Horizons 3Q | 2015

A Quarterly Newsletter for Homestead Funds' Shareholders

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Managing Turbulent Markets

The final weeks of August brought a rush of trading on Wall Street that sent major stock market indices into negative territory for the year. A steep and fast-paced selloff that began on August 18 pushed the S&P 500 Stock Index down nearly 10% for the year as of August 24. By the end of the month, stocks had recovered most of the decline, but broad market benchmarks were showing losses for the year to date. The S&P 500 was down 2.88% for the year as of August 31. Volatility continued into September.

Many investors had been anticipating a correction following the market's protracted advance, but the speed and strength of the recent ups and downs can be nerve wracking and stressful. We thought it would be helpful to share our views of the market's recent turbulence. We've also asked our client service associates' to provide some guidance for investors who may be inclined to make changes to their portfolio, even against a backdrop of whipsawing share prices. *(continued on page 2)*

A Case for Stocks: Why We're Bullish

Stephen Kaszynski, CFA
Director, President and CEO

The total return for the Standard & Poor's 500 Stock Index was slightly positive in the second quarter of 2015, extending the index's winning streak to 10 consecutive quarters. But stocks stumbled just after the close of the quarter, as investors grew increasingly anxious about the Fed's plans to gradually raise rates and signs of weakness in the Chinese economy.

We do not think the sharp gyrations are indicative of fundamental weakness in the domestic economy. Quite the contrary; we see many reasons to be optimistic.

- U.S. GDP expanded at a 3.7% seasonally adjusted annual rate in the second quarter of 2015, up from the initial estimate of 2.3% growth.
- Household formations are booming after seven sluggish recession and post-recession years. Housing is an engine for growth, supporting job creation and providing a tailwind for many sectors of the economy.
- The labor market has strengthened as the economy has improved. The unemployment rate has declined steadily from peak levels following the 2009 financial crisis.

Further, valuations for stocks have risen but price/earnings ratios are below the peak periods of the late 1990s and early 2000s. And while the transition to a more normal interest rate environment will likely continue to rattle the markets, rising rates are not necessarily or immediately bad news for stocks. When rates rise from very low levels, price/earnings multiples tend to expand, which can be good news for equities. And a rising rate environment can also go hand-in-hand with economic expansion and increased corporate earnings.

We believe there are a number of conditions supportive of economic growth and a generally favorable business environment, including lower energy prices, a strengthening housing market and rise in capital expenditures. And while there is likely to be a continued high level of volatility in the stock and bond markets, these sometimes indiscriminate price fluctuations create opportunities for active managers to spot opportunities or identify risks and in this way generate potentially above-benchmark returns.

Steve's remarks were prepared as of September 8, 2015. 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. Indices are unmanaged and investors cannot invest directly in an index. Housing data from Fundstrat Global Advisors.

Homestead Funds

Putting Volatility in Perspective

Signs of a softening economy and plunging stock prices in China may have been the spark for the market's August gyrations, but other contributing factors were likely continued declines in oil prices and expectations for rising interest rates. We don't view the sell off as an indication of fundamental weakness in the domestic economy and instead see a number of tailwinds that would support U.S. corporations' ability to grow earnings. (See related story "A Case for Stocks" on page 1.)

We can also provide some historical context. We note that this has been a long-running bull market—a six-year period of back-to-back gains. And while a period of outperformance for stocks doesn't itself trigger a corresponding period of under-performance, stocks don't move up in a straight line. As you can see in the chart below, there has been a wide range of returns in recent years, and only a handful of periods where the annual return was close to the average return for the period. Investors have had to withstand volatility in order to capture equities' upside potential.

Is There a Smart Move for Investors?

A sudden drop in prices is not necessarily a negative for long-term investors who count on the active management of their portfolios. Indeed, many have discovered the advantages of suddenly being able to access a greater number of shares at opportunistic lower prices. Buying at potential "discounts to the market" can help shareholders increase their base of shares as the prices of the stocks their fund is investing in become cheaper.

Assuming you've structured your portfolio to match your financial objectives and risk tolerance, you should avoid the temptation to make changes based on day-to-day moves.

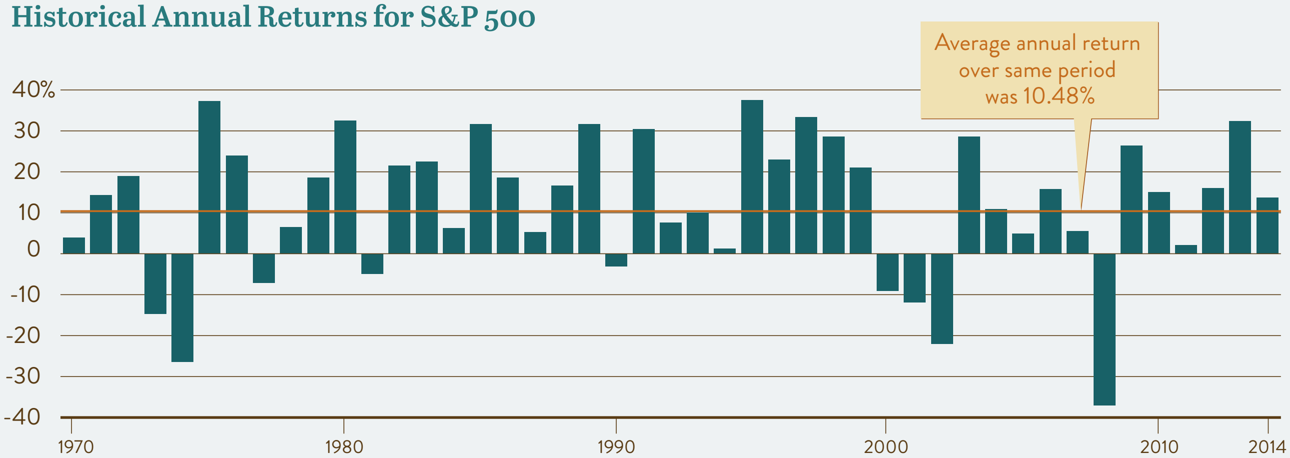
"Panic should not be the reason you sell shares. Yes, it's unnerving to see a large price drop, but investors who sell shares following a correction could be locking in losses. And they would miss out on the potential for a rebound," says Alaina Schrager, a Homestead Funds client service associate and Certified Financial Planner.

Here are a few non-emotion-driven moves that may make sense for you:

1. **Rebalance opportunistically.** Investors may want to use the stock market's volatility to add to equity positions at a discount relative to their pre-correction levels.
2. **Check your expectations for upside returns.** We think the economy and equity valuations could support further share price appreciation, but with heighted volatility. And, following six years of back-to-back advances for the broad stock market, advances may not be as robust or broad based.
3. **Make an appointment to talk with your financial advisor or a Homestead Funds client service associate.** It's important that your mix of stocks, bonds and money market assets is appropriate for your needs so that a period of underperformance won't force you to sell. It's also worth talking through your balance of active versus index products, given our view that stock selection may be of heightened importance over the coming months.

A client service associate would be happy to talk with you about your portfolio. Give us a ring at 800-258-3030 (say "representative" at the prompt). We're here on weekdays from 8:30 am to 5 pm ET.

Historical Annual Returns for S&P 500



Source: 2015 S&P 500 Stock Index returns, Bloomberg; Chart, MarketWatch

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. Indices are unmanaged and investors cannot invest directly in an index.

Small-Company Stock Fund—
Strategy Review and Significance of Interest Rate Backdrop

Historically, investors have viewed rising interest rates as negative for stocks, especially small-company stocks, but recent analysis offers a counterview. We sat down with senior equity portfolio manager Prabha Carpenter to discuss the implications of a rising rate environment on the fund's strategy and performance. Prabha's remarks were prepared as of August 28, 2015.

Q: Should investors think of rising rates as a headwind for stocks, especially small-company stocks?

A: We don't think that old adage is very helpful. There are a number of recent studies, including one by Russell Investments,[1] that show in fact that small-cap stocks have posted higher returns in rising rate environments than in declining rate environments. This is perhaps due to small-cap stocks being less reliant on debt to finance operations. Borrowing costs will increase in a rising rate environment, but many smaller companies self-finance. We are finding companies with sufficient cash on their balance sheets that are able to do just that.

Q. Assuming that we are entering a rising rate environment, does that change the team's approach to security selection or position weightings?

A: Not really. We are very company-specific in our analysis and structure the portfolio for the long term. We look for businesses that have the potential to grow earnings, expand their margins and compound returns.

We are also agnostic as to sector. If you compare the fund's portfolio to its benchmark index, the Russell 2000, the fund's weightings by industry are very different. We don't seek to replicate the composition of the index.

We look purely for the best companies. Those that, in our opinion, have have strong products and services combined with an ability to use their financial, operational and managerial levers to potentially generate superior returns over time.

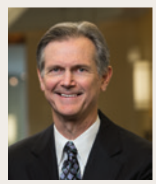
Q. Can you tell us about a few of the trends that you see supporting growth for some of the names in the portfolio?

There's a surge in the need for digital bandwidth, and that's been positive for Dycom, a company that maintains and installs cable for telephone and television companies and towers for wireless carriers. As of June 30, 2015, Dycom was the fund's largest position and represented about 5.4% of assets. Another opportunity is the expanded Panama Canal, scheduled to be operational in 2016. That is expected to spur dredging and construction activity. The portfolio includes some regional construction companies that stand to benefit.

Overview and Management

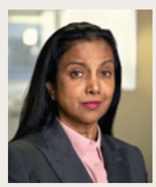
The Small-Company Stock Fund (HSCSX) seeks capital growth over the long term through investment in stocks that are priced below what we consider to be intrinsic value and in companies that are positioned to make a change in their business that may lead to an improvement in their competitive position or financial returns.

Under normal circumstances, the fund will invest at least 80% of its net assets in common stocks of companies whose market capitalization, at the time of purchase, is similar to the market capitalization of companies represented in the Russell 2000 Index.



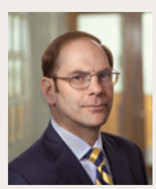
Mark Ashton, CFA

BS, Finance, University of Utah; MBA, Marketing Research, University of Southern California. Mark joined RE Advisers in 1999.



Prabha Carpenter, CFA

BA, Economics, University of Madras; MBA with distinction in Finance and BS in Business Economics, The American University. Prabha joined RE Advisers in 2002.



Gregory Halter, CFA

BBA, Finance, Cleveland State University. Gregory joined RE Advisers in 2014.

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 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.

[1] Russell Investments. The Russell 2000 Index in a rising interest rate environment: evidence from past cycles

Q: How would you characterize the opportunity in small-cap investing right now?

A: We continue to find attractive opportunities and view the economic backdrop as generally favorable. We added eight new names to the portfolio in the first half of 2015. These are all typical of small-company stocks, in that they are underfollowed by Wall Street analysts and researchers, so their prospects and valuations are not fully recognized. You have to do a lot of digging to find these opportunities, but when you do there can be substantial upside potential. If the company is successful in executing its growth strategy, it becomes more widely known and the stock becomes more widely held. It's like getting in on the ground floor.

Also small-company stocks are perceived as riskier than large companies—they typically don't have the deep pockets and their business franchise is usually more narrowly focused. That can be an advantage when the economy is expanding, because investors tend to be more comfortable with an increased level of risk.

Putting Clients First: Meet Our Service Professionals

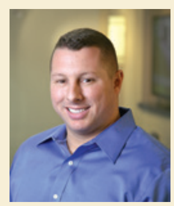
Your interaction with Homestead Funds begins and ends with the client service team. If you have ever called us to check the balance of your account, requested a transaction or received a letter about your account, you have already worked with a client service associate (CSA).

Drawing from years of training and industry experience, our team is dedicated to providing a personalized level of service to each shareholder they interact with. Each member holds either the Financial Industry Regulatory Authority (FINRA) Series 6 (Investment Company and Variable Contracts Products Representative Exam) or Series 7 (General Securities Representative Exam) securities license. They have also passed the Uniform Securities State Law Examination (Series 63).


Megan McFarland


Tanya Moat


Raymond Scott


Ken Surick


Sparkle Warthen

In 2014, the CSA team composed approximately 2,000 pieces of written correspondence and fielded more than 14,000 shareholder phone calls. The types of inquires received can range from the simple account inquiry such as those mentioned above to more complex topics like "What type of account should I open?" or "How should I invest my money with Homestead Funds?"

Here are some of the ways client services associates can help you:

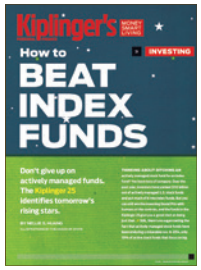
- **Fund and account education.** Whether you are brand new to investing or you have had an account open for years, you may still have questions. CSAs can assist with explaining the different account types offered by Homestead Funds and answer questions about the funds we offer.
- **Account overviews.** If you need to check account balances, review beneficiaries on your accounts to make sure they're current, or process address updates the client service team is happy to help. If you have questions about your quarterly statements or need assistance completing one of our forms, please don't hesitate to contact us
- **Asset allocation.** If you would like help identifying your goals and developing a strategy within your Homestead Funds account or you would like to review your current strategy, our client service team can help you to select a mix of funds appropriate for your risk tolerance and financial objectives.

If we can be of any assistance at all, please do not hesitate to contact us. You can speak with a client service associate by dialing 800-258-3030 (say "representative" at the prompt). We're here on weekdays from 8:30 am to 5 pm ET.

Asset allocation does not guarantee a profit or protect against a loss in a declining market. It is a method used to help manage investment risk.

News Briefs

Small-Company Stock Fund Featured in Two Major Financial Publications



Homestead's Small-Company Stock Fund was named to the Kiplinger 25, a list of the editors' top 25 mutual funds. The article appears in the May 2015 issue of Kiplinger's Personal Finance. The fund also made the list in 2014 and 2013. In selecting funds for inclusion, editors favor low-cost, low-turnover funds run by seasoned managers.

Also, the June 2015 issue of Forbes named the Small-Company Stock Fund to the Mutual Fund Honor Roll. To earn this distinction, the Fund had to outperform its peers in both bull and bear market cycles since 2000. The fund received a grade of A+ in bull markets and an A in bear markets. The Fund has remained on the Mutual Funds Honor Roll for its second consecutive year. To view the fund's performance for the recent standardized periods click here.

There were 990 funds in the domestic stock fund category that includes the Small-Company Stock Fund and all were graded on a curve over two up-and-down market cycles using annual returns from August 31, 2000, through May 31, 2015. A fifth of the class got an A and a fifth got a D. The Bs and Cs each go to 25% of the funds. In addition, funds had to have a portfolio team with an average tenure of at least 5 years. Sector funds, single-country funds, those not taking new investors and those with minimums over $50,000 were excluded.

Past performance does not guarantee future results. Investing in small-company stocks poses special risks, such as limited information on which to base investment decisions, and historically greater share-price volatility than larger-cap stocks have experienced. Investing in mutual funds involves risk, including the possible loss of principal. The Small-Company Stock Fund's expense ratio below the peer group average, as determined by Lipper for the period ended December 31, 2014.

Homestead Attends CFC Forum

Homestead Funds' senior client relationship advisor and Certified Financial Planner Alaina Schrager attended the National Rural Utilities Cooperative Finance Corporation's annual conference in June. This year's event was held in Chicago and featured discussions on issues and challenges facing the electric cooperative network.

Recent and Upcoming NRECA Events

Homestead Funds exhibited at this year's **INTERACT conferences** that kicked off July 11 in Boston and repeated on August 22 in Denver. We were also on site at NRECA's 2015 **Tax, Finance & Accounting Conference** for Cooperatives on August 2 in Denver.

The team will also be onsite at this year's **regional meetings** that begin September 9. If you are attending, be sure to take a minute to visit the Homestead Funds booth.

Team Work on Display at Staff Golf Outing

The firm's CEO and representatives from client services, portfolio operations, finance, compliance and marketing enjoyed a friendly golf challenge at a nearby driving range. Working together, a cooperative principle, plays a key role in our ability to provide a high level of shareholder service. We think the spirit of collaboration, friendship and community is evident here.

ESTABLISHED 1990

Homestead Funds: Celebrating 25 Years

NRECA's mutual fund company turns 25 this November, a milestone we celebrate with our shareholders, colleagues and many in the cooperative community who provided the vision and leadership necessary for our start.

Vision, Fortitude and Courage

The company's founding year was marked by Iraq's invasion of Kuwait and the U.S.-led military response, a spike in the price of oil and recession that lasted through March 1991. Declining business activity typically means declining corporate profits, and so recessionary periods are usually marked by below average performance for the stock market overall.

Attracting investors to the company's flagship equity fund, the Value Fund, would likely have been perceived as a challenge. But the cooperative community leadership behind the launch of Homestead Funds recognized the importance of the company's mission—to provide professional and affordable money management services to member system employees and their families—and understood that the success of the business should be measured over the long run.

There have been two other recessions in our corporate history: in 2001, the economy contracted following the dot.com bust and fallout from the events of September 11; in 2007 the subprime mortgage crisis destabilized the credit markets prompting an emergency bailout of the U.S. financial system. In the post-World War II period, however, the U.S. has experienced more periods of expansion than recession and those cycles have lasted longer.

Embodying the Cooperative Spirit

We are gratified that our shareholders have trusted us to guide the portfolios through changing business cycles, different macroeconomic backdrops and unprecedented world events. Homestead Funds has grown from two funds at launch to eight funds currently, our staff has expanded to meet investors' needs and assets under management exceeded $3 billion as of year-end 2014.

We share the can-do attitude that comes from being part of the cooperative community. Homestead Funds started small, but thanks to the support of our colleagues at NRECA and the cooperative community, we are looking ahead to our next quarter century of growth.

We thank our shareholders and the cooperative community for 25 years of support.