Homestead Funds

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Q1 2020 Market Review: A Shock to the System

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Mark Santero:
Hello, this is Mark Santero, CEO and president of Homestead Funds. I want to thank everybody for jumping in and listening to our first quarter market review. First and foremost, before we get started, I hope everyone is safe and well and is dealing with the pandemic. I want everyone to know that Homestead Funds is operating smoothly, and we are working remotely but with no interruptions to our service and support.

Without further ado, I'd like to talk to everyone about our agenda and then I'm going to turn it over to our two portfolio managers who will be speaking today: Mauricio, our senior fixed income portfolio manager, and Prabha, our senior equity portfolio manager.

What we'd like to cover today is our macroeconomic conditions and factors, the funds' absolute and relative performance, those funds' drivers of return, and then what I think everybody wants to hear, our outlook and fund positioning as we're now into the second quarter.

I'm going to turn it over to Prabha to give a brief update on the first quarter and the shocks to the equity markets.

Prabha Carpenter:
I echo Mark's sentiments. We hope you are all doing well. As we all know, the global pandemic, COVID-19, has brought to a halt an almost 11-year rally in the stock market. The U.S. Federal Reserve and other central banks have implemented policy initiatives on the monetary policy front, and the U.S. Congress, U.S. leaders and global leaders have implemented fiscal initiatives on the spending front. The equity markets have bounced back from the March 23 lows. We are down, but we have recovered some of our losses. We are awaiting news on the health care, therapeutic and vaccine fronts, and we are hoping for a gradual return to normalcy. Now I'll turn it over to my colleague, Mauricio, for fixed-income thoughts.

Mauricio Agudelo:
As you mentioned, the Fed stepped in during the quarter and cut rates during two emergency sessions. The first cut, 50 basis points — the second cut, 100 basis points in March — driving rates all the way down to zero. More importantly, the Fed brought back facilities that were put in place during 2008, and they also added the purchasing of corporate bonds to support the credit market.

We will now go into the performance review for the first quarter for the Short-Term Bond Fund. During the quarter, the fund posted a positive 1.27% absolute return trailing the benchmark by 68 basis points. What didn't work for the fund this quarter? Our long-term position in asset backed securities (ABS) detracted from performance and also our position in industrials, particularly the energy sector, the pipelines.

What worked for the quarter? The duration component of the fund and our exposure to Treasurys that we had ramped up during 2019. Now taking a look at the composition of the portfolio for the quarter, the duration remains fairly close to the benchmark. We took advantage during the quarter to add more corporates.

Looking into the Intermediate Bond Fund performance, the situation is very similar versus the Short-Term Bond Fund for the quarter. We trailed the benchmark by 97 basis points. The asset-backed sector also detracted from performance for this fund, and also the agency sector where we hold an underweight allocation.

What worked for the Intermediate Bond Fund? Our exposure to agency mortgage-backed securities, particularly the 3.0 the 3.5 coupon stack at a time when the Fed stepped in with a quantitative easing to support the mortgage-backed security market. And with that, the portfolio snapshot for the quarter, the duration is fairly close to the benchmark. Although at these levels of rates, we feel that is not as punitive going forward, the direction component of the portfolio relative to the benchmark.

Mark Santero:
Now I would like Prabha to talk about our two equity portfolios that we manage, first the Value Fund.

Prabha Carpenter:
The next slide shows the performance review of the Value Fund. The Homestead Value Fund, as you can see from this slide, has outperformed in every performance period listed versus the Russell 1000 Value benchmark. In a very competitive space like large-cap, we are indeed proud of our record.

What worked? The next slide will show you some of the performers and detractors. What worked for Value Fund in the quarter and over the long haul has been the overweight position in information technology and health care. Information technology in general has been one of the best-performing and most defensive sectors year to date, as at quarter-end. And some of the names you can see in the top 10 holdings — like Microsoft — are representative of the type of companies in the space. They're high-quality businesses with strong returns on invested capital. Microsoft is strong in Azure enterprise cloud computing and Office 365. Gross margins reached a six-year high, leading to earnings per share (EPS) growth of 37% year over year, and it has a fortress balance sheet.

Another top performer in info tech for the period was NVIDIA. The stock has been up double-digit year to date with the benchmarks down, and the company's data center in gaming graphics chips have buoyed results. In the health care space, Abbott, a long-term holding, has contributed to results. Health care has been a historical overweight. It's been ballast to the portfolio, and it's a combination of defensive and growth characteristics. Abbott with its initiatives on COVID testing is at the vanguard of improving living conditions for all.

What didn't work in the period were consumer staples, which underperformed. At the bottom of the same page, you see the valuation metrics, and I would point out the return on equity on a portfolio is 21.1% versus the Russell 1000 Value Index at 14.6%. Return on equity shows how profitable a company is for the shareholder, and these are very attractive numbers.

Now I'll go to the Homestead Small-Company Stock Fund. The performance page is this slide. As you can see, we outperformed the benchmark, the Russell 2000, for the quarter, for the one-year period and since inception. Info tech and health care sectors also led performance in this fund. And on the next slide you can see the top holdings. ManTech has been a long-term holding, a beneficiary of government IT outsourcing and growth. Five9 in the cloud-based contact center software setting has had strong demand with everyone working remotely. It's a big addressable market, and earnings have been compounding at double-digit rates.

LHC, a health care provider, with a high star rating for high-quality care, has also been a good performer during the period. And I would again point out at the bottom part, the return on equity for the fund is substantially higher than that of the Russell 2000. Detractors in this portfolio were some industrials and materials. Now I'll turn it back over to Mark.

Mark Santero:
As I said, where we were at the lows in the market on March 23 for the equity market and all of the dislocations and credit those first two weeks, it was a tale of two quarters. Literally, within a quarter — the January and February great performance, mid-March the roof caved in. So, what's ahead now that we're almost at the end of April and we've seen some market recovery? I'd like to turn it back over to Prabha and Mauricio to talk about what we see going forward. And Prabha, I think you have the first slide.

Prabha Carpenter:
Although we have faced and are facing a period of volatility and uncertainty over the near term, active management should outperform during these types of periods. And this first slide shows active managers through a full market cycle. This data is from Morningstar and Baron Capital. Active managers through a full cycle includes the bull phase, the bear phase and the full phase, and bar charts in the middle — I call it mustard brown, others may have a different description — but it shows stronger performance during bear markets. This is evident with the spike in those charts, and our performance reflects this experience.

And the next slide shows part of the same study. It reveals that in the large-cap category, the top-performing active managers have delivered positive returns over the full market cycle. And top performing is defined as managers who ranked in the top half of all large-cap managers, at least 60% of the time, based on three-year rolling monthly returns. It's a testimony to our efforts, process, skill and experience. And now I'll turn it back to Mauricio.

Mauricio Agudelo:
Prabha, as you mentioned, this is the time for active management to shine, and we are fairly confident in our process both on the equity and the fixed-income side. This is a chart that we displayed during the prior review for the fourth quarter of 2019. As we see here, the credit spreads during the quarter — as Mark mentioned, it was a tale of two halves. The second part of the quarter, we saw massive spread widening; investors were concerned about the effect of the COVID-19 crisis and the stress that it was putting to corporations — an event that basically came out of nowhere. As we see here, crazy spreads widened to levels not seen in the past 30 years, excluding the financial crisis. I would point out here the velocity of this spread widening was very fierce. It lasted all of about three weeks or so, and on the fiscal side, we've learned from ’08 in particular, the Fed reacted in a quick manner to bring back facilities used in 2008, and more importantly they put in place facilities to support the credit market, including purchases of corporate bonds.

What did we do in this regard and how are we positioned? Looking ahead, the team during the quarter took advantage of this dislocation in credit to deploy some of the Treasurys into frontend high-quality corporates when the spreads were near the widest levels and once we had full certainty that the Fed would provide a lifeline to the marketplace. As such, we are now holding an overweight position in both industrial and financial sectors for the Short-Term Bond Fund and as well for the Intermediate Bond Fund portfolios.

I'll pass it on to you now, Mark.

Mark Santero:
So that concludes our first quarter market review, and hopefully it's given you a little bit of food for thought going into now the second quarter and what we might expect. Although markets have stabilized, they continue to be volatile. As Prabha pointed out, until we have some type of clarity on the duration of the pandemic — a vaccine or therapeutics insight to mitigate the damages that the virus causes on individuals — the markets will in our opinion continue to be somewhat volatile. We are here to support your investments. Our people are on the phones. You can email me, you can call me if you have any questions on the presentation or on your individual holdings in the Homestead Funds. We want to thank you again, and we hope that you remain safe and well.

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