

January 2009

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 (“NESGX,” or the “Fund”), NASDAQ symbol NESGX, for the quarter ended December 31, 2008 (“4Q08”), the 12 months ended December 31, 2008 (“1 Year”), the three-year period ended December 31, 2008 (“3 Years”), the five-year period ended December 31, 2008 (“5 Years”), and from May 22, 2002 to December 31, 2008 (“Since Inception”). The Fund was down 17.42% for 4Q08, down 23.42% for the 1 Year, down 6.62% for the 3 Years, down 1.72% for the 5 Years, and up 6.79% 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 December 31 was \$3.283 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 December 31, 2008, NESGX’s sector holdings consisted of the following:

Sector	Long ⁽¹⁾	(Short) ⁽¹⁾	Total ⁽¹⁾⁽²⁾
Healthcare	0.2%	–	0.2%
Energy	–	–	–
Industrial	0.7%	–	0.7%
Financial Services	–	–	–
Business Services	8.6%	–	8.6%
Consumer	–	(3.7)%	(3.7)%
Technology	31.4%	–	31.4%
Telecommunications/Cable	13.4%	–	13.4%
Cash	49.4%	–	49.4%
			100.0%

(1) Based on percentage of total investments as of 12/31/08, 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.

NESGX's top ten holdings at December 31 (in descending order of market value) were Aspen Technology, Inc., ICx Technologies, Inc., Anaren, Inc., Super Micro Computer, Inc., MKS Instruments, Inc., STEC, Inc., Airvana, Inc., Eclipsys Corp., iRobot Corp. and Netezza Corp. The top ten holdings represented 37.65% of total investments versus 45.87% on September 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 fourth quarter, the market value of stocks sold short represented 3.72% of the total investments held by NESGX.

Investment Analysis

The fourth quarter of 2008 proved to be one of the most challenging investment environments in recent history and significantly contributed to one of the worst annual performances for equity investments. The performance of NESGX exceeded comparative indices and was a leader in the small capitalization growth category. A combination of high-quality companies and our defensive position of a mixture of short positions and cash going into the fourth quarter helped to mitigate the downward pressure we faced across most all industries. Our top performing investment ideas were in wireless infrastructure and defense oriented names. Anaren, ViaSat and ICx Technologies were our three top performers for the quarter. However, we were not immune to the downward market trends and returned a disappointing loss for the quarter and year. A combination of deteriorating credit markets, forced selling due to redemptions and liquidations, and heightened recessionary indicators were among the items that pressured the markets. Our worst performing names were in the hard disk drive sector, semiconductor capital equipment and, to a lesser extent, our small energy exposure, and they included Hutchinson Technologies, Compton Petroleum and Parametric Technology. We have since reduced these positions and were able to utilize these losses against earlier realized capital gains in 2008. Our dividend in November could not be mitigated as those gains were realized during the end of 2007 and had to be distributed in the 2008 tax year. Consequently, we remained vigilant in minimizing any taxable gains for the remainder of 2008 as we know our investor base seeks tax efficiency.

During December, a few equity names we have monitored became attractively valued. As a result of these valuations, we initiated modest positions with caution to any further deterioration in the equity markets. We continue to remain negative on financial and consumer discretionary names, and have added to shorts in consumer driven stocks. We also added short positions that supply the financial community, as we expect budgets to be reduced at end-customers that will ultimately impact sales and growth for these names.

We will closely monitor the semiconductor capital equipment makers as the sector continues to face a lack of end customer orders. Utilization rates in the semiconductor sector have significantly reduced the need for new capital equipment and repairs; however, this cycle in the semiconductor markets has been better managed than previous downturns, and we may see a sharp downturn followed by a sharp upswing. We remain cautious on the sector at this time but will expect to deploy capital if the opportunity and valuation become even more attractive.

We would like to take a moment to address the higher than normal levels of cash held in the Fund. Typically, the Fund invests at least 80% of its net assets in small capitalization equity securities of domestic issuers. Due to the abnormal market conditions that we have faced over the past year, we have maintained, and continue to maintain, a higher than usual cash position until we observe a more normal investment environment.

Investment Outlook

The economic environment continued to deteriorate at an accelerating pace throughout the fourth quarter despite unprecedented moves to stabilize and revitalize both the economy and financial markets by the Federal Government. Although not expected, most of these actions had limited near-term positive impact on the price of stocks and will require an extended period of time to have a meaningful benefit to the fundamentals of the economy and companies. We believe that our government and those in other countries are focused on taking most any action necessary to stop the downward economic spiral, but we are also well aware of the enormous problems facing the global economy.

We expect the new administration to work on the passage of a much anticipated stimulus package with a focus on multiple areas of infrastructure. We are realistic in our near-term expectations of any quick solution to the economic problems, as we believe any economic stimulus package or fiscal policy changes will require time to filter through the system, and we do not expect an immediate end to the current economic situation. We remained on the sidelines with regards to any long exposure to financial and consumer discretionary stocks. We do not believe that their troubles are over and will most likely persist into 2009 for some time. As always, we will continue to monitor these volatile times and wait for positive indicators of an all clear sign before we make a more substantial commitment to a return to a more normal investment environment.

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:

	4Q08 ⁽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⁾	-17.42%	-23.42%	-6.62%	-1.72%	6.79%
Needham Small Cap Growth Fund (after taxes on distributions)	-18.91%	-24.80%	-9.15%	-3.62%	5.22%
Needham Small Cap Growth Fund (after taxes on distributions and redemption)	-9.46%	-13.49%	-5.07%	-1.10%	6.23%

Benchmarks	4Q08 ⁽⁶⁾	1 Year ⁽⁷⁾	3 Years ⁽⁸⁾⁽¹⁰⁾	5 Years ⁽⁸⁾⁽¹²⁾	Since Inception ⁽⁸⁾⁽¹⁴⁾
S&P 500 Index ⁽³⁾	-21.94%	-37.00%	-8.34%	-2.19%	-0.62%
NASDAQ Composite Index ⁽⁴⁾	-24.37%	-39.98%	-9.81%	-3.95%	0.32%
Russell 2000 Index ⁽⁵⁾	-26.12%	-33.79%	-8.25%	-0.88%	1.69%

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. 10/1/08 – 12/31/08.
7. 1/1/08 – 12/31/08.
8. Compound annual growth rate. Assumes all dividends are reinvested in shares of the Fund.
9. Cumulative return for the three years was (18.56%), assuming all dividends were reinvested in shares of the Fund.
10. 1/1/06 – 12/31/08 (annualized return).
11. Cumulative return for the five years was (8.33%), assuming all dividends were reinvested in shares of the Fund.
12. 1/1/04 – 12/31/08 (annualized return).
13. Cumulative return since inception was 54.37%, assuming all dividends were reinvested in shares of the Fund.
14. The inception date of the Fund was 5/22/02. 5/22/02 – 12/31/08 (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.