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Investment Insights

From RE Advisers, Investment Advisor and Administrator for Homestead Funds

Homestead Funds

Issue One – 2015

Introducing Investment Insights

We are very pleased to introduce the first issue of *Investment Insights.*

This biannual publication is designed to spotlight how members of both our fixed-income and equity portfolio teams apply their expertise to Homestead Funds' actively managed portfolios. As they share their approach to fundamental analysis, they will also contribute some of the context that guided major selections.

Since each decision to buy, sell or hold portfolio holdings occurs against the broader backdrop of global macro-economic events, we will comment periodically on the influences impacting the securities marketplace. For a longer-term perspective, we will occasionally examine key historical events in depth — or share our perspective about the future.

In short, Investment Insights offers a way for advisors and investors to learn more about how the professional managers at RE Advisers think and perform their jobs.

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Perhaps you have your own topic you would like our portfolio managers to address. Feel free to send us an email with your idea to invest@homesteadfunds.com.

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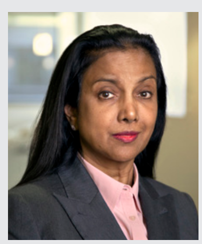

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Executive Summary

By Stephen Kaszynski, CFA
Director, President and CEO

For the markets, 2015 has gotten off to a good start. By February 24, investors saw the Standard & Poor's 500 Stock Index reach new highs, while the 10-year Treasury gained ground too. The positive mood so far this year was partly credited to Federal Reserve chair Janet Yellen, who again assured analysts earlier this year that the Fed plans to continue its go-slow approach to rate raising. Still, the continuing softness in the oil sector and continued downward pressure on intermediate-term interest rates offer a number of questions related to deflation and consumer prices.

This issue will explore some of our thinking concerning the combined impact of the oil price decline with further downward pressure on interest rates. It will begin with a quick review of the recent oil and deflation history that set the stage for 2015. Next, we'll detail three possible interest rate scenarios for 2015.

Then, from the equity perspective, our team members will use their work in identifying and evaluating PolyOne Corporation, one of the Small-Company Stock Fund's positions, to illustrate our rigorous fundamental approach to building the portfolio. When they first examined the quality of management at the firm, our analysts liked the firm's bold new product vision, a change of emphasis that helped the stock price almost double since its inclusion in the portfolio. As of December 31, 2014, PolyOne represented 1.84 percent of the fund's total invested assets.

In closing, let me say that I'm very excited about this opportunity to take the fund company into its next quarter century. We have a top-quality portfolio management staff with a great track record in multiple asset classes. We are committed to working as a team, bringing energy and momentum to growing the business and helping our investors meet their individual investment goals.

Stephen Kaszynski Joins Firm

Stephen Kaszynski, CFA
Director, President and CEO of Homestead Funds and RE Advisers

Steve, who assumed his new roles on January 31, 2015, is an industry veteran with more than 35 years in the money management business. He has broad responsibility for shaping the strategic vision and directing the business activities of the fund company and its related money management entity.

Steve graduated from Knox College, where he received a BA in Economics, and from the University of Chicago, where he earned an MBA in Finance. He holds the Chartered Financial Analyst designation.

The positive mood so far this year was partly credited to Federal Reserve chair Janet Yellen, who again assured analysts earlier this year that the Fed plans to continue its go-slow approach to rate raising.

Thinking about Deflation

The sharp drop in oil prices in the fourth quarter of 2014 and an unusual one-day "flash crash" in the Treasury market in October provided investors with a greater degree of volatility than they had experienced during the first three quarters of the year. While the drop in oil prices certainly has left consumers happier at the gas pump, this trend may place further downward pressure on interest rates as well — contributing to the current deflationary trend. To counter this downward drift, the Federal Reserve continues to hint that sooner or later it will raise short-term rates — the first such increase since June 2006.

What's the Matter with Deflation?

Deflation over the short term lowers the cost of goods and services and leaves consumers with more dollars to spend. Over the longer-term, however, it can cause consumers to defer purchases of bigger ticket items, restraining the economy's growth prospects as well as the borrowing behavior of consumers and businesses.

Additionally, in a deflationary economy, wages tend to drift downward along with prices. Eventually, lower wages tend to curtail spending. And, when decreases in prices lead to lower production, a deflationary spiral can occur, which reduces wages further, lowering demand and potentially eroding prices even more.

Deflations and Downturns

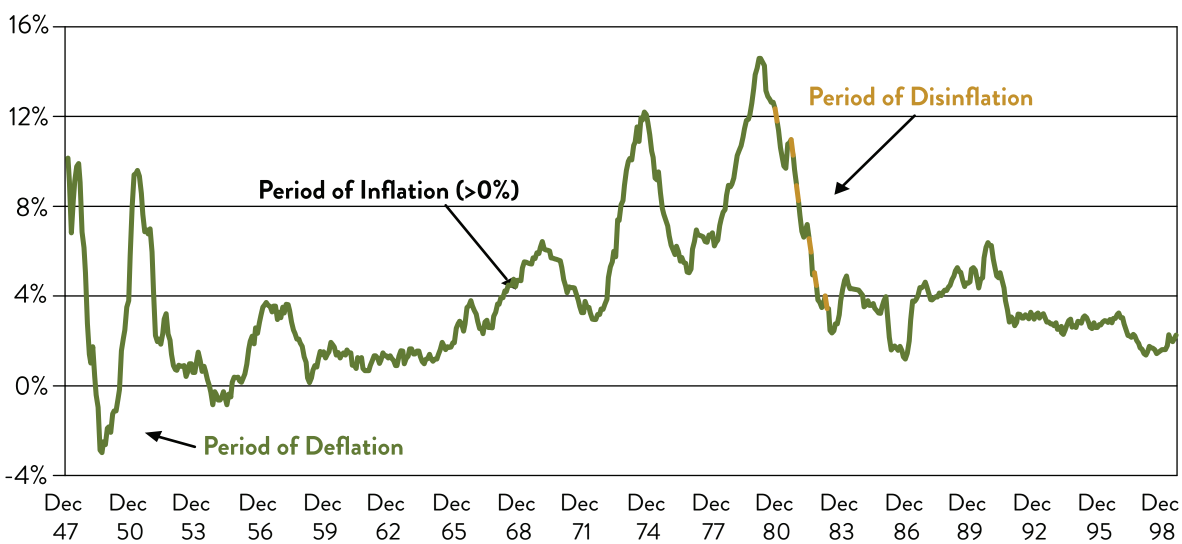
While deflation, inflation and disinflation all represent different types of price level behaviors, it is periods of deflation that are typically associated with economic downturns in the economy.

By way of illustration, the accompanying chart shows the percentage change in the Consumer Price Index (CPI) (all urban consumers, all items) from 1947 to 1998 over prior 12-month periods, and includes periods of deflation, inflation and disinflation.

Two brief periods, the first from approximately mid-1949 to mid-1950, and the second, approximately from the fall of 1954 to the summer of 1955, indicate brief periods of deflation as factored in the CPI.

From 1947 through 1998, except for those two periods, the CPI was in inflationary territory. From mid-1980 to mid-1983, there was a period of disinflation, defined as a period in which the rate of inflation declines from month to month.

Consumer Price Index Year-Over-Year Percent Changes Reflect Periods of Deflation, Inflation and Disinflation



Source: Department of Commerce, Bureau of Economic Analysis

Periods of deflation need not be as short as these two brief episodes in the 1950s. During the Great Depression of the 1930s, the nation experienced a much longer period of deflation. "Sustained deflations, in which prices fall steadily over a period of several years, are associated with depressions, such as occurred in the 1930s or the 1890s," according to economists Paul Samuelson and William Nordhaus, who have written extensively on this subject.[1]

Three Rate Scenarios for 2015

Addressing the deflationary spiral conundrum, here is the fixed-income team's view of what might be the best, the worst and the relatively neutral outcomes for rate directions and price levels in 2015.

Scenario 1

Best: Everything "Just Right" In our best-case scenario, we see the Fed finally raising rates at a steady, measured pace as our economic recovery continues and we return to a more normalized monetary policy. If Goldilocks were a bond investor, she might say the market is "just right" if rates increase slightly while not subjecting the market to large capital losses and — assuming the Fed is successful in its communication strategy — inflation stays relatively low. Typically, investors buy bonds for income, and a rising rate environment should present higher yielding options.

Scenario 2

Worst: Inflation Too Hot This scenario centers on what might occur if the Fed gets slightly too aggressive in raising rates. The Fed could quickly overshoot its 2 percent target inflation rate, for example, as a result of unanticipated macroeconomic events that might shake up investor confidence. Such upsets might come from the long-awaited arrival of wage inflation in the U.S. or a V-shaped rebound in the price of crude oil. For a market grown unaccustomed to rising rates, even minimal inflation might spark a broad market pullback.

Scenario 3

Neutral: Inertia In this steady-state option, the Fed keeps rates at zero, extending its policy of "financial repression," and investors continue to settle for mediocre real returns. This scenario is likely if commodity deflation persists, wage inflation remains muted and overseas economies fail to recover. Such a scenario could eventually boomerang and lead to weaker U.S. growth, an even lower inflation rate and calls for additional monetary easing.

Financial Repression and the Fed

First introduced in 1973 by Stanford economists Edward S. Shaw and Ronald I. McKinnon, the term "financial repression" described the methods by which governments can intervene in the money supply to effect economic change. While financial repression sets out to deleverage an economy by reducing debt and lowering interest rates, it can also facilitate a market for government debt.

Financial repression can include such measures as directed lending to the government, caps on interest rates, regulation of capital movement between countries and a tighter association between government and banks.

It's called financial repression because those who save earn very low, "repressed" rates on the money they set aside.

A Management Change Offered a New Vision

At RE Advisers, in addition to the other fundamental analytical tools we employ, we pay very close attention to the management quality of the firms we evaluate.

We find that well-managed firms tend to do well regardless of where they are in the business cycle. Even when an industry contracts or economic obstacles stand in the way, there are management teams that find a way to generate superior financial results.

While the quantitative facet of fundamental analysis relates to the numbers behind a company's performance, the qualitative aspect centers on those aspects that cannot be precisely measured. These are more subjective evaluations.

Often, it's the senior management behind a company's ideas and business plan that persuade us to take a closer, in-depth look at their underlying business model.

Watchful monitoring of companies is a constant requirement for active managers such as RE Advisers. Such was the case in 2006 with the appointment of a new CEO of PolyOne (POL) whose progress in changing the company's strategy and improving financial results attracted the interest of our equity team back in 2010. The CEO sought to implement a major business shift from an emphasis on ordinary commodity plastics to a higher-quality, specialty class of polymer products. Engineered for auto parts replacements, packaging and more, the new products attracted new customers and the company's stock price began to reflect the improved growth prospects.

Our remarks in a Barron's article last December described the rationale for including PolyOne in the Small-Company Stock Fund's portfolio: "Those (PolyOne's) specialty products now account for about 64 percent of (the firm's) operating income, up from 2 percent in 2005. Earnings per share (EPS) have grown at a 41 percent compound rate from 2006 to 2013. And return on invested capital has climbed from 5 percent in 2006 to 10.6 percent this year."[2] The EPS ratio is an indicator of profitability. It is a company's profits divided by the number of outstanding shares.

PolyOne Commodity to Specialty Transformation

2000 – 2005	2006 – 2009	2010 – 2014	2015 and beyond
• Volume-driven, commodity producer • Heavily tied to cyclical end markets • Performance largely dependent on non-controlling joint ventures	• Steve Newlin appointed, Chairman, President and CEO • New leadership team appointed • Implementation of four-pillar strategy • Focus on value-based selling, investment in commercial resources and innovation to drive transformation	• 20 consecutive quarters of double-digit adjusted EPS growth • Shift to faster-growing, high-margin, less cyclical end markets • Key acquisitions propel current and future growth, as well as margin expansion • Established aggressive 2015 targets	• Continue specialty transformation • Goal of $2.50 adjusted EPS by 2015, three times the EPS generated in 2011 of $0.82 • Drive double-digit operating income and adjusted EPS growth

Source: PolyOne Investor Presentation, 12/11/14. http://www.polyone.com/en-us/investors/Documents/POL%20IR%20Presentation%20-%20BOAML%20Basic%20Materials%20Conference%20w%20non-GAAP%2012%2011%202014.pdf

According to a PolyOne institutional presentation from 2014, which made the case for the firm's new business plans, the company's approach to product development had been transformed from its previous volume-driven commodity orientation to a three-part focus on value-based selling, investment in commercial resources and product innovation.

At RE Advisers, we tend to think of senior management leaders, such as those at PolyOne, as industry protagonists — often bringing best practices and particularly well-prepared for the timely decision making required to profit from situations others in their industry might overlook or choose to ignore.

More Watchful Monitoring Ahead

As 2015 is getting underway, the economic indicators suggest a stable and growing, but not necessarily accelerating, economy. Recent manufacturing and core capital goods orders have been less encouraging, but may remain positive throughout 2015. In our view, the U.S. Gross Domestic Product (GDP) is likely to increase to a range of 2.5 percent to 3.0 percent in 2015, signaling that a steady, somewhat muted pace to economic growth may be likely.

The equity outlook, much like the fixed-income environment, we think, should prove a bit more volatile than in previous years as market participants sort through the potential impact of lower oil prices, Fed interest rate moves and the degree of economic stimulus success achieved by Central Bankers overseas.

However, rather than being overly concerned about the shifting moods of the market, RE Advisers continues to watchfully monitor the candidates we find attractive. As we evaluate the industry protagonists we identify, we believe we may uncover other examples of how they translate their intellectual capital into new assets for their businesses in fresh and unexpected ways.

[1]Samuelson, Paul A., and William D. Nordhaus. Economics. 1998. The McGraw-Hill Companies.
Download PDF (pdf, 8.51 kb) http://www.frbsf.org/education/publications/doctor-econ/1999/september/deflation-disinflation-causes

[2]Barron's, 12/13/14. http://webreprints.djreprints.com/3530931274232.pdf

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.

Are You Looking to Customize an Investment Program?

Homestead Funds can help you or your financial advisor tailor one. Each Homestead fund is professionally managed to correlate with different time frames and profiles. When combined together in a custom program, they offer an added measure of diversification. Diversification does not guarantee a profit or protect against a loss in a declining market. It is a method used to help manage investment risk. Homestead Funds does not offer legal or tax advice. Please consult the appropriate professional regarding your individual circumstance.

Over time, as your objectives change, you can also alter your mix of investments at no charge by exchanging shares of one Homestead fund for the shares of another. Visit Homestead Funds to learn more today.

Prepared March 20, 2015

About RE Advisers Corporation

Founded in 1990, RE Advisers is an SEC-registered investment advisor and serves as investment advisor to seven of the Homestead Funds, as well as the administrator for the entire Homestead Funds family. The portfolio managers of RE Advisers have more than 100 years of collective experience. RE Advisers is a wholly owned subsidiary of RE Investment, a limited purpose broker-dealer that functions solely as the distributor and principal underwriter for Homestead Funds. RE Investment is a wholly owned subsidiary of NRECA United, Inc., a holding company organized by NRECA.

About Homestead Funds

Homestead Funds was created in 1990 to give National Rural Electric Cooperative Association (NRECA) members a convenient way to obtain professional and affordable money management. The funds are also open to investors outside of the cooperative community. The fund family offers a comprehensive range of eight mutual funds across the risk and reward investment spectrum. These no-load funds can act as complements or as alternatives to portfolio investments — or provide a customized blended solution to help meet your objectives.

Homestead Funds' investment advisor, RE Advisers Corporation, and distributor, RE Investment Corporation, are indirect, wholly owned subsidiaries of NRECA. 04/15

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