history and certainly since the Great Depression of the 1930s. We expect the markets to remain volatile with reduced visibility. We believe the world economy has been in a recession for sometime and will continue to remain in one in the foreseeable future. As the market continues to correct, we hope to see an increasing number of potential investments that will allow us to enter some new positions during the fourth quarter at attractive investment entry points.

Closing

I want to thank you again for your continued support. If you have any questions, thoughts or concerns, please do not hesitate to contact us at (800) 625-7071 or visit our Web site at www.needhamfunds.com.

Sincerely,



Chris Retzler
Portfolio Manager

This report is not an offer of the Needham Small Cap Growth Fund. Shares are sold only through the currently effective prospectus, which must precede or accompany this report. *Please read the prospectus and consider the investment objectives, risks, and charges and expenses of the Fund carefully before you invest. The prospectus contains this and other information about the Fund. Investment returns and principal value will fluctuate, and when redeemed, shares may be worth more or less than their original cost. Shares held less than 60 days are subject to a short-term redemption fee of 2%. The results contained in this report represent past performance of the Fund. Past performance does not guarantee future results and current performance may be higher or lower than these results. Current month-end performance is available at www.needhamfunds.com.* Total return figures include reinvestment of all dividends and capital gains. The investment risks of the Fund are increased by the Fund's non-diversified status and by the Fund's ability to invest in smaller company stocks, privately held companies and IPOs. Also, the Fund's use of short sales, options, futures strategies and leverage may result in significant capital loss. Funds holding smaller capitalized companies are subject to greater price fluctuation than those of larger companies.

To obtain a copy of the Fund's current prospectus, please contact the Fund's transfer agent, Citi Fund Services Ohio, Inc., at (800) 625-7071.

Needham & Company, LLC, member NASD/SIPC, is the distributor of The Needham Funds, Inc.

Exhibit A

Our performance relative to the major indices for these periods is as follows:

	3Q08 ⁽⁶⁾	1 Year ⁽⁷⁾	3 Years ⁽⁸⁾⁽⁹⁾⁽¹⁰⁾	5 Years ⁽⁸⁾⁽¹¹⁾⁽¹²⁾	Since Inception ⁽⁸⁾⁽¹³⁾⁽¹⁴⁾
Needham Small Cap Growth Fund ⁽¹⁾⁽²⁾	-4.12%	-10.56%	-0.21%	4.39%	10.34%
Needham Small Cap Growth Fund (after taxes on distributions)	-4.12%	-13.18%	-2.81%	2.74%	8.97%
Needham Small Cap Growth Fund (after taxes on distributions and redemption)	-2.68%	-2.94%	0.06%	3.93%	9.22%

Benchmarks	3Q08 ⁽⁶⁾	1 Year ⁽⁷⁾	3 Years ⁽⁸⁾⁽¹⁰⁾	5 Years ⁽⁸⁾⁽¹²⁾	Since Inception ⁽⁸⁾⁽¹⁴⁾
S&P 500 Index ⁽³⁾	-8.74%	-23.00%	0.22%	5.16%	3.31%
NASDAQ Composite Index ⁽⁴⁾	-9.07%	-23.05%	-0.14%	3.94%	4.85%
Russell 2000 Index ⁽⁵⁾	-1.39%	-16.48%	1.86%	8.18%	6.74%

1. Total Annual Fund Operating Expenses are 2.50%.
2. Investment results calculated after reinvestment of dividends.
3. The S&P 500 Index is a broad unmanaged measure of the U.S. stock market.
4. The NASDAQ Composite Index is a broad-based capitalization-weighted index of all NASDAQ Global Market and Small-Cap stocks.
5. The Russell 2000 Index is a broad unmanaged index composed of the smallest 2,000 companies in the Russell 3000 Index.
6. 7/1/08 – 9/30/08.
7. 10/1/07 – 9/30/08.
8. Compound annual growth rate. Assumes all dividends are reinvested in shares of the Fund.
9. Cumulative return for the three years was (0.63%), assuming all dividends were reinvested in shares of the Fund.
10. 10/1/05 – 9/30/08 (annualized return).
11. Cumulative return for the five years was 23.96%, assuming all dividends were reinvested in shares of the Fund.
12. 10/1/03 – 9/30/08 (annualized return).
13. Cumulative return since inception was 86.94%, assuming all dividends were reinvested in shares of the Fund.
14. The inception date of the Fund was 5/22/02. 5/22/02 – 9/30/08 (annualized return).

Note: The average annual returns shown in the above table and accompanying footnotes are historical, reflect changes in share price and are net of expenses. Investment results and the principal value of an investment will vary. Past performance noted above does not guarantee future results. When shares are redeemed, they may be worth more or less than their original cost. Since inception, the Fund's Adviser has absorbed certain expenses of the Fund, without which returns would have been lower.

The after-tax returns are shown in two ways: (1) assuming that an investor owned the Fund during the entire period and paid taxes on the Fund's distributions; and (2) assuming that an investor paid taxes on the Fund's distributions and sold all shares at the end of each period.

After-tax returns are calculated using the highest historical individual federal income tax rate and do not reflect the impact of state and local taxes. Actual after-tax returns depend on an investor's tax situation and may differ from those shown, and after-tax returns shown are not relevant to investors who hold their Fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts.