Quarterly Market Review

Third Quarter 2014

Homestead Funds

Summary

- Where rates are concerned, there seems to be no rush at the Fed to get back to normal. Higher interest rates seem unlikely in 2014; more likely next year.
- Positive price/earnings multiples, a key metric for determining equity valuations, showed that while stock prices look high in the short-term, strong long-term valuations were still in evidence.
- Small-cap and large-cap performance diverged sharply during the quarter, indicating that the U.S. business cycle may be near a mid-point in the economic expansion.

Homestead Funds client services team would be happy to talk with you about your goals and current investment program. Give us a call at 800.258.3030.

Macroeconomics

Markets proved once again that consensus thinking can come up short.

Following last year's strong equity performance, most remained convinced that a pullback was inevitable in 2014. Instead, the domestic market advanced smartly this year through quarter end, putting this year's final tally well within striking distance of last year's exceptional year-end numbers.

The ongoing dual of opposites between low-yielding bonds and high-returning stocks extended through the period. While bond holders found themselves under-compensated for holding higher-risk debt, equity investors continued to acquire stocks, fueled in part by positive stock market earnings, a rising dollar and strong valuations.

The interconnected relationships among global markets continued to be highly visible. With some 40% of operating earnings of S&P 500 firms generated overseas, domestic investors found they could invest internationally right here at home. Meanwhile, the Eurozone Central Bank under the direction of Mario Draghi continued its plans to formalize a more accommodative credit policy along the low interest rate path blazed by the U.S. Federal Reserve. Europeans hope the initiative will reverse the impact of its debunked austerity programs which have restrained, and in some cases, reversed growth trends. China's economic growth rate declined, too, a reflection in part that the U.S. consumer still isn't buying as many "Made in China" exports this year.

Increasing indications that a new spirit of corporate responsibility continued to take hold in America's boardrooms added to the luster of U.S. firms. The quality of personnel on corporate boards has also increased as a result of shareholder pressures. We see this activist spirit in the shareholder community as a heartening sign that will impact corporate capital allocations and growth rates in a positive way.

Macroeconomics continued

Third quarter activity continued to support a positive performance outlook for 2014. With the analytic metrics RE Advisers applies to each of our security selections, we believe that many key indicators still bode well. Earnings per share (EPS), another indicator for valuing stocks, are not out of line with their metrics historically.

Bonds

In the credit markets, yield spreads remained exceptionally narrow.

The benchmark Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index returned -0.07% for the quarter, while remaining up 1.11% year-to-date. The Bank of America/Merrill Lynch 1-5 Year U.S. Treasury Index returned -0.06% for the quarter and appreciated 0.75% for the year-to-date.

Seven-year and shorter U.S. Treasury yields climbed for the period. With yields low and spreads tight, investors are not being paid to take risk. There was little performance variation between bond sectors. While the credit markets have not been exhibiting a high level of volatility, we are watchful for unexpected events which could easily surprise the markets prompting a violent move in either direction, compelling the Fed to re-engage.

Bond investors were reminded once again during the period just how universally interconnected the capital markets really are as asset flows continued to chase yields from country to country. For the first time since the 2008 global financial crisis, the world's major central banks look ready to move in different directions. Many bond investors and analysts over the past year have focused on the U.S. Federal Reserve, which decided at the end of last year to reduce the amount of Quantitative Easing (QE) it had been providing to the U.S. economy since 2008. While this has shaped a widely shared perception that interest rates may be heading higher, the reality is actually somewhat different. Overseas central banks may be taking a page from the Fed on how to provide more liquidity to their economies, but they are making policy decisions independent of the Fed in an attempt to spur corporate borrowing and overcome stalled overseas growth scenarios in their own countries, especially in Europe and Japan.

Equities

We believe there are still good valuations to be found in 2014 and beyond.

The S&P 500 returned 1.13% for the quarter and 8.34% year-to-date. Small capitalization stocks continued to underperform their larger counterparts, as the Russell 2000 Index returned -7.36% for the quarter and -4.41% YTD. For the longer term, small and large companies generally performed in tandem for three, five and 10 year periods through quarter end.

Following the 2008-2009 global downturn, both small and large caps rode the upward momentum generated by more than six years of the Federal Reserve's accommodative Quantitative Easing programs. The unusual performance divergence between these two major equity sectors over the recent quarter showed that while investors may be feeling wary about smaller companies, larger companies increasing appeared attractively valued. The sharp loss of traction small caps experienced over the one-year-period ending September 30 indicated to us that the business cycle has probably advanced into the type of middle-aged maturity that favors large caps over smaller companies. Speaking of sectors, the best performance came from defensive selections like Utilities, which outperformed more growth-oriented, consumer-driven Cyclicals. Along with Financials, Energy, a sector we view as still very strong, drifted downward.

Equity gains underscored the sentiment that stocks appear "priced for perfection," the current Wall Street phrase that means the S&P 500 Index is so high that corporate profits and the economy have to keep improving just to sustain current prices. We believe there are still good valuations to be found in 2014 and beyond. When we consider the last 15-year period we see a remarkably consistent, Goldilocks quality to stock valuations not being overpriced or underpriced but more or less "just right." It's a good time for stock pickers like the portfolio managers for Homestead's Value and Small-Company Stock Funds. While a temporary pause is always a possibility in the investment business, we remain sanguine about our current selections, as well as our preferences for specific sectors like Industrials, Energy and Health Care.

Equities continued

Our commitment to shareholders remains the same: To stick with what we know best, which is to look for attractively priced stocks of quality companies, while remaining mindful to invest in businesses we understand well. We adhere to our disciplined portfolio selection approach – a discipline we've applied the same way to buying, selling and holding securities for more than 23 years.

Contributors

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Prepared: October 8, 2014

Past performance does not guarantee future results.

Investments in fixed-income funds are subject to interest rate, credit and inflation risk. Equity funds, in general, are subject to style risk, the chance that returns on stocks within the style category in which the fund invests will trail returns of stocks representing other styles or the market overall. Share prices of small-capitalization stock funds may be more volatile than those of large-capitalization stock funds. Smaller companies may have limited product lines, markets or financial resources, or their management teams may have less depth and expertise, compared with large-capitalization companies.

The BofA Merrill Lynch 1 – 5 Year U.S. Treasury Index measures the performance of short-term U.S. Treasury securities. The BofA Merrill Lynch 1 – 5 Year Corp./Gov. Index measures the performance of U.S. government and investment-grade corporate debt. The Standard & Poor's 500 Stock Index is a broad-based measure of U.S. stock market performance and includes 500 widely held common stocks. The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that Index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. It is not possible to invest directly in an index.

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